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Overlooked Strategies for Surviving the US-China Trade War

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The trade war between the US and China has escalated to a point far beyond the expectations of many. In what started as volleys of tariffs and a WTO complaint against China's "forced" technology transfer policies, now involves expanded export controls, inbound investment restrictions, restrictions on labor mobility, an FBI task force on economic espionage from China, visa limitations, and an embargo (albeit a temporarily relaxed one at the time of writing this article) against Huawei, a leading Chinese telecom firm. The supply chain disruptions from the trade war are immense.¹ And Western firms are increasingly fearful of regulatory reprisals in China.² While reconfiguration of manufacturing supply chains involving China has been on the forefront of many managers' responses to the trade dispute,³ currently available advice is sometimes ill-informed about how to best do so. Further, intellectual property (IP), innovation, and non-market strategies – some of which also involve reconfiguring supply chains, others which are distinct – are less discussed but critical for many firms to survive the tensions.

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Reconfiguring manufacturing supply chains the right way

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Trump tariffs, are fraught with risks. In some cases, it may be possible to reduce US tariffs to zero if a firm's goods undergo a sufficiently high level of manufacturing or **other transformation** in a country that enjoys duty-free treatment under a free trade agreement or other preferential arrangement with the US. However, in order for products to be eligible for US non-punitive "most favoured nation" tariffs, firms will usually need to perform a **"substantial transformation"** of their product components in a country outside of China and prove the country of origin of such transformation. Separate rules regarding the country of origin may also apply if the product is subject to antidumping or countervailing duties. Additionally, US export control laws have separate rules regarding incorporation of US technology into foreign-manufactured products.

Under long-standing case law, a product is "substantially transformed" if it obtains a new "name, character or use" in that third country. Generally speaking, mere assembly or packaging is not enough to achieve substantial transformation, and each country may have its own country of origin rules governing such transformation. In other words, if a company thinks it can install the last screw in an electronic device in Vietnam and thereby avoid US tariffs on Chinese goods, it is misguided. Much more substantial forms of manufacturing need to take place. If the country of origin is misrepresented to US Customs, US law provides for a range of penalties, including significant rewards to whistleblowers who report on fraudulent behaviour.

Intellectual property strategies

Restructuring IP transactions

IP rights are among the least expensive assets to reposition to reduce US duty rates owed to the trade war. This repositioning can be achieved in one of two ways.

First, firms may relocate their IP rights in a new country of manufacture. In certain cases, IP rights could help "transform" the manufactured goods sufficiently to qualify corresponding goods as originating from that country. Before undertaking any significant change of a supply chain, guidance should be obtained from US Customs.

Similarly, strategies for sourcing and integrating computer software, including that protected by IP rights, into products can alter the country of origin or US customs' duty valuation of those products. For example, embedding software into computer memory in a device in a country outside of China may be sufficient to transform that device from a memory device into a product having a new "name, character or use", such as a device to perform certain functions in a computer, and therefore able to avoid new US customs duties. In addition, if the software is not "sold" with the medium in which it is embedded rather the

customer is only granted a right to use the software, the value of the software may not be factored into the US customs' duty valuation of the product.

If relocating IP rights and production outside of China is not feasible, a second strategy is to restructure payments for IP rights to reduce the customs valuation of the goods when imported into the US. Companies that import goods from unrelated parties in China usually pay duties based on the “**transaction value**” or price actually paid for the imported goods. This transaction value can be adjusted to account for the licensing fees and royalties from the IP rights that the manufacturer of the products needs to pay, which is called a Customs “assist.”

One way to reduce the amount of “assists” is to pay license fees directly to third party licensors rather than have the manufacturer incorporate the license and royalty fees into the costs of goods sold to an importer.⁴ Importers can obtain guidance from Customs on valuation of their goods or contact their Customs broker for suggestions on additional strategies.

Based on current information, if a firm's imported products originate from China and are on the 25% tariff list of the Trump Administration without any exclusion from relief, they will be subject to duties of 25% as will their corresponding royalties.⁵ As of September 1st 2019, an additional round of products is expected to be subject to 10% duties.⁶ Of course these duties may change.

Leveraging China's improved IP regime

In 2019, a significant number of legal reforms – largely due to the trade war – were made to China's IP regime that make it less risky for Western firms to license to China, collaborate with Chinese partners, and otherwise engage in IP-intensive operations in the country.⁷ However, these important reforms have received insufficient attention in multinationals' strategizing for the Chinese market.

In March 2019, China's Foreign Investment Law was revised to explicitly prohibit “forced technology transfer” (FTT) policies and establish penalties for government officials involved in misappropriating foreign trade secrets. Also in March 2019, the Chinese government abolished controversial provisions governing the import and export of technology as well as controversial technology-related provisions governing Sino-foreign equity joint ventures. In April 2019, the Administrative Licensing Law was revised to prohibit the state from making technology transfer a prerequisite for granting business licenses in China.

These reforms join a wide range of others in 2018 and 2019 that transform China's IP regime into a less risky institution for Western firms. Foreign ownership restrictions were removed

on new energy vehicle (NEV) operations in China as of 2018, reducing the significant risks caused by a 2017 FTT policy requiring transfer of three core technologies to foreign-Sino JVs as a precondition for foreign firms to produce NEVs in China. In January 2019, a long-awaited national-level specialised IP appellate tribunal was established in China's Supreme People's Court to provide greater uniformity in adjudication of technology-oriented IP disputes. This tribunal, which is similar to the US Court of Appeals for the Federal Circuit,⁸ joins recently established specialised IP courts in China that hear cross-regional appeals and therefore help correct local protectionist tendencies. In April 2019, both the trademark law and the law governing trade secret misappropriation and other types of unfair competition were strengthened. Numerous other improvements have recently been made to China's IP regime.⁹

Unfortunately, improvements in China's IP regime have ironically come at a time when supply chains are being disrupted and the US is making it more difficult to engage in technology collaboration with China. Nevertheless, Western firms should capitalize on the recent IP reforms in China – looking past many of the criticisms about China's IP regime that initially fueled the trade war – with corporate-level-driven adjustments to their technology and IP management strategies. For example, foreign licensors can now more easily transfer their technologies to unrelated parties in China. US trade data reflects this change: unrelated party transactions now dominate US-origin technology transfer to China. More generally, the recent IP reforms in China make conducting IP-intensive operations and enforcing IP rights in China less risky for multinationals.

Some US firms and government officials have assumed that pushing for even more reforms to China's IP regime will bring even greater benefits. Indeed, other reforms would be helpful to further reduce risks of innovating in China.¹⁰ However, paradoxically, further ratcheting up the current trade war in an effort to squeeze even more IP reforms from the Chinese government may lessen the willingness of the authorities to actually effectively implement the important reforms that have already been made. This would be a lost opportunity for Western firms.

Navigating technology export controls

Firms investing in the US will need to find smart ways to maintain business continuity in the face of a more powerful Committee on Foreign Investment in the United States (CFIUS) and an expansion of US export controls, which can block mergers and acquisitions involving Chinese firms or technology transfers involving vaguely-defined “foundational”, “critical” or “emerging” technologies.¹¹ There are also export restrictions aimed at Chinese firms and a recent ban (albeit one temporarily relaxed at the time of writing this article) on selling semiconductor chips and software to Huawei in particular.

Varied IP and R&D responses are needed to address these challenges. As export control laws generally do not cover publicly-disclosed documents such as published patents,¹² firms should often still be able to license their US-derived patented technology to related or unrelated parties in China in the face of a more rigorous export control environment. Nonetheless, additional care may be necessary when licensing to Huawei and certain other companies placed on the **US “entity list”**, which can set restrictions potentially involving patents, such as participation in technical standards-setting bodies. At the same time, R&D-intensive US companies that patent in China and elsewhere may face additional challenges from US export controls if US-derived proprietary technology is involved. Companies will need to closely monitor changes in US and other countries’ export control regimes to see if their R&D programs will be subject to further regulation, if more liberal export control requirements are available for R&D activities conducted outside the US, and if company procedures for obtaining approval to file patents resulting from such R&D overseas need to be altered. Some firms, such as Oracle, have already had to significantly alter operations in China in light of some of these challenges.

Innovation strategies

From one perspective, Western firms and research organisations have seemingly benefited from the trade war effectively blocking innovative Chinese competitors out of the US market. However, despite these near-term advantages, **Western firms must realize that Chinese innovation cannot be contained in the long-run.** In fact, Chinese firms are already innovating in a range of industries and will become even more competitive in the future.¹³ For example, Tencent and Baidu are innovating in Internet business models, Haier is highly competitive in innovative consumer goods/white goods, DJI is engineering excellent drones, Huawei and Xiaomi are producing high-quality and affordable telecommunications equipment, Huawei is a leader in 5G standards setting, Alibaba is offering popular and inexpensive cloud data services, BYD is making competitive NEVs, BGI is advancing in genome sequencing, and Cloudwalk is developing advanced artificial intelligence facial recognition technology. Many of China’s innovative companies achieve startling growth targets by leveraging the rapid growth of the local market, incredible scalability and lightning-fast time-to-market, improving local IP protection, and government support and some local regulatory barriers against foreign competition.

Additionally, even if the trade war further fragments global markets, it will not prevent Chinese firms from being both domestically and internationally competitive.

Even in industries built upon decades of Western talent and research, where Western firms have sizeable experience curves and lead-time advantages, Chinese firms are making headway. For example, HiSilicon, owned by Huawei, is making competitive smartphone semiconductor chips, and Cambricon and Horizon Robotics are making competitive artificial intelligence (AI) chips. Further, despite the trade war, there will be considerable temptation for Western firms to collaborate with increasingly capable Chinese firms and

research organisations to advance next-generation technologies that no one dominates at present – ranging from various applications of AI to new energy vehicles.

Additionally, even if the trade war further fragments global markets, it will not prevent Chinese firms from being both domestically and internationally competitive. Chinese firms will inevitably leverage their growing presence not just in China but in other emerging markets, which account for almost two-thirds of world economic growth and more than half of new consumption over the last fifteen years.¹⁴ And China’s Belt and Road Initiative (One Belt, One Road) might help secure these important sources of future demand.¹⁵

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Further, the trade war has already emboldened a heightened sense of nationalism in the form of a feverish quest for technological “self-reliance” in China.¹⁶ This neo-techno-nationalism appears to be contributing to faster mobilisation of state and private resources that might enable Chinese firms to catch up to foreign counterparts in a range of industries, both emerging and more mature. Huawei, for example, is relying more extensively on its own CPU and modem for its cell phone sales in China and has recently launched its own operating system, named “Harmony”, for its cell phones.

Western firms need to respond not by remaining technologically complacent behind the protectionist barriers established during the trade war. Instead, to compete in the long-run they must ramp up investment in R&D, and trim down internal organisational barriers slowing time-to-market of new products and services, allowing quick and powerful responses to a more complex regulatory environment as well as to nimble, innovative, and increasingly global Chinese competitors.

Non-market strategies

Surprisingly restrained beforehand, official state propaganda and Chinese social media has turned uglier in 2019 as a result of the trade war. Anti-US pledges have arisen on the Internet and other Chinese media outlets to “fight” against US “bullying” by boycotting American products.¹⁷ Chinese outbound tourists, a massive source of revenue for some foreign firms, might increasingly focus their cash on “more welcoming nations” than the US.¹⁸ And the growing trend of skilled Chinese workers preferring to work for Chinese rather than foreign firms may very well quicken with the added incentive of increased US investigations into Chinese economic espionage. Although it is unclear if these burgeoning trends will be more serious in the future, to be safe, Western multinationals need to respond with smart non-market strategies.

European firms might capitalise on decreases of Chinese tourism to the US by ramping up marketing for European destinations.

Firms should engage directly with the US government and via US industry associations to ask for a more measured approach and resolution to the trade war. Some firms have already adopted this strategy: in May 2019, 173 Western firms together wrote to President Trump arguing that “It is time to bring this trade war to an end”.¹⁹

In the Chinese market, strategies should be adopted to present the best face possible to the Chinese government, suppliers, alliance partners, and household consumers. Western firms’ messaging, both via trade associations and on social media (e.g., Weibo and WeChat), may wish to strategically establish a measured distance from the US governments’ and some US firms’ more heavy-handed tactics. Corporate social responsibility (CSR) activities across China could also be ramped up in the instance that the trade war increases perceptions that Westerners at large are becoming aggressors towards China.

Surviving the trade war

While redrawing manufacturing supply chains has been on the forefront of many managers’ responses to the US-China trade tensions, effectively doing so is more complicated than many believe. Further, smart intellectual property, innovation, and non-market strategies are also critical to weathering the long-term battle that appears to be at hand. Some of these strategies may also be useful to firms facing other trade wars in the future – a probable prospect in an era of rising neo-populism and protectionism.²⁰