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IN THIS ISSUE

National Security Enters the Tech Rivalry Fray: New Regulatory Hurdles to Cross Border Investment

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Graphics Credit: Collier International

Fueled by a perception that China is becoming a strategic rival rather than a partner in the liberal global order, there are growing concerns about Chinese investments in strategic sectors abroad, not just in the US but also in Europe and elsewhere. Investments in key emerging technologies are attracting particular attention. In the abridged article for Global Asia, below, we lay out the wide-ranging regulatory frameworks that are being put into place to submit foreign direct investment to greater scrutiny on national security grounds. They are a new battleground in the war for technological supremacy.

Much has been made of negotiations between the United States and China amid their "trade war" over the past two years. Concerns by the US government about the role of Chinese firms – especially Huawei – in the buildout of next-generation 5G telecom networks around the world has provided the most recent episode in what has been described as a Cold War over technology involving Beijing and Washington. In part due to bilateral discussions between Washington and other capitals around the world, Huawei has been blocked from providing a tender for the buildout of Australia's 5G network, with Canada and Germany currently considering legislation to limit Huawei's role. In the US, existing rules ban the government's use of Huawei and ZTE equipment, and President Donald Trump's administration is considering a total ban on the use of Chinese equipment on US networks. With the focus of analysts on these trade issues, however, the critical changes in how countries are approaching foreign direct investment (FDI) have fallen by the wayside.

From Washington to Berlin and Brussels to Beijing, governments are increasingly turning to new and enhanced regulations in the name of national security to review and block cross-border mergers and acquisitions (M&A) – changing global patterns of FDI. The consequences of these new merger and investment regimes for regulators, governments and firms, however, remain under-explored. Given the new contours of inter-state competition and the role of emerging technologies in this competition, understanding these patterns is essential.

In 2018, the US passed legislation to expand the oversight procedures of the existing Committee on Foreign Investment in the United States (CFIUS) to include even minority stakes in American companies – including those from venture capital and private equity firms. China, too, passed a new law to address concerns about forced technology transfer in 2019, but still has significant oversight of foreign investment through its 2015 National Security Act, focusing on cybersecurity and critical technology. Germany has also become sharply concerned about Chinese FDI, in particular, and passed an amendment to its existing FDI rules in December 2018 that lowers the threshold to review deals to 10 percent from the previous 25 percent. Germany's minister of economics has also proposed both German-French cooperation on industrial policy in key industries and supported an EU-wide framework agreement on national security reviews by member states.

This essay analyzes the evolution of M&A rules driven by concerns over national security. We provide a brief history of CFIUS to examine its performance before noting its perceived limitations that led Congress to pass the Foreign Investment Risk Review Modernization Act (FIRRMA) in 2018. We then examine similar international efforts to address cross-border investment and discuss the potential consequences of these developments. Finally, we focus on the importance of three key issues: the problem of national security becoming an open-ended excuse for protectionism, how to address early-stage investments in emerging technologies, and whether active government participation in a host of industries will achieve its intended goal.

The Evolution of CFIUS

To understand the significance of new legislation and its potential effects on FDI, it is worth revisiting the history and evolution of CFIUS in the United States. Here we outline the evolution of CFIUS since its inception by Executive Order in 1975. Specifically, we point to the various amendments and to the processes that have been proposed and implemented to address concerns regarding the role of foreign investments in the economy and the interaction between domestic markets and national security.

Upon its creation, CFIUS was focused primarily on information and data collection – although it remained unclear what its role ought to be. It wasn't until the 1980s that Japanese acquisitions in defense-related sectors including steel, manufacturing, and semiconductors, along with the 1988 Exon-Florio Amendment outlining how CFIUS should review foreign investments, resulted in the presidential authority to block mergers, acquisitions, or takeovers. The standard for making this decision included "credible evidence" that the foreign investment under investigation would impair national security. The amendment also played a role in outlining the voluntary notification of acquisitions to CFIUS and made clear that these declarations would be confidential.

The Byrd Amendment later required CFIUS to investigate mergers, acquisitions, or takeovers in which: 1) the acquirer is controlled by or acting on behalf of a foreign government; and 2) the acquisition results in control of a person engaged in interstate commerce in the US that could affect the country's national security.[I] It is worth pointing out that there would be later disagreement concerning the degree to which these reviews were discretionary or mandatory – particularly in the case of Dubai Ports World in 2006, concerning the management contracts for six US ports and its potential sale to DP World – a state-owned firm in the United Arab Emirates (UAE). These contracts were already foreign-owned by the British firm P&O, but when P&O was acquired by DP World, Congress voted to block the deal. DP World would eventually sell P&O's management contracts for the six US ports to AIG, a US firm.

The DP World episode led to changes in the CFIUS process via the Foreign Investment and National Security Act of 2007 (FINSA). FINSA added "critical industries" and "homeland security" as broad categories of economic activity subject to CFIUS review; set out to define the standards for investigation; and gave CFIUS statutory authority. FINSA also sought to better define the circumstances in which an investigation would be appropriate, pointing to a threshold of 10 percent of voting securities as a standard for "controllability" as well as judgments by CFIUS members concerning board seats. The act also made clear that passive investment vehicles – investment funds, banks and insurance companies – carrying out their normal business do not constitute grounds for investigation.

From its inception to the present, five acquisitions have been blocked through the CFIUS process. President George H.W. Bush directed China National Aero-Technology Import and Export Corporation (CATIC) to divest its acquisition of MAMCO Manufacturing in 1990. More recently, President Barack Obama directed the Ralls Corporation to divest from an Oregon wind farm project and blocked a Chinese firm, Fujian Grand Chip Investment Fund, from acquiring Aixtron, a German semiconductor firm with US assets. In 2017, President Trump blocked the acquisition of Lattice Semiconductor Corp. of Portland, Oregon for $1.3 billion by a Chinese investment firm, Canyon Bridge Capital Partners, as well as the acquisition of semiconductor chip maker Qualcomm by Singapore-based Broadcom for $117 billion.

Looking at the five acquisitions that US presidents have decided to block, however, doesn't tell the whole story – given the selection effects concerning those investigations that run their course. Indeed, several mergers and acquisitions have been abandoned or reconstituted – including the DP World case noted above – to avoid being blocked through the CFIUS process.

New Developments in US FDI Regulations

As noted, the CFIUS process has been predominantly focused on controlling stakes taken by foreign firms in US companies or multinational companies with contracts related to US critical infrastructure. These "traditional" pathways of regulation, however, turn a blind eye to how a number of countries engage with American firms, particularly those in the technology sector working on emerging technologies – including artificial intelligence, quantum computers and next-generation space systems. The role of Chinese investment funds as well as Chinese funding for traditional venture capital firms in the US has been well-documented – though largely absent from the public discourse, which instead has focused on procurement guidelines (specifically related to Huawei and ZTE) and US-China trade concerns.

The 2018 FIRRMA legislation puts these issues back on the agenda. It expands the types of foreign activity in the US market that are subject to oversight. Specifically, FIRRMA lowers the threshold for investigating foreign investment to include any foreign "non-passive" investment in companies involved in critical technology. The technologies discussed during the floor debate concerning the passage of FIRRMA in the House of Representatives included artificial intelligence, robotics, augmented and virtual reality, new biotechnologies, new financial technologies, and advanced materials. According to Croley et al., FIRRMA changes the jurisdictional framework by extending CFIUS review to "any investment that relates to a US business owning or maintaining "critical infrastructure;" a business involved in the development, design or production of "critical technology;" or a business collecting or maintaining "sensitive personal data" of US citizens, in the event that the investor acquires (in connection with the investment) "any material non-public technical information;" is granted membership or observer rights on any board of the business; or has "any involvement" in the decision-making of the business."[2] Importantly, this means that transactions that do not lead to foreign control of a company are still subject to disclosure, review and investigation.

For some, this is a welcome amendment to the CFIUS review process. The US Department of Defense's Defense Innovation Unit (DIU), formerly DIUx, has a series of reports outlining how Chinese investments have contributed to technology transfer across the Pacific – arguing that the existing CFIUS review process has only been partially effective.[3]

There are clearly significant challenges associated with the new legislation. First, the US Treasury Department and other enforcing agencies face a series of decisions concerning which technologies will be subject to heightened scrutiny and control and whether some countries – particularly US allies – are to be exempted from the requirements. Second, companies will have to amend their own procedures and auditing processes regarding foreign investment and resulting voluntary declarations to CFIUS review. Both concerns are suggestive of the difficult balance that policymakers and companies must strike related to national security considerations while maintaining an open investment environment in the US. But the changes we have seen in new legislation, driven in large part by Chinese foreign investment, are hardly restricted to the US.

In the section below, we turn to international regulations related to FDI to contextualize US legislation and to point to the broader transformation of the regulatory regime driven by emerging technologies and a changing geopolitical landscape.

International Regulations on FDI

Countries have long sought to regulate FDI through unilateral, bilateral, minilateral and global arrangements. While not always explicitly focused on national security, such concerns often underlay efforts to restrict the amount and types of investment. In 1971, the Andean Foreign Investment Code sought to influence the terms on which its members contracted for various types of technology, seeking to avoid overpayments to multinational corporations (MNCs). Restrictions on specific sectors also formed a key part of the Code, with explicit exclusions for investment in critical infrastructure such as public services, finance and almost all media.

More recently, the focus of FDI regulations in the name of national security, as with the US case outlined above, has been driven by Chinese investments. In particular, concerns about core industrial sectors, emerging technologies and dual-use technologies have all been drivers of new regulations. In 2009, Canada created a national security review process for FDI based on its Investment Canada Act, focusing on a host of sectors, with an emphasis on defense-related industries and data security. Any transaction could be reviewed under this act, but of 4,500 cases since its creation, only 13 transactions faced review, with provisions for divestment or mitigating actions.[4]

In Europe, the UK has moved forward to strengthen national security reviews of investment, rather than only relying on the existing Competition and Markets Authority (CMA), which is based on a 2002 law that allowed the government to examine mergers based on national security considerations. The new approach, proposed in a July 2018 White Paper, specifies triggering events based on varying levels of shares and assets.[5] While parties to a transaction are encouraged to voluntarily submit their proposed acquisition to the government, the government also can initiate a review of transactions on its own. In terms of likely impact, the White Paper predicts that approximately 200 cases will be subject to review on a yearly basis, with about 50 requiring some mitigating action on the part of the parties in light of national security concerns. In response to this proposed approach, which is likely to be instituted by 2020, venture capital (VC) firms, law firms, pension funds and others have expressed concern about the possible uptick in cases that will fall under national security review. Under the 2002 law, only nine cases were subject to government intervention.[6]

In continental Europe, France has regulated and blocked FDI since 1966. Its 2004 law expanded the sectors that would be subject to review from weapons to include infrastructure investments such as electricity, gas, oil and water. Pending approval of the French Senate, the PACTE Law first proposed in June 2018 will expand its sectoral overview to AI, data, space, cybersecurity, dual-use goods, robotics and the like. The bill gives the government the right to suspend voting rights and dividend distributions, appoint a trustee in the company to oversee French interests, and sell French assets. Moreover, both acquiring and target companies can seek a review by the Ministry of Economy for their opinion of the investment.

Germany has for the most part been very welcoming with respect to FDI, with few restrictions for national security. Very recently, this has begun to change dramatically. Since 2004, the German Ministry for Economic Affairs and Energy (BMWi) has had the power to review M&A activity in security related industries including military equipment and IT products used for encryption. This review was extended in 2009 to include any M&A activity by non-European investors if a foreign entity acquired more than 25 percent of voting rights. In 2017, in the aftermath of concerns about a 2016 acquisition effort by a Chinese company of a German industrial robotics company and a proposed chip company acquisition, the scope of review was expanded to include critical infrastructure, cloud computing, telematics and some key software. The 25 percent threshold was lowered to 10 percent for sector-specific acquisitions that might impinge on national security, and the scope was expanded to include the media in December 2018.

In addition to these changes in German law, in early February 2019, breaking from longstanding German opposition to industrial policies at the federal level, the Minister of Economics, Peter Altmaier, proposed in a paper the "National Industry Policy 2030." In it, he calls for both a preference for European-wide mergers over outsiders, including looser rules on mergers, and industrial policies including a national investment facility to prevent M&A efforts by non-European companies. In particular, he points to the critical importance of national and European capabilities in AI, autonomous driving, automated production, digitalization and the platform economy. This effort was followed just two weeks later by a joint French-German manifesto on a 21st century industrial policy.[7] The manifesto calls for technology funding from the government in collaboration with the private sector, support for high-risk projects in new technologies, cooperation in R&D in AI, consortia, and better financing in general. Specifically with respect to M&A, without naming countries, it calls for consideration of "state-control of and subsidies for undertakings with the framework of merger control" and reciprocity in public procurement. There is little doubt that the goal of this effort is primarily to address Chinese industrial policy and investments. The manifesto also calls for implementation of an EU-wide screening procedure, to which we now turn.

The EU has long coordinated trade policy, but has done little with respect to creating common national security review policies on FDI. Currently, only 14 of the EU-member states have a national security screening procedure on FDI. But beginning with a European Commission proposal in September 2017 for the development of a framework to screen FDI entering the EU, the EU moved quickly, with both Parliamentary and Council approval by July 2018, leading to a proposed Nov. 20, 2018 agreement. Following approval by Parliament this year, the framework is likely to come into effect in November 2020. The accord does not call for a single common policy but for information exchange on best practices and allows the Commission to "issue opinions in cases concerning several Member States."[8] With respect to scope, the deal covers critical infrastructure and technologies, robotics, AI, cybersecurity, dual-use products, media, and broader infrastructure – similar to the coverage of the new German FDI laws.

In China, the Sino-Foreign Equity Joint Venture Law of 1978 permitted foreign investment, but with a host of strict regulations, management and oversight. In the 1990s, China created the Catalogue to monitor investments by distinguishing between investments that were encouraged, restricted and prohibited, thus providing sectoral restraints on investment. Examples of prohibited investments in the 1990s included the power industry, telecommunications, broadcasting, and military arms, among others, and created conditions on the type of technology that firms could bring in, setting the stage for later national security-oriented legislation. The Catalogue was replaced by a "negative" list, and in 2011, the government created a specific National Security Review process that focuses on M&A activities. Any domestic companies in defense-related industries, such as agriculture, energy, resources, transportation and technology could all be subject to review. The passage of the 2015 PRC National Security Law set the stage for a much more significant national security process on M&A, modeled in part on CFIUS. The first step was the June 2017 Cybersecurity Law, growing Chinese investments that affect the inflow of FDI into countries. In our view, we must pay attention to three critical issues.

First, while we agree with the concerns underlying this trend, particularly in areas such as cybersecurity[10] and emerging technologies that are dual-use (with civilian and military purposes), the question remains whether and how these new regulation will change the level of scrutiny concerning international investment. The temptation for protectionist interest groups to frame claims for protection in terms of national security in investment, just as they have in trade, may well prove irresistible. With the passage of FIRRMA legislation in the US, and comparable legislation elsewhere, there is a real danger that national security reviews will be abused. Most of this legislation, while specifying particular industries that are "critical," leaves a large amount of discretion in the various committees and enforcing bodies that are being set up. So far, at least in Western countries, the number of cases of national security reviews being used to block FDI has been remarkably small. But with new legislation on the books, and continued fear of China's outward FDI push, it appears inevitable that the number of cases will grow rapidly. A key question is whether the differing national approaches to national reviews of investment will lead to pressure to create an international regime to regulate what states are doing.

Second, the new emphasis on the regulation of investments by venture capital and private equity firms in the case of FIRRMA raises an important issue regarding how it will carry out its regulatory function. As we have argued, the prior focus of both the US and other countries' regulations on mergers and acquisitions may have been misplaced. If the goal of other states is to transfer key technologies across borders, there are alternative and more efficient vehicles for doing so, including early-stage investment. Over the last 30 years, innovation has been driven by startups backed by seed-stage and follow-up investments by venture capital funds. The new FIRRMA legislation in the US seeks to address this, but it remains an open question whether the opaque origins of investors in many venture capital and private equity firms will prevent technology transfer by foreign countries of critical innovative technologies being developed by Silicon Valley startups. A number of US-based firms, for example, have taken funding from sovereign wealth funds and monies from abroad and in turn channeled that investment into Silicon Valley. In principle, the FIRRMA legislation should lead to these types of transactions being reviewed. In practice, however, investors may argue that they do not have a controlling stake or a board seat and should avoid review. It remains unclear whether the CFIUS process that has hitherto relied on voluntary declarations has the regulatory power to address edge cases in which investors attempt to obfuscate their identity.

Third, it is also worth considering the question of whether efforts undertaken to reduce technology transfer and to mitigate their strategic benefits will have unintended consequences. When government funding vehicles have sought to provide early-stage investment in Silicon Valley firms, they are often last to the party. It is worth considering, then, how the research and development pipelines of companies are likely to be affected by rules designed to increase transparency and scrutinize foreign investment. On its face, increased transparency represents a good idea but it is also likely to increase the reporting requirements placed on (relatively small) firms and impact the speed at which startups grow.

FIRRMA and efforts like it that have been undertaken abroad, while increasingly common, are not a panacea. Understanding their effects and limits represents an important subject of study for companies big and small as well as academics and lawyers.

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DIRECTOR'S NOTE

Dear Colleague,

Thank you for your continued interest in the Berkeley APEC Study Center (BASC). Through your readership, we are excited to continue being a part of an interdisciplinary conversation regarding the dynamics of the increasingly critical Asia-Pacific region. This newsletter highlights BASC's approach to understanding international competition in the 21st century. As is hopefully clear in our opening piece, analyzing contemporary strategic rivalries requires a broad conceptualization of the links between the global economy and international security. Along those lines, this edition reports on two conferences BASC held in October 2019 on great power competition and middle power maneuvering in East Asia. This newsletter also presents research on multiple dimensions of Sino-American competition, and trade tensions between South Korea and Japan.

To begin, Alex Kaplan surveys the implications of ongoing technological competition between the United States and China. After discussing this dynamic in terms of Chinese industrial strategy and the US response via its foreign investment policy, he discusses how Chinese investment into the United States has not been entirely choked off—even in more geo-strategically sensitive areas of the economy.

Next, Tianyu Qiao contextualizes China's pending announcement of a non-reliable entities list. She explains how such a list is a countermeasure to US actions and juxtaposes it with China's other lists governing foreign investment. Against this backdrop, she considers the implications of such a move for Sino-American relations.

Third, Jazz Van Horn discusses the consequences of the protests in Hong Kong for the global economy and geopolitics. She argues that protest-induced disruptions to Hong Kong's financial markets could spill over into the Chinese economy and, by extension, impact the global trading system. She also considers how the US Congress's recent passage of a law affirming support for Hong Kong could ultimately exacerbate the ongoing trade war with China.

But, as Michelle Lee points out, South Korea and Japan are also engaged in a trade dispute with global implications. In analyzing Japan's decision to remove South Korea from its trading partner White List, she illustrates how this particular row differs from the other contentious episodes that have frequently arisen between the two countries by citing its implications for long-term security relations and global supply chains.

Finally, Lillian Gage critically examines the prospect of an international regime for digital trade. Using the US-Japan Free Trade Agreement as a springboard, she addresses the question of whether bilateral agreements like this one represent the future or if the issue can successfully be taken up in the World Trade Organization. Given the difficulties arising from data localization and other cybersecurity concerns, she argues that digital trade is not ready for an international regime.

Hopefully this newsletter will help enhance your understanding of the linkages between politics, economics, and business in the Asia-Pacific. BASC is especially grateful for the generous support from the Institute of East Asian Studies, the Center for Chinese Studies, the Center for Korean Studies, the Clausen Center, the Institute of South Asia Studies and Center for Long-Term Cybersecurity at UC Berkeley for our cooperative projects. We are also deeply grateful for the sustained support of the UC National Laboratory Fees Research Program in our collaboration with the UC Institute on Global Conflict and Cooperation, as well as the Taipei Cultural and Economic Office in San Francisco. We are also deeply grateful for the sustained support of the Ron and Stacey Gutfleish Foundation, the Notre Dame Pietas Foundation, Christopher Martin, and our ever-expanding group of former BASC alums.

Through our supporters, collaborators, and colleagues like you, BASC has the privilege of advancing the discussion on a range of critical economic and security issues.

Vinod K. Aggarwal
Director, Berkeley APEC Study Center

BASC PROJECTS:
SUPER AND MIDDLE POWERS IN AN ERA OF STRATEGIC COMPETITION

By Philip Rogers, BASC Project Director

Graphics Credit: UC Berkeley Institute for East Asian

On October 24 and 25, 2019, BASC organized two back-to-back conferences in continuation of its major research agenda on super and middle power competition. Scholars from across the globe convened at the UC Berkeley campus to present papers on strategic trade, industrial policy, and investment regulation with regards to powers in the Asia-Pacific and beyond.

The first conference, titled “Great Power Competition in the 21st Century: Linking Economics and Security”, was part of a multi-year collaboration with the UC Institute on Global Conflict and Cooperation. Through generous support from the UC-National Laboratory Fees Research Program, scholars working on the politics and economics of China, the United States, India, the European Union, and Brazil converged to discuss the implications of competition in a broad range of geopolitical and economic arenas. Papers examined such topics as the use of trade and foreign investment to promote soft power; the effects of technological competition on industrial policy and global supply chains; and the linkages between domestic and foreign policy.

The second conference, titled “Maneuvering in a World of Great Powers”, was hosted in conjunction with UC Berkeley’s Institute for East Asian Studies and made possible through generous support from the Taipei Cultural and Economic Office in San Francisco. In the spirit of the conference’s name, participants focused on the perspectives of Taiwan, South Korea, Japan, and even the United Kingdom against the backdrop geostrategic competition between the United States and China. Specifically, papers addressed issues like the global commons, maritime and nuclear security, clean energy initiatives, and trade/investment ties.

Both conferences reflect BASC’s emphasis on combing perspectives from economics and security studies to research contemporary international relations. Indeed, they are part of BASC’s agenda to foster research projects, symposia, and publications that help explicate the dynamics of regional and global competition among a variety of states across a multitude of areas.

US-CHINA COMPETITION HAS ADVERSELY AFFECTED BUSINESS ACTIVITY... BUT TO WHAT EXTENT?

By Alex Kaplan, BASC Research Assistant


Graphics Credit: National Committee on US-China Relations

The structure of the global economy in the coming decades will largely be influenced by the actions (or lack thereof) of the United States and the People's Republic of China. The United States is finding its global leadership role in a vulnerable position, a development that has reached a turning point under the Trump administration. Under the direction of President Xi Jinping, China is leveraging its economic strength to extend its influence in ways that alter the balance of global political and economic power.[1] The way these powerful states interact with each other will reverberate through almost every aspect of an emerging bipolar world -- especially in business, trade, and finance.[2] The US-China trade war is an example of a broader trend toward bilateral antagonism largely motivated by technological competition. This technological cold war has become a key geopolitical issue today, as it involves the race for leadership in critical technologies with a broad range of commercial and military applications like artificial intelligence (AI). Chinse actors, many of whom are state-owned enterprises, have pursued these technologies through investment in the United States. Washington, wary of China's rise, has acted to contain this activity. Yet despite the tenser investment climate that has resulted, the flow of capital between the United States and China has not been entirely choked off.

The trade war has exposed the volatile outcomes of great power competition. The effects of its tariffs have spilled beyond US and Chinese capital markets and throughout Eurasia due to the interconnectedness of supply chains in our globalized world. But while the economic impacts are globally consequential, seminal geopolitical issues are likewise at stake. Simply put, the trade war is not just about trade. US-China competition has become the pivotal geopolitical issue of the day. Today's conflict is the result of mounting skepticism over China's rise that began in the early 2000s given the uncertainty surrounding the Chinese Communist Party's ambitions.[3]

China's impressive ascension into the ranks of the largest, fastest growing world economies and the accompanying surge in international political power has made the United States consider China a legitimate threat. China's robust economy has allowed it to pragmatically pursue policy initiatives. China's compliance, or extent of compliance, with World Trade Organization (WTO) rulings reflects how it maneuvers the system to achieve broader goals. Beijing has pursued economic development goals by selectively utilizing industrial policy tools.[4] For instance, China temporarily uses non-compliant policy tools during stages of development but ultimately has a reputation as a reliable WTO member by complying with the rulings from the Dispute Settlement Body of the WTO.[5] In this sense, China leverages its position within the WTO to pursue economic statecraft. The nature of Chinese economic statecraft has focused on extending China's sphere of influence by asserting its industrial prowess on a transnational level through initiatives like Belt and Road. Coupled with China's rapid technological development and military modernization, the United States has come to perceive China's growth as a pertinent concern.

China has also set in motion several ambitious state-led projects (like Made in China 2025, the Internet Plus plan, and the National Integrated Circuit Investment Fund) to promote national rejuvenation. These projects entail channeling massive amounts of state investment into developing an indigenous technology complex with the aim of becoming a leader in emerging technologies.[6] Such efforts worry the United States for a number of reasons. The United States considers China's technological development to be associated with matters of national defense. China's "military-civil fusion" strategy, according to the US State Department, is a way to break down barriers between the civilian sector and its military industrial base to achieve economic development and military modernization.[7]

China's ability to realize its goals is heavily dependent on access to foreign technologies. Chinese actors have been collaborating with US companies to acquire proprietary technology to accomplish their tech-oriented development goals. The United States is a target market for Chinese investors hoping to acquire premiere American technology, especially in tech-hubs like Silicon Valley. From Washington's perspective, Chinese investment raises red flags given the sensitive nature and potential military applications of these emerging technologies (i.e., AI, cybersecurity, quantum computing, and the Internet of Things).[8] These are denoted as "critical technologies" by the Committee on Foreign Investment in the United States (CFIUS). CFIUS, the interagency committee authorized to review certain transactions involving foreign investment in the United States to determine their effect on the national security, defines "critical technologies" as "emerging technologies that could be essential for maintaining or increasing the technological advantage of the United States over countries of special concern with respect to national defense, intelligence, or other areas of national security, or gaining such an advantage over such countries in areas where such an advantage may not currently exist."[9] In these terms, China's technological advancement is a legitimate concern, as it could erode America's status as the paramount leader in innovation and cutting-edge technology.

The US government has thus tried to check China's rise by weaponizing its own trade policies. In so doing, the United States is hoping to curb China's ability to get its hands on US technology. By aggressively ramping up oversight on foreign investment, Washington hopes to keep an eye on, or in some cases intervene in, business deals between Chinese investors and private American enterprises who may be facilitating China's technological development. Through policies like the Foreign Investment Risk Review Modernization Act (FIRRMA), access to sensitive American technologies has become a greater challenge. Donald Trump signed FIRRMA into law in August 2018 as a way to augment the powers of CFIUS -- a clear indication of the US militarizing its US trade policy. FIRRMA strengthens and modernizes CFIUS to address national security concerns more effectively, and it expands the authorities the President has over CFIUS regarding national security concerns from foreign non-controlling investments.[10] While not intended to just target China, CFIUS has long been viewed as a serious way for Washington to scrutinize potential Chinese investments in US businesses.

However, FIRRMA ironically poses a threat to a wide range of innovative industries in the United States, as business transactions between them and foreign investors are likely to be subject to CFIUS review. Rhodium Group predicted that up to 75% of Chinese venture investments would be subject to CFIUS review under the Trump Administration's new rules.[11] The added red tape makes foreign investment into US startups less attractive[12] and has restricted the necessary funding entrepreneurs need to build sensitive technologies.[13] The threat that CFIUS could drain the resources and momentum of American entrepreneurs in industries who are ready to go to market is very real.[14]

While presidential blockages of deals based on CFIUS recommendations have occurred since 1990, the onset of the trade war has motivated Washington to more firmly tighten its grip over foreign investment in the private sector.[15] In 2019 alone, CFIUS has thwarted a number of business ventures between US and Chinse commercial actors. Beijing Kunlun Tech divested its 60% equity stake in the app Grindr due to national security concerns about data collected on the geolocation, sexual preference, and HIV status of its users.[16] China's ENN Ecological Holdings Company withdrew from a deal to purchase Toshiba's liquefied natural gas business in the United States due to CFIUS approval concerns.[17] CFIUS also ruled that iCarbonX, a Chinese company, a had to give up its majority stake in PatientsLikeMe, a health platform that collects personal data.[18]

The new powers of CFIUS have been successful in deterring Chinese companies from engaging in deals in the United States. Chinese conglomerate Fosun International has avoided US investments in sensitive industries because of the less-friendly environment, according to Mike Xu, the managing director of its Fosun Capital unit.[19] Also, the venture arm of Chinese e-commerce giant Alibaba Group Holding Ltd. is shifting to investments outside the United States, according to two people familiar with its operations.[20] These decisions illustrate a larger trend in business amidst the trade war; with it being harder to complete US-China deals- particularly in tech-related areas contingent on CFIUS approval- Chinese actors look elsewhere in the world where their money is less controversial.

Industries covered by FIRRMA that have seen a decline in investment include, unsurprisingly, companies at the forefront of emerging sensitive technology and IP licensing activity, especially in health-related industries like BioTech and Pharma. Chinese companies have been hungry to access new technology in order to enhance their own competitveness, especially related to drugs, and the Chinese government is supporting that effort.[21] These attractive industries had been a focus of Chinese investment, oftentimes at the direction of state-controlled investment vehicles like China Investment Corporation and the State Administration for Foreign Exchange.[22] About 40% of Chinese venture capital deals in 2018 went to biotechnology and pharmaceutical companies.[23] These industries were not immune to the increased oversight on foreign investment. William Hasletine, a biotech entrepreneur, had to abandon a new company, Constructive Biology, after a Chinese investor who pledged $30 million for a lab had to pull out because of CFIUS.[24] Within the BioTech industry alone, venture capital funding rounds from Chinese investors totaled $725 million through the first 6 months of 2019, a sharp decline from the $1.65 billion invested through the first half of 2018.[25] The recent investment slowdown speaks to stricter oversight from Washington.

However, business activity has not gone entirely stagnant despite the political tension dominating headlines and the serious concerns that come with increased regulations. "Trade friction has impacted our investments in the US, but not to the extent of stopping all deals," Kevin Xie, a spokesperson for China-based biotech company Fosun International, told Bloomberg. "Companies in the US still welcome investments and are willing to work with us, so we are making some changes in the wiggle room allowed under the law." The hostile investment environment in the United States has not fully stopped Chinese investors from trying to capitalize on the US market. Instead, investors are coming up with creative solutions to maneuver Washington's tight grip. US startups are rewriting deal terms to avoid a CFIUS review. For example, deals of this kind include provisions to prevent foreign investors from obtaining proprietary technical information, and denying them board rights, veto rights or additional equity in future rounds.[26] According to Aman Faird, a partner at Baidu Ventures (a venture-capital firm mostly funded by the prominent Chinese search-engine companto avoid CFIUS scrutiny.[27] Furthermore, China can still invest in US technology through layers of funds that obscure the money source.[28] Chinese pharmaceutical groups have been paying amounts to license drugs

drugs developed by US biotech companies. Unlike venture capital deals, these licensing deals do not usually involve taking an equity stake.[29] While it is true that it has gotten increasingly difficult to secure deals due to policies like FIRRMA and political friction resulting from the trade war, it is evident that there are still methods of investment to work around regulators.

The evolution of US-China relations is mirroring China's technological revolution. A watershed moment came with the outbreak of the trade war. The Trump Administration has been able to complicate China's growth through rounds of tariffs on billions of dollars of goods, but the trade war has likewise affected many of the appealing US industries in emerging technologies by discouraging Chinese investment with bolstered government oversight. Nevertheless, it is apparent that the ingenuity of Chinese investors and American entrepreneurs continues to show signs of life, indicating the resilience of international business even amidst an increasingly competitive geopolitical climate.

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A DIFFERENT VOLLEY IN THE US-CHINA TRADE WAR: CHINA'S UNRELIABLE ENTITIES LIST

By Tianyu Qiao, BASC Research Assistant

Photo Credit: Chinese Ministry of Commerce

The Ministry of Commerce of the People's Republic of China raised eyebrows on May 31st, 2019 in announcing the future creation of an "Unreliable Entity List". In essence, an unreliable entity refers to any foreign company, organization, or person believed to have "severely damaged the legitimate interests and rights" of Chinese firms by violating market rules, failing to uphold the spirit of contracts, or boycotting/cutting off supplies to Chinese companies for non- commercial reasons.[1] According to the Ministry of Commerce spokesman, Gao Feng, this introduction of an Unreliable Entitiy List is in cordial "accordance with relevant laws and regulations."[2] As presented, it intends to maintain international economic and trade rules and the multilateral trading system while safeguarding China's national security. Although Gao Feng made it clear that this Unreliable Entities List does not target any country specifically, he emphasized that "necessary measures would be taken" once an entity is identified for the list. But in the context of the ongoing U.S.-China trade war that has witnessed robust and comparable moves and countermeasures from both sides, this Unreliable Entity List also sends an intense political message between the two countries that goes beyond just tariffs.

The Contrast with Previous Policies

Although the Unreliable Entity List itself has not yet been disclosed, China's history of regulating foreign investment could help to explain its place in Chinese policy. Foreign investment has been a prominent part of China's economic growth, and a relatively complete range of laws and regulations governing it have developed over the years. In June 1995, China first promulgated the Provisional Regulations upon Guidance for Foreign Investment Orientations and the Guiding Directory on Industries Open to Foreign Investment. Since then, lists have regulated foreign investment activities by sorting sectors of the economy into three categories—the encouraged, the restricted, and the prohibited. For years all three categories were included in the same catalogue published annually, but a negative list was also published in the summer of 2018. In 2019, China bifurcated the catalogue with a positive document encouraging investment in certain areas of the economy and a negative document prohibiting foreign investment in sensitive areas of the economy.[3] While the general picture is one of actively regulating foreign participation in different areas of the economy, the Unreliable Entity List will be the first instance of China listing specific corporate actors from abroad. The lists of foreign investment have, for example, encouraged technology-oriented foreign businesses to utilize cutting-edge technologies to transform traditional industries such as machinery, textiles, and consumer good manufacturing while adopting a more circumscribed approach to foreign investment in financial services and automobile manufacturing. The 2019 Unreliable Entity List is unusual given its actor-specific dimension. This particular move lets people reasonably speculate that it is a direct retaliation against US bans on Huawei and other Chinese companies.

Who Might Make the List? FedEx's Struggles

Huawei has been a flashpoint between the US and China in the ongoing trade war. On May 16, 2019, the United States officially blacklisted Huawei under an executive order from President Trump banning US companies from selling to it or those doing business with it. Given its timing on May 31, 2019, there is suspicion that China's announcement of the Unreliable Entity List was a "direct response to the US sanctions against Huawei, its 70 affiliates, and other Chinese firms."[4] Following the Trump administration's decision, FedEx has been entangled in several Huawei-related disputes. Perhaps unsurprisingly, it currently faces the highest risks of investigation and appearance on the Unreliable Entitly List.

In May 2019, Huawei packages containing "urgent documents" that were supposed to sent from Japan to China ended up in the United States. FedEx apologized to Huawei for the unauthorized re-routing but maintained that the diverted package was simply a result of a mistake in transportation with no "external parties" involved.[5] However, within less than a month, another Huawei package was "mistakenly" returned to the sender. FedEx again apologized for its operational error while emphasizing that it "can accept and transport all Huawei products except for any shipments to listed Huawei entities on the U.S. Entity List."[6] Following the second incident, Huawei switched from its softer stance of "reconsidering its relationship with FedEx due to the lack of confidence" to vehemently reprimanding "the courier company [as] having a vendetta."[7] Moreover, the Chinese Ministry of Finance's spokesperson and state-run newspaper the Global Times both publicly implied that FedEx is very likely to be added to the Chinese government's upcoming Unreliable Entities List for infringing the interests of Chinese companies, arguing that recent hostilities and FedEx's erroneous behavior suggest distinctly political intentions and US government intervention. As China believes that it has both legitimate reasons and means for protecting itself against US aggression and unfair practices, FedEx may well be among the first to be on the Unreliable Entity List when it is released.

Implications for the US-China Relationship

Since taking office, President Trump has considered the Chinese government's stealing of key technology a way to gain unfair advantages in bilateral trade. In April 2017, the US Trade Representative officially initiated a Section 301 investigation into individual acts, policies, and practices of the Chinese government relating to technology transfer, intellectual property, and innovation.[8] The US Department of Commerce subsequently concluded that Chinese telecom company ZTE violated US sanctions and banned US companies from doing business with ZTE for seven years. In April 2018, the US Trade Representative released an initial list of 1,334 proposed products subject to a potential 25 percent tariff, and China responded strongly by imposing 25 percent tariffs on 106 US products, totaling to USD 50 billion. By August of the same year, both the US and China implemented a second round of tariffs, and the trade war with which the world is now quite familiar began roaring to a head. While there have been occasional signs that détente may be possible- China temporarily lowered tariffs on US autos and resumed buying US soybean exports in 2018,[9] and both sides indicated the resumption of Phase I negotiations in December 2019- it is worth considering the potential implications of the Unreliable Entity List in the context of the trade war, the broader US-China relationship, and the world economy as a whole.

1. Political Tit for Tat

The staunch attitudes shown from both sides imply that neither party will back down easily. Citing national security, both sides are translating the significance of trade war into political action. Since the onset of the trade war, the public witnessed not only two sides exchanging bitter comments but also the steadfast determination from both countries to continue tariffs and retaliation until the other side makes concessions first. But the struggle goes beyond tariffs. The United States passed the foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) to expand the powers of the Committee on Foreign Investment (CFIUS) and address growing "national security concerns over foreign exploitation" that traditionally have fallen outside of CFIUS 's scope.[10] On the other side, the official White Paper by the Information Office of China from September 2018 has dismissed the Section 301 investigation's findings and "denounced US. actions as trade bully-ism."[11] In the eyes of the Chinese, the United States is not only engaging in great power hegemony, acting unilaterally, and disrupting globalization; most importantly its companies are threatening Chinese national security-- the same rhetoric and rationale as used by the United States government. Thus, to the Chinese, the promulgation of an Unreliable Entity List is both rightful and unavoidable given US hostility. According to a Chinese state-run news agency, "China will never yield to US pressure, and China will take active countermeasures instead of reacting passively under US suppression."[12] Such emphatic rhetoric demonstrates China's determination.

2. Broadening the Scope and Number of Companies Affected by the Trade War:

As stated earlier, it is widely speculated that The Unreliable Entity List was announced in reaction to the Trump administration's decision effectively banning US companies from doing business with or sending essential materials to Huawei. Although at this moment details about the actual list have not yet been revealed, speculation around it has also generally referred software companies, mentioning in particular that Google and Microsoft are also at risk.[13] The broad definition of "unreliable entities" may include other global/American corporations and technology industries, including Qualcomm Inc., Intel Corp., and even Toshiba Corp.[14] Such measures against American tech companies means not only a harsher slap on the US economy but also may entail that competitors from other parts of the globe who are keen to penetrate Chinese markets more will fill in the gap.

3. Economic Backlash

According to several central bank governors and finance ministers at the International Monetary Fund and World Bank Fall meetings in October 2019, the collateral damage of the United States' trade war is already being felt from the fjords of Iceland to the auto factories of Japan.[15] IMF Managing Director Kristalina Georgieva contends that in this situation, "everybody loses."[16] The United States has acutely felt the side effects of the trade war. Records from the ISM Purchasing Managers Index (PMI) released on October 2, 2019 indicated the lowest levels of activity in manufacturing since the great recession, with the worst signal coming from the sharp drop in exports.[17] The reason for such findings is explained powerfully by Sam Stovall, chief investment strategist at CFRA Research: "If China buys less from us, we have less to manufacture, fewer orders to fill."[18] He also warns "it's hurting [the United States] as well as China" since China too has experienced slowed GDP growth for its part.[19] Due to the scope and number of companies that could be involved, the Unreliable Entity List could further exacerbate economic difficulties for both sides. The result may be that each party suffers fewer exports while paying extra costs that were previously not in play.

Conclusion

A worsening trade war is undesirable for both sides, with its spillovers potentially disturbing the entire world economy. However, as both sides have taken more measures and fanned hostilities, the trade war is no longer confined to trade and tariff-related issues. Instead, it has been escalated to encompass many dimensions, including but not limited to national security, political hostility, and public discontent. Most importantly, specific corporations from both sides—Huawei, FedEx, and Google—have become the potential targets, a political and business phenomenon not traditionally seen in the relationship between China and the United States. However, it would be too hasty to draw a conclusion about the Unreliable Entity List at this point. First, the it has not been published yet and many details about it are extrapolations, not a given. China might simply use this list as a rhetorical weapon to enhance or augment its negotiation strategy. Second, as mentioned earlier and confirmed by the Ministry of Finance's spokesperson, the measure is not targeting any country but meant to complement and amend China's own regulatory landscape. As such, foreign parties maybe should not perceive it as an imminent political move and adopt an inimical mindset too early. Third, the existence of an Unreliable Entity List does not guarantee a full-fledged assault on US corporations, given the economic interdependence between the two countries and conceivable US reaction and countermeasures. Still, both sides should proceed with care in order to restore beneficial trades to both countries as soon as possible.

Read the March 2020 issue of Business and Politics and submit your papers for publication at: https://www.cambridge.org/core/journals/business-and-politics

THE HONG KONG PROTESTS AND FINANCIAL MARKETS: A POTENTIAL BREAKDOWN

By Jazz Van Horn, BASC Research Assistant

The Hong Kong protests that started in June as a response to a bill that would allow prisoners to be extradited to mainland China have turned into a fight for democracy and independence from China. These protests not only have consequences for democracy and the political landscape of the area; they also have potential consequences for the worldwide economy. The protests can theoretically destabilize the Hong Kong stock market with repercussions for financial markets around the globe, and they could potentially exacerbate the situation around the US-China trade war.

Although Hong Kong stocks have dipped slightly since the beginning of the protests, the dip has not translated into the total breakdown of the market that was feared given the severity and length of the protests. The Hong Kong Stock Exchange (HKSE) started off November by reaching 4-week lows, with longer and more intense protests leading to more uncertainty and more extreme swings in both directions on the stock market.[1] Protestors successfully shut down parts of the financial district on some days, increasing uncertainty not only for local businesses, but also regarding the ability of the stock market to physically continue to operate.[2]

However, this outcome has not come to pass. While the Hang Seng Index, the largest index in the Hong Kong Stock Exchange (HSKE) decreased 6.1% from the beginning of the protests in June to the beginning of October[3], this does not indicate a large-scale breakdown of the financial markets, but simply a loss of confidence from some investors. Many major companies such as Budweiser have continued with IPOs[4], despite a 43% drop in IPO revenue from 2018.[5] One banker stated that the protests do not change the presence of good assets and the proximity to China, an opinion which seem to be backed up by investors. IPOs on the HKSE have raised $15 billion in the first 9 months of 2019, second only to the New York Stock Exchange. Although stocks may be slightly impacted, none of this suggests a large-scale breakdown of the financial markets.[6]

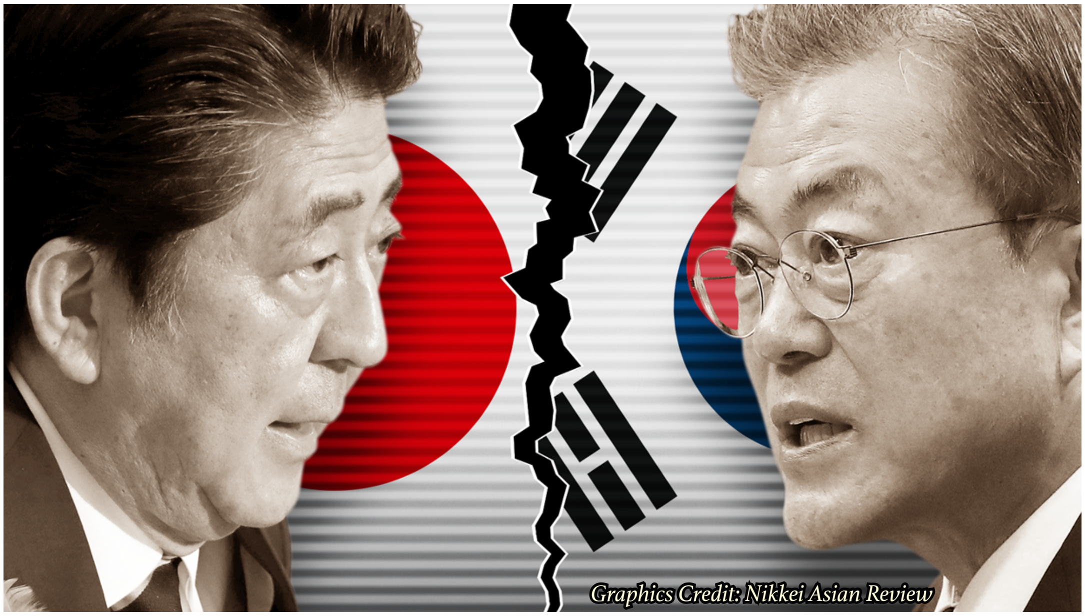
Even so, there has been talk about whether the effects of the protests will spill over into global stock markets, with most of the concern focusing on Chinese stock markets. The Shanghai and Hong Kong securities markets are linked, not simply by proximity and by common investors, but also by institutions such as the Bond Connect[7] and Stock Connect programs,[8] which reduce obstacles to foreign investors. Institutions such as these allow investors from China and Hong Kong to invest in each others' markets and enable foreign investors from other nations to enter the Shanghai stock market more easily. Thus, the HKSE is important to China, not simply as a supplier of Hong Kong investors, but also as a gateway opening up China to the rest of the world.[9] Were this gateway to close or severely change, it would have repercussions for investors around the world.[10] Furthermore, due to the United States' Hong Kong Policy Act, Hong Kong receives preferential treatment in American markets, as compared to mainland China.[11] US lawmakers from both sides of the aisle have already considered taking another look at the conditions of the bill to potentially reduce special permissions given to Hong Kong.[12] In our interconnected world, even if the HKSE does not fully fall apart, a large enough drop in stock prices is enough to set off a chain reaction around the world's financial markets.

Indeed, the protests in Hong Kong could pose a geopolitical disruption to global financial markets, especially in the context of the US-China trade war. President Trump signed a bill on November 27, 2019 to support the protesters in Hong Kong.[13] While Trump was expected to support the bill, which had bipartisan support in congress,[14] he voiced considerations of standing with China's President Xi Jinping so as to reach a trade agreement with China more easily.[15] If Trump had not signed the bill, the US could have been seen as supporting human rights injustices, especially since the bill includes provisions to not sell tear gas or other similar instruments used by Hong Kong police to control crowds. Failure on the part of the United States to condemn the continuation of aggressive police tactics could draw opprobrium from global leaders with consequences beyond China. But before the bill was passed, China threatened trade repercussions if the US was to sign the bill in support of Hong Kong protestors.[16] So far, it is unclear whether or not China will retaliate in response to the bill being signed; the United States and China have since agreed to so-called Phase One Trade Deal in December 2019. Under the agreement, China has pledged reforms to its intellectual property, technology transfer, agriculture, financial services, and currency/foreign exchange regimes while committing to increase its imports of particular US goods, and the United States has agreed to significantly modify its tariffs on China.[17] But there is still a possibility that a flare up in Hong Kong could derail this momentum and thereby impact financial markets around the world.

Overall, the protests in Hong Kong have the potential to have long-lasting effects not just on the political makeup of the region, but also for global financial markets. The protesters have physically shut down the Hong Kong Stock Exchange on multiple occasions, in addition to bringing up questions about the political future of the region, both of which increase uncertainty in financial markets in Hong Kong. Financial markets in Hong Kong are closely linked with financial markets in both China and the United States, which means that a large disruption of financial markets in Hong Kong could start a domino effect felt around the world. Furthermore, since the United States has supported the protests and China has threatened to retaliate, there remains a possibility that developments in Hong Kong could impact future trade negotiations between the two largest economic powers in the world. Few of the potentially destabilizing factors are due to the outcome of the protests; it is their continuation that that could prove more immediately disruptive. Even without an opinion on the ethicality of the protests, it is important to understand the potential implications on global financial markets.

THE JAPANESE-KOREAN TRADE WAR:
RAMIFICATIONS FOR REGIONAL SECURITY AND THE INTERNATIONAL ECONOMY

By Michelle Lee, BASC Research Assistant



Japan and South Korea have a long history of conflict, rooted in colonial grievances that have engendered disputes around compensation and retribution. In August of 2019, Japan officially removed South Korea from its White List of trade partners, which confers benefits such as expedited review and transportation. In doing so, Japanese officials cited national security concerns and accused the South Korean government of selling hazardous chemicals to North Korea.

In speculating on ulterior motives, there are a multitude of reasons why Japan may have decided to take the more aggressive stance with South Korea. The removal of Korea from its White List can be interpreted as an act of retaliation and reciprocity following Korea's Supreme Court decision in 2018. The verdict indicated that Japanese corporations were required to pay for forced wartime labor, while the Japanese argued that they had already paid decades back.[1] It may be part of a larger diversionary incentive in light of Japan's upcoming election, specifically catering to Shinzo Abe's attempt to garner more support and foster nationalism. With recent progress in the Korean peace process coinciding with US engagement, Japan's role in East Asian politics has become more and more obsolete. In terms of securing diplomatic interests and retaining a relevant voice at the table, Japan may also have an interest in escalating the conflict. Agnostic to true government motives, however, it is crucial to recognize that the Japanese government's decision comes with consequences for many different stakeholders.

South Korea has not only reciprocated by tightening import quotas of the fishing and agricultural industry, but also by inciting a nationwide boycott movement of Japanese goods. Uniqlo, one of the most popular Japanese brands in South Korea, reported a 40 percent decrease in sales after the trade dispute escalated in August.[2] The number of South Korean tourists going to Japan also fell by 48 percent, with some of the major Korean airline companies permanently suspending flight routes to Japan.[3] On an institutional level, the South Korean government has released statements foreshadowing the removal of Japan's preferred partner status and the creation of a new subordinate category to prevent Japan from reaping any trade benefits. As such, both countries have exchanged a series of aggressive protectionist policies that are increasingly tainting the economic relationship that both Japan and South Korea rely on.

It is true that similar rows have occurred periodically throughout the past few decades. Especially because of the history between Japan and South Korea, even meager trade disputes have had a tendency to heat up and scratch at past grievances. Still, the two countries have managed to always return to a cordial relationship, partly because of their dependence on each other for trade but also due to their close proximity to one another. When the Japanese government announced that it would take South Korea off its White List, the decision came as a shock to many as it seemed to emerge out of a relatively peaceful period. The most recent trade war between Japan and South Korea is unique, however, for two noteworthy reasons. First, recent actions suggest that this economic quarrel may grow into a wider militaristic conflict with more irreconcilable national security interests. This prospect significantly raises the stakes for both sides and threatens to permanently tarnish both the economic and political relationship that Japan and Korea have shared. Second, the ramifications for the international economy cannot be overlooked. While the spotlight for trade strife shines the brightest on the United States and China, Japan and South Korea's now critical role in technology supply chains entails a hitherto unparalleled threat to the international market. The contemporary status quo therefore diverges from the contexts surrounding past contentious episodes, and recognizing these differences is imperative for the two countries to be able to find common interests and move forward.

On August 22, the Deputy of the Blue House National Security Office announced that South Korea would terminate the General Security of Military Information Agreement (GSOMIA), which intended for the two countries to share intelligence on North Korea. Representatives from South Korea claimed that Japan went against national security interests and failed to provide a sufficient explanation for placing export controls on South Korea. They stated that the intelligence pact could not go on in light of the pertinent "trust issue" between the countries threatening the military relationship that both countries had fostered with each other for decades.[4] Fortunately, Moon Jae- In announced a reversed decision to stay in the intelligence pact with Japan on November 22.[5] A trade war directly influencing the renewal of a military pact was unprecedented, and although resolved this time around, the dispute came dangerously close to a situation in which negotiation would have become challenging, if not impossible. While the GSOMIA is a bilateral arrangement between Japan and Korea, the United States is also a crucial actor in this particular dialogue. Not only would the GSOMIA's termination symbolically ruin the holy grail of the US alliance system in East Asia, it would also destroy the US investment in East Asia's security architecture. It would also signal to China and North Korea that security cooperation—especially in an area that was typically treated more pragmatically—can be contingent on historical qualms. The GSOMIA is the keystone to the missile defense systems in both Korea and Japan. Japan's exclusive radar and satellite capabilities significantly bolster allies' capacity to track North Korean missile programs, which are currently only accessible through the platform that the GSOMIA provides.[6] Although the termination of this intelligence pact would not completely cut off military communication, the strategic efficiency and mutual trust fostered for decades would be absent.

In addition to linking trade and security to a greater degree, the spillover effects of the current trade dispute between Japan and South Korea economically impacts the international community to a far greater extent than previous conflicts between the two parties ever have. There are clear detriments to both Japan and South Korea, as the two rely heavily on each other for the trade of technological parts such as semiconductors, microchips, and display screens.[7] Japan acknowledges that it, too, will incur losses the longer the conflict is prolonged. However, there may be reasons to believe that South Korea will have more trouble finding alternative suppliers or match up to the level of quality that Japan is able to produce, resulting in relative gains for the Japanese in the long run.[8]

This trade war, however, should not be considered in isolation. The very contentions between the two countries are bound to have significant international ramifications at a time when economic interdependence is the global norm. Especially when it comes to the technological sector, South Korean companies like Samsung and SK Hynix provide over 60 percent of the world's semiconductor production[9], and a lag on these companies acquiring the necessary inputs can have repercussions for all the corporations that are in business with them. Japan's removal of South Korea from its white list will do precisely that: South Korean companies, specifically those in the semiconductor business, will be subject to new restrictions and a tightened licensing process, putting exports at the risk of being delayed for up to 90 days.[10]

Given the circumstances, it is important to understand what options there are to mitigate the detriments of the prolonged trade war. Traditionally, countries locked in a dispute of this nature would look toward third-party actors to sort out a resolution. However, mediation through an inter- governmental organization (IGO) such as the World Trade Organization (WTO) may be particularly more difficult in this situation. One reason is because mediation through an IGO can take a long time, perhaps even longer than the duration that countries can afford to bear the costs of the trade dispute. Because this trade war concerns technological products such as semiconductors, the inflows and outflows or goods are especially time sensitive. As a lot of countries are currently situated in a tech race, companies rely on the speed and efficiency of exchanging product inputs. In addition, because this conflict is not simply about trade and rather encompasses a multitude of historical grievances, international actors are more reluctant to step in. Lastly, the most prominent actors like the United States or China that could potentially intervene in the issue are engaged in a trade war of their own and are in no position to criticize wrongful trade practices (for example, tightening quotas or raking up tariff prices), limiting room for third- party intervention. All of these reasons make it more difficult for the trade war to be brought to an IGO's negotiating table. In fact, the South Korean government released a statement in October 2019 asserting the necessity of evaluating all the possible routes to negotiation before bringing forth the issue to third-party actors.[11]

Regardless of whether tensions ease up, it is imperative that South Korea decrease its reliance on Japan for critical technological products. Diversifying supply chains for key sectors is something that has been lacking throughout much of South Korea's recent industrial process, even though this process is vital for an economy to be formidable and sustainable. Unfortunately, diversifying production of critical parts takes a long time and is difficult to implement. Even in the case of South Korean companies being able to find alternative producers, there is still an open question of whether new suppliers will uphold the same level of quality that Japanese producers have promised for years. Still, a long-term plan of opening up to different countries and decreasing reliance on Japan is something that the Korean government must have in mind moving forward.

Recognizing that this trade dispute diverges from those that have transpired in the past is important, as traditional methods of resolution may not be applicable. The ongoing trade war between the United States and China has already impacted the world economy through tariffs worth billions of dollars. In an international system that faces numerous threats, uncertainty regarding trade and relationships looms the air. Fortunately, the two countries have displayed more willingness to negotiate better terms amid a sullied economic outlook. Authorities from Seoul announced that Japan and South Korea would be partaking in senior-level talks in December 2019, a sign of thawing relations.[12] Although the two sides may have conflicting grievances regarding their history, Jesper Koll, senior advisor at WisdomTree Investments argues, "pragmatism on the economic policy and trade front are poised to prevail".[13] If both parties can recognize the unique nuances of this particular dispute, such optimism may well be warranted.

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WHAT THE NEW US-JAPAN DIGITAL TRADE AGREEMENT SAYS ABOUT THE FUTURE OF INTERNATIONAL DIGITAL TRADE

By Lillian Gage, BASC Research Assistant

The new US-Japan trade deal may not be the free trade agreements of our liberal dreams. Some might see it as a side payment to US farmers that have been devastated by the US-China trade war, but what it says about the future of the data economy is important. It's a limited trade deal that has two parts: reduction or elimination of preexisting tariffs on agriculture, and rules for digital trade.[1] The president's office has released a lengthy, vague list of provisions on digital trade that the agreement has, the most important of these being non-discriminatory tax treatment of digital products, free movement of data across borders, and the prohibiting of data localization requirements.[2]

In this article I investigate the implications of the US-Japan Digital Free Trade Agreement for the greater international digital economy through three questions: First, will the US-Japan Digital Trade agreement be used as a model for future bilateral free trade agreements? Second, can the goals pursued in this agreement be pursued through a multilateral institution such as the World Trade Organization? Finally, should the future international digital trade regime prioritize the free movement of data like the US-Japan Digital Trade Agreement does? I conclude that future free trade agreements will likely not be fashioned in the likeness of this agreement, that the rules in this agreement are not practically pursued in the WTO, and that the way that data is treated in this agreement should not set precedent in the international digital trade regime.

Let's start with the question of whether the US-Japan Digital Free Trade Agreement can be used as a blueprint for future free trade agreements (FTAs). According to the Brookings Institute, countries are realizing the need for international cooperation on the issue of cyber security.[3] The Cato Institute points out the digital part of the trade agreement is very similarly to the TPP and United States-Mexico-Canada Free Trade Agreement (USMCA).[4] This might lead to us to believe that future digital trade agreements will be mod elled after the US-Japan Digital Free Trade Agreement.

The Cato Institute goes on to argue that the significance is low because the US and Japan already have very similar goals in regard to digital trade.[5] However, such analysis could be missing the beginning of a new digital trade governance regime. While the US and Japan might have similar incentives in regard to digital trade, this agreement, along with USCMA, is setting precedence for what the global digital trade arena will look like. While some of the more far reaching parts of the trade agreement are unlikely to become standard components of all future FTAs, they do address key issues such as the free movement of data across borders and data localization requirements. The principles of interoperability of institutions to ensure consumers against fraud and cooperation of e-contracts and e-signatures are principles that more states would be able to negotiate on a case-by-case basis.

This consideration brings us to the second question I would like to address: Must such negotiations always be bilateral, or could they be taken up in an international institution such as the WTO? According the Center for Strategic and International Studies, the deal could provide support for the upcoming talks on ecommerce in the WTO.[6] At the beginning of 2019, members of the WTO started talks with the goals of creating multinational rules to govern ecommerce. Currently, there are no rules within the WTO that govern ecommerce. The deal contains rules on the same issues that WTO members are hoping to institutionalize such as prohibiting barriers to cross border sales, barriers to electronically transmitted goods, ensuring safe e-contracts and e-signatures, and preventing data localization requirements and forced source code transfers.[7]

Though these talks are still in their infancy, doubts on whether WTO members will ever be able to make a deal are already emerging. While states such as the

United States and Japan are able to come to an agreement, getting a large and diverse set of countries to agree on rules will be much more difficult. Specifically, the issues of data and privacy will prove to be tough problems to solve.[8] The problem of data security is an issue of cyber security. Cybersecurity and the global trade agenda are in contention with each other. Brookings predicts that as the digital economy grows, trade restriction on the basis of cybersecurity will as well. Cybersecurity regulation will be destructive towards digital trade agreements, but free trade agreements are more flexible in accommodating these concerns.[9]

With these ideas in mind, the last question I would like to consider is whether or not the digital trade regime should prioritize free movement of data. The part of the agreement that cybersecurity experts and data activists are most worried about is the prohibiting of data localization and free flow of data across borders. The agreement treats data as if it merely a technical necessity to ecommerce. Ciuriak from the Centre for International Governance Innovation argues that data is itself an asset.[10] He concludes in his paper that data is not, in fact, treaty ready. The data economy comes with a host of social problems that cannot be addressed globally, such as income inequality and data privacy. The ownership of data is political, and not something that the international trading system is prepared to deal with.[11]

Data localization can give countries at least some control over tech companies. By signing this away, governments could be giving up that ability. Additionally, such an approach could be a loss to citizen ownership over their data as the impact of data is just unfolding. One thing that the agreement between Japan and the United States does get right regarding cybersecurity is that it recognizes the importance of enabling enforcement regimes to work in both countries. For example, it gives the APEC Cross- borders Privacy Rules System access to enforcement in both countries.[12] The issue of cybersecurity requires interoperability of institutions, which is something that the agreement in part recognized.[13]

To sum up, though the US-Japan Digital Trade agreement mimics digital portions of free trade agreements that have come before it, it will not turn out to be the digital free trade agreement that all future digital trade agreements are modeled after. The problems posed by data, privacy, and cybersecurity are not problems that will be easy to resolve in large multinational institutions. And to answer the question of whether this will this lead to an international regime based off of this treaty, I answer, "I hope not". The agreement does not go far enough in addressing cybersecurity concerns, and how could it? The data economy is a new phenomenon and the implications of data as a capital asset is still unfolding. While the United States and Japan have been able to come to an agreement, it is in large part due to their similar incentives. It is difficult to imagine an agreement like this being made in a major institution like the WTO.

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ENDNOTES

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