ARGO ASSOCIATES

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Increased risks for foreign companies in China

The Chinese government has been learning some lessons from the United States. In recent days they have announced plans for a list of "unreliable entities" that would be subject to unspecified punishments and proposed a separate list of firms that could be subject to export controls, just as Huawei has been subject to U.S. export controls, preventing it from accessing any American-produced technology.

These plans show how the on-going tension with the United States is pushing China towards elevating national security concerns above economic interests. To be fair, China has always used economic policy as an instrument of foreign policy – South Korean businessmen will remember the way an unofficial boycott of South Korean goods over the THAAD issue a couple of years ago caused sales to plummet in China (and eventually led to Lotte selling its business there). Now the Trump administration has also started weaponizing economic policy to achieve foreign policy goals (not just in China, increased trade tariffs were also used as a threat to cut illegal immigration from Mexico). China, which hitherto tended to pretend that boycotts of countries were simply the Chinese population acting in a spontaneous and patriotic manner, is now threatening to practice the kind of organized and official trade reprisals that have up to now been used primarily by the U.S.

It is highly likely that foreign, and particularly American, firms operating in China will now find themselves subject to reprisals from the Chinese state, which could include sanctions, fines, investigations, being denied access to certain technologies or raw materials, and even detention and imprisonment for business executives.

What are the options for Beijing?

Recently there has been some speculation that China might use its dominance in the processing of rare earths as a weapon, possibly restricting their supply to American companies. Speculation about such restrictions was heightened by the recent visit of Xi Jinping to a rare earths facility run by JL MAG Rare-Earth Co. (whose shares then surged dramatically). Xi was accompanied on that visit by Liu He, who has led China's trade negotiations. About 80% of rare earth imports to the U.S. come from China; nonetheless, there would be significant risks for China in it being seen as an unreliable supplier – this would likely push other countries to develop other suppliers and sources of rare earths, ultimately damaging Chinese interests.

Following speculation about restrictions on the export of rare earths, the Chinese government also announced the creation of an "unreliable entities" list. Although only limited information has been provided thus far, it appears that those companies that will be most likely to be targeted will be those that are complying with the U.S.'s own export controls and restricting technologies to Chinese firms. The Chinese Ministry of Commerce (MOFCOM) specifically mentioned that the issues the new list would focus on were: "unilateralism"; "trade protectionism"; and "blocking, ceasing to supply or taking other discriminatory measures against Chinese enterprises." The list –

if and when it finally appears - may not only be focused on American companies. The British company Arm Holdings shows how third countries can be dragged into the conflict. Arm has been forced to announce that it will stop supplying Huawei as the U.S ban also applies to foreign firms if at least one-quarter of their technology originates in America.

In addition, as mentioned earlier, China may also produce a list of companies subject to export bans that will not be allowed to buy Chinese technology. For now, these types of bans may be less damaging to foreign firms as China's leverage really lies in its control of the assembly of electronics products – in which it is home to over half the world's capacity – rather than in specific technologies. Through this dominance of electronics assembly China has the capacity to severely disrupt a number of U.S. tech companies that rely on the country for manufacturing, although such an action would also damage the Chinese economy.

Perhaps just as important as any of the above steps are the "informal" options that remain available for the Chinese authorities that we mentioned at the start of this article – bureaucratic delays and increased inspections, investigations, fines, sanctions, travel bans on executives, and even detention and imprisonment. A survey by AmCham China and AmCham Shanghai of their members last autumn (i.e. before tensions had risen to their current level) found that the majority of respondents (52.1%) were already suffering from increased inspections (27.1%), slower customs clearance (23.1%), and "other complications from increased bureaucratic oversight or regulatory scrutiny" (19.2%). It is now possible that China will move from these relatively low-level reprisals towards more significant actions. Just as this risk increases, Hong Kong is set to pass a hugely controversial new extradition law, which will further increase the dangers for foreign businesses. Up to now, Hong Kong-headquartered foreign businesses have been able to rely on Hong Kong's impartial and respected legal system; if the new extradition law is passed by Hong Kong's Legislative Council (where it is currently being debated in the face of mass protests) managers and directors of companies could be sent to face trial in mainland China, where the legal system is subject to political pressure. In addition, passing the extradition bill would put significant pressure on the U.S. to revoke the specific privileges extended to Hong Kong under the Hong Kong Policy Act. This would also create additional costs and risks for companies in Hong Kong.

Where is this all going?

At each stage of the campaign run by the Trump administration against China, commentators have anticipated an agreement and a resolution; however, the rhetoric and the actions have only been ratcheted up rather than toned down. The general tone is now extremely pessimistic in both China and the United States as to the development of the relationship across the long term. The next key dates will be 24 June when the Vice-President Mike Pence will make a new speech about China (his last one eight months ago was seen as defining a new U.S. attitude to China) and the G20 meeting in Osaka on 28-29 June when Trump and Xi may meet to discuss the current situation.

Whatever Pence says in his speech, it is likely to reflect the fact that a number of thinkers and policymakers in both the United States and China now see a rise in tensions as inevitable and military conflict as a serious possibility. One of the most eminent of these is John Mearsheimer, who revised his book *The Tragedy of Great Power Politics* in 2014 to add a chapter asking "Can China Rise Peacefully) (which was published as a standalone essay by "The National Interest" in October 2014). One issue that he highlighted was the "security dilemma" that the U.S. and China are becoming entangled in, whereby "when a country adopts a policy or builds weapons that it thinks are defensive in nature, potential rivals invariably think that those steps are offensive in nature". American policymakers may conceive of their actions as defensive measures to safeguard American interests; for Chinese leaders they seem like aggressive actions to damage Chinese capabilities.

Mearsheimer argued in his 2014 chapter that the U.S. will always try to prevent the rise of another regional hegemon and therefore "will go to great lengths to contain China and do what it can to render it incapable of ruling the roost in Asia. In essence, the United States is likely to behave towards China largely the way it behaved toward the Soviet Union during the Cold War". For Mearsheimer "containment is an alternative to war against a rising China" and he also predicted in 2014 that "there will probably be some restrictions on trade for national security reasons". Mearsheimer also stated that "the United States has a profound interest in seeing Chinese economic growth slow considerably in the years ahead. That outcome might not be good for American prosperity, much less for global prosperity, but it would be good for American security, which is what matters most." For Mearsheimer security always trumps prosperity, which is why he believes that economic independence between the U.S. and China would not be sufficient to prevent a war.

In his 2014 article Mearsheimer listed some actions that would suggest that his vision of events was becoming reality: "abundant evidence of government officials in Beijing and Washington identifying the other side as their number one threat … [policymakers that promoted co-operation between the two countries being] marginalized in the discourse and policy debates … travel restrictions … seeing the United States bar Chinese students from studying subjects at American universities that have direct relevance for the development of weapons and other technologies … export controls on goods and services that have a significant national security dimension".

Ultimately Mearsheimer concluded in 2014 that war between the United States and China was more likely than war had been between the United States and the Soviet Union during the Cold War. Of course, some thinkers would argue that the way that thinkers like Mearsheimer frame the issues – using a reductive model called "offensive realism" – does not allow for the many other factors that could influence U.S. and Chinese relations, not least the characters and beliefs of the leaders engaged on both sides. Nonetheless, the conclusion must be that military conflict between the U.S. and China – at least in proxy wars – cannot be dismissed as an insignificant possibility in Asia over the next ten to twenty years. As this is within the investment horizons of multinational corporations and pension funds it should be a possibility that is being taken seriously as a long-term risk.

About Argo Associates

We seek to provide our clients with the information and intelligence that will allow them to navigate acquisitions, investments, disputes, or frauds in a clear-sighted and rational way, minimizing risk and maximizing opportunities.

Information gathered may clarify the profile and background of key business people and managers; it could illuminate the operations of a company or demonstrate a history of fraud or mismanagement; or it could help our clients to assess the political situation in a given jurisdiction and how it may affect their investments or business operations.

Headquartered in Hong Kong, Argo Associates assists clients across Asia and – through international partners – globally.

Intelligence Gathering

“Intelligence” is central to making sense of the world and to decision-making. Argo Associates has developed a network of well-placed human sources across Asia and – through our partners outside Asia – globally. This network provides insights beyond what is available publicly – into leadership, operations, strategy, corruption, red flags, political connections and so on - and is supplemented by extensive research and analysis of publicly available sources – corporate filings, litigation filings, regulatory communications, media articles, social media postings and so on. In a world in which information is increasingly commoditized, high-level intelligence and analysis provides the insights that give our clients an edge over their competitors.

Fraud, Corruption and Disputes

Our intelligence-gathering techniques and in-depth research and analysis have also helped our clients uncover frauds within their operations or in those of a portfolio company or recent acquisition. Our professionals have provided numerous reports for arbitration or legal proceedings to recover the proceeds of fraud. We have also assisted clients in tracing assets globally when bringing a high-value claim against a company or individual. In high-profile disputes we have assisted top law firms in gathering information, evidence and intelligence in support of their clients’ cases.

Political Risk

Our political risk work has developed naturally out of our intelligence and investigative capabilities. We see political risk as an important part of the evaluation of many investments, mergers and acquisitions, as well as a key element of commercial disputes in many markets. We have helped our clients look at political risk in a new way, not just in terms of the broad outline of potential political developments in various countries, but with a focus on the impact on their businesses. For example, will growing frictions between two countries lead to tariffs that could impact the specific sector in which a portfolio company operates? Or, how will rising protectionism in a country alter the possibility of a fair result in an ongoing commercial dispute? Frequently, politics is local as much as national and we understand the importance of drilling beneath the widely-circulated opinions to a real understanding of what is happening.

Jason Wright, Managing Director of Argo Associates

Prior to founding Argo, Jason was a Managing Director in Hong Kong for Kroll. Before moving to Asia in 2011 he worked for Kroll in Italy for five years and then briefly in London.

In addition to assisting clients on numerous transactions, investigations and disputes in Asia and Europe, - particularly private equity funds, banks, hedge funds and special situations investors - Jason has also specialized in the analysis of political risk, whether that has involved examining the role of local politicians, regulators and other stakeholders, or broader geopolitical concerns.

Although he has managed projects across the whole Asia-Pacific region he has been particularly focused on China, Korea, and Southeast Asia, especially Indonesia, Vietnam, Malaysia and Thailand.

Jason is a scholar of St. Catherine's College, Oxford, having been awarded a Master of Arts (Oxon) in English Language and Literature, as well as a Master in State Management and Humanitarian Studies from La Sapienza University in Rome, Italy.

Lina Gautama, Director

Lina Gautama is a South-East Asia expert, focusing particularly on Indonesia, Malaysia and Thailand. An Indonesian national, she has advised clients on political, commercial and integrity risks across the region.

As well as handling complex investigations in sectors such as mining, oil and gas, and the automotive industry, Lina has also delivered anti-bribery and anti-corruption assessments for foreign investors and overseen pre-transaction investigative due diligence projects across the region.

Prior to joining Argo Associates, Lina worked with Control Risks, Keppel and ConocoPhillips. She holds a bachelor's degree in Business from Singapore Management University. Lina is fluent in Bahasa Indonesia, Bahasa Melayu and Mandarin, and speaks some French, Spanish and Thai.

ARGO ASSOCIATES

www.argoassociates.com
info@argoassociates.com
+852 3905 1892

Argo Associates Limited
Suite 401, Printing House
6 Duddell Street, Central
Hong Kong

Singapore office
Level 17, Frasers Tower
182 Cecil Street
Singapore 069547