Chi Time

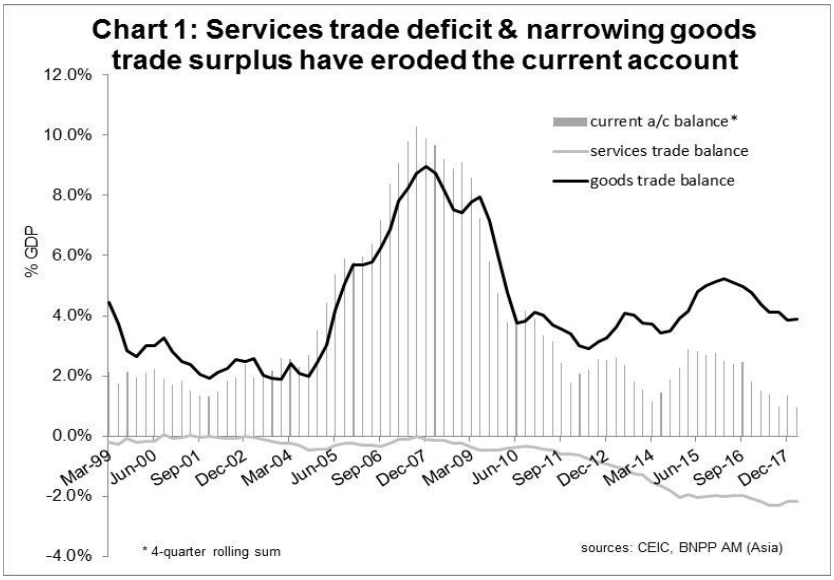
FOR PROFESSIONAL INVESTORS – 18 May 2018

CHINA'S CURRENT ACCOUNT DEFICIT AND IP THEFT

Don't worry about people stealing your ideas. If your ideas are any good, you'll have to ram them down people's throats.

Howard Aiken

China recorded the second quarterly current account deficit of –USD28.2 bn (or -0.9% GDP) in 1Q 2018. The first deficit was –USD0.9 bn in 2Q 2001. A widening services deficit was to blame (Chart 1). But a sharp rise in the amount of intellectual property (IP) fees that China paid also contributed to the deficit in 1Q. In fact, China's IP fee payments have been rising steadily over the years (Chart 2). Such a trend could be a tentative sign of stronger IP protection in China, which could help soothe the Sino-US trade tension.



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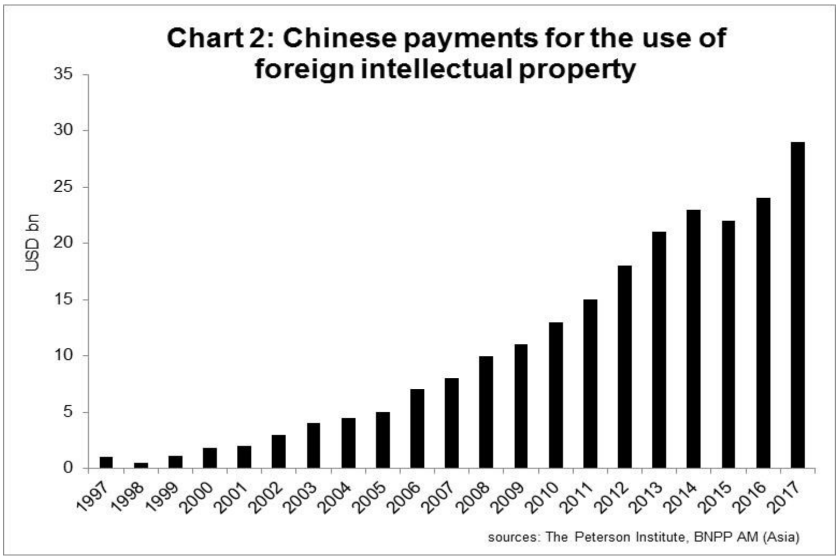

Granted, the first quarter current account deficit was partly seasonal; it should get back to a surplus in the coming quarters. But over the longer-term, as China's services deficit continues to grow and IP protection continues to improve (as reflected by the expected increase in IP fees paid) on the back of a narrowing trade surplus, *ceteris paribus*, the current account could turn into a deficit. That should not be a worrying trend though, as it will be a sign of economic maturity, which should also be conducive to internationalising the renminbi. It will also be a natural development as China moves towards the "Impossible Trinity" paradigm.

How much forced technology transfer and IP theft?

The fact that China recent current account deficit also reflects rising IP fees paid argues that the increasingly accepted narrative in the West that China acquires technology mostly through forced technology transfer from MNCs investing in China and through outright theft had exaggerated the story. Official data shows that China's payments of licensing fees and royalties for the usage of foreign technology have jumped four-fold in the last decade (see Chart 2). Furthermore, IMF data shows that China ranks fourth globally in the amount of licensing fees it paid to use foreign technology (Chart 3), even ahead of Japan, Singapore, Korea and other advanced economies.

It is important to note that licensing fees in Ireland and the Netherlands are paid mostly by foreign holding companies that are legally domiciled in these countries for tax reasons. This means that domestic Irish and Dutch payments of IP licensing fees are far less than what the headline numbers show so that China's global ranking in licensing fees paid for technology used within national borders would be even higher.

All this is not to deny to China's IP and technology-transfer mischievous behaviour. Research by the Federal Reserve Bank of Minneapolis estimated that half of the technology possessed by Chinese companies came from foreign firms[1]. However, there is no proof of the amount of theft and forced technology transfer, and it is not clear if these joint ventures (JVs) were successful at enabling Chinese firms to compete with the foreign firms all the time.

There is also evidence, in addition to our data here, showing that China is trying to strengthen its IP protection laws, as more and more foreign companies are starting to file patent-related cases in Chinese courts. Academic research[2] shows that US firms filed 10% of the patent-related lawsuits in China in the period between 2006 and 2011and won 70% of those cases. This success rate seems to refute the common belief that US (and foreign) firms could not get a successful fight in China.

The point is that one should not blindly accept the conventional wisdom that has often been twisted by sensational media headlines that affect judgement of the China risk.

Chi Lo, Senior Economist, BNPP AM

[1] Holmes, Thomas, Ellen R. McGrattan and Edward C. Prescott (2015), "*The Cost of Quid Pro Quo*", Federal Reserve Bank of Minneapolis, January 29.

[2] Love, Brian, Christian Helmers and Markus Eberhardt (2016), "*Patent Litigation in China: Protecting Rights or the Local Economy?"* Santa Clara Law Digital Commons.

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