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China options limited as U.S. panel outcasts Huawei, ZTE

Tue, Oct 9 2012

(Reuters) - China's leading telecom equipment makers accused in a U.S. congressional report of being a potential security risk may face fresh scrutiny in other markets, while American firms operating in China could be vulnerable to retaliation.

The U.S. House of Representatives' Intelligence Committee on Monday warned that China could use equipment made by Huawei Technologies Co Ltd and ZTE Corp - the world's second- and fifth-largest makers of routers and telecoms gear - for cyber-espionage through software embedded in Chinese-made network equipment.

In its 52-page report, the committee noted that "China's military and intelligence services, recognizing the technological superiority of the U.S. military, are actively searching for asymmetrical advantages that could be exploited in any future conflict with the United States. ... Malicious implants in the components of critical infrastructure, such as power grids or financial networks, would also be a tremendous weapon in China's arsenal," it stated.

China's official People's Daily newspaper accused the committee on Tuesday of acting on a "presumption of guilt" against Huawei and ZTE. "This foolhardy political step ... will impede the healthy development of Sino-American trade cooperation," said a commentary in the newspaper, which generally reflects government thinking.

It added that the committee had produced "not an iota" of evidence to back its accusation that Huawei and ZTE products were used for espionage in the United States. "This report, which spurns the facts and is suffused with prejudice, is a vicious expansion of trade protectionism," it said.

"COLD WAR" MENTALITY

The blow-up - a Xinhua English-language commentary spoke of "a Cold War mentality" in the United States - comes at a sensitive time for U.S.-China relations, ahead of U.S. presidential and congressional elections and a leadership transition in China.

Tensions have ratcheted higher with a series of trade actions against China by President Barack Obama, including his blocking of a privately owned Chinese firm from building wind turbines close to a U.S. military site, and his challenge of Chinese auto and auto-parts subsidies in a World Trade Organization (WTO) case.

His Republican opponent, Mitt Romney, says if elected he will label China a currency manipulator from day one.

Ed Snyder, an analyst at Charter Equity Research in San Francisco, said the committee's report could lead to retaliation against U.S. companies that sell products in China in the telecommunications industry and beyond. He mentioned Cisco Systems Inc, Google Inc, Qualcomm Inc, Apple Inc as examples, but said non-tech U.S. companies could also be hit.

"By calling them out like this, they're almost certain to get retribution," Snyder said. "There's a lot of ripe targets."

BALANCED RESPONSE

Sun Lin, an independent telecoms consultant in Beijing, however, played down the threat of retaliation against U.S. high-tech firms, such as Cisco.

"We have to remember that on a technological level, China is no match. Chinese customers want state-of-the-art products. In some sectors they can only come from the United States, Europe or Japan. If you shut down that source completely you will lose in the end," he said. Cisco and Hewlett-Packard dominate China's enterprise networking equipment market, where Huawei and ZTE lag in the range of products and services they offer.

Sun said Beijing was likely to seek a compromise between a political response balanced against Chinese business interests. "I do not believe we are going to see a substantial degree of retaliation in China," he said, though he did not rule out a possible kick-back at the U.S. pharmaceuticals or agriculture sectors.

Rather than direct action such as raising tariffs on imports from the United States, China is more likely to "make life a little more difficult" for U.S. firms operating there, said Enzo von Pfeil, an independent economist in Hong Kong. "It could be a sort of whisper campaign (to discourage Chinese from buying some U.S. products)," he said.

An executive from a major Chinese networking equipment distributor, which uses mainly Cisco products for its clients' enterprise networks, also said there was unlikely to be any sudden switch to Chinese products.



"Cisco has been in the market for many years and has built a good reputation. I don't think people will make the switch to other products immediately," said the executive, who is not authorized to speak to the media and didn't want to be named. "Maybe things will die down after the U.S. elections."

NOT A CASE FOR WTO

Similarly, few felt China would have much of a case if it went to the WTO, which arbitrates in major trade spats.

"It's a political problem, not a trade problem," said Tu Xinquan, a WTO expert at the University of International Business and Economics in Beijing. "Both governments are facing domestic pressures. The United States is looking at Chinese competition more seriously and trying to do more to lower the competitiveness of Chinese companies, especially when many big companies are related to the government. But those restrictions will be counterproductive," he said.

The U.S. report capped an 11-month investigation that Huawei itself had urged early last year, hoping such a probe would remove suspicions that killed its bids for U.S. communications company 3Com and U.S. server technology firm 3Leaf.

The panel said it referred to the Justice Department and Department of Homeland Security credible allegations suggesting Huawei may be guilty of bribery and corruption, discriminatory behavior and copyright infringement.

Huawei and ZTE, both based in Shenzhen in southern China, denied the allegations in the report, with Huawei spokesman William Plummer warning the panel's recommendations would set a "monstrous, market-distorting, trade-distorting policy precedent that could be used in other markets against American companies."

In Hong Kong, ZTE shares fell by as much as 8 percent on Tuesday, following Monday's 6 percent drop. The stock has more than halved this year, underperforming the benchmark Hang Seng index's 14 percent gain.

MASQUERADE

Employee-owned Huawei, founded by CEO Ren Zhengfei 25 years ago after he was laid off by the Chinese army, has expanded in Europe and India, and says its products are currently used in more than 150 countries. More than two-thirds of its annual revenue of \$32.4 billion is earned outside China.

Luke Coleman, media relations manager for Huawei Australia, said the company has "zero" Chinese government involvement, and there should be no impact on its business in Australia, where it supplies telecoms equipment and handsets and builds networks for mobile operators such as Optus and Vodafone, universities and a major state rail company.

Huawei, which has been barred from taking part in contracts to build the government's \$38 billion national broadband network, had Australian revenue last year of A\$229 million (\$234 million). "There's nothing new. From our perspective, this is a trade issue masquerading as a security issue," Coleman said.

A senior telecoms industry official in India - where Huawei has sales of about \$1.2 billion, excluding handsets - said that while the government will watch the situation closely, business would still buy Chinese equipment, primarily because of price.

"For operators, the biggest draw for buying Chinese equipment has been the price point and the financing available. It'll be a difficult proposition (to not buy Chinese gear) when the whole industry is under liquidity stress," the official said, declining to be named due to the issue's sensitivity.

In New Zealand, opposition parties called for an inquiry into Huawei's involvement in building a government-sponsored ultrafast broadband network. The Chinese firm last year signed an equipment deal with network operator Chorus Ltd, which is building most of the network.

"The taxpayer shouldn't be giving Huawei hundreds of millions of dollars to make it easier for Beijing to potentially spy on us," said Gareth Hughes, information technology spokesman for the Green Party. The government said the opposition was painting "a misleading view of the situation".

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