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**Abstract**: It was probably a combination of the objective of a constructive response to external headwind from the United States (US) and to some extent also from the European Union (EU) as concerns China's investment and trade policies on the one hand and the intrinsic insight that opening up the investment and trade sector in China would support its structural change on the other hand, why China in the first half of 2018 has launched a number of reform measures in inward investment and trade. These reform measures are introduced and discussed in more detail in this policy paper.

**Keywords**: China, FDI, trade, tariff, United States

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## I. Introduction

China's structural change from an export-oriented and investment-driven economy to a domestic market-oriented and innovation-driven economy is far from being completed. Excess capacities in many industrial sectors which stemmed from the massive fiscal expansion program after the 2008 crisis have not yet been removed. The "One-Belt, One Road"- Initiative is likely to become more an engine for export orientation than for domestic consumption and the exchange rate policy has not yet played its role as an instrument for a steady real appreciation of the Renminbi to increase domestic absorption. Fueled by the risks of a labor market mismatch between the skills of those losing jobs in the export industry and the skills of those required in an increasingly digitalized service industry, the government takes the immediate costs of job losses without an easy and rapid re-employment in service industries very serious. This is why it is ever more prepared to understand structural change as a long-term challenge with periods of postponement and delays rather than as a short-term straightforward strategy with "early harvest" prospects.

This cliff-hanger situation comes at a time when China faces stiff headwind from the United States (US) and to some extent also from the European Union (EU) as concerns its investment and trade policies. The US administration under Trump has launched a bundle of complaints against China comprising the alleged violation of private intellectual property rights, the forced technology transfer from foreign to Chinese companies through its joint venture requirements, massive subsidies substantiating the legitimacy of anti-dumping procedures and countervailing duties, and finally the evergreen complaint of currency manipulation towards undervaluation. To underline the seriousness of these complaints, the Trump administration in the first half of 2018 opened a tariff retaliation round against China. At the end, this round if it would escalate could comprise the entire China-US trade. As China with its trade surplus would finally have no imports from the US left to retaliate against, it could be tempted to extend retaliation to the zero-tariff service sector by canceling market access for US service providers in the Chinese market. Furthermore, the US and China could additionally use the investment sector as a battlefield by impeding the access of their investors to the partner country's market. A full trade war emerges at the horizon.

The EU as the other member of the trade policy triad (China-EU-US) is indirectly affected by the trade policy conflicts as many companies from Europe produce in the US and/or China as parts of cross-border supply chains and export to the partner country. In addition, the EU sees itself directly affected by China's reform policy since this policy includes as a core element a digitalization strategy in the manufacturing sector, called "Made in China 2025", or "smart manufacturing". To this purpose, Chinese companies are on a global shopping tour abroad to acquire digital know-how wherever it is offered on the investment market. As these companies

are widely understood by the EU and the US as actors following the objectives of the Chinese government and its strategic industrial policy, the EU Commission initiated by France and Germany has proposed to introduce a "screening" mechanism against foreign direct investment (FDI) to identify those parts of FDI which threaten domestic security interests and the control over key public infrastructure. Though Chinese companies are not explicitly mentioned as targets of the screening proposal, it goes without saying that the rapid increase of Chinese investment in EU high tech companies with a strong command on digitalization and artificial intelligence has been the trigger point of the screening initiative. Finally, both the EU and the US complain about an increasing extent of intervention of representatives of the Communist party in the daily operation of their affiliates in China.[1]

It was probably a combination of the objective of a constructive response to such external headwind on the one hand and the intrinsic insight that opening up the investment and trade sector in China would support its structural change on the other hand, why China in the first half of 2018 has launched a number of reform measures in inward investment and trade. They are introduced in more detail in the following.

## II. China Alleviates Inward FDI

### Recent Development in China's FDI Policy

On June 28, 2018 China's Ministry of Commerce (MOFCOM) and the National Development and Reform Commission (NDRC) jointly announced the newest version of the "Negative List" for Foreign Investment in China (MOFCOM and NDRC, 2018). With this new "Negative List", China further alleviates market access to foreign investors. Not only the number of restrictions and prohibitions specified in the List was reduced from 63 (2017 version) to 48 items. Also the regulations for some selected industries such as the foreign equity requirement were relaxed to some extent. The fact that China decided to shorten its "Negative List" and to expand its opening-up strategy without binding it to reciprocal steps in host countries of Chinese companies abroad, and disconnected from the parallel surge of retaliatory tariffs in both sides of China-US trade, supports the impression that China is starting to implement its promise to play a more constructive role in supporting the world economy and global governance than before.

China's decision for a new, shorter "Negative List" and for globalization may be surprising for some observers. But this decision is definitely not a spontaneous decision out of a sudden. Li Keqiang, Premier of China's State Council, already emphasized at the Council's Executive Meeting in late

[1] See, for example, Bickenbach et al., (2015) and European Commission (2013).

2016 that a new wave of opening-up towards the world economy should be initiated in China. This was further underlined and the message was further transmitted to the global community by President Xi Jinping at the World Economic Forum in early 2017. At the Boao Forum for Asia in April, 2018, he even provided a relatively concrete plan to outline how China may open up its economy, covering some key measures on liberalizing trade and investment (Xinhuanet, 2018). Considering the way how China's governance works, it is then not surprising at all that authorities of different kinds and local governments were requested to release various measures and documents to support the initiation of such a new opening-up wave that is strived for by the central government.

More concretely, the twenty policy measures which the State Council of China released in a circular (FDI Promotion Plan, in short: Plan; State Council of China, 2017) in early 2017 to promote FDI can be roughly grouped into three categories:

First, local governments are allowed to actively encourage investments by providing preferential treatment as long as the measures and the investments can foster local innovative, coordinated, environmentally-friendly ("green"), open and sharing development. In other words, the policy measures of this category aim at attracting quality investments to ensure that investments coming in can support local employment, economic development and technical innovations. In addition to preferential treatments, local governments should also keep improving the investment environments on site. Policy measures are also to be taken to provide national preferential treatment to qualified foreign firms which choose the less developed regions in China for their direct investments and/or as new locations for their business operations in the coastal area.

Second, policy measures should be implemented to further liberalize the market entry of FDI. As a result, China announced a new "Catalogue for the Guidance of Foreign Investment in Industries 2017" (MOFCOM and NDRC, 2017) and later the above mentioned new version of the "Negative List" 2018. These two key documents constitute the basic investment framework and set up the requirements for FDI in the coming years. On the one hand, FDI in high value-added, smart and "green" manufacturing, key selected business services industries, and creative industries are to be strongly encouraged. So is FDI planning to participate in key projects following the up-to-date development strategies of China such as its "Made in China 2025" strategy. On the other hand, market entry restrictions on FDI in some selected industries such as banking industry and automobile industry are to be relaxed. For example, market entry in the automobile industry is eased by various measures. According to the new "Negative List", the requirement of foreign equity ratio on FDI in manufacturing special purpose motor vehicles and new energy vehicles is removed. Such requirement on FDI in manufacturing commercial vehicles and passenger vehicles will be removed in 2020 and 2022, respectively. In 2022, the requirement that a foreign company can only found no more than two joint ventures in China to produce vehicles of the same category will be removed as well.

Third, authorities plan to improve related laws, regulations and other institutions to provide both domestic and foreign companies with a fair competition environment. Foreign companies should be treated in the same way as domestic companies (national treatment), in cases of, for example, acquisition of business permissions, capital requirement for firm registration, and participation in government procurements. Improved laws and regulations should also help protect the intellectual property rights of foreign firms in a more effective way.

**Why China's FDI Policy Matters for Its Development**

The twenty policy measures specified in the above mentioned plan of early 2017 were just a start of China's efforts in further opening up its economy to foreign investment. Following the Plan, further related measures were taken or have to be prepared by various Chinese authorities and local governments (NDRC, 2018).

Against the background of intensifying protectionism worldwide, it is to be questioned whether China should continue to open up its market to foreign investment. We are convinced that China should proceed its opening-up strategy particularly on the basis of the following arguments.

On the one hand, China's new FDI promotion plan is expected to bring positive impact on its economy in the long run mainly for two reasons:

First, the new plan opens a door to attract not just FDI per se but "quality" FDI. As indicated above, China particularly focuses on attracting quality FDI that will foster local employment, economic development and technical innovations. The goal is not to create low-skilled and low-tech jobs for its huge reservoir of workers as before, but to receive FDI that will help better utilize the increasing supply of skilled labor, support the structural change towards a sustainable and innovation-driven economy and help Chinese firms move upwards the global value chains. Considering the list of measures that countries may implement to attract and benefit from quality FDI proposed by Moran et al. (2017), China's FDI promotion plan and related policy measures construct a necessary framework that enables China to materialize the expected positive impacts of quality FDI on its long-run economic development.

Chinese firms can benefit from quality FDI by learning from the advanced know-how and accessing new technologies brought in by foreign investors. The positive FDI impact can be further spilled over to local firms which do not need to have direct investment relationships with multinational enterprises (MNEs). The rise in market competition as a result of increasing MNEs' activities in China can also force Chinese firms to continuously improve their operational efficiency and carry out innovation activities, thus enhancing their competitiveness in the long run. For maximizing such positive impacts, it is essential for China to ensure that foreign investors can be well integrated into the local economy. In other words, it would not be sufficient for China to just further expand their opening-up strategy to attract quality FDI but it should also encourage backward linkages and spillovers of different kinds from FDI to the indigenous economy. Some

potential measures in this regard are proposed by Moran et al. (2017) as well: the government of the FDI host country may consider to encourage direct assistance of foreign investors to domestic firms with respect to, for example, labor training, coaching regarding modern management practices, quality control, and financial planning. The government may also provide adequate institutional frameworks that would particularly encourage managers with abundant international experience and knowledge of technologies and management practices to found their own start-ups and ease worker movements across firms to facilitate knowledge spillover.

Second, against the background of increasing protectionist pressure on global trade and investment, China's insistence on opening up its market for FDI can only strengthen its role as a global player and even as a coming global economic leader. Moreover, FDI-friendly policies and its efforts in improving business and investment environment in China may help reduce fixed costs of FDI and MNEs' operational costs on site, respectively. This would act as a compensatory factor against the potentially increasing costs facing foreign investors in China who export their products to countries like the US which decided to raise retaliatory tariffs on some selected imported products from China. In this way, China's FDI promotion plan helps sustain its competitiveness in attracting FDI worldwide.

On the other hand, for three reasons, it is very unlikely that the new FDI promotion plan will pose immediate challenge on existing business structures and on the viability of Chinese firms:

First, although the more liberal policies towards FDI are expected to be able to allure more foreign investors to invest in China, it is very unlikely that the existing (domestic) firms will be faced with an immediately soaring competition pressure that may otherwise result in a wave of firm bankruptcy and thus will pose stability challenges on the economy and the society. Instead, the twenty policy measures specified in the Plan actually give the direction for the future development. For their realization, the authorities of different types and local governments need to develop concrete policies, rules and regulations. It would take time for the authorities to best explore their promotion foci, to consult related stakeholders and then to develop concrete policies. Since many authorities and local governments are involved in implementing concrete policies to attract and promote FDI, there is definitely a large need for coordinating related policies among ministries, local governments and various bureaus and offices. Furthermore, the coordination process is again time-consuming. After the policies are developed and implemented, it would still take time until the policies may have some real impact in practice. The new policies need to reach interested individuals and firms who first need to understand the new policies and then make their decisions for investment. Such decisions are not easily made given their long-term nature and high uncertainty. Thus, although Chinese firms are expected to face stronger competition due to new market entrants, they have time to prepare themselves for the rising competition challenge.

Second, China's FDI promotion plan does not (yet) treat all industries equally. The differentiation of industries into encouraged, permitted, restricted and prohibited industries for FDI enables China to open its industries to foreign investment stepwise with a large leverage for discretionary

actions, taking into account the development of firms' comparative advantages of the industries concerned. This again leaves time to local industries which particularly lack behind with respect to their competitiveness in the global market to invest more intensively and efficiently in related innovation and upgrading activities.

Third, China's FDI promotion plan and its related FDI-friendly policies focus on revising the formal institutions and rules facing (potential) foreign investors. How the policies can be actually carried out in practice is another challenge (Bickenbach et al., 2015). Moreover, informal institutions like social and cultural norms, traditions, codes of conduct and social networks play a substantial role for business transactions and investments in China as well (Bickenbach and Liu, 2010). Even if China moves towards relaxing its formal requirements on foreign equity ratios and on founding joint ventures between Chinese firms and foreign firms, it is very unlikely that foreign firms will decide to rapidly abandon equity participation of their former Chinese partners or will even carry out their investment projects on site without any marketing cooperation with domestic firms and suppliers in the future.[2] To pass through the still existing screening and approval procedures, and to deal with local employment, and sourcing and shipping activities, it may still be an advantage for foreign firms doing businesses in China to have Chinese partners who have the knowledge and skills in dealing with local affairs. Thus, China would not need to be afraid of a sudden, large-scale dissolution of sino-foreign partnerships that may otherwise pose huge and immediate adjustment challenges on domestic firms. That, by the way, would also weaken the case for demanding full reciprocity for Chinese firms operating in home countries of foreign investors so far under similar joint venture requirements. Policy reforms on both sides will just widen the scope of options. They should not be restricted to requirements of complete reciprocity.

## III. China Lowers Most Favored Nation (MFN) Tariffs and Simultaneously Retaliates against US Penalty Tariffs

### Recent Development in China's Tariff Policy

By July 1, 2018, China started to implement previous announcements made by President Xi Jinping to lower import tariffs on a Most-Favored Nation base (MFN) against all trading partners. For almost 1500 items, mostly consumer goods, tariffs were cut by almost 60 percent from an average level of 15.7 percent to 6.9 percent. More spectacularly, the 25 percent tariff on imported cars was cut to 15 percent, while a uniform tariff of 6 percent was fixed for car parts, down from an average of 10 percent.

[2] Against the background of the Chinese government's decision to (gradually) remove the requirements of foreign equity ratios in the automobile industry in the future, German car makers indicated in their interviews that they will continue their partnership with Chinese firms for their business operations in China (e.g., Handelsblatt, 2018).

To assess the effects of these cuts, it is needed to compare the Chinese tariff structure to that of their trading partners and other emerging countries. While Chinese tariffs are still significantly higher than those of the EU, Japan, and the US, its government imposes relatively low tariffs compared to many other developing countries. This holds particularly, if its economic size is taken into account, since large developing countries are often inward-looking and pursue import substitution strategies. India is a case in point.

**Weaknesses in China's Tariff Policy**

But the better is the enemy of the good. China's tariff policy has three weaknesses which the country should remove not only to address complaints from trading partners like the US and mitigate if not avoid trade wars but primarily in the interest of its own economic transformation.

First, unlike many other developing countries, until July 2018 China did not use the option of a unilateral tariff policy. Its so-called average applied MFN tariff on all goods of 9.9 percent is almost at the same level as its average final bound tariff of 10 percent (WTO, 2018). Compared to another large developing country, Brazil, which has a higher level of applied tariff (13.5 percent) than China but with applied tariff being much lower than its bound tariff (31.4 percent), the case of China shows that since its entry into the WTO in 2001, its tariff policy has been widely inflexible. It thus forwent the opportunity to use import tariffs to help accelerate structural change between import-competing industries and export industries and to respond to demands of trading partners without the need of a global agreement on lowering tariffs across the board. In short, adjusting tariffs below the internationally agreed upon "bound" level in both directions is a policy instrument which until July 2018 was lacking in China's policy tool box. It is to question whether unilateral tariff cuts will become a more prominent tool of China's industrial policy in the future.

Second, China's tariffs are sectorally very uneven. This indicates the high degree of selectiveness in China's tariff policy. Even after the tariff cuts in July 2018, a tariff on imported cars of 15 percent, for instance, contrasts with the uniform tariff on car parts of 6 percent. That suggests a much higher effective tariff on the value added process of assembling inputs to a complete car than it is indicated by the nominal tariff of 15 percent. As a back-on-the-envelope calculation, it can be assumed that the share of inputs in total value of a car is 70 percent, and that the input tariff and output tariff are 6 percent and 15 percent, respectively. That would result in an effective tariff on the value added process of assembling the inputs of 36 percent.

China has been a finishing touch producer. The so-called tariff escalation from intermediates to final products has led to much higher effective tariffs than the nominal level of tariffs. Such escalation has had a number of negative effects on China: (1) A distortion in factor allocation. The strongly protected assembling process has absorbed more resources from other sectors than if

tariffs on inputs and finished goods would have been equal. Such resource misallocation has impeded endeavors of the Chinese government to move China towards a balanced producer of upstream and downstream products alike with a stronger focus on raising the local content of production and on better supply for the local market. (2) An exchange rate effect towards appreciation driven by promoting the import of intermediates and impeding the export of the finished goods. No doubt, an appreciation of the Renminbi might be principally welcome to foster an inward-oriented consumption-driven economy over the old export-oriented investment-driven economy. However, this would come at a serious cost. The appreciation generates a bias against producing upstream products locally which makes China vulnerable against a politically motivated disruption of cross-border value chains. In its early stage, the recent trade policy conflict between China and the US provided a good example for such vulnerability. The US imposed a ban on ZTE, a Chinese telecommunications company, from buying US components for seven years (The Diplomat, 2018). Such components are critically needed to implement China's "Made in China 2025" strategy. (3) A technology effect. Theory suggests that protection subsidizes the least abundant factor used in the production technology. That is labor in capital-abundant countries and capital in labor-abundant countries.[3] Given that China relative to Western countries is still a labor-abundant country, this means that assembly industries in China are using more capital than it would be the case without high effective tariffs. This capital could have been more productively employed in other more upstream oriented activities. It is a resource waste and adds to all costs incurred by China due to its restricted capital account and the lack of a deep, transparent, and non-discriminatory domestic capital market. Companies operating in the protected assembly industry, many of which originate from abroad, could collect higher rates of return on their capital stock and thus excessively bind capital in the assembly processes. Viewed against the coming technological innovation in industry 4.0, it is not unlikely that without scrapping high effective tariffs in assembly processes China will encounter higher adjustment costs than necessary to manage the transition to the new era of industry 4.0. It could also impede the "Made in China 2025" strategy which strongly relies on a competitive domestic supply of "smartly manufactured" inputs which so far is not treated at a level playing field by the Chinese trade policy compared to finished goods.

The third weakness so far has been China's reluctant, not to say defensive role in the WTO which actually reiterates the "tit for tat" reciprocity syndrome of this institution. The announcement that China would be prepared to lower tariffs selectively raises the suspicion that the government just follows the old "hen and egg" approach: no concession without reciprocity. MFN tariff reductions across the board without a sectoral bias would be the strongest motivation for trading

[3] See Milner (1999) for more information.

partners to trust China in its endeavor to gain confidence from trading partners and to acquire a leadership role in the multilateral trading system.

The outcome of the escalating trade conflict initiated by the US administration is still open so far. By end-August 2018, US threats to raise the amount of US goods imports from China subject to penalty taxes from 50 billion US Dollar (in two portions being already in force of 34 billion US Dollar and 16 billion US Dollar, respectively) via 200 billion US Dollar up to the entire amount of Chinese goods exports to US (about 500 billion US Dollar) have not yet materialized. The direct effects on global GDP growth are expected to reduce growth by a fraction of a percentage point (estimatedly around 0.2 percentage points). Penalty taxes on Chinese goods exports worth of about 200 billion US Dollar to the US are also expected to contribute to rising global inflation. Indirect effects through investment foregone or turbulences on financial markets would be larger. China's retaliation would very likely also cover service trade as China could impede service imports from the US and US service companies' sales in China if the volume of Chinese goods imports from the US subject to tariffs would be insufficient to retaliate "tit for tat" through tariffs. Finally, even sales of US treasury bonds by China are discussed as a "tit for tat" response, especially if US measures against China would include a more restrictive screening of Chinese FDI in the US than in the past (see, e.g., Merler, 2018 and USTR, 2018).

## IV. Conclusion

Many of the complaints directed by the US and EU against China such as the violation of intellectual property rights, forced technology transfer caused by the requirements of the joint ventures with Chinese companies, currency manipulation or domestic subsidies with indirect effects towards export promotion should have been dealt with in the dispute settlements procedures of the WTO. The fact that this has not or only sporadically been the case suggests that WTO rules have serious loopholes and that China benefited from them at the maximum possible. As the multilateral arena so far has not proven to be effective to specify "unfair" trade practices more stringently, it is the bilateral arena only which will define the borderline between "fair" and "unfair" trade. This arena is in full operation as witnessed by permanent meetings between US, EU and Chinese trade and investment negotiating groups. It is very likely that given common positions of the US and the EU albeit separately conveyed to China, for instance in treating inward and outward FDI, China will offer proposals to better protect intellectual property rights and alleviate FDI access to the Chinese market. Yet, it is likely as well that China will seek new loopholes in international rules to achieve its strategic industrial policies. Yet, there are three developments which give rise to optimism that the escalation of conflicts can be contained. First, indirect pressure on China to comply with demands of its trading partners will come from the

insight of the Chinese government that the success of Belt and Road initiative hinges upon a positive approval by international lenders simply because China will be neither able nor willing to finance the infrastructure project entirely from its domestic resources. These lenders will expose "fairer" trade and compliance with international rules as a major prerequisite for funding. Second, the gradual decline of growth rates in China and the rise of domestic consumption rates will contribute to lower the Chinese trade surplus. Third, the strong exposure of Chinese companies in dollar-denominated debt at a time of a strong dollar has opened a source of vulnerability for China's financial stability which has not been left unnoticed by the Chinese government. An escalating trade and investment policy conflict could make this source a real threat to China's further growth momentum.

By end-August 2018, the trade policy conflict between the US and China is still in the escalation mode. But impeding mutual trade and FDI only serves as a theater stage of a far more reaching war between the two countries on technological leadership in digitalization and artificial intelligence. As this war will span over the next decade and will be fought on many battlegrounds such as investment in research and development, education policies, cultural openness to digitalized services and privacy regulations for personal data, the current trade measures initiated by the US administration and responded by the Chinese administration will be widely ineffective to decide on the outcome of the war.

Yet, the collateral damage of "tit for tat" trade policy escalation is big. Beyond its adverse implications for other trading partners suffering from the destruction of supply chains and for its negative momentum on the global business cycle, the escalation can induce the Chinese government to suspend or even cancel reform measures which were targeted to unilaterally liberalize trade and alleviate access for foreign investors. Such rollback could trigger further rollback measures from other trading partners thus launching a race to the bottom against openness for trade and investment. Early-warning signals have already been sent as seen by a more restrictive stance of the US and also the EU against investment from China. It will be a substantial challenge for both Chinese and US companies to convince their governments that the costs of such a race will seriously damage the well-being of many fellow citizens, erode their tax base and thus will undermine the governance capacity. This is not the price worth to be paid for the illusionary glory and fallacy of "my country first policy" in a world of commons.

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