

Banning American Parts in Chinese Mobile Phones: Economic Sanctions, Political Influence, and Trump's Trade War¹

On April 16, 2018, the U.S. Department of Commerce announced that it would ban ZTE, a Chinese telecommunications company, from purchasing parts such as micro-processing chips from U.S. companies for seven years. An earlier U.S. government investigation had found that the company had been selling telecommunications equipment to Iran and North Korea, in violation of U.S. sanctions. "ZTE made false statements to the U.S. Government when they were originally caught and put on the Entity List, made false statements during the reprieve it was given, and made false statements again during its probation," said then-Secretary of Commerce, Wilbur L. Ross.² The ban sent ZTE, which relied on many American-made components, into a tailspin. In response, the company launched an all-out campaign to fight for its survival, later even involving the presidents of both the United States and China. "The Denial order will not only severely impact the survival and development of ZTE but will also cause damages to all partners of ZTE including a large number of U.S. companies," ZTE said in a statement issued four days after the ban.³

ZTE

ZTE, the target of the ban, was headquartered in the People's Republic of China (PRC). Unlike the United States, which had a democratic political system and a free enterprise economic system, China had followed a unique model: an authoritarian one-party political system and an economic system of central state control, supplemented with private enterprises. PRC was established in October 1949, under the leadership of Chairman Mao and guided by the ideologies of Marxism and Leninism. Private enterprises had been forbidden

¹ By Jiyun Wu, Rhode Island College. Copyright © 2021 by the author; all rights reserved. Used by permission. The author would like to thank Anne Lawrence for her invaluable feedback during the revision process.

² "Secretary Ross Announces Activation of ZTE Denial Order in Response to Repeated False Statements to the U.S. Government," U.S. Department of Commerce, www.commerce.gov/news/press-releases/2018/04/secretary-ross-announces-activation-zte-denial-order-response-repeated. The term "entity list" refers to a list of individuals or organizations that have engaged in activities contrary to U.S. national security and/or foreign policy interests.

³ "ZTE Says the U.S. Export Ban Will 'Severely Impact' Its Survival," *The Verge*, April 20, 2018.

until 1978, when the country introduced its first economic reforms and legalized some private businesses. In subsequent years, China's leaders introduced more policies that expanded their citizens' economic freedom. However, China's political system remained intact, and the country maintained its one-party rule amidst the economic reforms that would catapult the nation to the status of an economic superpower. China termed its unique model "socialism with Chinese characteristics," while scholars outside China called it state capitalism or authoritarian capitalism.⁴

ZTE, known in China as Zhongxing (中兴, meaning "China Prospers"), was a partially state-owned enterprise specializing in telecommunications equipment and solutions. It provided telecom equipment and software to carriers and sold smartphones to retail customers. Headquartered in Shenzhen, a special economic zone in China, it began in 1985 as a joint venture of several subsidiaries of the Ministry of Aerospace Industry. The company first expanded into overseas markets in the 1990s. ZTE eventually became the fourth largest telecommunications equipment maker in the world. In 2018, the company did business in 160 countries and employed 75,000 people worldwide.⁵ In 2017, its total sales reached \$17 billion, with net income of over \$723 million.⁶ Together with Huawei, a more powerful competitor in China, it had pushed itself to the forefront of 5G, the next wave of wireless technology, vying with major Western players such as Nokia and Ericsson.⁷

ZTE launched its smartphone business in the United States in 2011. Since then, its sales had been growing steadily. In 2017, it became the No. 4 vendor of smartphones in the United States, behind LG Electronics Inc., Samsung Electronics Co., and Apple Inc., capturing 11.2 percent of the market and selling a 19 million phones. The company gained on its rivals by releasing inexpensive smartphones primarily aimed at users on prepaid cell phone plans. A key smartphone sold in the United States was the Axon M, a dual screen phone that folded in half. ZTE's entry into the United States was an impressive success story and the envy of its leading Chinese competitors, Huawei and Xiaomi.⁸

But ZTE relied heavily on American components: about a quarter of the components in its smartphones were U.S.-made. These components included, for example, microchips from Qualcomm, glass from Corning, and the Android operating system from Google. The U.S. microchips were especially important to ZTE; China supplied only 10 percent of its needed microprocessors. Therefore, the Commerce Department's ban posed a potentially fatal threat to the company.⁹

ZTE's Failure to Comply with U.S. Sanctions

The stated reason for the ban on ZTE purchases of American-made components was the Chinese company's failure to comply with U.S. sanctions.

Over the years, the United States had imposed various economic and trade sanctions on Iran, North Korea, Cuba, Sudan, and Syria, for either national security or humanitarian reasons. It regulated and restricted the release and sale of goods, services, and technologies to these countries through its export control and sanctions laws. Since they used components made by U.S. companies, ZTE's products were subject to compliance with American sanctions laws. Yet, U.S. federal investigators found that ZTE had not only shipped its products

⁴ "The Rise of State Capitalism," *The Economist*, January 21, 2012.

⁵ "Chinese Tech Giant on Brink of Collapse in New U.S. Cold War," *The New York Times*, May 9, 2018.

⁶ "China's ZTE Returns to Net Profit in 2017," *Reuters*, March 15, 2018.

⁷ "What Is 5G and Who Are the Major Players?" *Reuters*, March 15, 2018.

⁸ "Chinese Tech Giant on Brink of Collapse in New U.S. Cold War," *op. cit.*

⁹ "ZTE's Near-Collapse May Be China's Sputnik Moment," *The New York Times*, June 10, 2018.

containing U.S.-origin components to Iran and North Korea, but it had also devised an elaborate scheme to hide these activities from federal investigators, its internal investigators, and its own attorneys.

As early as 2012, the federal government probed ZTE for its alleged violations of U.S. sanctions against Iran. Federal investigators later found that for a period of about six years between 2010 and 2016, ZTE purchased U.S.-origin components, incorporated them in their products, and furtively shipped the products to entities in Iran. In 2016, the Commerce Department also uncovered two ZTE internal documents which seemed to show both ZTE's illegal activities and obstruction of justice. One described in detail its continuing projects in the U.S.-sanctioned countries; the other revealed an intricate flowchart to evade U.S. export controls. In fact, ZTE continued its illegal shipments to Iran even during the federal investigations. In total, the scheme allowed ZTE to generate hundreds of millions of dollars in revenues from Iranian entities.¹⁰ The company also made 283 shipments of U.S.-origin microprocessors, servers, and routers to North Korea.¹¹

In March 2017, following a multi-year probe, the U.S. government fined ZTE \$1.19 billion, the largest criminal penalty ever imposed for violations of trade sanctions. The federal government stated it intended to ban sales of U.S. components to ZTE, but it stopped short of implementing this plan. Instead, it allowed reprieves and placed the company on "probation." As part of the settlement, ZTE agreed to fire four senior managers and discipline 35 others by either reducing their bonuses or reprimanding them. Zhao Xianming, ZTE's chairman and CEO, stated that "ZTE acknowledges the mistakes it made, takes responsibility for them, and remains committed to positive change in the company."¹²

ZTE did fire the four senior managers, but it did not discipline the other 35. On the contrary, it rewarded them with full bonuses. As a result of the company's violation of the March 2017 settlement, the Commerce Department issued the ban in April 2018. The U.S. government order said that ZTE's repeated deception indicated that the company was "incapable of being, or unwilling to be, a reliable and trustworthy recipient of U.S.-origin goods, software and technology."¹³

A Blemished History

ZTE's misconduct was not confined to violations of U.S. sanctions. In other parts of the world where it conducted business, ZTE had also encountered various problems. In its own country, a ZTE subsidiary bribed a manager at China Mobile, China's largest wireless operator, in 2017. In the same year, the Filipino government awarded ZTE a \$330 million contract to build a broadband network. But the award caused an uproar in the country, as ZTE had allegedly inflated the price to pay kickbacks to the officials there, including then-president Arroyo; the contract was later cancelled. In Kenya, ZTE overbilled a contract with the local police in 2013; this contract was also later cancelled. In Algeria, two ZTE executives were convicted of corruption in 2012. In Ethiopia, a World Bank investigation found that the government had awarded a contract to ZTE in 2006 without competitive bidding, which gave the company monopoly over supply of telecom equipment for several years. Yet the service it provided there could be irregular: network glitches reportedly happened frequently, and smartphone users sometimes had to walk several miles to get a

¹⁰ "U.S. Hits China Telecom Over Iran—ZTE Agrees to Pay \$892 Million in Fines, Plead Guilty to Charges of Violating Sanctions," *The Wall Street Journal*, March 8, 2017.

¹¹ "ZTE Receives Record \$1.2 Billion Fine for Breaking US Sanctions," *The Verge*, March 8, 2017.

¹² "Chinese Tech Company Blocked from Buying American Components," *The New York Times*, April 16, 2018.

¹³ "China's ZTE, Saved by U.S., Has a Checkered Past and Shaky Future," *The New York Times*, June 8, 2018.

good signal.¹⁴ (To be fair, in general, ZTE was known for its good quality and service in the African continent, according to one telecom expert.¹⁵) Ethiopian government officials had also been concerned about the price ZTE charged for its equipment. (An upgrade to Ethiopia's telecom network a few years later was split between ZTE and Huawei.) In March 2020, the U.S. Justice Department had launched an investigation into ZTE's potential violations of the Foreign Corrupt Practices Act (FCPA), which prohibited U.S. businesses from bribing foreign government officials. Though ZTE was not a U.S. company, FCPA would apply to it if money involved in the foreign bribery cases had been wired through the U.S. financial system.¹⁶

Fallout from the Ban

Following the 2018 ban, ZTE's major manufacturing operations came to a halt, leaving many employees with little to do. They passed the time in training and team-building activities and singing motivational songs, such as "being together in the same boat."¹⁷ Demand for the company's products fell dramatically. In the United States, where ZTE had established a brand through years of marketing campaigns and efforts to cultivate relationships with wireless carriers, T-Mobile U.S. Inc. retracted an agreement to distribute ZTE's smartphones and other products, an agreement worth more than a billion dollars. AT&T, the major distributor of ZTE phones, continued carrying its products, but evaluated the impact of the government order on its business. Millions of ZTE phone users in the United States were left with a device at risk of being inoperable. ZTE's smartphones ran on Google's Android operating system. Following the ban, Google stopped updating its Android software and security patches on ZTE's phones and discontinued technical support for its customers. Some frustrated users contemplated switching to other brands.¹⁸

In other parts of the world, disgruntled telecommunications network operators demanded penalty payments for stalled supply shipments. The Italian carrier Wind Tre SpA, one of ZTE's biggest European customers, requested 100 million euros (\$117 million) from ZTE for interruption of the construction and maintenance of its network. Paul Triolo, a member of the political risk-consulting firm Eurasia Group, observed, "If you're a carrier in Europe that uses this company, and you're uncertain about whether the denial order is lifted, you are going to be re-thinking your supply chain, particularly with things like 5G." Testra Corp., Australia's largest telecom operator, stopped selling ZTE smartphones due to uncertainty in supply. MTN Group Ltd., one of Africa's largest network carriers, also considered contingency plans.¹⁹

The ban, although aimed at punishing ZTE for violating sanctions, also caught its American suppliers in the crossfire. At the time of the ban, Qualcomm Inc., the leading provider of ZTE's microchips, had proposed a takeover of NXP, a Dutch-based chipmaker, to diversify its microchips into the automobile business. Because both companies conducted business in China, the acquisition needed approval from the Chinese government. When China failed to give its approval, the bid fell apart.²⁰ The ban also impeded sales by American suppliers to the company. Qualcomm supplied at least eight of the 25 components on ZTE devices' main circuit board, including the modem and the power-management unit. The company would

¹⁴ Ibid.

¹⁵ "Chinese Tech Giant on Brink of Collapse in New U.S. Cold War," op. cit.

¹⁶ U.S. Probes Chinese Telecom Giant ZTE for Possible Bribery," *The Wall Street Journal*, March 13, 2020.

¹⁷ "Chinese Tech Giant on Brink of Collapse in New U.S. Cold War," op. cit.

¹⁸ "ZTE Blacklist Hits U.S. Phone Users," *The Wall Street Journal*, May 15, 2018.

¹⁹ Ibid.

²⁰ "Qualcomm Ends \$44 Billion NXP Bid After Failing to Win China Approval," *Reuters*, July 25, 2018.

stand to lose half a billion of sales from this ban—about 2 to 4 percent of its total revenue. About a dozen other U.S. companies were also adversely affected. For example, Acacia Communications Inc., a Massachusetts-based maker of fiber-optic networking components, generated \$385.2 million of sales to ZTE in 2017, about 30 percent of its total revenue in the year. NeoPhotonics Corp., a San Jose-based maker of optical gear, was hoping that its revenue from ZTE would jump from 4 percent in 2017 to 5 percent in 2018; the ban would dash the hope.²¹

ZTE's Fight for Survival

Following the Commerce Department's order, ZTE launched an all-out campaign to reverse of the ban.

Just three days after the government order, the company hired Hogan Lovells, an international law and lobbying firm, to influence U.S. lawmakers as well as handle negotiations with the Commerce Department. Norm Coleman, a former U.S. Senator (Republican-Minnesota) and the head of the firm's Government Relations and Public Affairs practice, handled the ZTE contract. The lobbying firm employed various tactics to influence the outcome. Its political action committee had already donated thousands of dollars to the campaigns of Senator Lindsey Graham (Republican-South Carolina) and Representative Ed Royce (Republican-California). While the debates on ZTE sanctions were going on in Congress, the firm donated to the senate campaigns of Claire McCaskill (Democrat-Missouri) and Tim Scott (Republican-South Carolina), who both served on the conference committee that could determine ZTE's fate. In addition, the company also threw a party, where both Senator Lindsey Graham and Representative Ed Royce were keynote speakers.²²

Over the next three months, ZTE paid Hogan Lovells \$1.28 million for its services. Through Hogan Lovells, ZTE retained Mercury Public Affairs, a lobbying and public relations firm, whose key lobbyist was a Trump campaign and transition official, Bryan Lanza. ZTE paid Mercury \$75,000 a month for three months to help set up meetings with relevant U.S. government officials. Altogether, during this short period, ZTE USA, the company's U.S. subsidiary, spent around \$1.4 million on lobbying to fight the Commerce Department's order. To put this in perspective, ZTE spent a total of \$510,000 on lobbying in 2017—less than half of what it spent in just three months the following year.²³

On June 7, 2018, the Commerce Department announced that it had reached a deal to lift the ban on ZTE. Lawmakers from both political parties then moved swiftly to block the move. On June 18, 2018, the Senate tucked a provision into the National Defense Authorization Act, which would prevent the lifting of the ban.²⁴ But on July 20, two days after the party given by Hogan Lovells, Congress removed the provision from the military bill and replaced it with a much watered-down provision, only restricting federal agencies from purchasing ZTE's products. Many of them had already been following these guidelines.²⁵ On August 1, the Senate eventually passed a bill that included the weaker provision. While many factors were at play in the lifting of the ZTE ban, the lobbyists from Hogan Lovells and Mercury Public Affairs boasted privately about the role they played in the Congressional outcome.²⁶

²¹ "Vendors to ZTE Face Hit on Revenue," *The Wall Street Journal*, April 25, 2018.

²² "Faced with Crippling Sanctions, ZTE Loaded Up on Lobbyists," *The New York Times*, August 1, 2018.

²³ *Ibid.*

²⁴ "Congress, White House Head for Showdown over Chinese Telecom ZTE after Senate OKs Defense Bill," *USA Today*, June 18, 2018.

²⁵ "Republicans Bow to White House on Chinese Telecom Firm ZTE," *The New York Times*, July 20, 2018.

²⁶ *Ibid.*

Senators of both parties expressed disappointment. Senator Chris Van Hollen (Democrat-Maryland), a proponent of tougher penalties on ZTE, said, "Clearly, they think that this is a good investment for them because if we had stuck with the stronger sanctions, it would have squeezed them very hard, as it was intended to."²⁷ Tweeted Senator Marco Rubio (Republican-Florida), "This is how #China influences our government policies. They spent a small fortune lobbying congress to drop restrictions on #ZTE and it worked."²⁸

The Geopolitical Backdrop of the Ban

Under normal circumstances, the U.S. Commerce Department's ban on ZTE would be strictly a legal matter; however, since it happened during escalating trade disputes and increasing national rivalry between the United States and China, the company soon found itself a bargaining chip in the trade disputes between the two countries.

A significant cause of the trade disputes was a large trade deficit with China. A trade deficit occurs when the total value of imports (in this case, from China to the United States) is greater than that of total exports (in this case, from the United States to China). Since China had joined the World Trade Organization in 2001, the trade deficit between the two countries had increased by 11.2 percent annually on average.²⁹ The deficit rose to a record \$375 billion in 2017, compared with \$347 billion in 2016.³⁰ President Trump had accused China of worsening the deficit through unfair trade practices and intellectual property theft. In particular, the United States maintained that China had forced American firms to transfer technologies to Chinese companies when they attempted to access the Chinese market. In 2018, to address the various bilateral trade issues, President Trump had imposed a series of tariffs on imported Chinese goods worth hundreds of billions of dollars. China, in return, had retaliated with its own tariffs on American exports, including whiskey, soybeans, pork, and cranberries—many of which were produced in Republican-dominated states.³¹

The trade disputes also unfolded in the context of increasing national-level rivalry between the United States and China. For decades, China had benefited from the liberalization of global trade; by 2010, it had risen spectacularly to become the world's second largest economy after the United States. Moreover, in 2015, China issued "Made in China 2025," an ambitious, transformative strategic plan aimed at transitioning its economy from its labor-intensive clothing, shoes, and consumer electronics industries into high tech sectors, such as artificial intelligence, microchips, aerospace, and self-driving cars. The plan positioned China to compete head-to-head with the United States and other developed economies, threatening American dominance in many advanced technology industries.³² For example, in 5G technologies, ZTE and, more importantly, Huawei, had become the world's major players. In response to the threat, the U.S. government had proposed restricting the export of some advanced technologies to China. The ban on ZTE, therefore, was also construed by some as an escalation of these restrictions. In other words, ZTE was caught in the geo-political rivalry.³³

²⁷ Ibid.

²⁸ "Faced with Crippling Sanctions, ZTE Loaded Up on Lobbyists," op. cit.

²⁹ "Growth in U.S.-China Trade Deficit between 2001 and 2015 Cost 3.4 Million Jobs," Economic Policy Institute, January 31, 2017, at www.epi.org.

³⁰ "Trump's China Impulses," *The Wall Street Journal*, June 16, 2018.

³¹ "Here's Exactly How Trump's Trade War with China Could Affect You," *Business Insider*, October 12, 2018.

³² "What Is 'Made in China 2025'—and Why Is It a Threat to Trump's Trade Goals?" *The Washington Post*, May 3, 2018.

³³ "Chinese Tech Company Blocked from Buying American Components," *The New York Times*, April 16, 2018.

Apart from the bilateral trade disputes and geopolitical rivalry, for years the U.S. officials had also expressed unease that equipment made by ZTE and its Chinese competitor, Huawei, might be used for espionage, network disruption, or other cyberattacks by the Chinese government. Both ZTE and Huawei made cellular-tower equipment and cellphones. Theoretically, manufacturers of telecommunications equipment could remotely switch off cellular-tower electronics by using a “back door”—a secret piece of code that could have devastating consequences. If this happened, it would take several days to restore everything back to normal. Though such threats were low, according to cybersecurity experts, they were nevertheless possible. In addition, manufacturers of cellphones could collect various data on phone users and even record their phone conversations. For this reason, phones made by Huawei and ZTE were not sold in retail stores on military bases.³⁴ These cybersecurity fears arose from the fact that these companies operated in an authoritarian political system, and it would be impossible for them to not cooperate should their government make such a request.

The Involvement of Two Heads of State

Although the stated reason for the ban on ZTE was its violation of sanctions—and not linked to the trade disputes between the two countries—the ban exacerbated the trade dispute and elicited a strong public reaction in China. It also became a huge embarrassment to the Chinese government, as ZTE was one of the country’s few successful multinational corporations and one that elicited great national pride. Less than a month after the U.S. Commerce Department banned ZTE on April 18, President Xi of China made a personal appeal to President Trump on behalf of the company. Around the same time, the Chinese trade negotiation team made easing the sanctions on ZTE a condition for further talks with the U.S. side.³⁵ On May 13, President Trump tweeted the following message:

President Xi of China, and I, are working together to give massive Chinese phone company, ZTE, a way to get back into business, fast. Too many jobs in China lost. Commerce Department has been instructed to get it done!

—Donald J. Trump (@realDonaldTrump)³⁶

At the time of the ban, President Trump was also planning a summit with Kim Jung Un, the North Korea’s leader, in Singapore in June 2018; the summit would be the first to be held by sitting leaders of the two countries. President Trump needed to rely on China to facilitate the meeting.³⁷

In the days before and after President Trump tweeted his intervention on the ZTE ban on May 13, 2018, China awarded Ivanka Trump, the president’s daughter, 7 new trademarks, in addition to the 27 she had already received in the country; these trademarks included books, housewares, cushions, snacks, and spices. The trademarks would allow Ms. Trump to capitalize on the large Chinese market. The timing of President Trump’s announcement “raises significant questions about corruption, as it invites the possibility that [Ivanka Trump] could be benefiting financially from her position and her father’s presidency or that she could be influenced in her policy work by countries’ treatment of her business,” said Noah Bookbinder, CEO of Citizens for Ethics and Responsibility in

³⁴ “Are Huawei and ZTE a Real Cybersecurity Threat?” *The Wall Street Journal*, May 29, 2018.

³⁵ “In Concession, Trump Will Help China’s ZTE ‘Get Back’ Into Business,” *Reuters*, May 13, 2018.

³⁶ “President Trump Says that He Is Working to Get ZTE ‘Back into Business, Fast,’” *The Verge*, May 13, 2018.

³⁷ “Trump Tells Republicans Not to Undercut Him on ZTE,” *The New York Times*, June 20, 2018.

Washington, a watchdog group.³⁸ Usually, it took close to 18 months to have a trademark approved. Six of the seven applications by Ms. Trump were submitted in March 2017; in May 2018, a little more than one year later, the applications were approved.³⁹

Following President Trump's intervention, the U.S. Commerce Department lifted the ban on ZTE on July 13, 2018, on the condition that the company would replace its leadership and allow the installation of an American team of monitors inside the company for 10 years. The company was also required to pay a \$1 billion penalty and place an additional \$4 million in escrow for possible future breaches of the U.S. sanctions.⁴⁰ Congress gave its approval in early August 2018.

Discussion Questions

1. In your opinion, why did the U.S. Commerce Department ban ZTE's purchase of U.S.-made parts? In your answer, please give three explanations and state which one you support, and why.
2. In your opinion, why did the Trump Administration and Congress reverse themselves on the ban and reinstate ZTE's right to buy U.S.-made parts? In your answer, please give three explanations and state which one you support, and why.
3. Do you believe ZTE acted in a socially responsible and ethical manner in its interactions with its stakeholders? Why or why not?
4. What power did the U.S. government have over ZTE? Do you think it used its power appropriately? Why or why not?
5. What influence did ZTE have over the actions of the U.S. government? Do you believe that ZTE used undue political influence? Why or why not?

³⁸ "Ivanka Trump Won China Trademarks Days Before Her Father's Reversal on ZTE," *The Guardian*, May 28, 2018.

³⁹ "Ivanka Trump Wins China Trademarks, Then Her Father Vows to Save ZTE," *The New York Times*, May 28, 2018.

⁴⁰ "U.S. Lifts Ban That Kept ZTE from Doing Business with American Suppliers," *The New York Times*, July 13, 2018.