CARLSON FINANCIAL MANAGEMENT

CHINA TRADE

The following is <u>not</u> a pronouncement of the Trump Administration. All knowledgeable observers agree on the essential aspects of the situation described below. Serious disputes arise, however, as to what actually should be done about it, if anything.

Last year the United States exported $130 billion worth of goods and services to China while importing $506 billion worth. The difference, $376 billion, is approximately two thirds of America’s entire trade deficit. The proportion of import to export, almost four to one, is way beyond the ratio with any other foreign country. The imbalance is not due to fair competition on a level playing field. The difference is due to the fact that China does not play by the rules of free trade.

The World Trade Organization (WTO) embodies those rules and the essential theme, albeit a long term goal, is that no government can apply laws for trade and investment that treat a foreign company any different than a domestic one. Amidst great fanfare China joined the WTO in 2001. There was a general euphoria in the industrial world; finally China’s enormous market of nearly 1.3 billion people would be open to foreign vendors.

But China had different ideas. The world’s markets would be open to their manufacturers but their domestic market would be hemmed in and restricted, sometimes by overt law and regulation, sometimes by more covert means. The first tool for protecting the home market is the oldest one, tariffs. A foreign car must pay a tax of 25% upon entry into China. The American tariff on imported cars, by contrast, is 2.5%. Rates vary depending on the type of product but all are in the range of 30%. That is a serious trade barrier.

The other side of protecting the home market is making Chinese products more attractive in the international market. This is done by currency manipulation. In economic parlance the term of art is that the yuan is ‘undervalued’. This means that the yuan’s value on the international market is kept artificially low, translating into a lower price in foreign currency. If a dollar was worth four yuan instead of six then American made products would be much more competitive. The dollar would buy only two-thirds as much Chinese product. There is lively debate among economists about just how much is the undervaluation; indeed there are even a few who claim that it does not exist. But the logic of the majority opinion is pretty hard to overcome.

The international value of China's currency is set by the government. The central bank determines how many yuan a dollar or a euro will buy. All other industrialized countries have a floating exchange rate. Supply and demand determine the ratio between a dollar and a euro, between a pound and a yen. By keeping the yuan's value low the Chinese government essentially forces the Chinese worker to subsidize the foreign consumer. Estimates of the level of undervaluation range around 40%.

With a price reduction of 40% and tariff barriers around 30% it should be no surprise that manufacturing flees America and Europe and goes to China. Between China's accession to the WTO and 2007 the Midwest alone lost one million factory jobs. A good fraction is due to automation and there is no question that an advanced industrial economy will need fewer factory hands. Still, it is estimated that 40% of U.S. manufacturing's decline in the 2000-2007 period was due to Chinese imports.

Just because China wants to keep out foreign made products does not mean they don't want the products. They just want to make it themselves. This is done by requiring that foreign manufacturers set up business in China via a joint venture with a Chinese partner. That rule cannot be overt, since it would be a violation of WTO's spirit, but it is imposed by the fact that the government issues licenses to operate and approvals to do business. The rules for these

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licenses and approvals are quite vague and they are generally not issued until foreigners finally get the message that they need a Chinese partner. This process is foreign investors' biggest complaint.

The Chinese partner brings another problem--technology transfer. Requiring such transfer is prohibited by WTO rules so the government leaves it to the partner to demand that proprietary technology be shared as a condition of the joint venture. The government adds a few rules to encourage the process. The foreign company must accept 100% liability for its technology. Basically, if anything goes wrong the foreigner is on the hook. The government often requires that the Chinese partner obtain a vaguely defined 'mastery' of the technology. In practice this means that the Chinese partner must receive the most advanced technology for a given process, even though it may not be currently needed for production in China. If modifications or improvements are made then the improvement itself is treated as the property of the joint venture. It isn't just the modification which becomes property of the joint venture; the original technology which is at the base of the improvement also is included.

Very often the Chinese partner will have a separate business which operates in the same industry as the joint venture. Employees are seconded to the joint venture, they learn things, then go back to the original company with a full understanding of how to implement the foreigners' technology.

If there are any secrets left after all of these maneuvers there is one final rule, all technology becomes property of the Chinese partner at the end of ten years.

China not only does its best to require foreign manufacturers to set up business there, not only virtually demands that technology be turned over, it also tries to force the foreign company to set up research and development operations in the country. Caterpillar, for example, has three research centers in China. So it is not just a foreign factory worker who is displaced. It is also the designer, the researcher and the engineer.

All developing countries will make attempts to protect their own markets and obtain foreign products on the cheap. What distinguishes China is that its actions are part of an orchestrated, comprehensive, government directed approach. Most important is simply its size. No international company can afford to ignore a market of 1.3 billion people. Fear of alienating the government means there is little resistance to Chinese policies in the business community.

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