How the Ceramics Industry will be affected by the US-China Trade War

(Reprinted from April's Edition of Ceramics Industry Magazine)

By Stanley Chao

April 17, 2019

The ceramic industry, largely considered one of China's key market segments, will face some formidable challenges in coming months as Presidents Trump and Xi Jingping work out a trade deal. Trump's demands on China to buy more American-made goods, stop forced intellectual property transfer, and curtail subsidies to Chinese companies have left Western ceramic companies asking themselves, "Should we invest in China? Will we finally have intellectual property (IP) protection in China? Will our China product and equipment costs go up?"

Let's take a look into my crystal ball and make some short and long-term predictions on the where the China-US relationship is heading and how Western ceramics companies should hedge their bets in China.

Short-term

China will do its best to appease Trump in the form purchasing more US soybeans, autos, crude oil, semiconductors and liquid nitration, but won't give in on the tougher, structural reforms like intellectual property enforcement, currency manipulation and the artificial propping-up of state-owned enterprises.

We'll see some loosening-up on some of China's industries like auto, credit card, banking and insurance. For examples, China has allowed Tesla to operate in China as the first fully-owned foreign auto company as well as allowing American Express to be the first foreign credit card company to perform local China currency transactions. At first glance, these sound like substantial gift-offerings. In reality however, these are nothing more than a cheap gimmick seeing that both the auto and credit card industries are already dominated by Chinese companies that don't fear any new foreign players.

China's premiere credit card company, Union Pay, has over 90% market share in China so won't sweat when American Express enters China. After all, the American credit card company will only be fighting for scraps; the last 10% share of China's credit card market. But China knows that these brand names create headlines and make Trump look good and appear to be the winner in this trade war. In the coming months, we'll see China grant operating licenses to more big names like Pay Pal, Visa, Mastercard, and Prudential Financial.

So will Trump and the US ever resolve the tougher, structural reforms that affect the ceramic industry? Can a foreign semiconductor packaging company operate in China without fear of its

IP stolen? Will China force a Western ceramic raw materials supplier to form a minority-owned joint venture? Unfortunately, these and many other issues will get kicked down the road.

Trump, in his quest for political wins ahead of the 2020 presidential elections, will gladly accept the increased promises of exports, declare victory and defer the bigger issues to a later date. The China problems will officially be closed. And China, once more, will be off the hook while waiting and hoping on pins and needles that Trump doesn't win a reelection so it once again can go back to the "same old, same old" ways of doing business with the West.

Bureaucratic Harassment

Trump caught China at the right time. Its economy has slowed, unemployment risen, and consumer spending softened forcing President Xi to give in to Trump's rhetoric and demands. This appeasement, however, won't last for long. Ever since China was colonized by Western countries in the 19 century, China's leaders have vowed never again to kow tow to "foreign devils." The payback is coming.

US Secretary of State Wilbur Ross said in an interview in 2018 that China was "running out of bullets," meaning that China could only tax $100B worth of US imports versus the over $500B the US exports from China, thereby giving Trump $400B more in bullets to play with. Mr. Ross, however, forgot how entrenched and embedded American companies are invested in China.

Take Starbucks as an example. China is Starbuck's second largest market after the US with over 3,000 stores, and will double the number by 2023. Similarly, KFC, Nike, Coca-Cola, Kimberly-Clark and Disney all have sizeable revenue streams coming from China. And when you add all the industrial names like Caterpillar, Deer, Boeing, Ford and General Electric into the mix, the US interests in China may be well in the hundreds of billions of dollars. Sorry Wilbur. China has way more ammo than the US.

China can retaliate in many ways but most of it will come in the form of what I term bureaucratic harassment. One of my clients, a Maine lobster fisherman, lost a $20,000 shipment of lobsters as Chinese customs "accidently" left the highly priced cargo sit outside on a hot, steamy August day in Shanghai. The fisherman lamented, "This is a first for me in over ten years of working with the Chinese. I don't know what to call it, an accident, revenge for Trump?"

The harassment won't come until Trump is out of office and a more conventional and predicable president presides. We'll see hundreds of Starbucks, McDonalds and Walmart stores closed for "health-related" reasons. Some US fortune 1000 executives may unexpectedly be detained for a few weeks on their next China business trip. Your ceramic products and materials headed to China may be lost or delayed in Chinese customs. Whatever the form, the harassment will be a show of force and a warning to the world that China is not to be taken lightly.

Huawei's Effect on the Ceramic Industry

China claims that the US is on an all-out smear campaign against Huawei, a supplier of telecommunications equipment and 5G networks. It's rumored that Trump may soon sign an executive ordering banning all US companies from using Huawei telecommunications equipment. This is on top of his directive that no US agency should use Huawei and the recent order to arrest Meng Wanzhou, its chief executive financial officer, for allegedly violating US sanctions on Iran.

Trump routinely abuses Huawei in public claiming that the company is nothing more than a spy machine for the Chinese government. But is Trump going too far when he demands that other countries- the UK, Germany, Poland, India and the Czech Republic- restrict Huawei's participation in their next-generation 5G network? China certainly thinks so.

Huawei is China's high-tech darling. Besides possibly Alibaba, Huawei is the most famous Chinese company in the world and is China's torch bearer representing innovation, entrepreneurship and all the goodwill that Chinese communism has to offer. Of all the things that Trump has done and said against China, a potential world-wide ban of Huawei would be considered the most egregious in President Xi's eyes.

China sees Trump's actions as an outright, blatant discriminatory act against a privately-owned Chinese company just trying to offer good products at good prices. You're now messing with a company's inalienable right to exist in the world, to sell its product freely and allowing consumers to decide on their own who to buy from.

If Trump's rhetoric continues and worse, if he succeeds in convincing other countries not to use Huawei, this could easily turn China's relatively harmless harassments into a full-blown economic cold war, which could negatively impact foreign ceramic companies doing business in China.

In a tit for tat strategy, China could ban Chinese firms, consumers and universities from using US technologies. For example, Comac, China's state-owned enterprise responsible for developing China's first commercial aircraft, could be prohibited from using US-made composite materials or ceramics in its fuselage design, brakes, seals, glass windshields or LED displays. The same could apply to the other many industries- semiconductor, construction, household appliances, and automotive- that rely heavily on foreign ceramic components and technologies.

Still Worth Investing in China?

I just detailed a lot of seemingly doom and gloom for foreign companies in China. Not so fast. Remember the Tiananmen Square riots in 1989 when Chinese paramilitary police killed Chinese students while protesting against China's Communist party? Soon after, hundreds of foreign companies bailed out of China, and political pundits declared that China would go back to the dark days of the Cultural Revolution. Fast forward to today and the companies that toughed it out are doing better than ever selling to a middle-class population of 400 million with a booming economy growing at plus 6%.

Similarly, the Sino-US tariff war and all the aftermath are only short-term blips that will, like Trump's presidency, come and go. Remember, China has always been a long-term play, not a place to make a quick buck and run. Companies must be in China for the long-haul. This doesn't mean, however, that you blindly stick with your original strategy. On the contrary, China is constantly changing so make tweaks here there to match the geo-political and economic climates.

Two Regional Trading Zones

As an example, this tariff war along with some of China's new economic initiatives is changing the dynamics of why foreign companies should go to China.

Twenty years ago, we went to China to outsource. Ten years ago, we went to China to sell to its 1.3 billion consumers. Today, companies need to be in China to not only serve the domestic market, but to sell to the other half of the world as China commences on its One Belt One Road initiative and building highways, ports, rail lines, and other infrastructure to economically link over 70 countries throughout Africa, the Middle East, Asia and Eastern Europe.

This new, modernized Silk Road will create two regional trading zones. One zone will link China as the hub to all of Africa and Eastern Europe, the Middle East, and a mixed bag of countries in South America and Asia. This new sphere of influence will now encompass 65% of the world's population and 35% of the world's GDP. The US will serve as the center of the other regional trading alliance along with Canada and Mexico, most of South America, Western Europe, and pro-US Asian countries.

Who ever thought that your China operations would also be servicing such countries as Indonesia, Pakistan or Rwanda?

Anti-US Sentiment

For Chinese consumers "Made in USA" is synonymous to "high quality", but that could change if Trump's rhetoric continues which means US imports to China could suffer. Chinese media outlets are continually asking its citizens, "Why should we buy American products and brands if Trump and Americans disdain us so much?"

I have already witnessed this anecdotally as I interviewed Chinese consumers outside a Starbucks in Beijing. One businessman told me, “I’m not going to spend my money on an American company that doesn’t like me or says bad things about my country! I’ll buy a cup of coffee from a local Chinese shop.”

This anti-US sentiment furthers the idea that foreign companies need to be in China. They need to manufacture locally in China, develop new products locally, hire local employees, have a local Chinese brand name, and ultimately, look and feel like a Chinese company.

The days of exporting to China or finding a distributor won’t fly anymore. To do business in China means one must be fully embedded and engaged in China. As one Fortune 100 C-level executive told me, “We are totally re-thinking China. We can’t just serve China from abroad. It needs its own headquarters.”

Ceramics and IP

Thought I don’t expect China to make any of the Trump-requested structural changes in the immediate future, they should implement some reforms in the next 5 years which will benefit the ceramics industry.

The Chinese see ceramics playing a supporting role in providing components and sub-systems to such key industries as aviation, robotics, consumer electronics and automotive, thus granting foreign ceramic companies more leeway to operate more freely in China. Foreign players may be allowed to operate in China as wholly-owned foreign subsidiaries without having to form joint ventures.

In the race to be first to market, Chinese OEMs (Original Equipment Manufacturers) will simply purchase foreign ceramic components without asking for the detailed blueprints or IP associated with the components. In the past, Chinese and foreign companies have squabbled over what IP need to be handed over which took many months and sometimes years to resolve.

Finally, to enhance China’s Made in China 2025 initiative, a plan to develop homegrown manufacturing technologies, many of China’s science and industrial parks may offer tax incentives and low rents and utilities to ceramic companies. Many municipalities are doing this to induce entrepreneurship, local employment and tax income.

Conclusion

The ceramics industry, in particular will have many opportunities in China as the country embarks in its Made in China 2025 and One Belt One Road initiatives. In addition, ceramics could be one of the first industries to take advantage of the structural changes that China must make to attract the world’s greatest technologies.

There will still be some hiccups along the way, but don’t let these knee-jerk reactions affect your longer-term plans. Plan accordingly: Look for your company to “act and feel” more Chinese, increase your China’s manufacturing presence, and prepare to sell to a new emerging regional trading zone led by China.