Geopolitical update: Brexit and US-China relations

November 2018
Two of the global developments that investors are most focused on today – US-China relations and Brexit – may initially seem as far removed from each other as the distance between the countries. One issue spans the globe, involving the deepening complexity between the two main engines of the world economy; the other concerns one country’s place within its region. Look more closely, though, and you start to see some of the major geopolitical fault lines fragmenting the world today.

Populist and nationalist governments and political movements are pushing to reassert the primacy of borders and roll back advances in globalization. The consensus behind economic openness and free trade has been turned upside down, amid demands for existing agreements to be redrawn or discarded altogether. New tariffs have been implemented, and supply chains have been disrupted.

These geopolitical dynamics are injecting more and more uncertainty into global markets: According to the most recent EY Capital Confidence Barometer, political uncertainty is cited as the biggest headwind to dealmaking in the near term. For 46% of respondents, regulation and policy uncertainty – for instance, concerning restrictions on foreign direct investment – are the biggest potential risks to dealmaking, and 20% of executives say they are refocusing on cross-border M&A because of changes in trade and tariff policies. Against this backdrop, the number of initial public offerings dropped 18% globally from the year-ago period.

Even so, businesses leaders and investors should not be content to focus purely on risk mitigation in this time of uncertainty. Change produces opportunities, and moving forward on value creation – with strategies and processes that factor in risks and create contingencies – is vital. Brexit alone will take 7 to 10 years to play out, and no one can afford to be in a defensive position for that long. And despite increasing tension, the US remains an attractive destination, particularly in lower-risk sectors such as agriculture, consumer products and retail, commercial real estate, and non-defense-related manufacturing.

Even amid rising geopolitical risks, the global economy has accelerated over the past two years, with a respectable global growth rate of 3.7% projected for 2019.

This geopolitical update takes a holistic view of these global developments, helping you set priorities and contingencies for how to proceed. Coming to terms with uncertainty, and having your eyes open to find the possibilities when others see only the darkening horizon, will position you to create your own good fortune.
Global investment is currently facing an environment of heightened geopolitical uncertainty. A 2017 survey\(^1\) of 1,500 investment professionals across the globe showed that more than two-thirds of respondents expected the changing geopolitical environment to negatively affect investment returns. Among the top concerns of these investment professionals were Brexit, the Trump administration and the fragmentation in the European Union.

Europe and the US are two of the most popular destinations for China outbound investment and the economic recovery in Europe has increased its appeal to global investors. According to EY’s analysis, in 2018 H1, Europe continued to be the number one destination for Chinese investors, accounting for more than two-thirds of China overseas mergers and acquisitions (M&A). At the same time, however, the rise of nationalism and populism in Europe has led to increased scrutiny and regulation on foreign investment. The Sino-US trade dispute is undoubtedly another great concern. Many experts believe that the longer the trade dispute lasts, the greater its impacts on both China and the US. Such a trade dispute will also affect the global economy. Recently, the US has announced new foreign investment restrictions designed to protect itself against national security threats, adding further uncertainty and concerns for Chinese investors.

Given the importance of Europe and the US in China’s outbound investment, this special edition on geopolitical situation focuses on:

- Outlining key geopolitical issues in the UK and the possible scenarios and impact from Brexit
- Highlighting the Sino-US geopolitical relations and the resulting geopolitical risks

Geopolitical risk has become one of the crucial considerations for Chinese companies to go global. To effectively identify and manage geopolitical risks, Chinese companies should carry out systematic and in-depth review and evaluation of the local political, legal and social environment in the initial stage of overseas investment projects. The research and analysis of geopolitical risk can help Chinese companies better understand the current global strategic situation and better control overseas risk.

Taking the geopolitical analysis of the UK and the US as an example, EY hopes that this report will help Chinese companies understand the factors affecting the international operation of enterprises and integrate them into their long-term business strategies. Going forward, we will leverage our global network to help Chinese investors understand the business implications of the geopolitical landscape, manage existing global operations and identify new business opportunities.

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\(^1\) Source: CFA Institute Survey
Introduction

The United Kingdom (UK) is slated to leave the European Union on March 29, 2019. Despite many opposing forces in the UK, a consensus that Brexit is inevitable has taken hold among politicians, investors, and business leaders in the country. But, as of November 2018, how Brexit will unfold cannot be predicted with a high level of confidence.

In the near and medium term (through 2020), multinational businesses and investors in the UK can expect increased volatility, uncertainty, complexity, and ambiguity concerning, for instance, the value of the currency, supply chain costs, business regulation, tariffs, customs clearing, worker permits, and market access.

Amidst this Brexit uncertainty and a decline in the UK’s relative attractiveness as an FDI destination in Europe¹, Chinese investors have continued to invest in Europe. This suggests that Chinese investors are seeking long-term opportunities with the expectation they can manage or capitalize on near-term risks.

That said, given the various dynamics at play, it is harder to predict the long-term effects of Brexit. But as with any other source of disruption, there will be winners and losers emanating out of post-Brexit UK.

¹ Source: EY’s 2018 European Attractiveness report
Brexit scenarios

Investors and businesses should plan for a range of scenarios and impacts in the 2019-2020 period and, perhaps, beyond.

**Scenario 1  Moderate disruption**

The British government’s bargaining position has set the country up for a hard Brexit, despite claims and hopes to the contrary. This scenario would most likely emerge as a “Canada-style” trade deal or a partial agreement on some terms but a refusal of Brussels to grant an extension to negotiate the remainder. Such a scenario could cover most goods, but those traversing borders could be subject to enhanced inspections and nontariff barriers, adversely affecting supply chains and business planning. A limited Brexit agreement likely would have little or no coverage for trade in services, so the services sector would be negatively affected without ready access to European markets. As it presently stands, EU nationals will be able to continue working and living in the UK without special permission for an interim period.

**Scenario 2  Severe disruption**

A no-deal scenario where the UK “crashes out” due to a failure to achieve agreement on a future relationship with the EU is a real possibility. Without an agreement, the economic consequences for the UK would be significant and result in near-term shocks after March 29. Trade relations will revert to WTO rules; most notably, this involves the levying of tariffs on goods exported to the EU and the establishment of a wide array of nontariff barriers, with significant effects on both manufacturing and services. Goods crossing borders will have to go through customs and inspection processes, which have yet to be set up, likely harming manufacturers more than an expected sharp drop in the value of sterling would help them. Some multinational companies have warned that production at UK factories would be disrupted for weeks or maybe months in a crash-out scenario.

**Scenario 3  Limited disruption**

The time required to reach a comprehensive and definitive agreement on the terms of separation and a future trading relationship between the UK and EU has passed. Facing a potential crash-out scenario, London and Brussels have signaled their willingness to defer significant changes for about 2 years if interim terms can be agreed—and this presently is the most likely scenario to occur. There are many possible variants in this scenario, since the negotiations on a permanent relations are still years away, but they would likely involve the maintenance of some form of free trade area. There may also be a separate stopgap agreement covering the free movement of services. It is under such a scenario that UK voters or politicians could reconsider Brexit at some time in the future. While the near-term potential for business dislocation would be significantly reduced, it would prolong the period of uncertainty and ambiguity by two or more years. Thus, the uncertainty and cost of doing business in the UK would still go up.

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1 “Canada-style” trade refers to The Comprehensive Economic and Trade Agreement between the EU and Canada.
Issues to consider

Macroeconomic and even sector-specific forecasts for the UK economy vary widely. Consequently, investors must closely examine specific companies and targets and evaluate how Brexit will affect them. Investors should consider several issues, including the following:

1. Timing
It is difficult to predict when business and investors will have clarity regarding Brexit terms and negotiations which may indeed go to the wire. Potential political uncertainty in the UK and the extent of the EU’s flexibility in its negotiation stance are perhaps the most significant threats to the relative success, or otherwise, of the Brexit negotiations. Any agreement will require thousands of new rules and regulations to be written, institutions and practices to be reformed (including the reestablishment of border regimes), and markets and companies to adjust. Ultimately, businesses and investors should expect Brexit to take 7-10 years to play out. In such a scenario, a wait-and-see approach, for most investors, is not feasible.

2. Political leadership
Brexit represents the most significant realignment of UK policy in decades and there is deep internal debate about what should be done. Moreover the current British government has limited room for finessing Brexit without imposing significant risks on the economy. As a result, political uncertainty is emerging as a big driver of the UK’s near-term economic outlook. London’s Brexit negotiations and policy could shift markedly if a new government comes to power. The current government has sought to deepen UK-China trade and investment ties, but a future government could have a different stance.

3. The strength of sterling
Since the Brexit referendum in June 2016, the pound has lost value, but so far, the markets have adjusted much more smoothly than many observers predicted. Not surprisingly, expert outlooks for the future vary widely. Nevertheless, sterling’s downward trend has elevated inflation and put pressure on household budgets and companies reliant upon inputs from abroad. At the same time, further currency devaluation will likely provide discounts for foreign investors and help offset rising complexity and costs for exporters.

4. Domestic economic potential
So far, the British economy has held up relatively well compared with more pessimistic forecasts, but underlying weaknesses are beginning to show and economists have downgraded both their near- and long-term outlooks. In October, the IMF forecasted that the UK will grow by only 1.4% in 2018 and 1.5% in 2019. Rising inflation, currency depreciation, higher business costs, a lack of real wage growth, and weak consumer and business sentiment could emerge as serious impact to Britain’s economic vitality.

5. Market orientation
Companies with a heavy exposure to trade with the EU, especially those that were using the UK as the gateway to the EU, will find it more costly and difficult to trade with EU-member nations under any Brexit scenario. Brexit will also impact UK trade with countries with which the EU has trade and investment agreements—including significant markets such as the US and Japan—until the UK can negotiate new bilateral agreements with them—a process that could take many years. On the other hand, trade and investment with emerging markets, including China, could become relatively more attractive. Some companies focused on serving the British economy could benefit from an import substitution strategy, but decreased macroeconomic potential and constrained household budgets could hurt the growth prospects of others.

6. Legal and regulatory jurisdiction
An uncertain legal and regulatory environment could significantly impact the parameters of an investment in the UK. Advocates for a hard Brexit have argued that London should have the ability to significantly ease business regulation and rules for foreign investment and trade. Yet regulatory equivalence and mutual recognition with the EU are critical to the future of many industries—particularly in sectors where the UK is strong, including law and finance, life sciences, and other technology-intensive industries. Moreover, without an agreement to remain bound by EU judicial standards (the so-called Recast Brussels Regulation), which guarantees mutual recognition between national courts, London’s status as a center for contract disputes is at risk.

7. Gateway status
The passporting right to provide financial services across the EU likely will end with Brexit. While some form of agreement keeping friction to a minimum is highly likely, most financial institutions are already moving people and headquarters offices. Notwithstanding, warnings about the demise of London as a global and regional business hub appear to be overblown, given the region’s enduring talent, infrastructure, language, and business culture advantages. London has distinguished itself as a global hub for education, creativity, and innovation and this is unlikely to change in any scenario. Thus, the information, digital, communications, arts, and entertainment sectors should continue to develop. In this light, London’s status as a top global real estate investment destination for the long term may not be diminished as much as some have predicted.

Source: International Monetary Fund, World Economic Outlook, Oct 2018
Introduction

The United States has long been a top investment destination for global investors. It has been considered an economically and politically stable and reliable market, and policy initiatives by the Trump administration in 2017 and 2018 to spur growth, cut business taxes and reduce regulation in financial institutions have made the US even more attractive — especially in comparison to other mature market economies.

Investors in China perceive the opportunity: in 2017, Chinese foreign direct investment (FDI) into the US totaled almost $30 billion — up from nearly zero in 2009. This was two times the volume of investment that flowed from the US to China in 2017.4

The US and China have the world’s deepest and most complex economic relationship, and this has yielded many benefits for both sides. But this rich and multifaceted relationship is evolving and, in many ways, becoming more complex. Investors from China pay close attention to the policy-setting in their country, and they should also pay close attention to rapidly evolving perceptions, politics and rules of investment in the US.

4 Source: Rhodium Group
Context: the US-China geopolitical relationship

Economic openness, including broad-based political support for free trade and investment, has been a hallmark of American economic policy since the end of World War II. Such principles have extended to the US’ economic relationship with the People’s Republic of China.

In his candidacy for the presidency, Donald Trump challenged many aspects of the postwar policy consensus by raising questions about the fairness of the US’ economic relationship with key partners around the world – including China, with which the US has had a large and persisting deficit in the trade of goods and services.

Since President Trump’s election, his foreign policy priorities have expanded from reducing the trade deficit with China to confronting a broader array of concerns. These include their perceived challenges to US firms doing business in China, such as restrictions on FDI; requirements such as mandatory joint venturing and technology transfer; regulatory hurdles that challenge competitiveness; and intellectual property protections. The Trump administration has also articulated an array of their national security concerns, including China’s growing presence in Asia; the Chinese government’s plans to lead in the development and diffusion of critical technologies; and claims of cyber threats emanating from China. To these points, in 2018, the White House commented on “economic aggression in the technology and intellectual property space” regarding China and the Department of Defense labeled China a “strategic adversary.”

Importantly, the election of President Trump coincided with a fundamental reappraisal by China experts and policymakers across the political spectrum in Washington. Both Democrats and Republicans generally have concluded that the US needs to adopt firm measures to rebalance the overall relationship.

So far in 2018, the Trump administration has imposed or announced tariffs on $250 billion of Chinese goods, and it has threatened to target another $267 billion – to effectively cover all goods imported to the US. Washington has also threatened to impose economic sanctions for a number of objections, and investment from China is now subject to greater scrutiny under the rubric of national security concerns and, importantly, to demonstrate reciprocity with FDI restrictions in China.

On October 7, 2018, the government of China criticized the Trump administration for “misguided actions,” and restated a willingness to work with the US to achieve mutually beneficial outcomes through non-confrontational and mutually respectful cooperation. There is a risk that the situation may become increasingly tense in the coming years before it stabilizes or gets better. Given this context of emerging geopolitical competition, tariffs and investment scrutiny are just two facets of a broad superpower relationship that is becoming more conflict-prone.

Issues to consider

Despite geopolitical tensions, the United States will remain a very attractive destination for Chinese investors – especially those with a long-term horizon. As they develop strategy in 2018 and 2019, Chinese investors should pay close attention to a number of near-term issues that will shape the FDI landscape. These include the following:

1. Domestic economic potential
   The US economy is enjoying one of its longest economic growth cycles in modern history, and the trajectory has shifted upward in 2018, due in part to government policies. In October, the International Monetary Fund forecasted US GDP growth for 2018 at 2.9%, slipping to 2.5% in 2019.
   - Investment is up and business and consumer confidence are very positive, but the US economy experiences periodic downturns – often when investor sentiment is high.
   - Risks to watch in 2019 are increasing labor costs and labor shortages, tariffs and supply chain dislocation, and rising energy prices.
   - Interest rates in the US are projected to continue rising; this will put upward pressure on the dollar, which will have implications on asset prices, competitiveness and growth potential.
   - Finally, economists expect that the stimulative effects of the tax cut could start dissipating by 2020.

2. Political leadership
   The election of Donald Trump as president in 2016 represented a significant departure from the American political norm. Since then, his administration has pushed the US in many new policy directions – regarding taxation and regulation, trade policy and international affairs, including US-China relations. While escalated political risk in the US over the past two years has not had a noticeable negative effect on economic activity or attractiveness, investors likely will have to navigate more political volatility, uncertainty and complexity in 2019. Issues of interest to Chinese investors, such as the issuance of EB-6 visas, could be affected in unpredictable ways by domestic political wrangling. The US will have a general election in 2020, and this represents another opportunity for a shift in US economic and security policy.
CFIUS review is a formal process that is specified by federal laws and regulations, and in principle, this process should be fact-based, rules-driven and predictable. This is not always the case: CFIUS review is also subject to many external, subjective and less predictable political forces that can shape outcomes. For example, it is not uncommon for members of Congress to express their personal opinion about the merits of a foreign investment located in their district — even though they have no formal role in the CFIUS process. Coverage in the media or opposition by competing business interests can also shape CFIUS deliberations. Ultimately, the president can approve or reject an application, and that decision reflects the recommendation of CFIUS as well as many political considerations. Finally, state and local politicians, the press, businesses and local activist groups often express their support of or opposition to a foreign investment — especially when a transaction is considered significant to the local economy, infrastructure, the natural environment or culture. In sum, the political interests of federal, regional, and local actors must be addressed as part of a transaction — especially in an era when perceived geopolitical tensions between the US and China are elevated.

The Committee on Foreign Investment in the US (CFIUS) is a federal government body that reviews the national security implications of foreign direct investment in US-based companies or operations. CFIUS was created in 1975, and subsequent legislation has expanded its purview and refined its procedures as the global investment environment and US public policy priorities have evolved. The interpretation of “national security implications” of foreign investment has always been flexible, and this has imparted a measure of uncertainty to the process. Moreover, in pursuing aluminum, steel and automotive tariffs, the Trump administration has made it clear that it takes a novel and expansive view of national security prerogatives as part of its trade and investment policy. Finally, while the law does not stipulate that the origin of investment is a criterion for review, scrutiny of investments from China has expanded significantly over the past seven or so years as trade, investment and security relationships between China and the US have evolved. This looks likely to increase, as the Trump administration has signaled its intent to use the CFIUS process to screen Chinese FDI more closely as a countermeasure to FDI restrictions in China.

The Foreign Investment Risk Review and Modernization Act of 2018 (FIRRMA) significantly expanded the legal basis for CFIUS review. In particular, greater scrutiny will be given to transactions involving real estate in locations deemed sensitive; companies with “material nonpublic technical information”; and “investment structures designed to circumvent CFIUS jurisdiction.” The law also stipulates mandatory filing requirements, increased staffing available to review deals, and an extended period for review. The new rules should start being implemented in 2019, and because many of these factors impart new uncertainties, investors should pay close attention to developments as they unfold. For example, in October, it emerged that past deals may be subject to retroactive review under new rules being drafted.

### Investment targets with higher sensitivity to geopolitical risks

- Industrially significant technologies, including artificial intelligence, robotics, nanotechnology and microchips
- Infrastructure, including port facilities and operations; energy and power production and distribution; roads and railways; telecommunications systems; and data centers
- National security-relevant technologies and manufacturing, such as aerospace, remote sensing, and telecommunications hardware
- Real estate near government installations
- Agricultural land

### Investment targets with lower sensitivity to geopolitical risks

- Retail and consumer sector, including e-commerce, entertainment and hospitality
- Agricultural operations, including livestock production and agricultural processing
- Commercial real estate, including office, multi-family and retail
- Non-defense-related manufacturing
- Educational services
The Geostrategic Business Group harnesses EY’s global resources – our on-the-ground local experience, sector knowledge, and key relationships – along with the political risk capabilities of select partners to bring world-class perspective and insights to businesses operating in nearly every corner of the world.

Deep Sector Experience and Knowledge

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