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China's New National Security Law

In late April, China released a new version of its national security law. Shortly thereafter, some prominent U.S. firms were raided by national security operatives, and there were reports of database access being restricted. In this report, we will discuss the new law and who has run afoul of the rules so far. The context of this new law is important since China isn't alone in increasing its focus on national security—the U.S. has been taking steps in this direction as well. As always, we conclude with market ramifications, where we will examine how the shifting focus on national security could affect foreign investment and trade.

The New Law

The updated law is remarkably broad. Chapter 1, Article 4, subheading 3 is as follows:

> *Activities carried out, instigated or funded by foreign institutions, organizations, and individuals other than espionage organizations and their representatives, or in which domestic institutions, organizations or individuals collude, to steal, pry into, purchase or illegally provide state secrets, intelligence, and other documents, data, materials, or items related to national security, or in which state employees are incited, enticed, coerced, or bought over to turn traitor.*

Essentially, any foreigner who gathers information that could be considered "state secrets" could be ensnared by this law. Perhaps even forecasting GDP or commenting on China's crude oil inventories could bring an indictment. Since the Chinese Communist Party (CCP) views every company as part of the nation's security effort, analyzing company information could innocently reveal a "state secret."

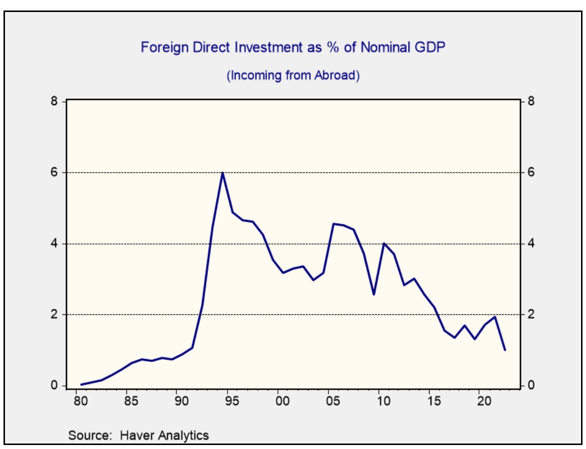
Recently, these actions have been taken on the grounds that China's national security was at risk:

1. Employees at Bain & Company's offices in Shanghai were questioned by authorities. Reports indicate that company computers and phones were confiscated. Bain, a consulting group, works with companies in China to gather information for marketing and other purposes. It is likely that this information-gathering raised questions from security officials.
2. Five local employees working for the Mintz Group were detained. Mintz conducts corporate investigations, including background checks, litigation, and fraud concerns. As a sidenote, another employee had been planning an overseas trip to Singapore but was detained at the border. Exit bans have also become common, especially for foreign nationals.
3. Access to Wind Information Services, a Shanghai-based database, has reportedly been restricted for foreign subscribers. There are reports of subscriptions being abruptly cancelled. The database is used by analysts to examine company and macroeconomic data.

4. A Japanese employee of the drugmaker Astellas (ALMPY, $15.27) was detained for alleged espionage activities.
5. Due to the recent crackdown, Forrester Research, a consulting firm, has decided to close its Chinese operations.
6. Security services raided multiple offices of Capvision, another consultancy that has offices in China's major cities.

In some respects, this new security law is anything but new. China follows "rule by law" instead of "rule of law," which means the law *gives the government power*. In the West, rule of law is designed to *protect citizens from government power*. China has a long record of detaining foreigners for alleged violations of state secret regulations. To a great extent, the new regulations broaden definitions of national security, but in reality, the CCP usually doesn't allow the law to restrict its activities.

What has caught foreign firms off guard is that China has also been wooing foreign direct investment. COVID-19 restrictions dampened direct investment into China, but as those restrictions are being lifted, the CPC leadership has been encouraging foreign investment. And yet, the national security laws are working at cross purposes to this goal.



The previous chart shows foreign direct investment (FDI) into China as a percentage of GDP. As the data shows, FDI has been falling steadily since 2005.

The recent raids and detainments have raised the alarm of the U.S. Chamber of Commerce, which is usually supportive of Chinese business and investment. A recent press release captures the uncertainty surrounding attempts to foster foreign investment in the current national security environment.

> *The U.S. Chamber of Commerce welcomes the recent statements of senior Chinese officials regarding their commitment to greater openness and desire to attract more foreign investment. However, foreign investment will not feel welcomed in an environment where risk can't be properly assessed and legal uncertainties are on the rise.*

The crackdown seems to be focusing on firms that gather data and intelligence, and as the quote from the Chamber highlights, without these firms, foreign investors will be flying blind.

Why Is This Happening Now?
There are three elements of this recent behavior that are worth noting:

1. The crackdown seems to be focused on consulting firms. One reason that these consultants are drawing the government's attention is that their methods are not too dissimilar to those used by intelligence agencies when fostering sources. The consultants create expert networks that foreign firms can consult about industries, firms, or policies, to name a few. When a foreign firm has an inquiry, the consultant brings in the experts to meet with the potential investor so they can obtain information

about an industry, firm, market, region, etc. This information may be critical to whether a foreign firm decides to invest in or conduct business with China. However, given that the new law broadens what is considered "national security," these discussions may be seen as violating security. The CCP tends to view all of industry as servicing the party and the state, so imparting insights to foreigners could be construed as passing secrets. For foreign firms, the information provided by the consultant firm's experts may be important in deciding on an investment. Beijing may be reluctant to share that information and may instead view it as a threat.

2. The CCP abhors foreign nations commenting on or interfering with China's internal matters. For example, a U.S. law that bans imports fabricated by Uyghurs in order to avoid the forced labor issue requires American importers to certify that the goods are not made with forced labor. Companies use consulting firms to assist in determining if imports are made with such labor. China does not want such scrutiny, so preventing firms from performing due diligence on this matter is seen as a way of preventing foreign interference.
3. Open-source intelligence is the gathering of publicly available information to gain an understanding of something. That "something" may be a company, a nation, a culture, etc. Although the intelligence agencies engage in this sort of intelligence-gathering, they have access to non-public information as well. The practitioners of open-source intelligence are widespread; private firms such as Stratfor or Geopolitical Futures engage in this sort of analysis. It could be argued that this report is a form of open-source intelligence. In general, the more data available to analysts practicing this form of intelligence, the more insights and connections that can be made. There is some evidence to suggest that think tanks had linked together information that was used by the U.S. government when it built its policy restricting China's access to cutting-edge semiconductors, arguing that these chips are used in military applications. The crackdown is designed to thwart these efforts.

The Divergence Between National Security Behavior and Fostering Foreign Investment

So, why are we seeing this divergence where China is wooing foreigners to invest while raiding Western research firms? One potential explanation is that two different elements of the government are involved, and their actions haven't been coordinated yet. President Xi elevated national security with a 2017 law. Essentially, national security is critical to all parts of society. At the same time, local governments, given the task of boosting economic growth, are seeking foreign investments to meet that goal. Without coordination, the two goals can work at cross purposes.

We expect this contradiction to be resolved by focusing on national security. China probably wants the foreign investment, but only on Beijing's terms. If a foreign firm requires the intelligence these consultants offer in order to make an investment, we suspect China would be willing to forgo that investment. The actions taken by the security apparatus in China raise concerns that simple analysis by companies can be seen as a threat to national security. If this atmosphere continues, it will certainly have a dampening impact on foreign direct investment.

The Big Picture

In the heady days after the fall of the Berlin Wall and the dissolution of the Soviet Union, the world appeared safe for capitalism. Francis Fukuyama postulated that we had seen the "end of history" and that there was no viable alternative to democracy and markets.

Although Fukuyama's actual position is more nuanced, the U.S. unipolar moment led policymakers to conclude that market development was the primary goal. The Washington Consensus pressed for democracy and open capital and goods markets. The important takeaway was that national security concerns no longer held the same preeminent position in decision-making as it had held during the Cold War. Although national security worries returned after 9/11, those concerns were mostly about addressing terrorism, not competition among the great powers.

There is mounting evidence that national security concerns have returned. We note that over the past few weeks, Treasury Secretary Yellen and National Security Advisor Sullivan have both given public speeches indicating the primacy of national security. Other nations are echoing similar sentiments. And, as we detailed above, China is clearly prioritizing national security.

Sullivan's speech was wide-ranging, but he pointed to industrial policy designed to rebuild the U.S. industrial base, in part, to thwart China. This new industrial policy is designed to support the energy transition, rebuild infrastructure, and adjust trade flows, but it also means more government intervention in the economy. Is it possible this trend would end with a new U.S. administration? Perhaps, but it is important to remember that President Trump led the charge in changing U.S. relations with China.

Prioritizing national security suggests that efficiency will not dominate the direction of policy like it did from 1990 to 2016, meaning that foreign investment will face scrutiny and domestic investment could be "steered" toward national goals.

There is a temptation, as often seen with children, to argue that the other party "started it," but as investors, it really doesn't matter if China or the West moved first to prioritize national security. The reality is that national security is rapidly emerging as the key goal that will change global investing and trade flows.

Ramifications

This evolving environment will create winners and losers. In some cases, it will take time to determine who these parties will be, but we can draw some broad conclusions about the direction of travel for markets.

The focus on national security will lead to higher price levels. When national security isn't a primary concern, economic actors can focus on efficiency which leads to lower costs. However, national security concerns will often lead to redundancies in supply chains that will likely increase costs. For example, the goal of building semiconductor foundries in the U.S. is not a decision based on efficiency but rather on security.

The focus on national security will also increase demand for inventories. For the past four decades, we have lived with supply chains characterized by *just-in-time* inventories. This logistical method allows producers to avoid the cost of managing inventories and the risk of supply disruption. The pandemic exposed the risk of just-in-time inventories. Furthermore, an unsettled geopolitical realm, where supply chains become risky, will encourage *just-in-case* inventory management which should be safer from disruption but will be more expensive.

Rising price levels will create a dilemma for central banks: if they raise interest rates to combat higher inflation, it could hamper government fiscal operations and weaken economic growth. In the U.S., rising interest rates are increasing debt-servicing costs, so at some point, governments and central banks are either going to deal with inflation through austerity (which is politically unpopular) or by allowing higher inflation to become permanent. We expect that central banks will eventually be forced to tolerate higher inflation in order to avoid permanent austerity.

Higher inflation trends favor short-duration assets such as value stocks, dividend-paying stocks, and short-term fixed income. Growth stocks will likely struggle in this environment. Commodities, due to inventory demand and their status as an inflation hedge, should also perform well.

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