The Changing US-China Investment Relationship

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\textbf{Abstract:} The United States and China are at a turning point in their investment relationship. China’s previous investments in the US were predominantly in government securities, while other holdings were negligible. Recently, the accumulation of treasury securities has slowed, and Chinese firms are increasingly making direct investments in assets as Beijing signals greater support for portfolio investment outflows. This article describes the nascent shift in patterns of Chinese investment in the United States and, using the case of direct investment, examines the implications for US-China relations. We discuss the policy agenda arising from Chinese FDI in the US, including issues of national security, competitive neutrality, and potential impacts on market structures.

I. Introduction

For the past two decades, both China and its relations with the US have been in a near-constant state of change, and yet the principal characteristics of the bilateral investment pattern were relatively stable. Direct investment by private enterprises made its way from the US to China. The export processing base catalyzed by those and other FDI inflows, combined with Beijing’s intervention in the foreign exchange markets, produced an official reserves horde that led to a reciprocal outflow of state-managed re-investment of official reserves into US government securities. China maintained capital account restrictions, which limited foreign portfolio investment inflows. And given the challenges all firms in a developing nation face when operating abroad (particularly in an advanced economy, such as the US), China’s firms made few direct investments abroad.

Today this long-steady pattern is changing. China is slowly expanding the windows for inbound portfolio flows, and senior officials are pushing for a “basically open” capital account by 2016 or 2017. The urgency of domestic financial system reform in China is consistent with that objective, although there are opposing camps on the sequencing – some arguing that capital account opening is a step toward domestic reform, and others arguing that internal reforms should be completed first. As time has dragged on, it has become necessary to make progress on both simultaneously. In the other direction, changes are afoot as well: outbound investment is no longer limited to official purchases of government securities, but has been joined by significant volumes of direct investment outflows managed by enterprises. That trend did not start with targets in advanced economies such as the US, but from a low base such flows are now growing rapidly.

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II. The Evolution of the China-US Investment Position

The build-up of China’s international investment position was shaped by its distinct development choices. While FDI was limited in the earliest years of China’s post-1979 reform period, by the end of the 1980s Beijing had opened the door wider to foreign direct investment, bringing much-needed capital, technology and managerial know-how to China and helping to knit the Chinese economy into efficient regional production chains. After joining the World Trade Organization (WTO) in 2001, China became the world’s second-largest recipient of foreign direct investment, and by the end of 2011 the nation registered an inward FDI stock of more than $1.8 trillion. Other capital inflows remained tightly controlled, so China’s international liabilities are dominated by inward FDI with short-term portfolio investment and other investment (capturing trade credit and other lending) accounting for small shares only (Figure 1).

The picture on the asset side (for China) is reversed. The majority of China’s international assets are official reserves. By definition, these reserves are held in liquid assets such as government securities, cash and other assets that tend to be low-risk and low-return. China’s second biggest position is other investment, which approximately matches the scope of trade credit and lending on the liabilities side. Direct and portfolio investment account for a relatively small share of China’s global asset position.

In short, China’s global portfolio is dominated by reserves, trade-related credit and other low-risk holdings on the asset side, while equity portfolio investment and FDI are minor positions. The central bank and other state-related entities dominate those holdings. The liabilities side is dominated by inward FDI assets by private companies.

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3 The FDI figures in this paragraph refer to balance of payments data collected by the People’s Bank of China, which were corrected in 2010 to account for reinvested earnings from existing FDI assets.
The China-US investment relationship largely mirrors the evolution of China’s international investment position. Neither the US Bureau of Economic Analysis (BEA) nor China’s central bank offer a detailed breakdown of bilateral international investment positions, but several data points from the BEA and the US Treasury’s International Capital System (TIC) allow us to draw a rough picture of China’s holdings in the US and vice versa. The US investment position in China has long been dominated by foreign direct investment of US multinationals in China (Figure 2). By the end of 2011, US firms had around $60 billion of FDI assets in China, six times as much as ten years earlier. Since 2005, portfolio equity holdings (equity stakes of less than 10% of voting rights) have grown quickly as a result of the participation of strategic foreign investors in the privatization of Chinese banks, listing of Chinese firms in US stock exchanges and the gradual expansion of access for foreign investors to China’s stock markets through the Qualified Foreign Institutional Investor (QFII) program. By the end of 2011, US investors held around $80 billion of portfolio equity stakes in China, down from a peak of $100 billion in 2009. Compared to these equity stakes, US exposure to Chinese debt instruments was minor, due to restrictions on foreign investment in such securities maintained by Beijing.

The following charts are just the best available snapshots, but they are by no means complete, as no reliable statistics exist due to difficulties capturing financial flows.

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In contrast, China’s investment portfolio in the United States today consists mainly of low-yield government debt securities, a small portion of equities and corporate debt, and very little direct investment. By the end of 2011, China owned at least $1.56 trillion in long-term debt and $5 billion in short-term debt. Almost 99% of those instruments are US government obligations in the form of treasury or agency debt, while corporate debt only accounts for around 1% of total holdings. China’s total holdings of US government securities are almost certainly higher than these official numbers suggest, as a result of indirect purchases through third countries.

State-related entities and investors under the Qualified Domestic Institutional Investor (QDII) program have also gradually expanded their holdings of US equities, amounting to $159 billion by year-end 2011. FDI is the smallest position with an accumulated stock of $9.5 billion at the end of 2011, according to official estimates from the US Bureau of Economic Analysis (BEA). The problem of holdings through third countries also applies to equity investments and FDI, so these figures likely underestimate the real value of Chinese holdings in the US.

**Figure 3: China’s Investment Position in the United States, 2011***

*Billions of US dollars

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4 Treasury securities are debt instruments issued by the US Department of Treasury. Agency securities are debt instruments issued by government-sponsored corporations (such as Ginnie Mae or the Federal Home Loan Banks), and therefore enjoy an implicit or explicit government guarantee.

5 For a discussion of this phenomenon, see Setser and Pandey (2009).

6 This figure is based on ultimate beneficiary ownership. For a detailed discussion of available data sources for Chinese investment in the United States, see Rosen and Hanemann (2011).
Looking forward, China’s external investment position is expected to change dramatically in light of the changing nature of the Chinese economy. The Chinese model of investment-led growth was hugely successful, producing three decades of double-digit growth. However, a new growth model is needed for the next stage of economic development, and China is beginning a structural adjustment process that will alter the country’s global investment position. Officials from the PBOC have repeatedly hinted at intentions for a free capital account by 2016, which would boost outward FDI and two-way portfolio investment flows (Figure 4).8

The process of rebalancing China’s international investment position has already begun, as two-way flows between the US and China since the financial crisis illustrate. A lower current account surplus has slowed China’s accumulation of foreign exchange reserves, greatly moderating the growth in Chinese US treasury holdings. The growth of FDI by US multinationals in China is off its peak, but Chinese FDI flows to the US in 2012 were more than three times higher than in 2007. And recent policy changes are signaling fast growth of two-way portfolio investment flows, albeit from a low base.

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8 Figure 4 presents the result of a modeling exercise with the goal to project China’s international investment position in 2020 under the assumption that the capital account is fully liberalized by then and that China’s external position follows the patterns of other emerging economies going through a similar process.
Figure 4: Projections for China’s IIP If Capital Account Is Fully Liberalized
USD billion, total stock (IIP)

III. Chinese FDI in the United States

A shift in patterns of outbound foreign direct investment is at the forefront of China’s changing global investment flows. While inward FDI dominated the Chinese story in the past, the nation’s global outward FDI took off in the mid-2000s and has been growing quickly ever since (Figure 5). The turning point showed up in 2005, as booming Chinese domestic investment-driven demand sent commodity import prices soaring and state-owned enterprises began venturing abroad in greater numbers to acquire stakes in extractive projects in hopes of increasing supply security and sharing in profits. Despite a volatile global FDI environment, Chinese outward FDI grew from less than $5 billion annually before 2004 to more than $80 in 2012. China’s share in global OFDI flows grew from less than 1% in 2007 to 5% in 2012, making China the world’s fifth-largest outward direct investor.
While China’s OFDI boom was initially focused on extractive industries in developing countries, flows to mature market economies have increased rapidly since 2008. Europe and the United States have become the primary growth markets for overseas expansion by Chinese firms. The latest official figures from the Bureau of Economic Analysis and China’s Ministry of Commerce put China’s OFDI stock in the United States in 2011 at $9.5 billion and $8.99 billion, respectively. This is already a significant increase compared to five years ago, but those figures underestimate the real extent of Chinese FDI in the US; the extensive use of offshore financial centers and tax havens makes it difficult for statistical agencies to accurately track Chinese FDI.

For these reasons, researchers have developed a range of alternative databases to capture Chinese capital outflows collecting information from the bottom-up on Chinese FDI projects. Among them is our Rhodium Group China Investment Monitor (CIM), which covers acquisitions and greenfield projects by Chinese-owned firms in the United States with a value of $1 million and higher. This method is not directly comparable to the traditional balance of payments approach to collecting FDI data, as it neglects reverse flows and misses intra-company loans and other follow-up flows. However the bottom-up approach overcomes many of the weaknesses of the traditional approach – such as of the lack of accounting for offshore

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9 The BEA stock figure refers to data compiled following the Ultimate Beneficiary Owner (UBO) principle.
financial centers—and allows for a detailed, real-time assessment of Chinese investment flows and ownership in the United States.10

Our Rhodium Group monitor records 620 Chinese deals in the United States between 2000 and 2012, amounting to $22.8 billion (Figure 6). These 620 deals include 436 greenfield projects—factories, offices and other facilities built from scratch—and 184 mergers and acquisitions of existing companies and assets. Acquisitions account for 85% of total investment value ($19.45 billion) and greenfield projects for the remaining 15% ($3.35 billion).

The figures make clear the recent spurt in growth of inflows. Before 2008, Chinese FDI flows into the United States typically stood below $1 billion annually, with the singular exception of Lenovo’s $1.75 billion acquisition of IBM’s personal computer division in 2005. Since 2008, Chinese investment has gained momentum, growing to just under $2 billion in 2009 and $5.5 billion in 2010. In 2011 Chinese investment came in slightly lower at $4.6 billion, but reached a new record high of $6.5 billion in 2012. With announced deals worth more than $5 billion by the end of the first quarter, 2013 will likely be another record year for Chinese direct investment in the United States.

Figure 6: Chinese Direct Investment in the United States, 2000-2012

Number of deals and USD million

Source: Authors’ compilation. For updates and information on methodology see http://rhg.com/topics/cross-border-investment.

The distribution of Chinese investment by industry presented in Table 1 reflects the mix of domestic structural adjustments pushing firms abroad and the pull factors attracting investors to the US.

10For a detailed review of existing data sets and their advantages and weaknesses, see Rosen and Hanemann (2011) or Hanemann and Rosen (2012).
First, the unconventional energy boom has made the United States a prime frontier for global oil and gas investments, and is attracting Chinese firms eager to expand their overseas production bases and involvement in cutting-edge extraction techniques. The 2005 CNOOC-Unocal deal failure chilled Chinese enthusiasm about natural resource projects in the United States, but the boom in unconventional oil and gas extraction has revived interest in North American acquisitions, resulting in several larger-scale oil and gas plays since 2010.\(^{11}\)

Second, structural adjustment at home has fueled Chinese interest in American higher value-added manufacturing and service operations. Increasing competition, rising factor input costs (especially labor), environmental compliance and remediation costs, and local impediments to consolidation to achieve economies of scale have spelled the end of the old Chinese business model focused on domestic markets and exports. These operating realities are compelling Chinese firms to look at US assets to increase their competitiveness at home and preserve access to US customers abroad. A growing number of acquisitions and greenfield projects in industrial machinery, electrical equipment and components, automotive, alternative energy, medical devices and communications equipment illustrates the pressures on Chinese firms to move up the value chain and invest in technology, brands, human talent and other competitive assets. Increasing investment in higher value added service operations including research and development, customer service and retail illustrate the move up and down the value chain.\(^{12}\)

A third important factor behind China’s OFDI is the increasing readiness of Chinese firms to go abroad. After three decades of inward orientation, firms were ill-prepared to operate in mature economies, but with time firms have grown more sophisticated. Firms increasingly recognize the importance of localizing foreign management and workforces – for example Minmetals in Australia, Haier in the United States or Volvo in Sweden; they are increasingly familiar with the political environment in overseas markets -- see CNOOC, which has found the right strategy to buy into North American energy assets including the recent $15 billion takeover of Canadian oil producer Nexen; and they understand the importance of using local partners and institutions to pursue their goals, as Wanxiang did when it recently obtained the assets of battery producer A123 Systems despite a challenging bankruptcy procedure and heavy lobbying from domestic American opponents.

Finally, Beijing’s official line changed from opposed to highly supportive of FDI in overseas markets. This reversal was driven by a mix of motives across different bureaucracies, including awareness of the importance of global operations for firm competitiveness (MOFCOM and SASAC), fading concern about maximizing foreign exchange reserves (MOF and PBOC), and increasing awareness of the strategic vulnerability entailed in a US debt-heavy portfolio of external assets (NDRC, PBOC and others). While the OFDI approval process is still burdensome for many firms, it has been significantly relaxed in recent years and sovereign investment entities such as the China Investment Corporation and the SAFE Investment Company have begun to take direct stakes as part of their diversified holdings.

\(^{11}\) For example, CNOOC’s acquisition of stakes in Chesapeake Energy projects in 2010 and 2011 worth $1.7 billion and Sinopec’s acquisition of Devon Energy in early 2012 valued at $2.5 billion.

\(^{12}\) Some prominent examples include Huawei and Yingli Solar establishing high-tech R&D centers in California in 2011 and Lenovo establishing a fulfillment center in North Carolina in 2008.
Table 1: China’s FDI in the US by Industry, 2000-2012
USD million and number of deals

<table>
<thead>
<tr>
<th>Sector</th>
<th>Value (USD mn)</th>
<th>Number of Projects</th>
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<tbody>
<tr>
<td></td>
<td>Greenfield</td>
<td>M&amp;A</td>
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<tr>
<td>Coal, Oil &amp; Gas</td>
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<td>5,222</td>
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<td>Utilities</td>
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<tr>
<td>Entertainment, Media &amp; Publishing</td>
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<td>2,614</td>
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<tr>
<td>Consumer Products &amp; Services</td>
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<td>2,050</td>
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<tr>
<td>Industrial Machinery &amp; Tools</td>
<td>197</td>
<td>1,711</td>
</tr>
<tr>
<td>Metals &amp; Minerals</td>
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<td>70</td>
</tr>
<tr>
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<td>739</td>
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<td>Software &amp; IT Services</td>
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<tr>
<td>Aerospace Equipment &amp; Components</td>
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<tr>
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<td>Financial Services &amp; Insurance</td>
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<td>Food Processing &amp; Distribution</td>
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<td>Construction Services</td>
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<tr>
<td>Total</td>
<td>3,347</td>
<td>19,447</td>
</tr>
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</table>
IV. New Political Challenges Arising From the Shift in FDI Patterns

Past conflicts in the US-China economic relationship have focused on trade, exchange rates and IPR violations. Investment-related disputes arise mostly from existing Chinese restrictions on inward FDI and the treatment of foreign companies. Some US officials also voiced concerns about Chinese holdings of US Treasury bonds. Chinese concerns mostly related to the safety of their US Treasuries holdings, agency bills related to Fannie Mae and Freddie Mac, and small equity stakes in US companies in light of the global financial crisis. The larger political relationship will change as these investment interests evolve, and we can anticipate some of those changes in light of outward FDI patterns.

Balance of Payments Effects
Bilateral and global balance of payments imbalances have become an important source of US-China tensions. Aside from changes in the financial account, rising Chinese outward FDI could impact current account dynamics in two important ways.

First, outward FDI could further widen China’s massive surplus with the US in goods trade by allowing firms to expand into higher value-added exports that require local operations for marketing, customer support and other activities. Greater OFDI may also allow Chinese firms to deliver a greater range of services to Americans, for example construction and engineering services. At the same time, OFDI can also serve as a substitute for trade to serve overseas markets, and the localization of production could help bring down the US-China trade surplus. In recent years some Chinese firms have started to localize production in industries prone to anti-dumping tariffs and those in which proximity to customers yields competitive advantages, but the scope is still low; it remains to be seen whether we will see significant localization of manufacturing and other operations.13

In addition to trade patterns, growing outward FDI may also have a longer-term impact on US-China investment income flows recorded under the current account. In the past, foreigners have managed to earn a much higher rate of return on assets they own in China than they had to pay on their liabilities to Chinese investors.14 Due to these differentials in investment returns, China’s net investment income was almost continuously negative from the early 1990s forward despite a positive net overseas assets position of more than $1.5 trillion in recent years. Bilaterally, meanwhile, the US paid around $40-50 billion in investment income to China in recent years, while income payments on Chinese assets added up to around $10 billion a year (Figure 7).

This is a significant gap, but still remarkably low given that Chinese US assets are more than ten times higher than US assets in China. A greater relative share of FDI and other higher-

13 For example Tianjin Pipe Corporation’s manufacturing facility for steel tubes in Texas.
14 In recent years, foreign returns on Chinese assets were on average 2-4% higher than Chinese returns on foreign assets, using the BOP and IIP figures as a proxy.
return assets could change those advantageous return differentials and further push up these net income payments, resulting in a sustained US current account deficit independent of changes in the goods trade deficit. This would put additional pressure on the US to rebalance its trade relationship with China to ensure the sustainability of its net international investment position.

A Level Playing Field

In addition to those macroeconomic questions, the rise of Chinese investment also raises concerns resulting from the nature of China’s socialist market economy. One of those concerns is that the position of state-owned enterprises and existing asymmetries in market access could further increase the unevenness of the playing field between Chinese and US corporations.

Policymakers and executives are increasingly nervous that the preferential status of Chinese state-owned enterprises (SOEs) could spill over into the global economy, undermining fair competition between Chinese and foreign enterprises for global assets. The United States has long supported international efforts to develop frameworks to ensure “competitive neutrality” between SOEs and private sector firms, but the rise of China as global investor has produced

\[\text{Of course a greater share of OFDI is no guarantee for more profitability. It depends on the profitability of those FDI projects.}\]
new initiatives.16 In 2011, US Undersecretary of State Robert Hormats declared that the United States sees “state capitalism” as “a new challenge to the global consensus on open markets and private investment”.17 Concrete US steps to address those concerns have included adjusted terms for bilateral investment treaties (BITs) and new terms in free trade agreements, such as the Trans-Pacific Partnership (TPP). In May 2012 the US and the European Union released a set of “Shared Principles for International Investment” calling for a coordinated approach to address the “challenges posed by state influence in relation to commercial enterprises”.18 Domestic proposals range from increased monitoring and transparency requirements to an expansion of the CFIUS review process to include economic considerations (a “net benefit” test like in Canada) and post-market entry performance assessments.19

Worries about unfair competition are exacerbated by persistent asymmetries in market access. Despite its policy of opening up, China remains the most restrictive G20 country when it comes to formal openness to inward FDI (Figure 8). Given the low level of Chinese OFDI in the US and elsewhere, this was not a major focus point in the past. However in light of increasing Chinese investment abroad in sectors that are closed to foreign investors in China and a perceived negative turn in the business environment for foreign and private firms in recent years, reciprocity in market access is becoming an item on the US policy agenda. At the APEC meeting in November 2011, President Obama warned China that “the United States can’t be expected to stand by if there’s not the kind reciprocity in our…economic relationships that we need”.20 In a March 2012 speech Secretary of State Hillary Clinton announced that the US would use Chinese investment interests in the US as leverage for achieving broader goals in US-China economic relations, including “an end to discrimination against US companies”.21 The timing of the Federal Reserve’s approval of ICBC’s takeover of the Bank of East Asia (during the S&ED, at which China announced a partial liberalization of foreign investment in China’s securities industry) suggested that the US government is indeed ready to use regulatory leverage to elicit such concessions from China.22

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16 Internationally, the US is supporting ongoing efforts by the Organization for Economic Cooperation and Development (OECD) or the United Nations Conference on Trade and Development (UNCTAD) to develop competitive neutrality frameworks.
18 See Hanemann (2012b).
21 Secretary Clinton’s remarks at the US Institute of Peace China Conference on March 7, 2012 can be found at: http://www.state.gov/secretary/rm/2012/03/185402.htm.
Market Power and Antitrust

Another emerging concern is the potential market power that Chinese companies can achieve through overseas acquisitions, and the potential abuse of that power due to the Communist Party’s ultimate control of Chinese enterprises in the absence of rule of law.

Antitrust authorities review global M&A transactions to ensure that acquisitions do not lead to an unhealthy concentration of market power that could negatively impact consumer welfare. Usually regulators would assess market concentration based on the entities that are controlled by the acquirer’s parent firm. However, regulators in developed economies are struggling over the treatment of Chinese companies with respect to ultimate ownership. The EU Commission has announced that it intends to treat all firms managed by China State-owned Assets Supervision and Administration Commission (SASAC) as a single corporate entity for purposes of assessing market share, since they ultimately report to the same controlling shareholder -- the Communist Party of China.23 And the Chinese behavior of restricting rare earths exports to the disadvantage of foreign consumers has demonstrated to many policymakers that the government could use such market power to implement industrial policies at the expense of foreign consumers and producers.

Aggravating these concerns is the fundamentally different role and implementation of competition policy in China and OECD economies. For the past decades China’s firms have operated in a producer-oriented environment, and a credible consumer welfare-oriented

The competition policy program still does not exist. State-owned enterprises enjoy oligopolies in many industries and are not disciplined by a pro-competitive agency to prevent collusion or other abuses of market power. Comments by Chinese officials to “avoid unhealthy competition” among Chinese firms for overseas assets are raising additional red flags that this focus on producer welfare could spill over into foreign markets. While there are signs of possible change in these regards, they are a ways off.

The clash of competition policy interpretations has started to become visible in the troubles of Chinese firms with US courts and antitrust authorities with regard to exports. In 2012 and 2013, several Chinese producers of vitamin C faced trials in the United States on price-fixing allegations, defending their actions by pointing to requirements by the Chinese Ministry of Commerce to coordinate production and fix export prices. It seems inevitable that the Department of Justice and the Federal Trade Commission will take the special characteristics of China’s competition policy and ownership structures into account when reviewing future Chinese M&A transactions in the United States.

**Regulatory Compliance and Transparency**

Disputes between China and the US over fraudulent claims by US-listed Chinese firms illustrate another major concern that arises as a result of the advent of new forms of cross-border investment: dissimilar degrees of transparency and regulatory supervision between China and modern market economies. As an emerging economy with a hybrid “socialist market economy”, China’s legal system and regulatory institutions are not on par with those in the United States or other OECD economies. Compared with other top-five global investors, the quality of corporate governance in China is low, and combined with the potential volume of Chinese outflows that presents a new challenge. Further, provisions such as China’s State Secrets Law appear to be applied in ways more aligned with particular vested interests than national welfare, complicating cross-border regulatory cooperation. A related problem is that China does not generally enforce foreign court orders, making it impossible for foreigners to held Chinese citizens and firms accountable for potential damages they cause abroad now that they are investing directly in places like the United States.

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National Security

Finally, the recent wave of Chinese FDI has resuscitated old concerns about national security risks related to foreign ownership of US assets. Foreign ownership of assets is widely acknowledged to present a narrow set of concrete national security threats. There are four major concerns: control of strategic assets (e.g., ports, pipelines); control over the production of critical defense inputs (such as military semiconductors); the transfer of sensitive technology or know-how to a foreign power with hostile intent; and espionage, sabotage, or other disruptive action. 26 Given its economic size, its authoritarian political system, the role of the state in the economy, its relations with pariah states such as North Korea and Iran, and its aspiration to rapidly modernize its military power, it is not entirely mysterious why the United States would harbor national security concerns toward China that were not present to the same degree in other bilateral investment relationships. 27

The Committee on Foreign Direct Investment in the United States (CFIUS), which screens foreign investment for national security threats, is generally well designed and has a tradition of openness to foreign investment with few limitations. CFIUS is only mandated to screen for


27 This paragraph draws heavily from Graham and Marchick (2006), chapter 4.
narrow security concerns, not for “economic security” or net benefits to the US. CFIUS’s recent track record reflects the United States’ openness to Chinese investment: of more than 600 investments since 2000, most did not require review. Those transactions that are submitted to CFIUS generally receive fair hearings and are usually approved.\textsuperscript{28}

At the same time, technological change is forcing CFIUS to adapt to new realities, and recalibrating the definitions and criteria of the review process will take time. Vested commercial interests playing on sinophobia and security hawks bent on excluding Chinese firms without reference to specific threats have managed to politicize the screening process in the past, and deals can be politicized outside of the formal CFIUS screening process as well. These problems have left some investors uncertain about the prospect of their investments, especially in the telecommunications and information technology sectors. Recent attempts to politicize investments were less successful than in early years, but US civilian leadership must redouble its effort to defend the neutrality and transparency of the CFIUS process and stand up against politicization. As a national security process largely immune from appeal and review, the continued quality of CFIUS is dependent on the fidelity with which the executive branch defends its mission – maximizing the openness of the United States to foreign investment.

On the Chinese side, the CFIUS process is often poorly understood and seen as a protectionist tool. At the same time, China in 2011 enacted its own national security review process for inward investment that has a far broader definition of review criteria, including “national economic security” and even “social stability” as criteria to block foreign investment.\textsuperscript{29} In practice this framework has not been applied systematically yet, but it will become more important as China gradually switches from its approval system to a modern regulatory regime for inward FDI built on a presumption of openness excepting for national security and antitrust review.

It is in the interest of both the US and China to work together to find solutions to the looming challenges that will erode investment openness. Clearly, strategic trust that obviates the need for a more elaborated regime to preserve two-way investment flows is not going to pop up overnight: it would be unrealistic to make such mutual confidence the goal for solving this problem. Washington and Beijing will ultimately need to recognize that bilateral investment is beneficial to both nations despite mutual misgivings, not only in the event they can be resolved.

\textsuperscript{28} In recent years CFIUS approved Chinese takeovers in a broad range of sectors, including aviation, power generation and resource extraction.
V. Conclusions

The China-US investment relationship is changing. As the analysis of China’s direct investment flows illustrates, this shift will have wide ranging implications for relations between Beijing and Washington, economically but in political and security terms too.

Greater Chinese FDI offers enormous opportunities for the US in the forms of fresh capital, job creation and maintenance, taxes and (to some degree) innovation spillovers. It can help solidify wobbly support for the US-China economic relationship in general. Closer interaction with China in the past meant more abstract benefits, such as lower prices for consumer goods, and some very concrete downsides, including diminishing manufacturing employment. Now Chinese investment dollars are creating jobs, generating tax revenue and producing other local benefits. Chinese firms employed 30,000 Americans by the end of 2012, up from fewer than 10,000 five years ago. These changes will give Americans a more tangible stake in the benefits of US-China economic cooperation.

At the same time, greater Chinese investment causes additional concerns because of the unusual nature of China’s state and economy. National security has been the primary policy focus thus far, and will remain important. But new economic accusations will arise, including distortion of global asset prices, unfair competition through abuse of market power, and damage to consumer welfare. The United States and other aspiring hosts for hundreds of billions of dollars of future Chinese flows must find appropriate solutions to legitimate concerns while untangling them from illiberal instincts to err of the side of caution and hold Chinese competition at bay at the same time.

These challenges will require substantial new thinking by Chinese policymakers as well. Risks associated with Chinese investment in target countries are not all imaginary; many are rooted in the idiosyncrasies of China’s political and economic system. Suspicions about Chinese firms arise from the relationship between the state and the corporate sector in China. Foreigners can hardly be blamed for wondering what the bottom line is if the top executives of China’s state-owned enterprise are appointed by and beholden to the Communist Party, business decisions are routinely subjected to political considerations, and firms are larded with loans regardless of their business prospects. Instead of blaming foreign protectionism, Chinese policymakers should accelerate domestic reforms that increase transparency, improve corporate governance, level the playing field between private firms and SOEs, improve market access for foreign firms, implement a credible and consumer-oriented competition policy, and refrain from interfering with firms’ overseas investment decisions. If there are not more serious efforts to solve those institutional deficiencies, the risks of resistance to Chinese overseas investment in the US and other host countries will increase substantially.

Of course, making those changes will carry an economic and political cost for China. Beijing could well conclude that the benefits of promoting an open global investment environment for Chinese firms is not worth these costs. This is China’s sovereign prerogative of course, just as it is the prerogative of other nations to set investment policies accordingly if Beijing chooses not to conform with the institutional norms that have prevailed in the international system in
the past. What is clear is that the global economy will be better off if mutually satisfactory solutions to future investment openness can be implemented.
References


