Critical Issues Confronting China: Trade War and China’s New Phase of Development

Fan Gang, Chinese Academy of Social Sciences

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When Fan Gang was a visiting scholar at Harvard University during 1985–87, bilateral trade between the U.S. and China was so minuscule that it did not warrant any meaningful research at the National Bureau of Economic Research (NBER) based in Cambridge. No one would have imagined that bilateral trade relations would flourish so much in the following three decades that significant trade-related disputes today threaten the trajectory of arguably the most important bilateral relationship in the world. Fan is currently a professor at the Graduate School of Chinese Academy of Social Sciences (CASS) and the Peking University HSBC Business School, and the Director of China’s National Economic Research Institute (NERI).

On the one hand, Fan is astonished at this dramatic growth of economic relations; on the other hand, he is somber about the daunting challenges confronting this bilateral relationship, which includes the remarkable unison among American politicians across party lines on China issues, in a sharp contrast with the typically fractious U.S. political arena. Nonetheless, Fan believed that the trade war could serve as a wake-up call for the Chinese, taking them out of their complacency about their past achievements, and instead, forging tough reforms in a more open environment, which would have a positive impact on China.

Fan first framed this trade war from the perspective of China’s economic development. According to Fan, China’s spectacular economic success over the past four decades is the biggest catch-up story among all development experiences of latecomer countries. He considered that Japan’s real successful catch-up-phase was in the Meiji Restoration period in the second half of the 19th century rather than the 1950s–70s when it “re-emerged” from the shambles of World War II.

Fan thought China’s catch-up experience was no different from any other latecomer’s experience. Developing countries generally do not have the necessary human capital due to inadequate education and skills, physical capital, productive technology and effective institutions for economic growth. Their only advantage lies in their cheap labor. The initial phase of their development therefore takes advantage of cheap labor. If they want to go further, they have to learn from the outside and be able to imitate others, since they lack innovation capacity.
themselves. As they engage in international trade and attract foreign direct investment (FDI), they then establish a knowledge network, accumulate know-how information in their human capital, and enjoy positive spillover effects through a variety of exchanges. Eventually, they reach a stage of being able to create new knowledge, or new technology, from the existing knowledge they have acquired over the years.

Once they reach this stage of development, protection of intellectual property rights (IPR) becomes an issue. Concerning China’s alleged “technology theft” or “forced technology transfer,” Fan underscored three issues. First, a large amount of basic science and technology is in the public domain, available for anyone willing to pore over it. “Stealing” is not an issue in this area. Second, he rebutted the accusation of China's forcing technology transfers through joint ventures with foreign companies. He insisted that the exchange of foreign technology for foreign companies’ entry into Chinese markets has been completely voluntary. Foreign companies agreed to do so “for their own business calculations.” Third, China has considerably improved its protection of IPR because it needs to motivate its own people to innovate. Although all latecomers “copy” or “steal” technologies from advanced countries to various degrees, China is too large to rely on this furtive approach. Now that China pays about $30 billion per year for the use of foreign patents alone, it must be more innovative. Therefore, it is in China’s interest to protect IPR.

From this point of view, Fan maintained that the current trade war and tightened export control of high-tech exports to China can be beneficial, as it forces China to do the inevitable hard work in fundamental research and development, and to become serious about its technological gap with advanced countries. More importantly for Fan, though, is that this external pressure necessitates reinvigorated domestic reforms. Recent examples include abolishing foreign ownership ceilings in the automobile industry and the financial services sector. In his opening speech at the Shanghai International Import Fair two days before Fan’s presentation, President Xi reiterated China’s commitment to free trade and global multilateralism by further opening China’s markets, reducing trade barriers, taking into account its competitors’ interests, and striving for win-win cooperations.

Fan then compared today’s trade war with that of the 1930s, when the Smoot-Hawley Tariff Act of 1930 went into effect, which not only shrank the trade volume and the GDP of all the countries involved, worsening the Great Depression, but also contributed to the outbreak of World War II. While trade wars can often result in lose-lose situations, Fan identified three differences of today’s situation from the past. First, today’s highly integrated global supply chain did not exist in the 1930s. In this global supply chain, China has only a very small profit share. Apple’s iPhone illustrates this point. China’s value-added portion in the final sale price of the
iPhone is less than 10 percent, while most of the profit goes to the U.S., Japan, South Korea, and other advanced countries. Those countries with much bigger profit shares than China have more at stake in the trade war.

Second, some characteristics of the global market have changed. China’s exports to the U.S. only amount to 17 percent of its total exports, whereas its exports to Europe and other emerging markets are 19 percent and 50 percent respectively. Third, China’s domestic market is very large and deep; furthermore, it has the most comprehensive industrial capabilities since its industry spectrum covers more than 200 industries. Thus, China has quite a bit of room to maneuver in any trade war and to ameliorate its impacts.

In conclusion, Fan underlined the importance for developing countries to open up because only then can they benefit from the international order represented by the WTO, which has special provisions for developing countries. He believed that it is much more important for China to now focus on doing the right things at home, namely further reforms and opening up, rather than crafting a “tit for tat” retaliation plan. Only in this way can China become more competitive globally and more prosperous domestically.