



How Chinese-U.S. relations continue to worsen

By Angelo Katsoras

Introduction

For both China and the United States, the spike in tensions caused by Russia's invasion of Ukraine and House Speaker Nancy Pelosi's visit to Taiwan has heightened the sense of urgency to become less reliant on one another in certain key sectors.

All of this is making it more and more difficult for companies to navigate the maze of contradictory rules, where complying with U.S. regulations could mean violating Chinese law, and vice versa. This drives yet another nail in the coffin of an era when companies in strategic sectors could concentrate most of their production in regions of the world with the lowest costs without having to take geopolitical fault lines into consideration.

U.S. targeting China with more stringent sanctions

Potential restrictions on outbound investments

While the U.S. government screens foreign investments in American companies that could be detrimental to national security, it has virtually no measures in place to scrutinize U.S. investments in countries considered rivals, such as China. This may soon change. A proposed bill called the National Critical Capabilities Defense Act would implement regulations prohibiting U.S. investments abroad that it determines undermine national security.¹

The proposal has been introduced several times in Congress and has not yet come close to passage. However, we feel there is sufficient bipartisan support for it to be approved in the next year or two.

While Democrats and Republicans are at odds over most issues, there is strong bipartisan support for taking a tougher line against China. Beijing's reaction to Pelosi's trip to Taiwan will likely further strengthen this sentiment and consequently support for this legislation.

Continuing efforts to deny China access to key technologies

In 2018, the United States managed to convince the Dutch government to block Netherlands-based ASML from selling its most advanced machines to China. The company is the world's top maker of lithography systems for semiconductors. Now, the United States is pushing for this ban to include a wider range of ASML's less advanced chip-making gear.²

Since late 2020, the United States has barred American companies from selling without permission to China's Semiconductor Manufacturing International Corporation any equipment that could be used to fabricate semiconductors 10 nanometres (nm) or smaller. The smaller the number, the more advanced the chip. This ban was recently expanded to cover anything more advanced than 14 nm.³

Mass delisting of Chinese firms

Under the Holding Foreign Companies Accountable Act passed in 2020, foreign companies listed on Wall Street must let American regulators inspect their books. Companies that do not comply for three consecutive years beginning in December 2020 will be delisted. China is the only major country that refuses to be subjected to this rule, citing national security concerns.

Should the United States and China fail to negotiate a compromise, roughly 260 Chinese companies face delisting.⁴ The recent spike in tensions between the two countries over Ukraine and more recently Taiwan will make it even harder to reach a deal.

On the Chinese front, authorities are already forcing certain companies that handle sensitive information to stop trading in the United States over fears their data could be exposed to foreign powers. The delisting of Didi Global from the NYSE in December is a case in point.

¹ "White House wants transparency on American investment in China," Washington Post, July 13, 2022

² "To Slow China's Semiconductor Sector, the U.S. Eyes More Export Bans," Stratfor, July 11, 2022

³ "U.S. Pushes Expansion of China Chip Ban, Key Suppliers Say," Bloomberg, July 29, 2022

⁴ "China plans three-tier data strategy to avoid U.S. delistings," Financial Times, July 24, 2022

This dispute has already all but shut the door on new listings by Chinese companies in the United States. Only five Chinese companies have launched American IPOs since July 2021.⁵ In anticipation of being delisted, many Chinese companies have sought alternative listings in Hong Kong.

Human rights-focused legislation

Since June, the United States has prohibited imports of products from the Xinjiang region of China unless companies can prove forced labour was not used. Disentangling from this region will not be easy. In 2020, Xinjiang accounted for 20% of the world supply of cotton, 9% of its aluminum, and 45% of its polysilicon, a key ingredient in solar panels.⁶ This rule could, among other things, complicate America's goal of significantly ramping up adoption of solar power over the next several years. The International Energy Agency found that "China's share in all the key manufacturing stages of solar panels exceeds 80%."⁷

China disputes the presence of forced labour in Xinjiang and has tried to blunt these sanctions by passing the Anti-Foreign Sanctions Law, which prohibits companies from enforcing U.S. and other foreign-inspired sanctions.

Biden's executive order on electric vehicles runs into time constraints

President Biden issued an executive order calling for electric vehicles to make up half of new automobiles sold by 2030. This ambitious target, however, affords industry little time to build up domestic production, potentially keeping the United States reliant on Chinese technology and supply chains for years to come.

China controls about 60% of the world's production of rare earth minerals and nearly 90% of the refining capacity. China also refines 35% of the world's nickel and 50% to 70% of its lithium and cobalt.⁸ It also makes 80% of the cells that power lithium-ion batteries.⁹

This leaves the United States and Europe between a rock and a hard place. On the one hand, the long lead times associated with building up energy and mining infrastructure means that the greater the effort to meet environmental targets in the near term, the higher the likelihood that the United States and Europe will become even more dependent on China's green energy supply chains. On the other hand, if the West decides to transition more slowly in order to give their domestic supply chains time to reach a critical mass, they will likely miss their environmental targets by a very wide margin.

China intensifying efforts to become self-reliant in key technologies

China has recently ordered central government agencies and state corporations to replace foreign-branded personal computers with domestic alternatives within two years. This means that over 50 million computers could be replaced.¹⁰ It has also been reported that China will soon require that all printers and copiers be designed and manufactured in China.¹¹

Semiconductors exempted

These mandates do not extend for the time being to semiconductors because, despite years of efforts, China still remains dependent on foreign suppliers for the most cutting-edge chips and the equipment to manufacture them.

Efforts to break this dependence include spending \$150 billion on chip production between 2015 and 2030 and trying to recruit semiconductor workers based in Taiwan, the world's leading producer by far of advanced chips (over 90% market share). The Taiwanese government estimates that from 2014 to 2019, more than 3,000 semiconductor workers—7% of Taiwan's chip workforce—moved to China. Taiwan has reacted to this recruitment by passing a law in May that criminalizes economic espionage and requires government permission for employees of companies that work in "national core technology" to go to China.¹² Taiwan also prohibits its companies from building advanced semiconductors in China.¹³

It is important to note, however, that China does have a strong market share in the production of lower-end semiconductors, such as those 28 nm in size widely used in automobiles and other electronics. It is estimated that China will account for 25% of

⁵ "Nearly 150 U.S.-traded Chinese companies at risk of delisting," Nikkei Asian Review, June 14, 2022

⁶ "U.S. Aims to Expand Export Bans on China Over Security and Human Rights," New York Times, July 5, 2022

⁷ "Solar PV Global Supply Chains," International Energy Agency, July 22, 2022

⁸ "The Role of Critical Minerals in Clean Energy Transitions," International Energy Agency, May 2021

⁹ "Red Flags for Forced Labor Found in China's Car Battery Supply Chain," New York Times, June 20, 2022

¹⁰ "Made-in-China PC Rule Won't Advance Nation's Tech Prowess," Bloomberg, May 10, 2022

¹¹ "President Xi Jinping in 2018 oversaw the launch of "China Standards 2035", a long-term strategy for developing tech standards," Nikkei Asian Review, July 6, 2022

¹² "Taiwan is worried about the security of its chip industry," The Economist, May 26, 2022

¹³ "Semiconductors: U.S. subsidy vote more about fate of Chinese chipmakers," Financial Times, July 19, 2022

the world capacity for the fabrication of 28-nm chips in 2025, up from 15% in 2021.¹⁴ But China remains heavily reliant on US and European technology to manufacture these chips.

Tensions make it harder for Western firms to operate in China

Tesla is an example. In May 2021, its cars were banned from certain military bases and housing facilities in China. More recently, they were forbidden from entering the Chinese coastal district of Beidaihe, the site of a secretive annual summer meeting held by Communist Party leaders for two months starting in July.

The widely reported reason for this ban is that the sensors and cameras in the vehicles could be used to spy on China's leaders for the United States. Tesla, for its part, has stated it complies with rules barring the transfer of data abroad. Other analysts feel that these restrictions are really part of a long-term plan to disadvantage Tesla in favour of homegrown champions.

Elon Musk's ties with the U.S. space-military-industrial complex via his company SpaceX and his decision to give Ukraine access to his Starlink internet satellite system have also aroused suspicions in China.

All of this comes at a time where his operations in China are causing unease in Washington. Senator Marco Rubio, the top Republican on the Senate Intelligence Committee, introduced a bill in December that would bar the National Aeronautics and Space Administration and other U.S. agencies from awarding contracts to companies with suppliers that have ties with China.¹⁵

Will great power tensions force certain corporations to break up?

One of the first major Western companies that could be forced to answer this question is HSBC. Headquartered in London, this company makes most of its profits in China/Hong Kong, which renders it particularly vulnerable to the escalating geopolitical rivalry between the superpowers.

In 2020, the United States criticized the bank for cooperating with Hong Kong authorities by freezing the accounts of political activists. That same year, China attacked HSBC for its role in providing documents that facilitated the arrest in Vancouver of Huawei CFO Meng Wanzhou, who was accused by the United States of trying to evade sanctions on Iran.

Recently, Ma Mingzhe, Chair of Ping An, China's largest insurance company, called on HSBC to split up its Asian and Western operations. Ping An owns 9.2% of HSBC's shares. Among the reasons cited were low investor returns.¹⁶

This position likely had to be approved by the Chinese government beforehand. Localizing control of the bank's Asian operations fits China's agenda of becoming more self-reliant in key sectors.¹⁷ **The more tensions rise between the West and China, the harder it will become for companies in key sectors to navigate this political divide.**

Increasingly tighter controls on private sector and individuals in China

China feels this era of heightened geopolitical tensions necessitates greater control over companies and government. Below are examples of what Chinese authorities have done in this regard over the past few years:

- Since 2018, foreign companies in joint ventures with state-owned Chinese firms have been required to have a Communist Party Cell within their organization. This rule will reportedly soon be extended to foreign fund managers.¹⁸ HSBC recently became the first foreign bank to install a Chinese Communist Party committee in its investment banking subsidiary (HSBC Qianhai Securities). This could pressure other foreign banks to follow suit. Communist Party Cells are essentially a means by which party representatives can oversee and perhaps attempt to influence a company's operations.
- It was reported last March that a Communist Party directive had been issued barring senior officials from owning property abroad or stakes in overseas entities, including through spouses and children. (It is unclear whether this only pertains to future purchases or extends to current holdings.) Reasons for this include fears that the international holdings of senior officials could be targeted if tensions continued to mount with the West.¹⁹

¹⁴ "China Chase Chip-Factory Dominance-and global clout," Wall Street Journal, July 24, 2022

¹⁵ "Elon Musk's Business Ties to China Create Unease in Washington," Wall Street Journal, March 20, 2022

¹⁶ "Breaking up HSBC," South China Morning Post, July 9, 2022

¹⁷ "Peter Ma: China's shy insurance tycoon bursts into the limelight," Financial Times, May 6, 2022

¹⁸ "Chinese Communist Cells in Western Firms?" Wall Street Journal, July 11, 2022

¹⁹ "China Insists Party Elites Shed Overseas Assets, Eyeing Western Sanctions on Russia," Wall Street Journal, May 19, 2022

- It is reportedly getting harder for Chinese to move abroad. Stemming the outflow of capital is one reason given for this development. This could mean that strict controls on outbound travel put in place on account of the pandemic will not be fully reversed anytime soon.²⁰
- While the reasons given for China's regulatory crackdown on the IT sector in 2021 include the risk of sensitive data falling into the hands of foreign governments and anticompetitive practices, we feel that another reason was to prevent the emergence of centres of power that could eventually challenge the complete control exercised by the Communist Party. IT companies are of particular concern because their platforms give them access to huge databases. This view has been influenced by what occurred in Russia following the collapse of the Soviet Union and recent events in the United States. The collapse of the Soviet Union was followed by the rise of Russian oligarchs who for a period of time had more power than the state. Moves by Twitter and Facebook to block then President Trump from their platforms also caught Beijing's attention. China wants to avoid any scenario that would permit its companies to have anywhere near the same level of influence.

China's moves to assert greater control over companies and society in general can also be seen as a challenge to the long-established Western orthodoxy that a country cannot become rich without first becoming democratic and loosening state control over education and business. Simply put, one side sees democracy and freer markets as essential to prosperity, while the other views one-party rule and government control as the key to delivering economic growth.

Will China invade Taiwan?

Despite the recent spike in tensions over House Speaker Nancy Pelosi's visit to Taiwan, we do not feel an invasion is imminent. However, China will continue to pressure Taiwan via a combination of unprecedented military exercises, economic sanctions and trade embargoes. Both great powers are aware that even a minor outbreak in hostilities between the two would shake the world economy and financial markets. For example, one could imagine the impact that the disruption of advanced chip supplies from Taiwan would have on China, the United States, and the global economy.

Despite these potential consequences, we feel the risk of an invasion will be much greater several years down the road, particularly if China concludes that no peaceful reunification is possible. The risk would be heightened further still if China acquires the ability to mass produce its own advanced chips. President Xi, who will secure a third 5-year term in power in November, wants to resolve the island's status on his watch. One strategy China could first employ is an air and naval blockade around Taiwan in hopes this would lead to Taiwan's surrender without having to undertake a risky land invasion.

In the event of an outbreak of hostilities, the United States would find itself in an almost untenable position. On the one hand, it would be very costly to defend Taiwan militarily. This is particularly the case given China's growing military power and its ability to concentrate its forces close to home while America's military might is spread out around the globe. Taiwan is roughly about 80 miles from mainland China compared to around 8,000 miles from the United States. On the other hand, deciding not to defend Taiwan would cause a huge loss of global geopolitical prestige and other countries, particularly in the Asian region, would think twice before basing their security on an American-led alliance.

Conclusion

Tensions between China and the United States are being driven by a combination of factors including a great power rivalry, radically different economic/governance models, conflicting financial regulations and, most importantly, a lack of trust.

On the one hand, the United States suspects that China's aim is to steal U.S. technology and become the world's top geopolitical power. On the other hand, China feels that the United States is seeking not only to gain greater access to the Chinese market but also to restrain China's rise as a global power.

The war in Ukraine and tensions surrounding Taiwan have further fuelled their mutual distrust and have fast-forwarded plans by both powers to become less reliant on the other in certain key sectors.

It is in this context that the United States is seeking to restrict where its companies can invest in China, intensifying efforts to deny China access to key technologies and potentially forcing most Chinese firms to delist from American stock markets. The United States is also taking a page from China's game book and directly supporting key sectors. The recent passing of the \$280-billion Chips and Science Act, which includes \$52 billion for domestic semiconductor production, is a case in point. This bill

²⁰ "It's getting harder and harder to leave China, even as record numbers head for the exits," Globe and Mail, July 21, 2022



also includes a rule stating that companies receiving funding cannot make new investments in advanced semiconductor manufacturing plants in China or other countries of concern for 10 years.

As for China, in addition to strengthening its hold over green-energy supply chains, it is looking to increase its self-reliance via the following measures: mandates to produce more computer hardware domestically, massive efforts to close the gap in the advanced chip sector, and exercising more control over companies operating in China, both foreign and domestic.

To navigate these political tensions, companies will increasingly base production and supply chains closer to points of consumption. This means, among other things, having separate databases, software systems and research centres. In certain situations, some companies could even be forced to sell off certain of their operations as they are forced to choose between China and the United States.

Finally, as a result of all this, it is almost inevitable that American and Chinese companies heavily dependent on one another's markets in sectors deemed strategic will lose market share over the long term. For example, China's intentions to build up its capacity in the semiconductor sector, combined with American restrictions on sales to China, mean that U.S. semiconductor companies will very likely lose ground in China over the medium to long term. This includes companies that design software and equipment needed to manufacture semiconductors. The likely reorganization of these supply chains will reduce economies of scale and add to operating costs.



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