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The US-China Trade War: What Are The Irreversible Impacts?

Inside view with Mellon's Aninda Mitra

Rafe Lewis: Hello and welcome to Double Take, the Mellon podcast. I'm your cohost, Rafe Lewis, director of investigative research here at Mellon's Boston headquarters.

Jack Encarnacao: I'm your other cohost and investigative researcher, Jack Encarnacao. Together, Rafe and I deliver boots on the ground research to Mellon's investment professionals finding experts and primary materials far removed from the echo chambers of Wall Street. We hope it gives our investors unique and differentiated insights into the companies they cover.

Jack: That's precisely what we intend to do for the audience of Double Take. For each episode, our goal is to provide our listeners with two unique viewpoints on the hottest investment issues of the day, one from inside of Mellon and one from outside.

Rafe: I have to say we're pretty darn excited to launch this podcast with a deep dive on what's arguably the single most consequential driver of equity and fixed income price gyrations in 2019, the U.S-China trade war. Not only are we discussing a big beefy topic, we're doing so with a bonafide guru on the subject, Aninda Mitra.

Jack: Here's some background on our said guest superstar today. Aninda is a senior sovereign analyst at Mellon. He's based in Singapore where he's responsible for research on much of Asia including and perhaps especially China. Aninda has more than 20 years experience as a sovereign analyst and economist focused on Asia. He joined the firm in March, 2014 from Fitch Ratings credit wire service where he served as senior director, Asia Pacific.

Jack: Aninda, welcome.

Aninda Mitra: Thank you for having me.

Rafe: Aninda, the reason we've invited you here today on Double Take is to get your assessment on what's changed irreparably, permanently as a result of this China-U.S. trade war. We read news stories all the time and listen to public company commentary on the serious impacts of tariffs, anti-dumping duties, investigations and arrests of company executives, delisting of firms from trade exchanges. The list goes on and on.

Rafe: Where in all this wreckage is there permanent damage and not just transitory pain that could end when and if these tariffs get lifted?

Aninda: That's a great question. I think China's growth trajectory has depended over the past two to three decades significantly on technology access, on improving or increasing global trade volumes and access to U.S. markets and markets in other advanced industrialized countries. That opening, those openings are ebbing now. They're waning.

Aninda: I think it's not just restrictions that the U.S. is imposing through trade channels and investment channels on China, but even the Europeans have become a lot more cautious about opening up their own markets and access to technology for Chinese companies without the reciprocity coming through from the Chinese side who have remained far more protective of their own industry so as to gain a greater global market share and become more dominant in their own marketplace.

Aninda: The two-way opening needs to happen, and I think China is gradually moving towards that phase, but for now, the pace it has chosen for itself remains very slow. That's what seems a bit more permanent, that break between the rest of the world, especially advanced industrialized countries' appetite for remaining open to China while China takes its own time to reciprocate is reaching a breaking point. That's the permanent damage if you will for global trade flows, for intermediate production chains and supply chains around the world, which are starting to fragment.

Aninda: That's lowering global trade, and it's having a significant amount of damage for more export, more open and export driven economies around the world.

Jack: Aninda, we hear a lot about this idea of decoupling, the notion that the highly interconnected economies of the United States and China will be forcibly separated over time by laws, regulations, facts on the ground. How close would you say we are to a decoupling, especially after the trade war or at least since the trade war has set in?

Aninda: Well, decoupling will be painful. It's like separating Siamese twins of sorts. The world has benefited tremendously from U.S. demand and Chinese supply. The whole asset class of emerging markets on the rise is really predicated on China playing an increasing role in a globalized world. If that process were to come to an end, and if there is no replacement for this process, no other countries that can fill the shoes that the China is leaving behind, that can be extremely problematic for not just the complexity of supply.

Aninda: That's become more and more sophisticated over the past few years, but also, demand in China itself is slowing. That can be equally problematic for many countries around the world who have relied on continuing increases in global trade and continuing integration of global supply chains. That's beginning to fragment, and that's becoming more and more painful for many economies around the world.

Rafe: As we think about decoupling, I mean, I guess a key question is what does China have that can't be replaced in other countries when it comes to satisfying U.S. demand, Europe demand for lower-cost goods, you name it?

Aninda: That's a great question. I think those supply chains will shift but it won't happen overnight. Two things to keep in mind, first, China still offers a level of scale that no other country can provide at the moment in terms of replacing production platforms and so on. I mean, you hear a lot about businesses moving out to Vietnam for instance, or moving back to Taiwan from where a lot of electronics was outsourced to China, but nobody has the scale of China.

Aninda: I mean, Vietnam size is but a small province of China. Its labor force and so on simply cannot provide the kind of scale that the coastal provinces of China for instance would have provided. Yes, there's a cost angle as well, and China's become a more expensive place to source production from. China has been vacating some low end and low cost production activities for a number of years now. It needs to be more of a multilateral initiative where these things shift out to other countries just beyond Vietnam and Taiwan, possibly towards Indonesia, India, Philippines and so on and so forth.

Aninda: Even many African countries, I think, have prepared themselves to provide the kind of manufacturing platform. Again, not on the same scale but at least some viable alternatives, but these processes take time. They're not going to happen overnight. The second thing is China itself will make things tough. I mean, I think there's been a lot of talk about making it more and more difficult for firms to leave China altogether in terms of tax restrictions.

Aninda: Selling down land and property and equipment and so on and so forth is not going to be easily done out of China. These are the main impediments, I think, which will slow this process down.

Jack: It seemed to be you put your finger on a difference in acceleration here between where China stands as far as going fast and where the folks that supply on China... pardon me, the folks who rely on China for supply, how quickly they expect China to go. Is that a function of what's happened with American tariffs, or was that slowness coming even before this back and forth broke out?

Aninda: I think it's a function of China's dominance in the production supply chain. It can pick the speed and the time at which some of these supply chains shift. It is indeed also a function what multinational companies would themselves prefer to do, but it's not entirely their call alone. China as a destination country for many years of production and relocation and production can still impose restrictions at the speed at which they move out.

Rafe: Is there a lot of peril for a multinational that's both sourcing goods from China and services as well as selling into China if they decide to decamp for another country like Malaysia and Indonesia, Thailand?

Aninda: Possibly. I think, the Chinese authorities to set a precedent or discourage a broader shift along those lines could discourage such activity by imposing restrictions and so on. It's going to be a slow moving process. It's in China's own benefit again to vacate areas where it is not very competitive in anymore, but it does have a lot of heft in that process, and which is why I don't think it's entirely up to the multinational company to just get up and leave just because it chose to do so.

Rafe: Aninda, if I'm reading you correctly, it sounds like what I'm hearing from you is that the term decoupling is somewhat overblown here. There's going to be an interconnectedness for quite a while due to the facts on the ground and the difficulty of leaving, the difficulty of departing from this wonderful giant billion plus market of humans buying things in that country.

Aninda: Well, yes and no. I think, we are talking about... I mean, a few years ago, it would not even be plausible for someone to think about moving entirely out of China. Now, it is. The reason for that is everybody wants to have a China plus strategy. They should've thought about that a long time ago, but now given the developments at a political level and at a global trade level, this hedging strategy has become much more of an imperative for multinational strategies around the world.

Aninda: This is a process which I think has moved into a higher gear, but it's not going to proceed as rapidly as you said, some people think will be the case or seems to be inevitable. Rather, the pace and course that this takes will also depend on China's own reactions to these processes and of course to the nature and scope and the pace of the bilateral trade and investment relationship between the U.S. and China.

Jack: When it comes to American firms selling to Chinese consumers as opposed to just relying on China for source materials or inputs, as we know, globally, the biggest shopping day is Singles Day in China, which takes place in November. It's their Black Friday, but several times more multiplied. One of the things we saw was a survey the other day, 2000 Chinese consumers, three quarters of them plan to avoid us labels and opt to buy local Chinese brands citing patriotism is the main reason.

Jack: Can we stuff that genie back in the bottle or have Chinese consumer's sentiments changed such that if you're an American from selling in China, you just have a distinct disadvantage now because of what we've seen over the past year?

Aninda: I don't think these perceptions, patriotism or otherwise is a lasting phenomenon. I mean, if the tone of the relationship changes, the consumer's preferences will change as well. At the end of the day, there's a lot of fondness for American labels, American brands in China. U.S. products are were well regarded. It's difficult for me to envisage a situation where unless there's a truly better alternative that Chinese consumers would definitively and permanently walk away from U.S. goods, quality and branding, brand names matter at the end of the day.

Aninda: Any notion of patriotism coming in the way of consumer preferences is I would characterize that as a more temporary and passing phase rather than a permanent feature of consumer preferences in China.

Rafe: I guess that's assuming that the government there doesn't take a more heavy handed approach to dealing with US-based goods.

Aninda: One of the things which was an area of concern, and this is something that the Chinese government has not tapped into, is the value of U.S. Sales of products produced and sold in China is equivalent to the entire trade surplus that China runs against the U.S. One way to sort of get back at the U.S. would be to curtail some of these sales, but the reason the Chinese haven't done that is because it would hurt their own consumption dynamic.

Aninda: There isn't an alternative for every single product that the U.S. sells in China. Yeah, you could buy a cheaper Xiaomi phone or a Huawei phone instead of an expensive Apple phone, but not everything that's made by and sold by U.S. companies in China is replaceable that easily. I think there has been more selectivity, more caution in the degree to which the Chinese have cracked down on U.S. sales, but this has clearly not been a front and center issue in the bilateral relationship just yet.

Aninda: If anything the Chinese have tried to retaliate by imposing Counter tariffs or even higher tariffs on imports from the U.S., but they haven't come down very heavily on us sales in China of goods and services produced within China itself.

Rafe: That's a good read. Speaking of the nuances within this dynamic, Jack and I have spent innumerable hours in the past several months speaking with a wide variety of companies impacted by the U.S.-China trade war. We are increasingly anecdotes about Chinese manufacturers setting up new plants and operations, not only in nearby Asian nations, but perhaps more intriguingly right here in the U.S.

Rafe: They're doing this, of course, to avoid the punitive duties, the tariffs, but it made us wonder if the strategic goal is to hurt

China and weaken its economy, how effective can that be if the company producing the goods is still Chinese-owned and operated?

Aninda: Well, I don't know if the strategic goal is to hurt and weaken China is to fix the trade deficit. That's a stated purpose at least. To the extent that the Chinese have responded by relocating some of their production within the U.S., that's a good response. That's what happened with Japanese companies in the past when there were trade frictions with Japan. I mean, Toyota and so on relocated a lot of production back to the U.S.

Aninda: They still make the profits, but they employ U.S. workers. If the Chinese follow a similar approach, I think that's a very good response in terms of taking some of the sting out of the the hostility that has come up in the bilateral relationship.

Jack: An example of that I think would be technology. A big part of the legal basis for imposing these tariffs from Washington has been this argument that national security is somehow on the line if we continue to rely on Chinese suppliers for the next wave of infrastructure and tech be it 5G or whatever it might be. With national security is the backdrop and the legal reason to be able to impose these tariffs sort of by fiat, by the executive branch, it seems that the notion is that if we can find ways to get these pieces of technology from countries that are not domiciled in China, where the manufacturers are not actually physically located in China, but if they're in Vietnam, they're in Thailand, if they're in the Philippines, that somehow that achieves a strategic national security goal.

Jack: However, we hear and have heard that just because the factory is in Vietnam does not mean it's still not owned by Chinese nationals.

Aninda: Sure.

Jack: That in fact the proceeds and profits from that factory don't flow back to Beijing all the same. What of that.. Is that a shoe to drop here? Do you think that potentially countries that are being tariffed for this national security reason might spread beyond China if it's discovered that there's Chinese ownership underneath a lot of the outside of China manufacturing locations?

Aninda: That's a great question. I think so far, the production relocation has been dominated by multinational companies rather than Chinese companies, but that is happening. Chinese companies are also looking for other places to invest in, build up production capability so as to avoid the direct hit of tariffs. As far as technology goes, I suspect the U.S. would be much more comfortable with a Korean company or a Swedish company in taking the lead on 5G or other high tech areas.

Rafe: Let me push back on this a little bit because plenty of the rhetoric from Trump, from vice president Pence, from others in the U.S. administration is that the made in 2025 that China made in 2025 campaign is about them taking control of artificial intelligence, burying viruses within our ability to maintain our own global competitiveness. I guess what I wonder is is there a possibility that there's a barrier coming, more conflict?

Rafe: For example, I think about U.S. semiconductor companies. Is it possible they're going to be prohibited from even sending their products to China to allow them to be able to build this infrastructure that could make China much more competitive from a defense position and not to mention commercially?

Aninda: That's another good pushback.

Rafe: Sorry.

Aninda: No, no, no. That's a great question. Look, I think the way things are headed, China itself will start to become more concerned about intellectual property. It is building a lot of intellectual property of its own at the moment. That to me is a glimmer of hope that they will come around to the table and agree to some of the controls that the U.S. would like to see put in place. It will inevitably delay the whole process of reconciliation or time it takes to prevent further fragmentation.

Aninda: Ultimately, the Chinese will get to that stage where the sheer amount of IP and value add that they're bringing to the table on their own will possibly at some point bring them to some sort of an agreement with the U.S. on imposing some control on IP. Now, will that amount to changing their own laws and so on, which harks back to their rhetoric of reimposition of unequal treaties is something that's not clear to me at this point.

Aninda: To come back to your question of will there be a complete decoupling of 5G and other potential technologies which have... well, other technologies that potentially have a dual use in civil as well as military areas, I don't know the answer to that, but I would end up by saying that it is ultimately in China's own interest, long-term interest, to agree to some of these controls and so on. That could be at the heart of recent discussions where they have become a bit more comfortable with phase one in terms of agreeing to at least some level of controls on intellectual property but without perhaps going to the extent of amending their own domestic legislation to please the administration on that.

Aninda: Having been burned once with a complete collapse of trade talks, I suspect go heading into the elections, any phase one agreement would possibly... Both sides would agree to disagree on a few items, but not want to see the whole phase one agreement collapse at this stage.

Jack: Back to the AI example as part of getting ready to talk to you today, Aninda, Rafe and I polled folks at Mellon about what they see as irreversible impacts of the trade war even if such a deal were to happen. Our director of research pointed out something that's on his mind. He covers tech for us. From the perspective of Chinese firms that want to make advances in AI, they are still very reliant on American-based semiconductor companies to pull that off.

Jack: There is not a domestic semiconductor industry that's robust enough yet in China that they can self-source that key technology. Do you see that changing? Do you see that as perhaps an outmoded viewpoint in just a couple of years? China likely would want to build up their own semiconductor capacity such that they can lead an AI. He pointed this out too. If you extrapolate that further, you think about how in this country there's a pullback on data collection.

Jack: There's data privacy legislation. There is a shift in tone about the comfort level Americans have with their data being used to feed AI machines. Conversely, in China, it seems to be precisely the opposite. I'm sure there are data privacy concerns in that country, but the government has much more ability to pull data into an AI system. As we know, that's the lifeblood of AI. The more you can pull in, the sharper you can make it and the bigger gains you can make.

Jack: Two-part question there, will China be focused, do you think, in the near term on not being reliant anymore on American semiconductors, and do you see their advantages the way their society is set up helping them a lot in AI and disadvantaging America in that battle?

Aninda: I think the Chinese will take a long time to get to that stage where they can wean themselves completely off of upstream dependence on U.S. semiconductor products. Will they not try? I think they will try to do so. Will they be successful by 2025? I question that proposition, but that doesn't stop them from trying.

Aninda: Coming back to the societal question, I think on the surface, it is true that the there is not a civil society pushback against data acquisition, increasing state surveillance, social credit system which ranks everything from your behavior to your emotions in determining how productive or valuable a citizen you are for the Chinese state. Nonetheless, I think there will be some degree of limitations. I mean, I think the recent developments in Hong Kong for instance highlight that a determined population can get around restrictions.

Aninda: I mean, they can mobilize themselves to use technology to their advantage, and push back quite heavily against a very overbearing state. That has nowhere nearly come to pass anywhere in China. I'm just pointing out the instances of Hong Kong where when push comes to shove, a population can push back.

Rafe: Aninda, last question, and it puts you on the hot seat a little, but I think it's a fun hot seat to be on. It's the fourth quarter of calendar year 2019. We're well into the U.S.-China trade war now. How do you think it ends?

Aninda: I think there'll be a truce up until the elections. That's been our base case scenario as well in framing our global macro outlooks for next year. We are assuming some rationality from both sides. The Chinese need a bit of a pause to get their policy act together. They need a bit more space to make their stimulus policies a bit more effective. The U.S. needs a pause to avoid steep economic and financial market downturn going into the elections, especially if Trump wants to have some tailwinds behind him.

Aninda: That being said, I'm not terribly optimistic to be honest about the medium term future. It is not yet an ideological conflict per se, but it's a very determined strategic conflict that is definitely coming into focus. So far, we've only covered trade and technology, but there's a lot of geopolitics as well. The U.S. has legislated the Hong Kong democracy and human rights bill. The U.S. is committed by treaty to defend Taiwan. The U.S. also would like to see more disarmament in North Korea. South China is a sticking point as well.

Aninda: There's a whole host of other issues that I... I'm naming only a few here where the U.S. continues to rub up against China's rise. China's rise, one could argue that no one can stop China's rise. It's a very large country. It's become increasingly sophisticated. It has a well entrenched history of statecraft and having its way. I think backed by a large economy and an increasingly powerful military, it will continue to rise, but the U.S. can slow it down.

Aninda: I would not discount U.S. power. It withstood two world Wars and a cold war, and it still has alliances and treaty alliances and bases around the world, which makes it a formidable power to oppose. Long story short, stay tuned, this geopolitical conflict is not going to end anytime soon. Although, we do expect a short-term truce in 2020.

Jack: Well, Aninda, thanks so much for getting us started out of the gate here on Double Take. It's a great conversation.

Aninda: Thank you.

Jack: We'll catch up with you again some time. Thanks a lot.

Rafe: Welcome to Double Take, the Mellon podcast. It was great hearing an Aninda Mitra's perspective. Now let's dive quite a bit deeper into the US China trade war, shall we? Jack, tell us about our next guest.

Jack: With pleasure, Rafe. Double Take listeners, our expert outside view comes from Craig Allen today. Craig is president of the US-China Business Council, a private, nonpartisan, nonprofit trade organization representing roughly 200 American companies that do business with China. Including, I believe, 23 of the 30 companies that make up the Dow Jones Industrial Index, and a good hunk of the S&P 500™ too. Craig, who's joining us by phone, has a long illustrious career in foreign service, beginning back in the mid eighties at the Department of Commerce International Trade Administration. There were a lot of twists and turns to his career, but he eventually rose to the ITA's Deputy Assistant Secretary for China. Craig studied political science and Asian studies at University of Michigan, and got his MS in foreign service from Georgetown. Craig, welcome to Double Take. Thanks for being with us.

Craig Allen: Thank you so much for having me on.

Rafe: Craig, we hear a lot, and read nonstop, about potential short term and long term ways the American and Chinese governments are seeking to end this trade war. But one thing that really interests Jack and me, in particular, is what has changed permanently. In other words, what impacts of this trade war are now irreversible, irrespective of a quote unquote peace deal.

Craig: So I think that there are a good number of ways to look at that question. One way is to note that the technology issues have really risen to the fore. And that through both export controls and through investment controls, technology trade going both ways across the Pacific, which had been growing very rapidly, has been very much inhibited. And I think that even when we are over the trade dispute, it is very likely that the technology dispute will continue. But not in a manner that would follow the typical trade war scenario, and not through the typical trade war type of legal instruments, the 301 or the 232. Rather, the technology issues will be structured and formed by export controls, investment controls, and increasingly, data controls. So I think that that is something that we have to anticipate, particularly in our high tech world, for the foreseeable future.

Jack: Is there a way, Craig, to think about, beyond the back and forth of tariff lists and import export controls, what a solution looks like around those technology challenges because that doesn't sound like it's ever going to get solved. It sounds like a permanent state of competition between the US and China. Have you seen light there?

Craig: It is extremely difficult because most of the issues that we're talking about are couched in national security terms. And there is a out, or a get out of jail card if you will, within the WTO, if something does affect national security. Also I would note that the WTO was written 25 years ago, before the, certainly the common usage of the internet, and digital trade, and genomics, artificial intelligence, and a good number of other technologies that we're talking about here. And so there are no rules of the road for the industries. Now we can impute rules of the road for those industries from WTO principles, but the WTO is in fact silent on many of those issues. And therefore we need to come to either a bilateral, a regional, or a multilateral agreement.

Craig: Now, I think that the Trans-Pacific Partnership, currently known as Comprehensive and Progressive Trans-Pacific Partnership, was a good attempt to establish such rules. But neither the United States nor China are members of the CPTPP currently. And thus, while that might be a guideline, it's not a useful referee in the case of the US and China. And so certainly until the bilateral political situation improves, I don't expect that we're going to come to any UC agreements on the high tech side. And even with improvement in the bilateral relationship, the United States and China take pretty different approaches to science and technology, and those approaches are diverging, not converging. And the scientists [inaudible 00:05:39] that this subject will be with us for quite some time.

Rafe: That is a sobering thought. You know, when I think about your members, I mean these are mainly multinational corporations, many of them. And when you talk about something like data controls, I mean presumably the data to flow in multiple directions. From the United States to your operations in China, from your operations in China to the United States, to other markets that you might be, you either have manufacturing in or sales or any number of other units. I'm just trying to understand what data controls could even look like and still be functional for your 21st century multinational corporation.

Craig: Well, this is a emerging subject of great importance. And one that all your listeners should be thinking about. Because fundamentally Europe, China, and the United States have very different views on privacy and other data related issues. Now with regard to US China data flows, both the United States and China have restricted flow of personal identifiable information, or PII, from one country to another. And this is not abstract. There have been three Chinese mergers with American high tech companies, from which divestiture has been ordered by the US government, because it gave the Chinese companies, these are private Chinese companies, access to personal US information, or PII. Similarly, the Chinese are implementing PII regulations which, while not yet fully rolled out, could inhibit multinational banks, insurance companies, pharmaceutical companies, and others from incorporating China into their global computer and information systems. One of our members has noted that it is possible to be compliant in China, and it is possible to be compliant in America, but it may not be possible to be compliant in both countries.

Rafe: A catch-22.

Craig: This is a serious problem. It's a serious problem. And the US-China Business Council is in dialogue, with the Cyber Administration of China, to try to ensure that they understand the problems that not only American, but Chinese multinational companies have in complying with their laws, and getting them to adjust their laws so that we could bring the world's best cybersecurity, and IT, and data privacy to China as we do on a global basis. But right now that is a huge challenge and an area of great concern, to not only American companies, but Chinese.

Craig: I was recently talking to one of the world's leading internet entrepreneurs, Chinese company, one who's been very successful globally. And he noted to me that he had to keep his data, his global data, in Silicon Valley, and his China data in China. Because if he brought his global data back to China to apply their AI, he would not be able to export it. It would be illegal to export it. So the Chinese regulatory regime needs work here. And I'm proud to say that we're trying to advise the Cyber Administration of China to ensure that the wheels of global commerce continue to turn. But that is not a done deal yet and this is a very rapidly developing area.

Jack: And that's important, Craig, just to level set for our listeners, because we always hear about decentralized storage of data, cloud this, cloud that. Right? As it regards where data is stored and acted upon by AI, or whatever it might be. And if you could sort of bring our listeners up to speed, in terms of what isn't and is allowed, in terms of cloud in China. I mean essentially China, if I'm not mistaken, and please correct me if I'm wrong, sort of bans you from operating in China as an enterprise, and pulling your data from a data center that's located in the cloud outside of the country. So you can have cloud storage in China, but it must be in China, the servers.

Craig: So there are multiple elements to this question. The main public policy question that we face with the Chinese is that the Chinese will not allow wholly foreign owned data centers in China. In other words, they're requiring that foreign cloud providers joint venture with Chinese cloud providers, and thereby forming a global competitor potentially. So that's a problem. There is another element of this problem on the cyber security, or on the information side, and the Chinese are requiring inspections of critical information infrastructure, which cloud computing could be considered a part of. And so some American companies are concerned that these inspections might include questions concerning proprietary information that they have about their systems. The other problem area, as I mentioned before, is PII, or personal identifiable information, and what PII can flow out of China and what cannot flow out of China. And the regulations are very unclear, requiring a lot of head scratching, and a lot of angst by foreign companies who do not wish to violate Chinese law. But who do wish to provide Chinese clients with world class service. So that is, again, an area where much more dialogue is needed.

Craig: Now I would say on financial services, there's another regulator there, which is the Central Bank of China, and they have their own requirements. And we have, through the US-China Business Council, a dialogue with them on these technical issues. And I would say that they're pretty good. They recognize that Chinese banks need to serve both Chinese and foreign clients outside of China. And that therefore that data flow needs to be pretty efficient. So I'm not as worried about the Central Bank of China. I am worried about the Cyber Administration of China. And the Public Security Bureau of China, which does the infrastructure security.

Craig: So multiple regulators looking at different parts of the information flow, and on the Chinese side, there's very little coherence to the regulatory structure, which is giving my members and all multinational corporations a lot of headaches. But this is rapidly developing. And my goal is to keep up a dialogue to ensure that the Chinese regulators don't inadvertently stamp out effective multinational corporation internal information flows. They don't want to do that, but they want to have adequate protections, which we completely understand. So drawing that line between adequate protection and not impeding the free flow of information, not compromising PII, not compromising corporate encryption, and not compromising corporate systems is the objective that we are reaching for.

Rafe: When you, I'm glad you brought up regulatory because when you look at US companies, and other kind of western companies, in China over the last 20 so years, over the last maybe five years, there was already somewhat of a move out of that country because labor costs were going up. There were some of these regulatory issues. The trade war seems to have really catalyzed that and accelerated some of that move out of China. And I guess it makes me wonder, do the Chinese from a government perspective, the regulators, do they actually want western companies there?

Craig: Yeah.

Rafe: And if so, do they want to alter their regulatory regime to make it as appealing as possible?

Craig: Right. So I think your question is very well formed and very good. And I would say that the situation in Beijing mirrors, pretty closely, the situation in Washington. And that is that there are various factions, some of whom are more protectionist, some of whom are more free trade. And China and the United States also mirror each other, in terms of if you go down to talk to any American governor or Chinese governor, or any American mayor or Chinese mayor, they are all in on welcoming foreign investment, but the Capitol is a little bit more concerned, particularly about the national security side.

Craig: So I think that the numbers suggest that American companies are doing well in China and that most of them are expanding their footprint on China in a general sense. It is true that China is no longer a labor intensive market, a labor intensive market for cheap labor intensive manufacturing. And it is true that a lot of apparel, and textiles, luggage, sporting goods, footwear, plastic, simple electronics that are produced in a labor intensive manner are moving out of China. And that is largely as a result of demographics. That is the Chinese workforce is declining, and the numbers of rural to urban migrants is declining, and it is also associated with demographics due to cost. The average hourly cost of simple Chinese labor, factory labor, would be $8 to $10, and that's much more expensive than elsewhere in Asia. But I would say that the loss of labor intensive manufacturing is more than compensated by increases of foreign direct investment in services, heavy industrials, financial definitely, and Agra business.

Craig: So there are natural secular shifts here underway, which are healthy and good, and increased investment in many, many industries. Now as I had indicated earlier, the question mark is really over high technology. And is there a good strong sustainable future for American high technology companies in China? And likewise, is there a good strong secure future for Chinese high technology companies in the United States? And I think that the answer to that is kind of, it depends.

Craig: Both countries are reconsidering the bilateral relationship. And both countries are trying to reduce dependencies in areas where they feel that their national security might be affected. And in particular, we should focus on telecom. The Huawei case is extremely interesting. And the Chinese similarly are focused on telecom, data, internet, control over the information space, semiconductors, and other areas. So overall, I would say it's a pretty bright picture. 97% of my companies were profitable in China last year. Most of them said that they were doubling down in their investment, but at the same time a good number have said that they're very concerned about the future. And I think that that adequately, or accurately, describes where the bulk of American companies are with regard to their investments in China. Depending on the sector, most are doubling down. The exceptions to that may be in the labor intensive and the high technology industries. Everything else is go, go, go.

Jack: Craig, could you put me in the shoes of one of your members who's trying to figure out how to deal with 25% increases in their import costs and trying to manage around that. What's sort of the range of options at my disposal? Which do you see exercised most? Is it the exclusions from the tariffs, and petitioning Washington to just get out from underneath these new costs? Or is it something else? What's sort of the preponderance that you're seeing?

Craig: Well, most, so it's a complicated melange of responses. And I think that Tolstoy was right when he said, "Every unhappy family is unhappy in their own unique way." And I think that that perfectly describes the American and Chinese companies that are caught up in the tariffs. They all have very unique special situations and different pain points. So, and to a certain extent we could quantify this, that trade between the United States and China, going both ways, is down about 20%. Investment is also down. But, for the most part, that reduction of trade by 20% is also accompanied by trade with other trading partners up a commensurate amount.

Craig: So supply chains are flexible, remarkably flexible. The market works here, pretty well. So many Chinese companies, that have been exporting to the United States, have been willing to invest in Mexico, Thailand, Malaysia, Vietnam, to continue their relationships with their American suppliers. Many American companies also increased investments outside of the United States, so as to supply Chinese clients. So the sad fact, the sad macro economic impact of the tariffs has been a disinvestment in manufacturing in both countries. Exactly the opposite of what had been intended. That is to protect American manufacturing.

Rafe: Well, Craig, the other thing that we hear quite a bit here though is that the Chinese consumer has kind of pivoted into a more kind of patriotic buying stance and maybe is stiff arming some western, or at least some American, merchandise, classically branded American merchandise. And I guess I'm wondering how agile that cohort is. I mean, can they turn back around and start to love American merchandise again or is this kind of a permanent shift we're seeing here?

Craig: So we're hearing contradictory information on this. According to surveys, Chinese are becoming much more patriotic. But according to trade data, we don't see that in the data. So what we are seeing is that Chinese consumers are telling surveyors that they are becoming more patriotic, as they munch away at their McDonald's or Kentucky Fried Chicken, or at their Starbucks. Now perhaps they don't realize that those brands may be American. Or perhaps they're telling the surveyors what they think the surveyors want to hear. But at least heretofore, we do not see data that supports the idea that Chinese have become more patriotic.

Craig: Now, that's not true across the board. It is true that some American companies have been told not to bid on government projects, government procurement if you will. And so there are cases where American companies had been excluded by risk adverse Chinese bureaucrats, but we don't see that in the consumer data yet. But let us be humble. And recognize that nationalism, among the 20% of the the global population that proudly calls themselves Chinese, is potentially a very, very large global force. And we do not wish to stir up anti-American Chinese nationalist response at all, and we should be careful not to do so.

Jack: Whenever there is discussions, Craig, about what things might look like on the other side of this dispute, the word enforcement is always front and center. How do you think about how whatever promises might be made in the months, and even years, to come can be enforced? What that means to the US and what that means to China?

Craig: Well, that's a very important question and it's one that the two negotiating teams have spent a lot of time on. What we understand is that a new enforcement mechanism will be put into place that will involve, on a relatively frequent basis, deputy assistant secretary, or director general level going up to under secretary level, going up to the secretary level, and then ultimately with additional sanctions that can be put in place if agreements are not made. So a great deal of thought has gone into this. I suspect that the enforcement mechanism, as you would have it outside of the WTO and in any bilateral arrangement, is going to be somewhat bureaucratic, somewhat value laden, and somewhat unpredictable. I think that we're going to miss the days when we could take things to the WTO, and have a independent, neutral arbitrator help us to resolve disputes. Because the US and China are mighty giants, both of us, and neither one takes well to perceived threats or to perceived injury. And neither one is going to sit back if they feel that they are being unfairly disadvantaged.

Rafe: Clash of the Titans. Well, thank you, Craig Allen, president of the US-China Business Council, for joining us on our inaugural episode of Double Take, the Mellon podcast. Thanks so much.

Craig: My great pleasure. Thank you.

Disclosure

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