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This is not a trade war, it is a struggle for technological and geo-strategic dominance

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IS THERE A CASUS BELLI FOR A TRADE WAR?

In many advanced countries, the attitude towards US trade measures against China seems to be: Trump is wrong in using blunt tools, but he is right in pointing to a real problem. But what exactly is the problem? Is there a *casus belli*?

US complaints are often based on the large US external deficit. Economists like to point out that trade balances have little to do with trade policy because a current account deficit is just the mirror image of an excess of domestic investment over domestic savings. As long as trade measures do not have an impact on savings or investment, they will not affect the current account balance. But even abstracting from these considerations, it is difficult to find a rationale for a US-China trade war given that the current account surplus of China has disappeared, as shown in the last column of the Table 1.

Trump himself often motivated his actions with trade (instead of current account) balances. Looking at trade imbalances yields a somewhat different picture than current accounts, especially if one focuses on trade in goods, which seems to be the metric preferred by the US president himself. For example, on goods (first two columns in Table 1) one finds that the US deficit is very large, at USD 750 billion (4% of US GDP), while both the euro area and China have very large surpluses, worth more than 4% of GDP (whereas Japan does not figure anymore). This implies that even viewed from this angle, there is no reason for the United States to focus on China.

Trade in services (columns 3 and 4 in Table 1) shows the relative strength of the United States in this sector. The United States has a surplus of USD 250 billion, while China is running a deficit on services (mainly tourism) of the same magnitude. However, the United States receives only a part of Chinese tourism, which leaves the bilateral balance on goods and services deeply negative. Economists tend to focus on the current account (last columns in Table 1), which besides goods and services also includes capital income. On this measure, China is no longer a part of the problem, as its current account surplus has essentially disappeared. Global imbalances have become a transatlantic issue, as the deficit of the United States is mirrored in a surplus of the same size for the euro area.

In terms of trade 'imbalances' it is thus difficult to find a *casus belli* against China unless one focuses on bilateral balances in goods. But in this case the transatlantic dimension is equally important.

DOES CHINA PROTECT AGAINST IMPORTS?

One argument for the United States to focus on China could be that the euro area is running a large trade surplus, but at least has open markets; whereas the trade surplus of China could be due to protectionism. But even this argument does not stand up to scrutiny. The standard tool of protectionism is tariffs. On this front, the problem seems very limited. The average tariff rate applied by China has continue to fall even after its entry into the WTO in 2001, which had already forced the country to reduce tariff protection by one half. Indeed, the average applied tariff now seems to have fallen to less than 4%, and there are few complaints about tariffs even though China maintains an unusually high number of tariff peaks, i.e. high tariffs for very limited product categories. A CEPS study finds that China's tariff schedule contains an unusually high number of tariff peaks. But these high tariffs affect only products of limited relevance. Moreover, tariff peaks are not even on the list of complaint of either the United States or the EU.

Tariffs were in any case yesterday's problem (until Trump dusted them off as a weapon for his trade war). But they provide one clear numerical indicator of obstacles that traders (in goods) might encounter at the border. There are many other ways to create obstacles to trade. It is difficult to measure the overall importance of these 'non-tariff' barriers to trade because they can consist of so many different measures, including licensing, conformity assessment, etc. These non-tariff measures are difficult to keep

Table 1

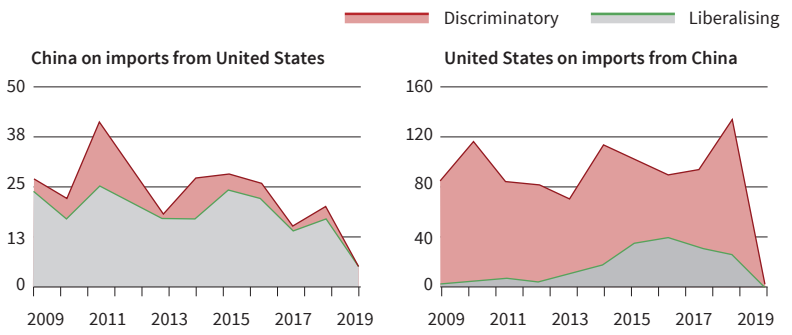
Trade and current account imbalances

	Net balances 2016				Current account 2018
	Goods		Services		
	USD billion	% GDP	USD billion	% GDP	% GDP
US	- 753	- 4.0	248	1.3	- 2.5
China	494	4.4	- 244	- 2.2	0.3
Euro area	487	4.1	65	0.5	3.5
Japan	51	1.0	- 11	- 0.2	3.7

Source: World Bank.

Figure 1

Number of new interventions implemented each year: US and China



Source: Geneva Initiative.

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track of because they usually concern only a specific sector or product.

However, the website of the Global Trade Alert Observatory has since 2008 provided an excellent running observatory of new measures (called state interventions) introduced by major trading nations. For China, this independent body finds only around 25 new measures that might restrict trade with the United States (annual average since 2008). Interestingly, China also enacted about the same number of new measures that have the effect of liberalizing trade with the United States. China has thus not become more protectionist against the United States.

The other way around the situation looks very different: the United States has enacted between 80 and 100, or about 4 times more, restrictive measures against China, which far outstrip the much less numerous liberalizing measures. Moreover, as illustrated in the Appendix, one finds a similar asymmetry between Germany and China: in recent years, China has introduced about as many liberalizing as protectionist measures. But Germany has taken mostly protectionist measures *vis-à-vis* China.

This means that in terms of trade measures, China is being more sinned against than it is sinning itself. One could of course argue that protection against Chinese exports is needed because exporters there receive subsidies. This is one point on which the complaints seem justified. When China joined the WTO, it took on the obligation of notifying the phase-out of a number of existing subsidies and notifying all those that continue (Annex 5a and 5b to the Accession Protocol). However, this 'soft' commitment was not honored. In late 2018, China suddenly sent a notification to the WTO for all the missing prior years. However, it seems that these notifications were incomplete, as found in the latest WTO Trade Policy Review. In principle, the United States and Europe could offset the advantages that these more or less hidden subsidies give Chinese exporters by introducing countervailing duties. In practice, this is difficult because the opaque nature of the subsidies makes it difficult to prove their impact in specific cases.

STATE-OWNED ENTERPRISES

The case for countervailing action would be justified in particular in the case of exports by state-owned enterprises (SOEs). This might have been a problem in the past, when SOEs accounted for one half of exports. But now their share of overall Chinese exports has fallen to less than 10%.[1] Despite their now very limited importance for trade, SOEs constitute another bone of contention between China and the 'West'. This has of course little to do with 'trade' policy, since SOEs are just one element of the economic order in China. As mentioned, SOEs do not play a large part in Chinese exports and if they practice unfair pricing the problem can be dealt with by traditional countervailing duties and other measures.

The real complaints about SOEs relate to the structure of the Chinese economy. Complaints from the European Chamber of Commerce in China concern the preferential treatment given to SOEs mostly in non-tradable sectors like financial services, etc. Of course, the dominance of huge state-owned banks creates the temptation to favor SOEs in the allocation of credit. But a lack of access to cheap credit should not be a problem for foreign-owned or -invested companies, which usually have a major multinational enterprise with access to global capital markets behind them. Private Chinese enterprises ought to be equally, or perhaps even more, disadvantaged by SOEs having preferential access to capital.

The role of SOEs in the Chinese economy is difficult to document in detail, but most statistics suggest it remains important, albeit having fallen somewhat over the last two decades. For example, SOEs still account for about half of the capital stock of industrial enterprises (down from three quarters). Moreover, SOEs tend to be large. A number of them, especially the large state-owned banks, now rank among the largest global companies.

But these examples are not representative of the entire sector. SOEs remain an important factor in the Chinese economy, but their importance has declined considerably over the last decade and more recently. For example, SOEs now account for only about one quarter of (urban) employment and a similar share of profits (and only one tenth of exports,

[1] There is one exception that proves this rule. The Chinese Railway Corporation, which is of course vastly larger than any other railway company in the world, has spent heavily on R&D, allowing it to become an important exporter of trains and material. China alone now accounts for one half of all global trade in this sector. But this sector is not typical of overall Chinese trade patterns.

as mentioned above). Foreign-controlled enterprises make more profits (31% of the total), while the share of profits going to private Chinese enterprises is even higher.

Chinese statistics show that foreign-invested enterprises generally achieve much higher profitability than state-owned ones and that the profitability of foreign-invested enterprises has persisted, not fallen, over time, although it remains slightly lower than that of private Chinese ones. There is thus evidence that while SOEs are not efficient in their investment, they play only a small role in exports and their continuing role has not impeded continuing high profitability of foreign investment in China. Some observers have detected a revival of the role of SOEs more recently, but the evidence for this is still tentative.[2]

THE REAL PROBLEM IS FDI

The finding that there is no *casus belli* for a classic trade war is confirmed, if one looks carefully at the complaints enumerated by the United States or at the detailed report published by the European Chamber of Commerce in China summarizing the complaints from its over 1,600 member companies. This report makes interesting reading because one does not find many complains about 'trading' practices, at least in the narrow sense. The main complaint of EU enterprises in China is the perception of unfair treatment by the Chinese authorities. The main complaint of the US government is that US high-tech firms are forced to reveal their technology and trade secrets. An additional, common complaint is that in many sectors foreign firms are not permitted to hold a majority stake in joint ventures. The core of all these complaints is thus not trade, but FDI and the situation 'behind the border', in the Chinese market.

Measuring barriers to FDI is as difficult as measuring non-tariff barriers to trade. Barriers to cross-border investment can take many forms, such as limits on foreign ownership in certain sectors, different fiscal treatment for foreign-owned enterprises, or outright bureaucratic discrimination. The OECD publishes a composite indicator of restrictiveness towards FDI. For China, this indicator shows that overall, the country is far less open than OECD countries, but that there has been continuous, albeit slow improvement.

A further subtle distinction one needs to make is that between barriers to new inflows of direct investment (i.e. investment with the implication that the foreign investor obtains control over the investment) and the treatment of enterprises that are under foreign control. In most OECD countries, a company incorporated in a different home country is treated in the same way as any other domestically incorporated company (this is called 'national treatment'). But in China, there is a special regime for 'foreign-invested enterprises'. In the past, the purpose of this special regime might have been to protect foreign investors from an overbearing domestic bureaucracy. But today, there is a widespread perception that 'foreign-invested enterprises' are not treated fairly.

The complaints have come in the light of the rapidly changing context in China itself. The real change might simply be that in the past the formal handicaps that foreign-owned enterprises faced were compensated by the eagerness of the provincial authorities to attract foreign investment. As long as provincial leaders were also judged on the amount of FDI they attracted, they would provide many incentives to outweigh the formal restrictions on FIEs. Today, there is less emphasis on growth in the evaluation criteria of provincial leaders, which means local authorities have less reason to provide incentives for FDI.

Moreover, the technology gap between Chinese and foreign enterprises is shrinking rapidly in many sectors. Restrictions on majority foreign ownership mattered little in the past when the formally majority Chinese partner (often owning 51 percent) had an incentive to acquiesce to the *de facto* control of a foreign investor who had superior technology or market access abroad. With technology on a more level playing field, it is the uneven playing field as to restrictions on foreign majority ownership that starts to matter. This is also the reason why it is more appropriate to speak about a 'technology war' than a 'trade war'.

'FORCED TRANSFER OF TECHNOLOGY': A CASUS BELLI?

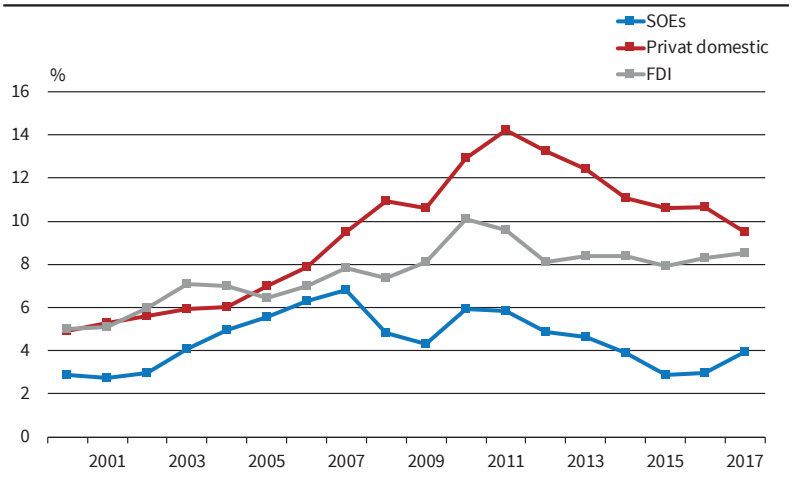
Exhibit one in the complaints about Chinese unfair practices is what the US authorities call 'forced transfer of technology'. The term 'forced' suggests a degree of coercion that does not make economic sense. A US company can always choose not to invest in China. If a US or European company chooses to invest in China despite the requirement to transfer technology, it does because it expects to make a profit. That profit might be smaller than it would have been with no technology transfer requirement, but the choice of going into China anyway reveals that the company sees more opportunities than risks.

Moreover, the Chinese partners (for example, in a joint venture) know that the foreign investment will come with a technology transfer. This means that the local partners will be ready to accept that the valuation of the foreign investor's contribution to a joint venture includes the value of the transfer of technology. For example, the local partner or the local government can provide cheap land, infrastructure, tax exemptions, or loans on favorable terms. In other

[2] The data for 2017 shows an unusual jump in the profits of SOEs (while those of private Chinese enterprises fell). It is too early to tell whether this is the result of a re-classification or other statistical adjustments.

Figure 2

Profit rates in China



Source: Chinese Statistical Yearbook. © ifo Institute

words, the transfer of technology, because it is the rule, will be priced into any FDI deal. The continuing high profitability of foreign-invested enterprises suggests that this has indeed been the case.

It is only natural that American and European companies will assert in surveys that they would be better off if they had not been 'forced' to transfer technology. However, these statements do not take into account the fact that the terms on which the initial investment was made probably contained advantages that were available to the Western investors only because of the expectation of technology transfer. It is of course likely that in many cases the most efficient investment deal would not have involved a wholesale transfer of technology, but perhaps only a licensing agreement or the payment of royalties. However, that should be only a secondary consideration, since the present value of the foregone licensing fees or royalties would have figured implicitly in any investment deal.

It is often impossible to prove the pressure exerted by Chinese authorities to transfer technology, because China made a formal undertaking when it entered the WTO that it would no longer require technology transfers.[3] However, because of this WTO undertaking it seems that the pressure to make technology transfers has become informal. According to many observers, the Chinese authorities even avoid e-mails that could be used as proof, instead giving only indirect oral 'hints'. It is thus likely that in reality this pressure to transfer technology does persist.

HAS FORCED TECHNOLOGY TRANSFER AFFECTED PROFITS?

However, as argued above, FDI inflows should continue only if it remains in the interest of foreign enterprises to invest in China, knowing in advance that the pressure to transfer technology will exit, but might be offset by other advantages. The confirmation of this reason can be found in the rates of return on FDI in China: these have remained high, as can be seen from different angles. Chinese statistics themselves report the rate of return on foreign-invested, state-owned, and private domestic enterprises.

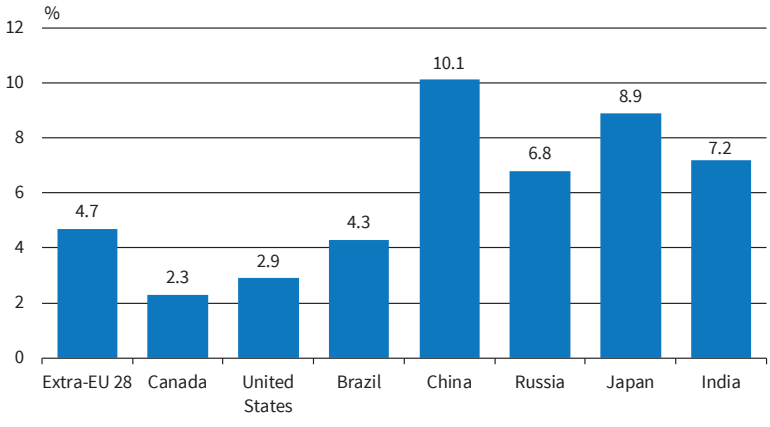
Figure 2 shows the profit rates of these three groups since China joined the WTO. The rate of return on FDI (as measured by Chinese statistics) has in fact tended to increase slightly over time. It reached a natural peak during the Chinese boom of 2010, but at around 8% it remains much higher than that of SOEs (around 3%). The profitability of private Chinese enterprises is somewhat higher than that of foreign ones, but the difference has narrowed recently to about 2 percentage points.

Another indicator is the profitability as seen from the home country. Figure 3 shows the profitability of FDI for the EU. The average rate of return on outgoing FDI is somewhat below 5%: under 3% for EU investment in Canada and the United States, but 10% for

Figure 3

Average rate of return on FDI

2014–2017



Source: Own calculations on the basis of Eurostat data. © ifo Institute

[3] See the Chinese WTO Agreement. Also, in Annex 1 of the Protocol, China pledged to abolish technology transfer requirements in order to comply with the WTO Trade-related Investment Measures (TRIMS)—but that is only with regard to trade in goods.

investment in China. China seems to offer by far the highest rate of return among all the major destinations for EU direct investment abroad.

The problem with the FDI statistics is that almost none of the FDI from OECD countries to China goes directly into that country. In both the US and the EU statistics, the share of foreign direct investment going to China is less than 4% (less than for Brazil, for example). This is why one has to take the balance-of-payments FDI data with a big grain of salt.[4]

All these considerations suggest that the cost of 'forced transfer of technology' for US and other Western high-tech companies might be vastly exaggerated. But the argument also applies the other way around. Why should China continue to insist on this policy of linking market access for foreign investors to a transfer of technology? The key official argument on the Chinese side is that in a developing country the local companies are in a weak position *vis-à-vis* foreign investors whose technology they might not fully understand. This argument is also used in many less developed countries, whose FDI regimes are often as restrictive as that of China.

However, the argument that China is a developing economy that deserves special exemptions from WTO rules becomes less and less tenable as the country develops its own technological expertise. China's indigenous capacities for research and development have literally exploded over the past few decades. Spending on R&D is now larger as a percentage of GDP, and larger in absolute terms than in Europe and many other OECD countries. Today, there is thus little need to protect Chinese 'infant' industries.

Rapidly advancing domestic know-how and the absorption of technology also explain why Western complaints have become more vocal. Many Western firms probably agreed to a transfer of technology under the assumption that Chinese competitors would anyway not be able to adapt and master it. Part of today's complaints stem from the fact that this expectation of superiority has been confounded. China produces more bachelor graduates in science and engineering than the United States and Europe combined.

One reason why the Chinese authorities remain so reluctant to give up on their technology transfer policy is that they are making a mirror-image mistake to the United States: they overestimate the impact of informal state intervention to 'foster' the transfer of technology. They fail to see that Western companies will take this policy into account when deciding on investments in China, offering worse terms than if they were able to keep their technology and use licensing agreements instead. Moreover, these other forms of technology transfer are becoming more and more widespread, with the result that recorded royalty payments from China have grown very quickly and now amount to close to USD 30 billion per annum—putting China second only to the United States in the league table of paying for foreign technology. This shows that a large and increasing share of technology transfer has not been 'forced'. Very recently (late December 2018), the government of China announced that it would abolish those administrative measures that result in de facto 'forced technology transfer'. It remains to be seen whether this new policy will actually be implemented across the many different layers of government involved (central, provincial, and local governments, many different ministries, etc.).

CONCLUSION

An outright trade war between the United States and China (in the sense of both sides imposing stiff tariffs on each other's imports) remains unlikely. However, tensions between the two countries are likely to persist. President Trump's tough stance on China remains popular in the United States, not so much due to the bilateral trade deficit or frustration about lost business opportunities, but because of the concern that China is about to outcompete the United States for technological leadership in a number of sectors considered critical for national security (on both sides of the Pacific). The reason Sino-US tensions on FDI and the associated 'forced transfer of technology' are so intense is because they are mostly about income distribution between two monopolists. The Chinese authorities hold the key to access to a vast, and quickly growing, market whereas Western companies still have a monopoly on the best technology in many sectors.

The United States and China account for a large share of global trade, but they alone do not dominate the global economy. In the coming 'cold economic war', the side that can obtain the support of neutral powers will have a strong advantage. Other large trading powers—Europe and Japan, for example—do not share the US desire to keep China down and are thus unlikely to back unreasonable trade measures. However, Europe and Japan share the narrower US concerns about an uneven playing field generated by persistent Chinese state intervention in the economy. It is up to the Chinese authorities to allay legitimate concerns about these issues, which go to the heart of a global rules-based trading system. The Chinese economy is now so strong that restrictions on foreign ownership and any form of forced transfer of technology are no longer needed.

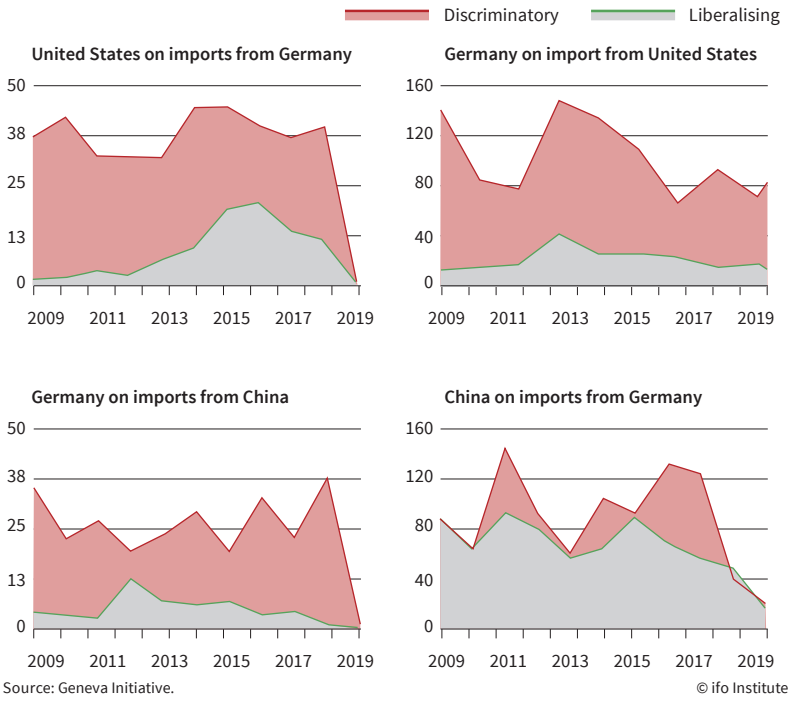
[4] Data on greenfield (projects) assembled by UNCTAD shows a very different picture regarding the distribution of FDI, but this source has no information on the profitability of these projects.

APPENDIX
MARKET DISTORTING MEASURES: GERMANY VS. US AND GERMANY VS. CHINA

Across the Atlantic one finds a rough equivalence of measures, if one takes Germany to represent Europe. The absolute number of measures is somewhat greater for the United States (about twice as many, see the difference in scale in Figure A1). But this is understandable given the countries' relative difference in size. However, if one looks at Germany *vis-à-vis* China, one finds a similar asymmetry to that between China and the United States: for China, the number of liberalizing measures roughly equals the number of protectionist ones. But Germany's measures affecting China are more commonly of the protectionist kind.

Figure A1

Number of new interventions implemented each year: US and China



Source: Geneva Initiative.