The Geopolitical Impacts of Investment Restrictions and The Liability of Being Multinational

By Margaret Kenney

Graphics Credit: Anthony Wallace/Agence France-Presse/Getty Images

On 9 August 2023, the Biden administration released a long-awaited executive order detailing new investment rules for private equity and venture capital firms in "countries of concern."[26] In this case, Biden is referring specifically to the risks of investing in China, Hong Kong, and Macau. The rules ban investments in certain Chinese high technology companies within the semiconductor, quantum computing, or AI sectors.[27] In addition, the order creates a notification regime if private equity or venture capital firms would like to invest in Chinese high technology companies. The United States has never before placed explicit bans / restrictions on outbound investment, instead focusing on incoming funds; therefore, some are dubbing the bill "reverse CFIUS." The order will enter a period of notice and comment before taking effect, offering industry, government, and civil society (among others) an opportunity to provide feedback. In its current form, the executive order is particularly narrower than previously expected; Republican legislators expressed frustration following its publication that the order did not go further in regulation of more industries / sectors. However, the order leaves the door open to the addition of more industries that could become politically sensitive and important for national security.

With the Chinese economy already in a difficult position following the COVID-19 pandemic and the crackdown on U.S. companies internally, there are significant concerns about how this executive order could impact China's ability to sustain firm innovation and performance. Prior to this action, FDI into China had fallen by 89 percent from the previous year.[28] Beijing, with an unequivocal denunciation of the order, called attention to its anti-competitive and anti-free market nature. The PRC spokesperson stated that: "the move's real aim is to deprive China of its right to develop and selfishly pursue US supremacy at the expense of others." In the remarks, Beijing also reserved the right to respond, leaving U.S. investors nervous about the potential for backlash specifically in export controls of rare minerals (as one example).[29]

This investment restriction will have significant implications for the structure of the international system and international political economy. Namely, the crackdown on international cooperation may result in the localization of firms and a "liability of being multinational." With heightened tensions between the United States and China, firms are increasingly being caught in the crossfire of their geopolitical conflict with major impact on their business operations and profit margins.

Strange (1996) argues that "the internationalization of production is slowly but surely undermining the whole concept of nationality" (57). Despite these scholarly discussions that companies are becoming increasingly multinational and "stateless" as a result of globalization, Wellhausen (2014) demonstrates that nationality is still salient to firms as it provides them cover (through BITs) from foreign government expropriation. I argue that the recent developments in the U.S.-China trade war will only heighten the localization of firm's identity and increase the liabilities of operating as a "stateless" MNC. It may instead be preferable for the firm to divide into concentrated domestic firms, rather than operating as a worldwide conglomerate. Localization will occur through two mechanisms: (1) the breakup of multinational investment firms into regional or localized firms to avoid scrutiny and (2) the decrease in mergers and acquisitions of high technology firms because of a lack of cooperation between the United States and China.

Regardless of the Biden administration's assurances that they are not pursuing decoupling, the localization of firms to avoid U.S. or Chinese scrutiny will have significant policy implications. There will be significant effects on the investment environment, as firms face increased operating costs and avoid the Chinese market due to potential liabilities. In addition, the breakdown of firms will permanently cement the increasing lack of consensus and cooperation in the business community. Finally, the response of U.S. firms to this executive order will provide insight into business's willingness to cooperate with Biden's economic statecraft: a record that has proven so far dismal. A new administration could roll back these controls fairly easily, given that they take the form of an executive order rather than congressional statutes; however, once firms begin to fragment and localize, there will be path dependency given the costs and difficulties of undertaking these large-scale changes. In addition, national security concerns in regard to China are one of the few bipartisan issues in the highly polarized American political system; Biden maintained the majority of Trump's orders in regard to China. Therefore, these policy implications will have long-run consequences for the structure of the international system and U.S.-China conflict.

Mechanisms

Firm localization

The new investment restrictions incentivize localization to avoid scrutiny of high technology investments in both the United States and China. Many firms may prefer to break up operations into multiple entities, rather than removing all investment in China, given the potential payoffs of Chinese startups (e.g. success with ByteDance) and their large consumer market. With the potential for the executive order to expand into additional sensitive sectors, investment firms will have to weigh the costs of complying with the costs of operating separate national entities in comparison to the threats of the investment bans and notification regime.

As an example, Sequoia – a venture capital (VC) firm – has already initiated this localization process (prior to the EO). Sequoia had been under significant scrutiny due to their investment practices in China. The VC firm had invested in an artificial intelligence startup which eventually became a contractor for China's People's Liberation Army (PLA).[30] Although perhaps unexpected by the VC investors, this situation highlights the U.S. concerns with investment in sensitive technologies and how they can be operationalized outside the commercial context to heighten China's military stature. Firm behavior and national security are now inextricably linked due to dual use technologies.

In part because of the pushback as a result of geopolitical tensions, Sequoia announced that they would separate into three separate businesses: Sequoia Capital (US), HongShan (China), and Peak XV Partners (India and Southeast Asia).[31] The partners of these three companies stated: "To deliver on our mission, we have decided to fully embrace our local-first approach."[32] Once the businesses separate in March 2024, they will no longer share a back office, infrastructure, or profits.[33] Although the firm predicts that its investor base will continue to stay the same after the split, the increase in operational costs will surely have an impact on the firm's capabilities and investment potential.[34]

With the U.S. now implementing explicit limitations on investment in sensitive sectors, it is likely that other venture capital and investment firms will face similar trade-offs and even greater pressure to avoid risky cross-national investments. To evade U.S. scrutiny and investigation, these businesses may choose to disentangle their multinational business portfolios (like Sequoia) and localize, rather than test the boundaries of the investment regulations.

Prevention of mergers and acquisitions

Along with the breaking up of companies, U.S.-China competition has prevented the concentration of industries and consolidation of companies through mergers and acquisitions. China, the United States, and the European Union have created extensive regimes to regulate antitrust. New amendments to China's 2007 Anti-Monopoly Law called for increased scrutiny of potential monopolistic behavior and raised fines for participating in monopolistic behaviors in 2022.[35] If the merger involves firms that make more than $117 million per year in China, they are required to undergo review by the Chinese State Administration for Market Regulation.[36] There are certainly legitimate reasons to deny a proposed merger and acquisition, particularly if it would violate antitrust rules and create a monopoly within an industry. However, this lever of power seems to have been politicized based on geopolitical tensions and may continue to be used as such. In addition, the increase in staff and concentration of review inside the Chinese State Administration for Market Regulation make it clear that these developments are not merely a result of unintended slow bureaucracy, but a purposeful slowdown to impact U.S. business interests.[37] Given the number of firms that meet the threshold for Chinese antitrust review, the agency's actions will have far-reaching consequences.

As one example, Intel (a semiconductor manufacturer based in the United States) had hoped to acquire Tower, an Israeli chip manufacturer, to expand its production of chips. Despite approval by U.S. and EU antitrust regulators, Beijing refused to provide a ruling on the transaction.[38] Intel had allocated extensive efforts toward liaising with Chinese officials to move the transaction forward, with the CEO visiting China in July 2023 in a final push to receive a ruling on the merger.[39] However, the Chinese anti-monopoly regulators never responded to the request and the merger expired, requiring Intel to pay a $353 million fine for failing to close the deal.[40]

The merger would have allowed Intel an opportunity to expand its chip manufacturing and production; given the sensitive nature of this technology and its applications, especially with the concentration of production in Taiwan's TSMC, it appears that the Chinese government was nervous about the United States continuing to build these capabilities and preventing their export to Chinese markets. With the CHIPS Act simultaneously providing significant funding to Intel's chip development,[g] this merger appeared to be another threat to China's desire for military and technological growth.

In addition, the merger between U.S.-based Broadcom Inc. and VMware faces similar bureaucratic hurdles in China. With the merger slated to close on 30 October 2023, Broadcom announced that the deal will "close soon" after missing this initial deadline.[41] The effects on investment are not trivial; the failure to close the deal has resulted in investors feeling spooked and a significant loss in stock market value.[42] Beyond the case of Intel and Broadcom/VMWare, other examples of China's silence on merger and acquisition approval include Qualcomm's 2018 attempted purchase of NXP. Similar to the other two cases, the chipmakers did not receive China's approval ahead of the merger deadline; "the failed deal was considered a victim of the growing U.S.-China trade tensions at the time."[43] With the continuation of these trade tensions, it appears that China's willingness to retaliate via non-approval of mergers and acquisitions will have long lasting effects.

China appears to have slowed its review of U.S. mergers and acquisitions across the board. As a potential precondition to approval, the agency has requested that firms under review "make available in China products they sell in other countries in a bid to counter U.S. exports controls on China."[44] These developments are viewed as retaliation for the U.S. restrictions on China's tech industry.[45] In addition, this economic statecraft lever is viewed as a "relatively subtle and low-cost way to pressure foreign companies and by extension, their governments."[46]

This delay in M&A review may have a "chilling effect" on investment; further, companies "may need to choose between having operations in China or carrying out mergers and acquisitions across the globe."[47] With the benefits of operating in China and the sunk costs that companies have already invested there, these delays in merger review could limit consolidation and leave firms more localized (rather than multinational) in the long run as U.S.-China tensions remain heightened. In addition, these changes may result in divestment and lack of expansion in China because of the increased costs of doing business and the difficult regulatory environment.[48]

Policy Implications and Conclusion

The breakup of MNCs into smaller, localized firms will have significant effects on the operating environment of firms and the international political economy. Rather than being able to share bureaucratic and administrative apparatuses, the individual firms will have to maintain separate departments, such as compliance. Overhead costs will increase and, coupled with high interest rates, could deter the growth of investment. Subsequently, important innovation in startups and other firms may be deterred. In addition, without the ability to undertake mergers and acquisitions in high technology sectors, consumers may face higher prices as firms are prevented from reaching economies of scale and consolidating redundant functions through partnerships with other firms.

Next, inter-firm coordination and communication will be complicated even further as localization continues, exacerbating collective action problems amongst firms. Since the breakup of the "inner circle" of American business as a result of bank regulations, there has been limited political consensus and communication between firms.[49] This breakdown has been detrimental to business' ability to pursue coordinated action on broad based and moderate policies that benefitted the public. By decomposing relationships between firm leadership even more by

[g] The CHIPS Act offers subsidies to domestic chip factories; with Intel currently building two fabs in Arizona and two in Ohio, "it stands to be the biggest beneficiary. Its payouts will likely total several billion dollars or more, arriving gradually through 2031." See Oregon Live. 2022. Biden signs $280 billion CHIPS Act; Intel stands to be the biggest winner - oregonlive.com. Oregon Live. Available at <https://www.oregonlive.com/silicon-forest/2022/08/biden-signs-280-billion-chips-act-intel-stands-to-be-the-biggest-winner.html>. Accessed 22 August 2023.

localizing firms and breaking down MNCs, consensus will grow exceedingly more difficult. Although business advocacy is often associated with single-minded profit maximization, American business leaders were able to advocate for the public good and offer helpful policy recommendations to the government at the height of their power in the twentieth century.[50] Permanently altering these relationships could permanently break down communication channels and make collective action problems for business more difficult. In the difficult geopolitical environment amidst U.S.-China tensions and the Ukraine War, the present time requires more coordination, not less, amongst business to solve problems and increase profit margins across the board.

Finally, localization would be another substantiation of the issues that the U.S. government faces when attempting to implement economic statecraft to protect state security through economic levers. Namely, U.S. companies are largely unwilling to accede to the demands of the government when it negatively impacts their business interests.[51] When comparing the United States to “strong states” (China, Japan, South Korea, and Singapore) that are pursuing economic statecraft, it is unlikely that the United States will be able to compete using these levers, without a centralized decision-making system and supportive firms.[52] Given the attempts to circumvent policies through costly measures – the breaking up of companies – it is clear that firms are likely to find ways around U.S. national security protections to continue inflating their profits rather than cooperating with efforts to protect national security. For economic statecraft to work, the United States will need to invest significant efforts into cultivating stronger relationships with business leaders and taking their feedback into account prior to policy publication (rather than initiating notice and comment periods to hear their thoughts in the aftermath).

In conclusion, the rise in economic statecraft and U.S.-China competition will have profound structural consequences for the international system. In this article, I discuss the potential for firm localization as a result of new U.S. investment restrictions and Chinese hostility to mergers and acquisitions – at the very least in high technology industries, but perhaps beyond as well. Future research should track the empirical response to these policy changes, as well as pay attention to China’s potential retaliatory response.

Read the December 2023 special issue of *Business and Politics* and submit your papers for publications at: https://www.cambridge.org/core/journals/business-and-politics