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Political risk and firm exit: evidence from the US–China Trade War

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ABSTRACT

When do political risks lead to divestment from a profitable market? Existing theories argue both that foreign investors may be sensitive to political tensions, but that they may only be sensitive to violent conflict. Using the crucial case of the US–China Trade War, we outline how political risks increased rates of exit among foreign firms while firm entrenchment mitigated these risks. Using a new dataset on all foreign-invested enterprises registered in China between 2017 and 2019, we implement triple interaction models to isolate the impact of increased political risks, investor national origin, and entrenchment on firm exit. Our findings show that heightened political risks during the trade war did increase firm exits by 34% – 3% points – over the pre-conflict baseline. Tariffs, the targeted effect of the trade war, increase US firm exits by 1% point. Firm exit is determined by the balance of heightened political risks against the availability of firm-level resources to mitigate these risks. These findings reconcile the conflicting expectations of the 'business as usual' and 'follow the flag' literatures about how firms respond to political risk, highlighting the tremendous collateral damage tariffs can cause in an age of global value chains.

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KEYWORDS

Political risk; trade war; foreign direct investment; China; global value chains; international business; international trade

Introduction

Multinational corporations (MNCs) engage in foreign direct investment (FDI) when political risks are low (Barry, 2018; Pandya, 2016; Jensen et al., 2012; Jensen, 2008), national security interests between sending and target countries align (Biglaiser & DeRouen Jr., 2007; Rodman, 2001), and when property rights are protected (Wellhausen, 2014; Biglaiser & Staats, 2012; Li et al., 2003). Comparatively little is known, however,

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about the determinants of FDI flight, or the politics of divestment. Do elevated political risks increase the likelihood that foreign investors exit from a once-promising market? When political relations sour between sender and host countries, will FDI 'follow the flag' out of the market? If so, are some firms more likely to exit than others?

We build on work by Vekasi (2019), Barry (2018), Graham et al. (2016) and Camacho and Rodriguez (2013) to unpack the effects of political risk on divestment. Previous research on the impacts of political risks and FDI flight focuses on risks associated with violent conflicts, such as civil wars, insurgency and terrorism, demonstrating how MNCs' behavior depends on the different stages of the FDI lifecycle. While the probability of FDI entry decreases with conflict duration and intensity, once the costs of investment are sunk, firms are resilient to all but the most intense forms of political risks, and FDI exits are rare (Barry, 2018). Firms with the same national origins act similarly because of a sense of 'shared political risk' (Wellhausen, 2014). We expand the literature on FDI exit by examining how MNCs respond to an important episode of non-violent political risk: The US–China Trade War.

Even before the trade war, China represented a crucial case for understanding both FDI investment and divestment. China is one of only two non-US allies among the top 20 largest recipients of FDI stocks between 2005 and 2022,[1] making China a crucial case for understanding variation in firm exits as both a geopolitical rival to the US and the second largest recipient of FDI in the world, trailing behind only the US. The US–China Trade War offers a unique opportunity to examine the impact of political risk outside of armed conflicts. The trade war represents the most serious disruption to global supply chains since their emergence. Studying the effects of political risks on FDI in this influential case could help establish the scope conditions for a theory of FDI outflows. On the one hand, we would expect national origin of the firm to be the most salient in this case where geopolitics looms so large. On the other hand, the size and depth of the Chinese market may convince some foreign investors to ignore pressures from their home governments to decouple from China.

We argue that the 2018 US–China Trade War increased political risks across the board for all foreign MNCs operating in China, contributing to the exit of some China-based subsidiaries. Costs of business increase through concrete measures such as tariffs and export controls but political risks also increase intangible costs, such as uncertainty about the future business environment and political pressure from sender governments as well.

These factors drive political risk for China-based operations by raising costs and changing the rules of the game, with significant ramifications for overseas production. But some firms resist the influence of these adverse effects of intensifying geopolitical competition through greater entrenchment in the local market. We utilize micro-level data from the original Foreign-Invested Enterprises in China (FIEC) Dataset to implement triple interaction models identifying the conditions under which the trade war increased divestment through firm exit. We find that the blunt effect of the trade war – the souring of business relations felt by all MNCs operating in China – was significant, increasing MNC subsidiary exit by an average of 3% points, or approximately a 34% increase over pre-trade war levels. We find that US firms in industry classes with higher tariffs – the targeted effect of the trade war – were marginally more likely to exit than MNCs from other countries in the same industries by approximately 1% point. Firms from countries with close

political alignment with China, while more likely to exit before the trade war, do not exit at a higher rate when tariffed, but still suffer significant blunt effects of the trade war. Finally, firm entrenchment in China mitigates the effect of rising political risks, reducing firm exits. These results are consistent with the emerging literature on the heterogeneous impact of political risk on domestic economic actors (Vekasi, 2019; Li & Liu, 2019; Davis & Meunier, 2011; Kastner, 2007). The trade war increased overall firm exits but had a heterogeneous effect in terms of which MNCs exited China.

Our results have significant theoretical and empirical implications for understanding the dynamics of FDI flows, especially between geopolitical competitors. Theoretically, we present one of the first systematic attempts to understand divestment through firm exit during a clearly demarcated period of heightened political risk. We show that the interaction of heightened macro risk and the differing capacity for firms to mitigate micro risk drives firm exits. Empirically, we provide evidence that the trade war elevated political risks for all foreign MNCs in China, but tariffs marginally accelerate FDI exits in affected industries. The trade war had a greater blunt effect than targeted effect, with smaller and newer firms bearing the brunt of its impact. This suggests policy initiatives using tariffs to encourage the re-shoring of specific industries may have limited effects and carry unintended distributional consequences. Our results also explain the uneasy coexistence of economic decoupling with business-as-usual found in the current era of the US–China Trade War. They help explain why the anecdotal evidence on how much decoupling or derisking is actually happening as a result of Western politicians pressuring MNCs to divest from China is mixed. Finally, our research highlights the need to analyze political risk outside of the extreme case of violent conflict.

The case: the US–China Trade War

After accusing China of unfair trade practices and intellectual property theft, the Trump administration imposed four rounds of tariffs on Chinese goods between July 2018 and May 2019, specifically targeting intermediate and capital goods supported by the 'Made in China 2025 Initiative' which quickly expanded to include a wide array of consumer goods as well (Zhang, 2022). Chinese officials retaliated with four rounds of tariffs on US goods, such as soybeans, whose production was concentrated in Republican-supporting districts (Kim & Margalit, 2021).

The US–China Trade War quickly expanded beyond tariffs to a wider set of policies aimed at the 'strategic decoupling' of the two economies. A slew of other policy measures designed to curb Chinese competitiveness in emerging technologies – the so called 'tech-war' – and to heighten ideological competition between the two systems of government – the so-called 'new cold war' – accompanied the escalation of tariffs. Since 2018, the Department of Commerce added more than 600 Chinese companies, including Huawei, one of the world's largest information and communication technology suppliers, to a list of entities subject to stringent export licensing requirements for US technology. The US Congress expanded controls *via* the Export Controls Reform Act to cover dual-use emerging and foundational technologies and also increased scrutiny of Chinese investment in dual-use, high-technology sectors *via* the Foreign Investment Risk Review Modernization Act of 2018. The Department of the Treasury expanded the Office of Foreign Asset

Control's financial sanctions to penalize Chinese human rights abuses in Xinjiang and Hong Kong.

The Department of Justice launched a nation-wide China initiative to identify instances of Chinese intellectual property theft, and the Department of State canceled visas of Chinese scholars suspected of economic espionage. The Biden administration not only kept the Trump administration's tariffs on China in place, but also intensified efforts to cut China off from advanced technologies. The US–China Trade War garnered significant attention as researchers inside and outside of academia tracked the coverage of tariffs (Bown, 2019) and attempted to identify its causes and political logic (Hua, 2022). This dramatic incidence of economic statecraft highlights how supply chains create more powerful tools for political manipulation than ever before (Chen & Evers, 2023; Lee & Maher, 2022). This article adds to the growing literature on the wide-ranging consequences of the US–China trade war. Previously identified consequences include its influence on public opinion, securitizing economic relationships and popular support of a global liberal economic order (Dolan et al., 2021; Bulman, 2022; Steinberg & Tan, 2023). This impact on public opinion also impacts US electoral outcomes (Chyzh & Urbatsch, 2021). Individual firms changed their political behavior in response to the trade war, including decisions to exit markets or voice opposition at home (Liu et al., 2022) and petition for tariff exclusions to protect their industries (Lee & Osgood, 2022). A remaining area of inquiry is how political risks heightened by the trade war impact investor behavior. While there is some preliminary evidence of the trade war reshaping supply chains,[2] less is known about the heterogeneous effects of the trade war on firm exits from China.

Evidence of MNC divestment from China in the wake of the trade war is mixed. Aggregate foreign investment in China held steady during 2018 and 2019 and increased dramatically in 2020 despite the Coronavirus pandemic when China briefly overtook the US as the largest recipient of FDI (UNCTAD, 2021). The number of foreign-invested enterprises entering China outpaced exits (Figure 1). Yet, exits increased from an average of 7.7% before the escalation of the trade war to 11.2% in 2019 after new tariffs and retaliatory tariffs were placed on nearly all bilateral trade.

What accounts for this discrepancy between the increased rate of firm exit and the steady level of overall FDI? Did the US–China Trade War succeed in starting an exodus of MNCs from China, beginning the process of decoupling as some commentators and policymakers claimed? Does national origin influence which firms are more responsive to calls to economically 'decouple' from China?

The geopolitics of FDI outflows

Theoretically, we know more about the politics of FDI inflows than FDI outflows. Foreign investors are more likely to invest in a country with favorable economic conditions or when seeking new markets (Dunning, 1980; Cheng & Kwan, 2000; Wadhwa & Reddy, 2011). MNCs are more likely to enter a market when property rights are protected (Wellhausen, 2014; Biglaiser & Staats, 2012; Li et al., 2003) and when there are strong institutions (Pandya, 2016; Jensen et al., 2012; Jensen, 2008). Large-scale political disruptions in the host country, including violent conflict and decrease investment (Barry, 2018; Pandya, 2016).

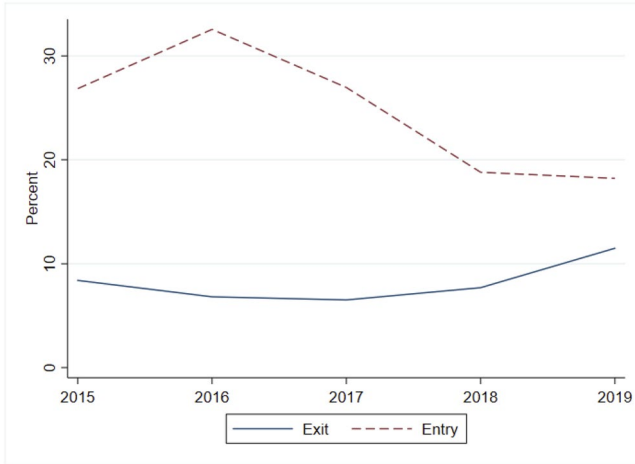

Figure 1. MNC entries and exits since 2015. Data represent the percent of foreign-invested firms that either are established in a given year (entry) or that exit in a given year (exit). *Source:* FIEC Dataset.

The existing literature on the politics of FDI offers conflicting expectations about how foreign investors in China are likely to respond to the trade war. The most prominent recent study on the effect of political tensions on trade and investment finds a powerful null relationship (Davis & Meunier, 2011), suggesting that firms continue to operate 'business as usual.' The authors point out that the costs of movement are substantial for firms engaged in intra-industry trade, and these relationship-specific sunk costs discourage fluid adjustment by economic actors to changing political circumstances. Foreign MNCs in China depend on its vast industrial base for suppliers and are embedded in regional supply chains. China has actively attracted FDI domestically through establishing free trade zones and internationally through signing bilateral investment treaties (BITs). These are production network relationships that take years to forge and are very costly to replace. Davis and Meunier (2011) point out that weakening alliance ties or animosity between rivals would not produce a parallel shift in economic ties. They conclude that in an era of globalization, 'actors lack incentives to link political and economic relations,' and thus investment can proceed 'business as usual' despite political conflict.

Alternatively, the literature on investment 'following the flag' suggests that US FDI aligns with its alliances (Biglaiser & DeRouen Jr., 2007) and that bilateral FDI is higher between security allies (Li & Vashchilko, 2010). Trade and investment create security externalities: Trade with allies benefits security relations while trade with adversaries increases security costs (Gowa & Mansfield, 1993). Li and Vashchilko (2010) argue that allies are less likely to restrict foreign entry into the economy, which lowers political risks in the host for investments from an allied home country. Nigh (1985) finds that because host governments have difficulty distinguishing the interests of the US government and those of US investors, investors watch events of cooperation or conflict between the nations closely for information about the business environment they might face in the host nation. International cooperation should increase US investment, and conflict should decrease US investment.

These theories are unsatisfying when evaluating the present economic decoupling dilemma where politics and economics are pulling MNCs in opposite directions. China is a puzzle for the IPE literature on the politics of FDI. As an autocratic, non-US allied country with a non-independent judiciary and uncertain property rights protection, it has emerged as one of the world's leading FDI recipient countries despite being a risky place to invest. Scholars have noted the political risk tolerance of foreign firms in China, termed 'hot economics, cold politics' (Vekasi, 2019; Aggarwal & Govella, 2013). Does 'business as usual' hold in an era where politicians seem more concerned than ever about economic security and geopolitics? Or has the unprecedented increase of political risk in China caused more firms to 'follow the flag'? This article explores the role of nationality and firm-entrenchment in mitigating political risks at the firm-level and shaping decisions to exit from China.

Theorizing political risks and firm exit

We argue that variation in divestment through firm exit results from differential experiences of political risks among foreign MNCs and their firm-level characteristics that mitigate the costs of political risks. Political risk increases the likelihood of exit, but not all firms experience exit pressure equally. Both national origin and firm entrenchment affect firms' exposure to political risks.

Political risk and firm exit

We argue that the US–China Trade War heightened both broad and targeted political risks, encouraging firm exits. Political risk refers to the risk investors suffer as a result of politics. Political risks are the risks of governments breaching an implicit contract with investors.[3] Extreme cases of political risk – rare occurrences of interstate violent conflict – dominate existing studies of how risk affects FDI. Yet less intense but more common forms of political risk are also likely to impact investment.

The political actions taken by both China and the United States increased uncertainty and political risks for MNCs. The rapid deterioration of US–China relations and resulting policy uncertainty caught MNCs by surprise. Between 2018 and 2019, the US trade policy uncertainty index topped 800, multiple times above its mean of 100 from 1985 to 2019, reflecting an 'extraordinary' level of uncertainty (Baker et al., 2019). Most analysts and business leaders initially expected a negotiated settlement to be reached in 2018 before the tariffs would be implemented (Davis & Wei, 2020). They initially saw the threat of tariffs as mostly posturing, and thus the breakdown of talks and implementation of these tariffs in July and August 2018 startled many MNCs. The timing of this bargaining failure was difficult for MNCs to anticipate in advance. But the onset of the trade, tech and cold war with the US dramatically increased political risks for foreign MNCs doing business with China.

Political risk has long been established as an important determinant of FDI inflows and firm entry (Pandya, 2016) but plays a more ambiguous role for firm exit (Barry, 2018). Political risk, regardless of form, erodes the business environment and increases the likelihood of firm exit, all else equal. We argue that the

political risks create two effects: A targeted effect of micro-political risks and a blunt effect of macro-political risks.[4] The targeted effect of the trade war is expected to increase for those firms exposed to tariffs and other retaliatory measures. However, it also has a blunt chilling effect across all foreign businesses because even foreign firms that do not export directly to the US face elevated regulatory uncertainty, greater difficulty securing financing or insurance, and more uncertainty about Chinese growth.

Firms vary not only in terms of their exposure to micro- and macro-political risks, but also in their capacity to respond and adapt. We hypothesize that the exposure of individual firms to political risk is mitigated by their national origin and their degree of entrenchment in China. The national origin of the firm will serve as a filter for exposure as some foreign firms are more likely to be targeted by specific policies. The 'follow the flag' literature suggests that political risks emanating from the trade war should be more acute for some foreign firms than others depending on if the relationship between their country of origin and China is friendly or hostile. The 'business as usual' literature suggests that a firm's degree of entrenchment in China must also be considered. Less entrenched firms have less costs sunk in China and fewer political resources; they are likely more sensitive to political risks. For better entrenched firms, exposure to tariffs could increase the cost of doing business but may not be enough to convince them to stop doing business in China. They may also receive more favorable treatment from local governments or business partners to continue operating in China.

Previous scholarship on both 'following the flag' and 'business as usual' has used bilateral economic flows, be it trade or FDI, as the unit of analysis. We argue that the impact of political risk on firm exits must be understood and analyzed at the firm level rather than the dyadic level. Different firms make different decisions depending on exposure and entrenchment, and their behavior can be more than the sum of its parts. Firm exit is a costly decision that can result from either acute exposure or inadequate capacity to respond. Aggregate FDI stock data at the national level would not show a change if many small firms exit but most large well-entrenched firms remain as a result of the trade war. We synthesize the insights from both the 'follow the flag' and 'business as usual' approaches to analyze pathways of how political risks can result in firm exit across different firms.

Casualty

The most straightforward pathway for firm exit is between targeted political risks and low-entrenchment firms. Both the US and China targeted retaliatory tariffs to maximize political leverage while minimizing economic harm. For these firms that lack scale and experience in China, exposure to higher tariffs could put an unbearable strain on business models and cause them to go out of business. Firms from countries that are hostile toward China, such as the United States, should be especially exposed to targeted political risk. Firm exit for these casualty firms likely means liquidation; the tariffs that target them put the marginal firm over the edge into insolvency.

De-risking

For better entrenched firms, exposure to tariffs could increase the cost of doing business but may not be enough to convince them to reduce their footprint in

China. However, some of these firms exposed to targeted political risk may choose to preemptively reduce their exposure to China by divestment or restructuring. National origin is a key driver of derisking behavior because US and US-allied firms face additional reputational risks and regulatory pressure from their home governments to reduce exposure to China due to national security concerns. These firms that 'follow the flag' choose to exit whereas the less well-entrenched firms are forced to exit.

Collateral damage

The trade war also has a blunt effect on global value chains beyond those importing/exporting firms that have to deal with higher tariffs. Arguably, the primary way that the trade war elevated political risks in China was to magnify uncertainty and undermine investor confidence. As the *South China Morning Post* reported in 2019, 'China [was] holding onto US dollars by increasingly restricting business and individual transfers out of the country' while foreign financial institutions were 'increasingly reluctant to lend US dollars to Chinese banks given worries about financial risks amid the trade war.'[5] Additionally, firms that invested in China with the expectation of amicable US–China relations, promising growth, and low political risk had to quickly adjust to much more negative outlooks.[6] Similar to the casualty pathway, firms that lack scale and experience in China will be the least prepared to deal with the new reality of economic decoupling.

Business as usual

More entrenched firms that are not directly targeted by policies should be the least likely to exit, as they have greater costs sunk and deeper relationships in the host country. These firms can carry on business as usual provided that they are prepared to deal with the blunt effects of the trade war. Some firms may even benefit from the market share vacated by competitors that are under pressure to exit China. The national origin of firms may make some difference here as firms from countries friendly to China should be under the least political pressure from host and sender governments and stand the most to gain from the shifting tides of geopolitics.

The trade war can thus cause voluntary exits (as in the de-risking pathway) as some foreign firms whose operations in China are profitable can choose to 'de-risk' from China because they anticipate future political risks. It can also cause involuntary exits (as in the casualty and collateral damage pathways), in which firms on the margins of profitability could be pushed over the edge by additional costs of doing business. Our measure of FIE exit does not allow us to distinguish between these voluntary *vs.* involuntary exits. It is difficult to causally identify why specific firms exit China or whether the exit is voluntary or involuntary without a firm-level survey. We hope that subsequent research by management scholars can further unpack whether an FIE is put out of business or whether it chooses to sell or restructure assets.

However, we can try to determine, all else equal, the independent effects of political risk exposure, national origin and firm entrenchment on all forms of firm exit to try to better understand the consequences of political shocks like the trade war on all exits. We offer a general theory for how political shocks, like that

delivered by the trade war, can influence the behavior of MNCs. We distinguish between the targeted and broad political risks that resulted from the onset of the US–China Trade War in 2018. National origin should be a significant driver of firm exit only after political tensions are heightened. But entrenchment should matter both before and after the trade war.

The blunt and targeted effects of political risk

Specific policy initiatives can directly increase the cost of doing business for specific sectors or firms, creating a targeted effect of political risk. Often targeted political risks, such as targeted sanctions or export controls, are the intended consequence of government policy. These micro-risks make the targeted firms less attractive to financiers, insurers and partners.

As outlined above, the trade war increased multiple forms of political risk for specific firms. The most targeted of these are the export controls placed against Chinese technology companies, increasing political risks for their foreign suppliers. Tariffs operate at the product rather than firm-level but are nevertheless a form of targeted risks. US Section 301 tariffs had the explicit aim of punishing industries linked to Made in China 2025. US tariffs make exports into the US more costly for targeted firms. MNCs and the global supply chains they participate in depend on the trade of intermediate goods as well as finished products, all of which can be more difficult to produce when trade barriers increase. Thus, the targeting of tariffs is inexact because it hurts foreign firms of all nationalities that export goods from China to the US.

Second, elevated political tensions generate a blunt effect for all foreign firms in the host country. These macro-risks make China, and all firms with exposure to China, less attractive to foreign investors. With global value chains, it is not just US firms that are exposed to the political risks of the trade war and tariffs.

As political relations deteriorate, the business environment for MNCs in China becomes more uncertain, deals become harder to negotiate, financing becomes more difficult to obtain, political risk premiums become more expensive and state meddling in markets becomes more likely. Unstable political ties between the host and sending countries increase uncertainty not only for MNCs of the sender country, but also for all MNCs linked together by global value chains. While one firm might not be directly affected by tariffs, the firms they engage with may be. The uncertainty that results from the macro risk emanating from the trade war should accelerate investment exit. Additionally, sender country governments can put pressure on MNCs to leave a particular host country, souring business ties at home. This leads to our following hypotheses:

H1a: *Macro political risks from the trade war will increase firm exits across all MNCs (blunt effect).*

H1b: *Micro political risks from tariffs will increase exits from affected industries (targeted effect).*

The trade war had a blunt effect on all MNCs operating in China regardless of industry or nationality. These larger risks are likely to affect many MNCs regardless of industry or nationality due to the complex nature of supply chain linkages. The US–China Trade War represents a concerted political effort to

reverse decades of trade and investment integration. The uncertainty caused by deteriorating US–China relations poses a risk to profitability for most foreign firms operating in China. Even if a firm does not export to or import from the US, they might work with suppliers or sell to customers who do. They might do business with the growing number of Chinese firms added to the US entities list. Or they might just reduce investments because they anticipate slower economic growth in China due to the trade war. Thus, this blunt effect of the trade war increases political risk systematically across a wide range of firms in China. Tariffs, on the other hand, create a targeted effect on specific MNCs. The USTR's List 1 and 2 tariffs explicitly targeted products that benefited from Made in China 2025. Industries targeted with more tariffs and those with greater tariff intensity should face higher political risks as they experience greater creeping expropriation. US tariffs are taxes on Chinese exports, meaning that they should raise costs for all MNCs creating goods for sale in the US market. Chinese tariffs are taxes on American imports, meaning that they should raise costs for all MNCs that use US-produced materials or components. Tariffs directly increase the cost of business for these firms.

The effects of national origin

The existing literature suggests that firm nationality is a key determinant of which MNCs faced with rising political risks take flight or fight (Wellhausen, 2014). Nationality, defined by the investor's country of origin, can influence firm exit through multiple pathways with mixed results. We compare the effects of national origin across firms from the US, US allies and China-aligned countries.

First, one might expect US firms to be particularly vulnerable to targeted political risks and be the most likely to 'follow the flag' out of China. International cooperation increases US investment and conflict decreases US investment (Biglaiser & DeRouen Jr., 2007). Investors watch events of cooperation or conflict between the nations closely for information about the business environment they might face in the host nation (Nigh, 1985). So, just as investors 'follow the flag' in choosing where to invest, the same logic might also make them more likely to get out of China. Additionally, US firms are more likely to be targeted by tariffs because of an increased probability of engaging in US–China trade, increasing the micro risks as well. This leads to the first hypothesis of how nationality affects firm exit:

H2a: *US firms, particularly those in tariff-affected sectors, are the most likely to exit.*

Second, firms from US-allied countries also suffered from the targeted and blunt effects of the US–China Trade War. The conflict, particularly the intensifying 'tech war,' quickly dragged in US allies like Canada, Japan, Australia and the United Kingdom. For example, Canada was hit by Chinese trade restrictions on soybeans, pork and canola oil after the Canadian government arrested an executive of Huawei Technologies in December 2019 at the United States's request. The US also pressured many of its allies such as Germany and the United Kingdom to ban Huawei from their 5G networks, elevating political tensions between China and those countries. Firms from US-allied countries also faced increased reputational risks and pressure from home governments to de-risk China-reliant supply chains. At the same time, US firms complained bitterly that US tariffs were hurting their

competitiveness relative to European and Japanese competitors. Thus, we consider the role of US alliance on firm exits with these countervailing forces in mind.

H2b: *US-allied firms, particularly those in tariff-affected sectors, are more likely to exit.*

Finally, we examine how friendly diplomatic relations or quasi-alliances with China might mitigate both micro and macro political risks and reduce firm exit. Unlike the US with its global network of 51 treaty allies, China does not have a formal set of traditional alliances other than North Korea. In recent decades, however, China has taken a more proactive role in deepening bilateral strategic partnerships. As of 2018, China has concluded partnership agreements with 78 countries, of which 34 are at the highest level of 'comprehensive strategic partnerships' and 60 are at the level of 'strategic partnerships' or above (Li & Ye, 2019). Bilaterally, China has also worked to expand defense cooperation with a larger set of countries, most recently with Singapore in 2019. China lacks formal treaty allies but instead uses defense cooperation agreements (DCAs) to coordinate defense policies, conduct joint military exercises, promote training and education exchanges and support defense-related research and development. China has signed 20 DCAs with countries, such as Russia, Pakistan and Indonesia. Finally, China launched the ambitious Belt and Road Initiative (BRI) in 2015 to fulfill an ambitious set of economic and strategic objectives (Ye, 2020). As of 2018, 134 countries had signed up to the BRI (see Online Supplementary Appendix A.2 for the full list of China's SP, DCA and BRI partners). Based on 'follow the flag' logic outlined above, these agreements should increase trade and investment because firms whose governments have friendlier ties with China might be expected to receive preferential treatment. Q3

None of these cooperation agreements in diplomatic, defense and economic domains alone provides the same benefits of a traditional alliance, but together they should signal the likelihood of cooperation and conflict between China and the home government of foreign investors in a similar way that alliance treaties might. We investigate the effect of all three types of international partnerships individually and also create an index of countries with the closest alignment to China. We expect firms from these quasi-allies to experience the least amount of targeted political risk and thus be less likely to exit.

H2c: *Alignment between China and investor home countries mitigate trade war risks and reduce firm exits.*

The choices of more and less well-entrenched firms

Finally, MNCs differ in their entrenchment in the local market when operating overseas, which affects exposure to political risks. Firms with greater local entrenchment have higher potential for relationship-specific sunk costs and political resources. Whether or not a conflict reduces trade or investment depends on how firms incorporate rational expectations and uncertainty into their profit calculus of trading firms (Li & Sacko, 2002). Unexpected onset or severity of conflict could induce rational firms to exit China if these risks outweigh the expected profits from staying.

Firms that have smaller amounts of capital invested have less experience (more sensitive to political risk) and less costs sunk. They are also marginally more likely to fail the rate. There is a sizable body of work business scholarship that finds that size increases survival and that larger firms are more difficult to fail and liquidate.

H3: *More entrenched firms are less likely to exit, even in the face of political risks.*

These measures go beyond the simple expectation of increased fixed assets reducing exits, but instead incorporate the broader understanding of the possible mechanisms relating firm heterogeneity with exit decisions, as the case of Japanese firms in China highlights.

The Senkaku/Diaoyu island disputes between China and Japan long created political tensions, but trade and investment between the two countries continued to flourish. However, large Japanese firms respond differently to cycles of political risk and anti-Japanese sentiment than smaller firms. Even though they were more exposed to risk and targeted by nationalist boycotts, larger firms were less likely to leave China and less concerned about political risk than smaller firms (Vekasi, 2019). Thus, our concept of entrenchment goes beyond simple sunk costs, allowing for greater conceptual inclusion of other protective benefits firms enjoy from greater experience in local markets.

Methods and data

The FIEC dataset provides micro-level data not previously available to analyze the effects of the trade war. The FIEC database is an original database compiled by the other, drawn from the Ministry of Commerce records of foreign-invested enterprises. All foreign-invested enterprises in China are required to report annually to the Ministry. The FIEC Dataset compiles each of these reports from 2014 to 2019. Over six years, there are more than one million firm-year observations.

These FIEs range from firms begun by individual entrepreneurs to subsidiaries of major MNCs. FIEs are the legal destination given to firms with foreign capital operating in China and have historically enjoyed more preferential policies when it comes to taxes and financing.[7] The FIEC data follows a power distribution with a few large investors and many small investors, where the largest MNCs contribute the majority of registered capital.

The unit of analysis for all subsequent sections is the firm-year operations with two time points including the year before the trade war, defined as operating between July 2017 and June 2018, and the year after the trade war from July 2018 until June 2019.[8] The two panels capture exits of firms the year before the trade war, the 2017–2018 panel, and after the trade war, the 2018–2019 panel. This allows us to analyze exit using the records of the registered FIE subsidiaries in the immediate aftermath of the trade war.

Results presented below represent the short-run effects of the trade war on firm exits in the year following the major escalation of US–China trade hostilities in 2018 and before the Phase One Trade Agreement was signed in January 2020, as well as before the Covid-19 pandemic upended the global and local economy. The final sample is an unbalanced panel of firms operating in 2017 with two time periods: Exit in the year prior to the trade war and exit in the year immediately after the trade war. The sample is unbalanced because while new entrants are not included in the sample, firms do exit in the first period. Each model includes the time indicator variable – trade war – to capture the different time points.

Dependent variable: firm exit

The dependent variable measures *firm exit*. A firm is defined as exiting if they report in one year but do not report in subsequent years. Between 2018 and 2019, just over 32,000 firms exit the dataset (Table 1). Our pre-trade war panel identifies exits that occur between the 2017 and 2018 registration periods and the post-trade war panel identifies exits that occur between the 2018 and 2019 registration periods. The second panel thus captures exits after the initiation of the trade war and the pre-trade war panel provides an immediate comparison group. Exit increases between 2017 and 2019 for firms of all ownership from 7% to 11%. US firms had a slightly higher probability of exit in 2018 but exited at an average rate in 2019.

Our measure of firm exit includes a full closure of a firm, sale, or subsidiary closure.[9] When investors invest solely in one FIE that closes its doors, that investor also exits the market. When a subsidiary of a large MNC exits, the parent company does not necessarily cease all China operations. The FIEC does not provide information on whether the subsidiary was sold/acquired, went out of business, or was restructured. We focus on the closing of individual operations in China because this should closely proxy the extent of divestment – after all, when CEOs talk about derisking, they are usually talking about gradually reducing their footprint in China rather than ceasing all operations.[10]

Independent variables

Political risk

As discussed above, we expect the probability of exit to be affected by the level of political risk. We disaggregate the effects of the trade war by the macro risks and micro risks leading to blunt and targeted effects of the trade war, respectively. Blunt effects relate to the macro risks related to the souring business climate and heightening uncertainty in China resulting from the trade war. We capture the blunt effects of the trade war with an indicator variable that captures the trade war period. This is a general measure to capture time effects related to the start of the trade war that plays a key role in our modeling decisions. All firms doing business related to US–China trade face greater uncertainty after 2018 than before.

Targeted effects result from micro risks resulting from tariff exposure. Firms targeted by tariffs should exit more than firms unaffected by tariffs. Ideally, we would be able to identify exposure to tariffs at the firm level. Unfortunately, these data are not available, leading us to aggregate exposure to the industry class. We matched tariff data from Bown (2019) to Chinese industry classes identified in the FIEC. If any products within a given industry class face tariffs, the indicator variable takes the value of 1.[11] For robustness, we constructed a *tariff intensity*

Table 1. Number of MNCs by year and ownership, with percent exits.

	Total MNCs			US MNCs		
Year	Number	Exits	(Exit %)	Number	Exits	(Exit %)
2017	257,404	16,731	(6.50)	16,141		
2018	285,203	21,846	(7.66)	16,670	1341	(8.05)
2019	308,569	35,238	(11.42)	16,536	1893	(11.45)

Source: Foreign-Invested Enterprises Dataset. *Note:* Firm ownership is not available for 2016.

measure for both the US and PRC tariffs. Tariff intensity takes the count of products subject to tariffs in the industry-class divided by the number of industries in that class to account for variation in industry size.[12] We focus on tariff exposure rather than other kinds of sector- or industry-level variation because it is the most direct and transparent way to measure the targeted effect of the trade war given available data.

National origin

To test the impact of national origin and political alignment, we analyze the effects of the trade war for US firms compared to MNCs from US-allied, China-aligned and non-aligned countries.[13] US firms accounted for 6% of all firms in 2018. US allies should also share the 'follow the flag' logic while non-allied should be the least likely to divest. US and allied firms are more likely to be subject to targeted policies, in addition to tariffs, that discourage investment in China. The efforts to ban the export of advanced semiconductor equipment to China by both US and US-allied firms (from Japan, Netherlands and South Korea) are an example of such targeted policies. US-allied firms accounted for 21% of all firms in 2018.

To test H2c, we construct an index of China-alignment from three sets of bilateral agreements: Strategic partnerships (SPs), DCAs and BRI membership. A country is deemed China-aligned if it has all three bilateral agreements with China as of 2018.[14] The data on DCAs comes from Kinne (2018) and includes 28 DCAs as of 2010. The data for SPs come from Li and Ye (2019) and includes 59 SPs as of 2016. We include all partnerships at the level of 'strategic partnership' and above, and do not distinguish between 'comprehensive strategic partnership of coordination' with Russia or the 'all-weather strategic cooperative partnership' with Pakistan from the plain 'Strategic Partnership' with South Korea or Canada. The BRI partner country data come from the Council on Foreign Relations; it includes 130 countries that signed BRI memorandum of understanding with China before 2019. China-aligned firms accounted for 7% of all firms in 2018.

Entrenchment

For Hypothesis 3, we utilize common indicators of firm entrenchment: Length of time operating in China and size of registered capital. As both of these indicators increase, firm exit is expected to decrease. Across the dataset, the average firm has been operating in China since 2009, with the vast majority entering after 1989.[15] The earliest registered US-invested firm in China was registered in 1980. Registered capital is highly skewed across firms, with the median firm having 18.34 million USD invested. The average US firm in 2018 has 11.5 million USD in registered capital.[16]

Controls

The literature evaluating the role of political risks in determining FDI focuses on the domestic institutions of the host country. MNCs prefer to locate in democracies where contract enforcement is better (Li et al., 2003; Jensen, 2003, 2008). Domestic institutions that protect property rights and provide credible commitments reduce these domestic sources of political risk. One strength of our analysis is the ability to control for national-level variation in host country institutions. To control for variation within China, we include provincial fixed effects. These controls capture

historically driven institutional variation, particularly between coastal and central provinces and province-level variation in policies toward MNCs.

To capture characteristics of the sending country that may mitigate risks of engaging with China in trade, we include sending country GDP (log), democracy (defined as 1 if Polity IV is six or greater), distance (between capitals) and tax-haven status of the sending country. Firms from wealthier countries may be more established and have access to better production networks, sheltering them from the effects of the trade war. The FDI literature suggests that in times of heightened tension, foreign investors from democratic countries may be more sensitive to political risks in an autocratic host country. Being physically closer to China reduces transaction costs of international business, with firms from closer neighbors expected to exit at a lower rate than firms from farther afield. Investment from tax haven countries and territories may be capital originating in mainland China, making these firms technically foreign, but operated by Chinese owners.[17] Finally, we include a control for signed BITs with China. BITs address the obsolescing-bargain problem by forestalling ex-post trade barriers or expropriation by the host government (Pandya, 2016; Bauerle Danzman, 2016; Allee & Peinhardt, 2014) and are expected to reduce exit.

To control for firm-level variation, we include controls for joint venture status measured as an indicator variable based on reported ownership structure, service industry firms,[18] and exporter status indicating if the firm mentions exporting in its business activities.[19]

Modeling strategy

In subsequent sections, we use hierarchical logit models to estimate the relationship between firm exit, political risk, and the mitigating factors of firm entrenchment. The mixed effects models provide random intercepts for country of origin, providing less biased results when our sample of firms includes multiple countries.[20] This design compensates for correlation in errors associated with the nesting of firms by sending country. We cannot claim that the implementation of tariffs was fully exogenous. Not knowing the specific determinants of why tariffed products were chosen, we use interaction terms to isolate the impact of the trade war. When comparing firm national origin, specifically US firms, US-ally firms, China-aligned firms and non-aligned firms, we use triple interaction term models with each national origin group modeled separately because these categories are not mutually exclusive, other than non-alignment, which is defined as countries that are not the US, US allies or China aligned. The results should be understood as the effect of trade war variables on firms from the national origin category relative to all other firms.

Determinants of firm exit

Political risks: blunt and targeted effects

To identify the blunt and targeted effects of the trade war (H1a and H1b), Figure 2 presents marginal effects of the baseline model interacting the trade war indicator and tariffed industries. The year after the trade war began, firms were 3% points more likely to close than the year before the trade war, representing the

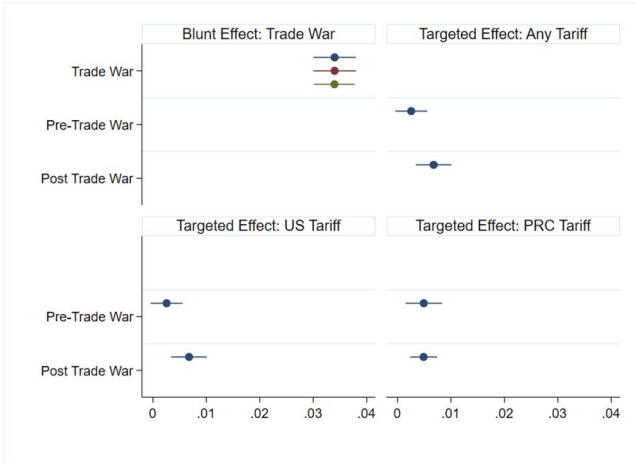

Figure 2. Marginal effects of trade war and tariffs, baseline model. Estimated from a baseline interaction model of trade war and tariffed industries. Marginal effects of tariffs measured in the first year of the trade war. Full results available in Table A5.

blunt effect of the trade war. This represents a 34% increase in baseline exit rates from before to after the trade war.

The targeted effects of the trade war, specifically the increase in exits due to tariffs, were relatively small compared to the blunt effect. Tariffed industries had a higher rate of exit before the trade war began, indicated in Figure 2 by the statistically significant pre-trade war marginal effects for all three measures of tariff exposure. Both 'any tariff' measure and the US Tariff measure increased exits during the trade war period. In the first year of the trade war, firms in tariffed industries were 0.35% points more likely to exit than non-tariffed firms, increasing the exit rate by approximately 5%. This correlation is driven by US tariffs. Chinese tariffs are not correlated with an increase in exit during the trade war in the baseline model. The findings of the baseline model provide evidence for a strong blunt effect of the trade war – 34% increase in exits across the board – and a small effect of targeted micro risks – 5% increase in the exit rates for US tariffs, but not specifically Chinese tariffs.

Firms both in and outside of tariff-targeted industries face different potential risks of the trade war, however, due to their national origin. US firms could be exiting at a higher rate compared with other countries because they are most exposed to political risk in the US–China trade war. Firms from countries allied with the US could also face higher political risks because of the trade war due to political pressure. If countries place political pressure on their firms and economic actors to align with international diplomacy, governments of US allies could side with the US and divest from China during the trade war. Firms from countries more closely aligned with China are expected to exit at a lower rate, potentially mitigating the effect of tariffs.

To test these possibilities, we implement four triple-difference models. The triple difference allows us to compare firms from 1) different national origins and political alignments, 2) subject to tariffs or not and 3) before and after the trade war. This research design allows us to identify the relative increase of exits by varying

degrees of political risks, with US firms with tariffs experiencing the most risk and China-aligned firms with no tariffs experiencing the least.

Figure 3 presents predicted probabilities for each national origin group compared with all other firms. Both before and after the trade war, China-aligned firms and non-aligned firms have the highest rate of exits compared with US firms and firms from US-ally countries. Again, we see the most significant effect is the blunt trade war effect: There are greater differences between the left- and right-hand side of the figure than between the tariffed and non-tariffed firms. On average, US and US-allied firms have similar exit rates, but the targeted effects of tariffs differ slightly.

Like the baseline model, Figure 4 presents the marginal effects of being in a tariffed industry before and after the trade war. Before the trade war, US and firms from non-aligned countries in soon-to-be tariffed industries were no more nor less likely to exit, but after the introduction of tariffs, exit rates increased. China-aligned firms had a higher rate of exit than US and US-allied firms, but both the blunt and targeted effect of the trade war were smaller for China-aligned firms compared to other firms. Before the trade war, firms from US-ally and China-aligned countries that would become tariffed in the trade war exited China at a lower rate than other firms, but this difference disappeared in the trade war. During the trade war, tariff-exposed firms from China-aligned countries and US-ally countries were no more nor less likely to exit than non-tariffed exposed firms.

The comparison of the marginal effects of tariff rates provides a nuanced understanding of the targeted effect of the trade war. Compared with all other firms, US firms did experience the largest targeted effect of the trade war, with the largest marginal impact of tariffs. While tariffed China-aligned firms were no more likely to exit China than non- tariffed China-aligned firms, all else equal, exit rates did increase, as they did for US-ally firms.

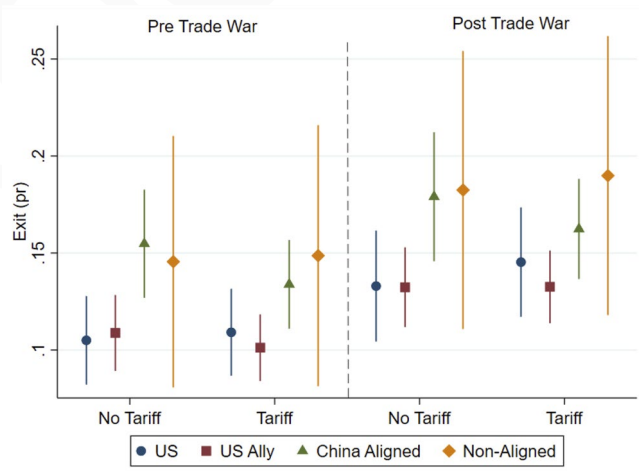

Figure 3. Predicted probability of exit, calculated from triple difference models. Predicted probability of exit for US, US-ally, China aligned and other firms, calculated from separate triple difference models with indicator for political alignment. Tariff measured as tariffs from either the US or China. Results table available in Online Supplementary Appendix Table A7.

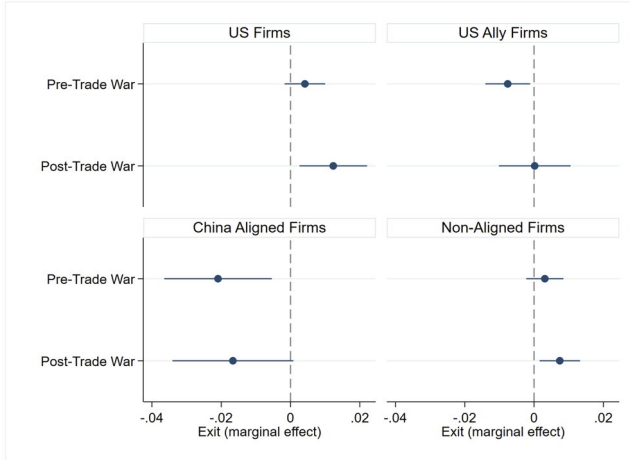

Figure 4. Marginal effects of tariffed industry on exits before and after trade war, by political alignment. Marginal effects of exits for tariffed industries by political alignment calculated from separate triple difference models with indicator for political alignment. Tariff measured as tariffs from either the US or China. Results table available in Online Supplementary Appendix Table A7.

When looking at US firms specifically, there is a small, statistically significant difference for tariffed US firms during the trade war compared to all other firms. US firms subject to tariffs during the trade war do have a slightly higher probability of exiting. This holds for both US and PRC tariffs. The magnitude of this effect, however, is small: The marginal effect of tariffs in the trade war period is approximately a 1% point increase. The same does not hold for firms from US allies. This comparison provides significant evidence that the broad coalition of US allies decoupling from China is not happening in the short run. When the sample is limited to exporters only, only US tariffs remain significant. This result is expected because of the nature of Chinese tariffs compared to US tariffs.[21]

Figure 5(a,b) presents a comparative sub-sample analysis of all US firms and US exporters. We implement a series of logit models with interaction terms to isolate the marginal effect of the trade war and tariffs among US firms specifically. Differences between the left and right side depict the blunt effect of the trade war and differences between no tariff and tariff markets present the impact of tariffs.

For both subsamples, the largest impact of the trade war is the blunt effect: Shifts from the left side of the figures to the right side of the figures. Consistent across all measures of tariffs, the marginal effect of the trade war is approximately 3%. US firms are approximately 3% points more likely to exit after the onset of the trade war, regardless of their experience of tariffs. Of our measures of targeted trade war effects – experiencing any tariffs from the US or China, and the intensity of tariffs – none are more likely to increase exit. This is likely because many MNCs are 'in China, for China' and not relying on exporting products to the US market.[22] In fact, US-invested exporters had a lower rate of exit than the average US firm (Figure 5(b)). This counterintuitive result stems from a few factors. First, firms rarely engage exclusively in exports and most also produce for the Chinese domestic market. After the imposition of tariffs, firms may shift their focus from exporting to producing more for the domestic market as Liu et al. (2022) find. Second, firms operate in

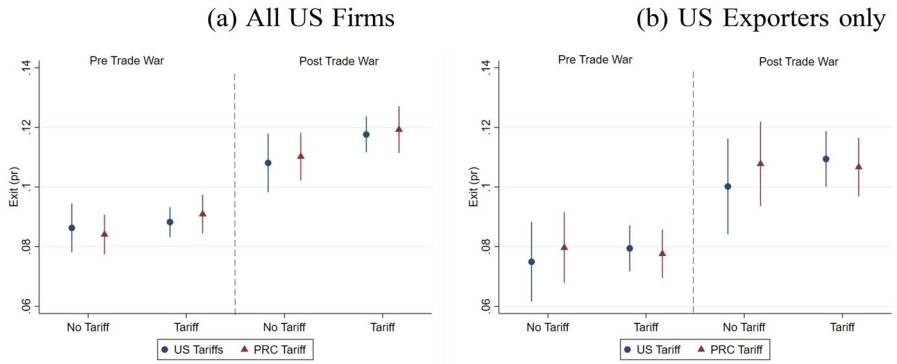

Figure 5. Predicted Probabilities of Political Risk on Firm Exit, US Firms. All measures of tariffs interacted with trade war to estimate marginal effects of tariff measures during the trade war. Full results available in Online Supplementary Appendix Table A6.

dense networks of economic activity, meaning tariffs experienced by one firm may affect the business of other, non-exporting support firms around them. Finally, our measure of exporters is limited to firms that mention exporting in their business activities description. This introduces possible measurement error in identifying exporters. Restricting the sample to only firms that mention exports in their business description results in the same pattern as aggregate models with all US-invested firms. Tariff intensity does not have a statistically significant relationship with exit during the trade war, regardless of whether the tariffs are from the US or China, except for China-aligned firms, where both US tariff intensity and Chinese tariff intensity increase the probability of exit in the first year of the trade war.

In sum, we find significant and consistent evidence that the blunt effect of the trade war does increase firm exit overall through the collateral damage pathway. There is slight evidence that the targeted effect does increase US firm exit when compared with non-US firms, but not within the US sub-sample and not more among exporters. This increase in US firm exit is relatively small compared to the blunt effect, suggesting that US tariffs are causing exits through the casualties pathway rather than the de-risking pathway.

Firm entrenchment effects

As Hypothesis 3 predicts, firms entrenched in the local market are less likely to exit than newly established firms. Firms operating in China for longer periods of time and with greater invested capital have greater sunk costs as well as greater access to political capital, thus they should be less likely to exit.

Firm experience has a non-linear relationship with exit (Figure 6(a)). Firms that entered China right before its ascension to the World Trade Organization (WTO) are the least likely to exit. Older firms have higher variance in their probability of exiting, possibly due to standard business cycles. Young firms, those only operating for a few years, are significantly more likely to exit. Firms established only one year ahead of the start of the trade war have a 20% chance of exiting, likely because of fewer resources being newly established.

Registered capital operates in a similar pattern. The more registered capital, the higher the sunk costs, and the less likely firms are to exit. Unlike age, the relationship between logged registered capital and exit percent is linear (Figure 6(b)). Both of these factors increase the incentives for enterprises to remain in China, regardless of trade war variables. In other words, larger and older firms are less likely to exit both before and after the outbreak of the trade war, and this effect does not interact with tariffs.[23]

Conclusion

This article is a first attempt to understand the impact of political risk associated with an escalating trade war on foreign divestment. Political risk, heightened by the trade war, did lead to greater firm exit, but followed an economic rather than a political logic. The most significant impact of the trade war was the blunt effect: Heightened country risk caused MNCs to exit China at a higher rate across the board, regardless of country of origin. The specific and targeted effects of the trade war, contrary to political expectations, only had a marginal increase in the probability of exiting China for small sub-groups of firms. National origin had a much smaller effect on firm exit than we anticipated. US firms targeted by tariffs did exit at a slightly higher rate compared to all other firms. However, neither US-allied firms nor China-aligned firms 'followed the flag' to exit China at greater or lower rates compared to counterparts. Overall, the blunt effects of the trade war for all firms were roughly three times greater than the targeted effects for US firms targeted by tariffs. Finally, firm entrenchment in the local market provided resources that helped firms weather the storm of political crises. Firms that are larger and older were significantly less likely to exit China.

These insights contribute to a growing theoretical literature on the political economy of firm exit or foreign divestment, complementing the much larger literature on FDI in-flows. Relatively little is known about the determinants of divestment from a representative sample of firms. Existing evidence suggests broad, macro trends can either encourage or discourage longevity in overseas business

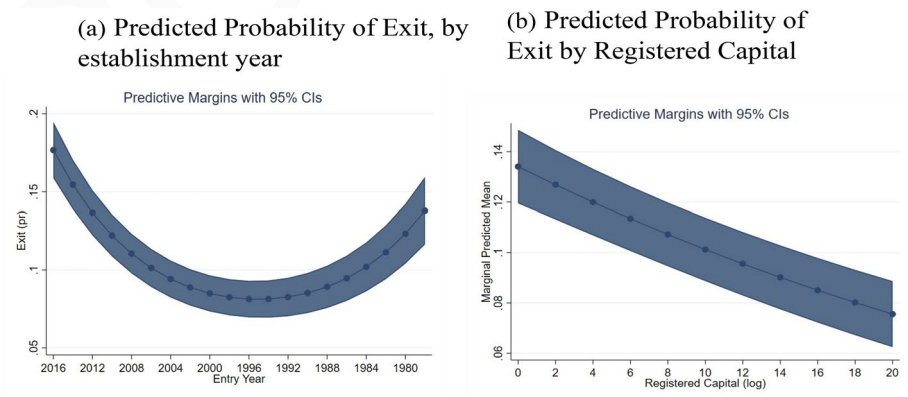

Figure 6. Firm entrenchment and probability of exit. Predicted from hierarchical logit model with non-linear effect of firm length. The model includes international agreement and trade war variables, country of origin controls, firm controls and province-fixed effects.

operations. The arguments presented here highlight the importance of understanding the heterogeneous effects of heightened political risks across firms, both in firm traits and protections from international institutions.

The research also speaks to contemporary policy challenges as policymakers strive to understand the extent and dynamics of US–China decoupling. The US–China Trade War constitutes the most significant uptick in political risk, short of armed conflict, for one of the world's largest FDI recipients. The Eurasia Group, a leading political risk consultancy, identified the deteriorating US–China relationship as a top risk for its clients in 2019 (Bremmer & Kupchan, 2019). Politicians and pundits have tended to focus on the intended effects of tariffs to produce targeted effects, such as reversing offshoring or even promoting 'friendshoring.' US Trade Representative Robert Lighthizer has repeatedly asserted that the trade war reduced dependency on a global adversary and ended the 'era of reflexive offshoring' (Lighthizer, 2023).

These results also reconcile seemingly contradictory accounts about the pace and scope of economic decoupling from China glimpsed from surveys and aggregate statistics. For example, the *SCMP* reports in July 2020, 'A poll of 200 companies with global supply chains conducted by sourcing specialists Qima in June found that 95% of respondents from the United States [and half from the European Union] planned to change suppliers away from China, due to the confluence of current issues and the uncertainty of future trading patterns.' Yet, according to two 2019 surveys conducted by the American Chamber of Commerce in China and the European Union Chamber of Commerce in China, only 9% of US firms and 11% of EU firms considered shifting current or planned investment from China to other markets (Kennedy & Tan, 2020). Our results reconcile these seemingly contradictory survey findings by showing that firm exits have increased since the onset of the trade war, particularly among the smaller firms sampled by Qima, but the well-entrenched firms that make up the membership of the American and EU chambers are the least likely to exit China. As the President of AmCham China said when survey results on the impact of the trade war were released, 'in contrast to some global narratives, our China-based data suggests that the majority of our members will not be packing up and leaving China anytime soon.'[24]

Since data collection for this article concluded in 2019, questions about the political economy of firm exit and the politics of FDI between geopolitical competitors have intensified. Scholars and policymakers are more keenly interested in how MNCs respond to political risks after the Russian invasion of Ukraine in 2022, the Israel-Hamas War in 2023, and the possibility of a Taiwan Strait conflict. The temptation to use 'targeted' economic instruments like sanctions or tariffs to achieve political goals is also greater than ever. Our results suggest these are blunt instruments that could cause a lot of collateral damage to the global economy without generating the desired political outcomes. MNCs are finding it harder and harder to maintain 'business as usual' but they are not necessarily 'following the flag' and investing where politicians direct.

This article highlights multiple avenues for future research. Our primary analysis explores the impact of international and domestic drivers of divestment in the year immediately following the initiation of the trade war. Businesses, especially those with significant fixed asset investment, may not react immediately to tariffs or a souring business climate in the short-run. These longer-term effects are not

captured in this article and are an important area for future research. Research can also shed light on how firms can use tariff exclusions and other avoidance strategies to minimize costs. Additionally, questions arise as to what the diversification strategies are that firms take in the face of rising costs. Comparative data of MNC behavior in countries outside of China would help verify whether MNCs are using a 'China + 1' strategy to de-risk rather than exit. Finally, the focus of this article is on tariffs and the blunt *vs.* targeted effects of the trade war. More qualitative evidence is necessary to identify the effects of financial sanctions and export controls that encourage or enforce decoupling.

Notes

1. Russia is the other, and total FDI stock in China ($350 trillion) is nearly 10 times larger than that of Russia ($36 trillion).
2. See, e.g. Freund et al. (2023) and Zeng et al. (2023).
3. Graham et al. (2016) posit that political risk stems from the risks of host governments violating implicit contracts with foreign companies. We expand this definition to include actions by or between any state.
4. The business literature (Simon, 1982; Alon & Herbert, 2009) distinguishes between macro and micro political risks. Macro risks are general political risks – like political instability or regulatory uncertainty – that impact all businesses exposed to a particular country, while micro risks are firm-specific risks, such as labor unrest at a factory or being hit by sanctions. The US–China Trade War elevates both types of risks. We have opted to use the language of blunt and targeted to describe their effects on firm exit. Macro risks produce a blunt effect and micro risks produce targeted, firm-specific effects.
5. Yueng, Karen. 9 June 2019. 'Why is US dollar access so restrained in China as trade war rages on?' *South China Morning Post*. Available at: https://bit.ly/3M9Qc2u. Accessed May 2022.
6. For example, the premiums for political risk coverage linked to China increased by 67% according to a WTW report. The proportion of global businesses who reported purchasing political risk insurance nearly tripled from 25% in 2019 to 68% in 2023. As a head of the Political Risk Division at an insurance broker argued, all American companies in China need to have political risk insurance because '[n]o one knows how each government will continue to act and react as these tariffs continue to be imposed'.
7. All MNCs, commonly understood as firms with operations in at least one country that is not their home country, are by definition FIEs. But not all FIEs are MNCs, as some are directly invested without a parent company located abroad.
8. The vast majority of foreign entities submit their registration information between April and June each year. Earlier years currently suffer significant missing data on industry and country of origin, especially for firms that exited before 2017.
9. We are confident that liquidation is the most likely fate for most FIEs that exit. Using the same data source Liu et al. (2022) unpacks the exit measure for a sample of 500 US-registered FIEs hand matched to the US-based parent company using other firm-level data providers. Their work suggests that FIE exits consist of 20% subsidiary closure (partial exits where the parent company continued to operate in China), 10% due to renaming or rebranding, with the remaining 70% accounted for by liquidation as a result of default or bankruptcy.
10. Unfortunately, the MOFCOMM registration data does not provide operational-level details about firm-level changes in investment or personnel. These alternative measures are an important area for future research.
11. There are 92 industry classes in the database. Approximately, 47% of industry classes experience some tariff exposure, affecting 75% of firms in the FIEC database.
12. Tariff intensity models can be found in the Online Supplementary Appendix.
13. The US Allies measure comes from the COW Alliances Dataset in the World Economics and Politics (WEP) Dataverse.
14. Table A4 shows the complete list of China's treaty partners.

15. One firm has a stated entrance date of 1951, a Polish-funded joint venture in Shanghai.
16. Another potential form of entrenchment could be joint venture status. But joint venture ownership structures create countervailing forces in episodes of heightened political risk. Having a domestic partner correlates with local resources and relationships that could help reduce risk and exposes a firm to greater creeping expropriation risk because of the domestic status of the partner firm. Evaluating the complex effect of ownership structure is beyond the scope of this paper, but we do include joint venture status as a control variable.
17. We include a measure for sending country tax haven because there is a chance investments from these countries are actually mainland Chinese investors who round-trip their investments. Anecdotally, domestic investors like Alibaba might incorporate in tax havens like the Cayman Islands to take advantage of preferential policies meant to attract foreign investors or to protect capital from the state. While technically foreign in the eyes of the state, these firms may operate differently locally because their investors are, in the end, domestic rather than foreign. Unfortunately, we are unable to trace original ownership from all tax haven registered firms.
18. Service firms generally have lower fixed capital investments and may be more likely to exit.
19. As a robustness, we also run all models restricting the sample to exporters only. The results remain substantively the same.
20. The analysis uses melogit command (multi-level mixed effects logistic regression) for Stata SE 15.1. The second level provided random intercepts for country of origin.
21. Kim and Margalit (2021) found that Chinese tariffs systematically targeted US goods that had production concentrated in Republican-supporting counties, particularly when located in closely contested Congressional districts. Unlike US tariffs in Lists 1 and 2, Chinese retaliatory tariffs were not designed to induce firm exit and Chinese leaders tried to reassure foreign investors.
22. These results on the rather limited targeted effect of tariffs may be due to tariff exclusions. Since the start of the trade war, US firms and trade groups applied for around 53,000 tariff exclusions, with 13% of these granted. To address the potential impact of exclusions on firm exit, we ran a secondary analysis, where we examine 13,683 exclusions requests for List 1 and 2 tariffs and are able to identify 47 industry categories affected by exclusion filings. Firms in industry categories with at least one exclusion application have a slightly lower rate of exit than those subject to US tariffs without an exclusion filing (11.4% exit *vs.* 10.0%). The impact of tariffs on exits remains around 1.5%, suggesting the potential for exclusions is not driving the smaller effect of tariffs. A discussion of tariff exclusions is available in the Online Supplementary Appendix.
23. Interestingly, joint venture status increases the probability of firm exit. We speculate that this is because JV firms considering exit might have an easier time offloading China assets to their partner firm at a competitive price. We plan to explore this variable in greater depth in future work.
24. Reuters. 16 April 2020. 'Most US firms have no plans to leave China due to coronavirus: Survey.' Reuters. Accessed May 2022.

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Data availability statement

Data supporting this manuscript can be found at: https://www.samanthavortherms.com/research/#business.

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