The FT US-China trade war guide

A Financial Times Future Forum think-tank report
The worldwide coronavirus outbreak and its effect on supply chains has thrown into sharp relief a process that was already under way thanks to the trade war between the US and China — the decoupling of the world’s two largest economies.

In this first report from the FT Future Forum think-tank — which follows a panel discussion with leading Financial Times columnists — Lucy Colback examines the challenges that this great dislocation presents for European and British companies.

The report assesses the short, medium and long-term implications of the mutual antagonism that began in earnest when US president Donald Trump imposed $400bn tariffs on Chinese goods in 2018.

How are companies to react in a commercial landscape roiled by trade tension? Do they restructure production chains and switch component suppliers, as some have done already, and so accept increased friction and higher prices? Or do they continue to rely on China, even as such dependence arguably looks more risky?

The geopolitical context makes such decisions harder than they might otherwise be. The tussle between the two superpowers is not simply over trade — rather, the tariff war is a proxy for a deeper and potentially more disruptive conflict with political, technological, cultural and military dimensions.

As China aims for self-sufficiency in high-tech industries by 2025, European and British companies could find that market access will mean adherence to Beijing’s own technological standards.

The phase one trade deal signed by the US and China in January, just as the first cases of coronavirus came to the attention of the global media, offered a respite of sorts.

The question is how long this easing of tensions will last.

Jonathan Derbyshire
Acting deputy world news editor, Financial Times
How to navigate the US-China trade war

Global supply chains are at risk as the world’s two biggest economies threaten to decouple, writes Lucy Colback

In the years since China’s accession to the World Trade Organization in 2001, the country’s economy has grown to become second only to the United States in purchasing power parity terms. In the past decade, its global trade influence has also spread, and China has gradually usurped the US as the major supplier of goods to Europe, Asia, Africa and South America.

As long as it operated as a cheap factory, China’s growth was welcomed by the US, and its emergence as a new market for consumer goods was eagerly anticipated. However, in the mid-2010s — possibly provoked by China’s covert military expansion into the South China Sea and its expansive Belt and Road Initiative, as well as an ambitious plan to move up the value chain outlined in 2015 — the relationship between the rising nation and the incumbent superpower became more competitive.

Within the context of Donald Trump’s “America First” brand, the gloves came off. Unhappy with the trade imbalance, the US president kicked off a trade war in 2018, imposing tariffs on two waves to encompass around $400bn worth of goods shipped between the US and China. The fallout for companies has been considerable.

This new, more combative relationship has changed the global commercial landscape, disrupting supply chains — most noticeably, perhaps, in the technology sector. It has arguably accelerated a trend that was already under way, giving China an incentive to develop its own standards and achieve self-reliance in critical strategic sectors, including high tech. Perhaps the most significant consequence of this is the potential for a longer-term decoupling of China and the US, and the emergence of two rival and separate spheres of influence, in both trade and technology.

The coronavirus outbreak, which emerged in Wuhan in December 2019, shutting down China’s economy for an extended period, has served to highlight the likely consequences of a dislocation of the world’s two largest economies.

On January 28 2020, the FT Future Forum think-tank brought FT commentators and China experts together with companies representing sectors from retail to law to discuss these developing challenges. In this report, we discuss the impact of the US-China trade war and the implications for European and British companies.
The medium-term outlook

1. Switching suppliers: as the trade war has dragged on, companies have had to consider finding alternative sources of inputs for their production chains. Less simple than buying completed goods from new vendors, switching to new component suppliers comes with friction costs as well as, potentially, higher prices. Trust, quality assurance and logistical networks all have to be rebuilt. The chain is not well oiled, at least to start with. Manufacturers lose.

For reasons including politics and commercial sensitivities, few companies are prepared to share what they have been doing to restructure their sourcing.

But consider Li & Fung, a Hong Kong-based sourcing agent, which revealed in its 2019 interim results that it had helped one US retailer move its reliance on Chinese inputs from 70 per cent to 20 per cent over two years, with plans for another to go from 40 per cent to 10 per cent by 2020, outsourcing to at least seven other economies.

Not all companies are moving that quickly. A September 2019 survey carried out by the EU Chamber of Commerce in China noted that just 10 per cent of respondents had changed suppliers, although this number had risen from 6 per cent in a January 2019 survey. One company admitted that its reliance on China was “dangerous”.

As recently as January 2020, Citi’s Financial Strategy and Solutions Group also noted that one-third of western European companies in the global MSCI index have “meaningful China trade risk exposure driven by larger manufacturing activity”.

The coronavirus outbreak has provided a stark illustration of how reliant many companies still are on China. For those that have hesitated, and are resilient enough to survive, it may finally provide the necessary impetus for supply chain diversification.

2. Uncertainty paralysis: investment decisions are increasingly on hold as companies cannot predict what happens next in the trade war. Another broadly negative situation.

The World Uncertainty Index, which tracks uncertainty around the globe, shows that the condition is rampant worldwide. The measure, based on the frequency of the word “uncertain” in Economist Intelligence Unit reports for over 140 countries, spiked in the fourth quarter of 2019.

As usual in such an environment, companies are trying to do as little as possible. In May 2019, one-third of respondents to an AmCham China survey said that they had delayed or cancelled their investment decisions, more than in a similar survey taken the year before.

The September 2019 EUCham survey also noted that there was a strikingly high level of paralytic nearly two-thirds of respondents said that they had left their strategies unchanged but were “monitoring the situation”.

Compared to a previous questionnaire in January, a higher proportion were taking steps to adapt to the trade war – partly accounted for by the 25 per cent who said they had delayed investment and expansion decisions.

Uncertainty surrounding US policy does not help. During the Future Forum panel discussion, the FT’s Martin Wolf noted that even the Americans do not seem to have decided what they want. Mr Wolf said that the phase one trade deal came “in the context of America going through a massive rethink in its relations with China, and it hasn’t made its mind up yet”.

Worse, the deal itself is not fixed, given that it allows Mr Trump to retaliate if he does not like the way the Chinese implement the agreed terms.

3. The phase one trade deal: this has secured some gains for EU and British companies. Laws which focus on fairer treatment of foreigners, open up some of the financial sector to foreign investment and put in place protections for intellectual property are good for Britain’s financial sector, and both EU and British creative and design industries.

The US has been vocal about its commercial losses due to China’s “economic aggression”. The White House has estimated that intellectual property theft costs the US between $250bn and $600bn a year; no wonder then that it has been pushing China to address the issue.

The phase one deal extracted concessions on the treatment of foreign interests in China. Forced technology transfers have been outlawed, ownership limits on pension management and life insurance enterprises have been relaxed. Britain, in particular, still thrashing out the terms of its departure from the EU, should welcome the opportunities this presents – assuming that China enforces the new laws.
The long-term view

The conflict between the US and China is not simply economic — it has political, cultural and military dimensions. For these reasons it is unpredictable and is unlikely to dissipate anytime soon. The greatest risk over the longer term is that the US and China split into two spheres of influence, one servicing the US and abiding by its standards — from technology to governance — and another centred around China. As the charts tracking the change in trade dependency show, the likelihood is that China’s sphere will be larger and incorporate the lion’s share of global growth potential. Will those caught in the middle, including companies in the EU and Britain, be able to operate in both?

1. Manufacturing capacity shifts: this is tougher and involves even more cost than moving sourcing, requiring new factories and workers. Even if they are able to relocate factories, it is not a given that companies would be able to use their non-Chinese Asian capacity to service the US sphere, should two distinct trading blocs develop. Localising operations in each of the US and Chinese spheres also may not solve the problem due to conflicting laws, loss of control or property and difficulties in repatriating profits.

In December 2018, Paul Maitland, adviser to Oxford Analytica, noted in the Harvard Business Review that companies were starting to move their production facilities. Now, he says, if you want to be a textile or factory worker in Vietnam, “bad luck”. Capacity in this first choice for relocation is already constrained.

An executive from an Asian sourcing company agrees that the easy wins have already been achieved: “ Buckets, plastic pots and so on are hard to move because injection moulding equipment is not easily relocated.” As for textile factories, even Vietnam still needs to import the fabric from China, since it does not have the necessary mills. This only superficially circumvents country still needs to import the fabric from China, since it does not have the lion’s share of global growth potential. Will those caught in the middle, including companies in the EU and Britain, be able to operate in both?

Meanwhile, China is being more strategic about which parts of the supply chain it gives up. AmCham points out that companies in Shenzhen, which have tended to dominate production of technology outsourced from the US, may form out lower-end assembly to neighbouring countries while holding on to higher value processes. And, as with Vietnam and textiles, China provides many of the components required by the end product. It is intriguing that Vietnam has overtaken Germany as China’s fifth largest export partner.

The chances of such production capacity returning to the west, certainly in the near term, are slim. Mr Maitland points to comments from Tim Cook, chief executive of Apple, that production engineers in China could fill several football fields, but barely a room in the US. On the upside, moving production to new countries could only facilitate production of technology outsourced from China, well established for outsourced manufacturing. But Laos or Cambodia? The regulations and legal infrastructure, human capital — not there. Mr Maitland observes.

Nonetheless, Mr Maitland notes that given the longer term risk of a decoupling of the US and China, “it is critical that commercial counterparts retain optionality” and have strategies in place to cope with future change.

2. Technology divorce: makers of technology products in the US and China are increasingly barred from using each other’s products on “national security” grounds. China plans to stop foreign technology firms operating out of state offices by 2025. The US has barred government agencies from buying equipment from certain Chinese suppliers including Huawei and ZTE. The US has already cut off the Huawei’s US supply chain, forcing the US to find alternative US vendors for Huawei.

The ban has been bad for vendors of US technology into China, but has also left the EU and Britain, and their companies, in a tricky position — as illustrated by the diplomatic fallout from the UK’s Huawei decision.

At the very least, US moves to put China behind a firewall are likely to accelerate the latter’s quest to develop its own technology standards. It also makes the self-sufficiency identified as an overarching policy aim in the “Made in China 2025” plan a far more pressing need. The Council on Foreign Relations notes that the plan targets 70 per cent self-sufficiency in high-tech industries by 2025 and a dominant position in global markets by 2049, through methods including use of subsidies, acquisitions and tech transfers.

In a 2017 analysis of China’s ambitions, the EU chamber of commerce in China noted that the Chinese press had reported RMB2 trillion in funds gathered in 2015 to support the effort. Its advice to European companies looking to cope with the challenge includes aligning themselves with China’s long-term goals, continuous innovation, identification of emerging competition by monitoring international mergers and acquisitions and diversification of markets and clients.

This may not be easy, but it is imperative for survival. “The existential threat”, says Mr Maitland, is that “China becomes technologically innovative on top of its production and engineering expertise, but the US, while it can still design, cannot recover its lost production and manufacturing skills. Then the west becomes dependent on China rather than China being dependent on the west.” The US’s policies appear to be accelerating this trend.

3. The tech divide cements the economic divide into two spheres: Dr Yu Jie, senior research fellow on China at Chatham House, notes that since US-European Forum panel that China wants to assert what she termed the “discourse of power”, not only developing and acquiring technology but setting standards, she suggested that China might make conditions of net access that international companies adhere to these standards.

Trying to operate across two distinct spheres could become as impossible as using a Betamax cassette in a VHS video player used to be. The Balkanisation of technology systems means businesses would face the difficulties of operating between jurisdictions if electronic communications, for instance, are not standardised.

Anyone who has tried to use Google in China has already encountered this challenge.

Without a unified front, navigating the middle ground between China, whose money is needed for investment, and the US, the traditional ally whose clout is relied on for defence, will be difficult for companies in Europe. This is especially the case for post-Brexit Britain. As already noted, it has clashed with the US over Huawei, although given the existing telecommunications infrastructure, there was no cheap alternative.

British companies may pay the price. Many representatives of businesses at the Forum said they felt themselves to be in an invidious position.

Politics create a climate of uncertainty

World Uncertainty Index, GDP-weighted average

Consumption a relatively insignificant driver for Chinese economy

Consumption expenditure (% of GDP)

China


Source: World Bank

Source: World Uncertainty Index

‘Without a united front, navigating the middle ground between China and the US will be difficult for companies in Europe’

Politics create a climate of uncertainty

Uncertainty concerning Brexit and US trade policy

US fiscal cliff and sovereign debt crisis in Europe

Iraq war and outbreak of SARS


Source: World Bank

Conclusion

There is an outside chance that China and the US will “re-couple”. The economic damage wreaked by the coronavirus might bring them together. This is unlikely to happen anytime soon.
Foundation Partners

The FT Future Forum think-tank is supported by our foundation partners — Bridgepoint, Google, Huawei and Iberdrola — and these groups help to fund our reports.

Partners also share their business perspective on the think-tank advisory board. They suggest which topics the forum should cover — but the editorial director makes the final decision.

Think-tank reports are written by a Financial Times journalist and are editorially independent.

Our partners feature in the following pages. Each profiles their business and some offer a view about the US-China trade war. All partners could comment on the trade war but some chose not to contribute. All partners’ views stand alone. They are separate from each other, the FT and the FT Future Forum think-tank.

Foundation Partner

Bridgepoint is a major international alternative asset fund management group, focused on providing private equity investment and private debt lending to middle market companies.

Our focus is on acquiring or investing in businesses with strong market positions and earnings growth potential where significant additional value can be created through transformation — either domestic or international expansion and/or operational improvement.

With over €20bn of assets under management, we invest internationally in six principal sectors — business services, consumer, financial services, healthcare, manufacturing & industrials and media & tech — via a platform of offices in Europe, US and China.
Google's mission is to organise the world's information and make it universally accessible and useful.

Through products and platforms like Search, Maps, Gmail, Android, Google Play, Chrome and YouTube, Google plays a meaningful role in the daily lives of billions of people. Google is a subsidiary of Alphabet Inc.

To foster global innovation we must embrace globalisation and fair competition
Victor Zhang, Vice-president, Huawei

The current push towards a technological decoupling — born of a desire to suppress competition and restrict choice — is at odds with the way that technology has boomed over the past 20 years.

When state-of-the-art tech is combined with globalisation, the benefits enjoyed by customers and organisations are substantial.

Technology thrives in a competitive, open world. It evolves best when not placed in a straitjacket, such as that imposed by national borders. It is no coincidence that two decades of openness have given hand in hand with rapid innovation.

Since the Information Technology Agreement was signed in 1996, removing tariffs on 97 per cent of technology products, tech sector trade has quadrupled, access to the internet has boomed and the tech ecosystem has globalised, driven mainly by consumer demand in the US and Europe.

Suddenly, tackling the world’s biggest challenges seemed well within our grasp. The intent was there and, with healthy competition flourishing, investment in research and development quickly followed.

Like many global tech groups, Huawei enjoyed growth because of liberalised global market conditions and openness.

The company was quick to seize the opportunities and it has invested more than $73bn in research and development since 2010.

Other groups have done likewise, providing direct benefits to the countries in which they work, all around the world.

Innovation creates jobs, boosts gross domestic product and lifts living standards.

Recently, Huawei has borne the brunt of US hostility to globalisation, which has included allegations of secret subsidies.

Our supply chain adapted to this pressure, allowing us to continue serving our customers. Our investment in research and development, and work with commercial and academic partners, continues to create benefits for those nations committed to free trade and open markets.

Huawei believes in globalisation and open competition, a level playing field, the protection of intellectual property and non-discrimination. We also support a rules-based global trading system underpinned by the World Trade Organization.

If it is allowed to gather pace, anti-globalisation could result in competing systems, which in turn will reduce innovation. This would set back global connectivity and push up costs... and the biggest losers will be consumers.

Let us not jeopardise future benefits by pursuing forced fragmentation. Instead, let us collaborate on goals such as setting global rules for the new era of digital trade. Co-operation is the way we can unlock the full potential of innovation.

*Huawei’s views are separate from other foundation partners, the FT and the FT Future Forum think-tank
Open global trade is vital in a sector such as renewable energy. The changes that will lead to a more sustainable future will be devised and developed in every corner of the world.

The climate crisis is an immediate threat to mankind. It is vital that barriers to trade do not increase costs or cause delay.

Iberdrola is a leader in the worldwide renewable power industry. Over 20 years the company has seen the sector grow and costs drop sharply. Electricity from renewables is now cheaper than that from most traditional sources with greater emissions.

At such a critical time, international politics must not affect the huge progress made.

Every country wants the best for its people and economy. The good news is that a cleaner planet offers industrial opportunities globally. Transport and heating powered by green electricity increases the potential for prosperity.

Those countries that share their technical knowledge will benefit most. The free flow of ideas is crucial to increasing efficiency and reducing cost.

The EU is a good example of what can be achieved when countries work with a common goal. More than ever, the European model of co-operation shows the right way to address the challenges we face. Let the world work together.

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**About FT Future Forum**

The FT Future Forum draws on the FT’s global influence as the world leader for financial and business news. It acts as an exclusive and authoritative venue for businesses to share ideas and intelligence. It enables the exploration of emerging trends and seeks to define and solve the issues faced by business and society.

The forum set up the think-tank to make best use of the expertise of member companies and to pull together cross-sector knowledge.

The think-tank invites experts, including academics, industry specialists and policymakers, to collaborate and contribute in workshops and consultations. This information is fed into reports that go before an audience of global leaders.

You can find how to take part in the FT Future Forum and think-tank by emailing michael.hepburn@ft.com