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CHINESE DIRECT INVESTMENT IN THE UNITED STATES

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Chinese Direct Investment in the United States

Thilo Hanemann and Daniel H. Rosen

Abstract: The United States and China are at a turning point in their economic relationship. In the past, foreign direct investment (FDI) flowed predominantly from the "developed world" to the "developing world," from countries such as the United States to those like China. Now, Chinese firms are increasingly investing in developed economies, driven by structural adjustment at home. In this article we describe this inflection point for Chinese FDI in the United States and examine the patterns of Chinese investment in America to date. We then discuss the potential impacts of greater levels of Chinese FDI and how the special characteristics of China's political and economic system challenge the traditional stance of openness to FDI in the United States and other developed economies. Finally, we summarize the political reaction in the United States to date, with a particular focus on emerging "next generation" policy issues.

I. Introduction: A New Era of Chinese Outward FDI

Foreign investment was the cornerstone of China's post-1978 economic miracle, bringing much-needed capital, technology and managerial know-how to China and helping to knit the Chinese economy into efficient regional production chains.[1] After joining the World Trade Organization (WTO) in 2001, China became the world's second-largest recipient of foreign direct investment, amassing an inward FDI stock of more than $1.8 trillion by 2011.[2] 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 shuffle the country's global investment position.

One element of China's changing global investment position is a turnaround in patterns of FDI. While inward FDI flows continue to grow and dominate, outward FDI took off in the mid-2000s and has been growing quickly ever since (Figure 1). The turning point came in the mid-2000s, when Chinese demand sent global commodity import prices soaring and state-owned enterprises began venturing abroad in greater numbers to buy stakes in extractive projects to increase supply security and profits.

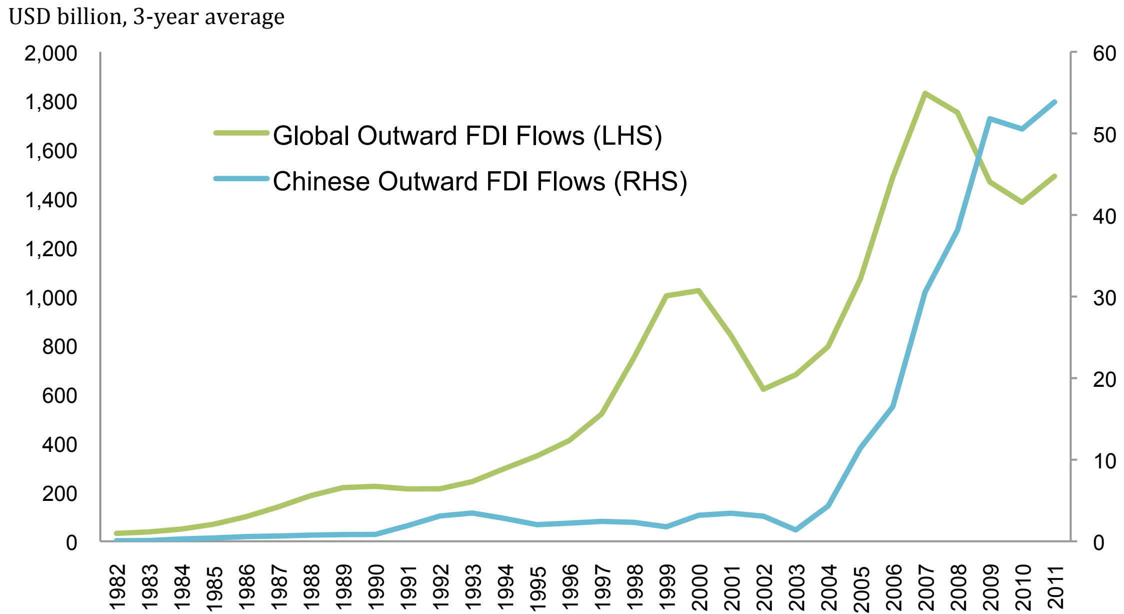
This push for natural resource investments boosted Chinese outward FDI to more than $50 billion in 2008. In 2009, outflows somewhat slowed amid the global financial panic, but reached another record high in 2010 with almost $60 billion. In 2011, outflows faltered only slightly to $50 billion amid renewed global financial instability. China's share in global outward foreign direct investment (OFDI) flows increased from less than 1% in 2007 to 3% in 2008 and 5% in 2010, making China the world's fifth-largest outward investor behind the United States, Germany, France and Hong Kong, and the world's top emerging market outward investor.

[1] E.g. Rosen (1999) and Naughton (1995).

[2] 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.

Figure 1: China's Outward FDI vs. Global FDI Flows

USD billion, 3-year average



Source: Ministry of Commerce (People's Republic of China), State Administration of Foreign Exchange (PRC), UN Conference on Trade and Development, Rhodium Group.

As Chinese FDI surges, the world should expect to see *hundreds of billions* of Chinese investment dollars in the decade ahead—even by conservative estimates. By 2020, China's GDP will likely have surpassed $20 trillion (a GDP per capita around $14,000). The current low OFDI-to-GDP ratio of 5% would yield $1 trillion in new OFDI through 2020 ($100 billion per year on average). If China's ratio rises to the transitional economy average of 15%, outflows would amount to roughly $3 trillion, or approximately $300 billion annually. Based on those projections, cumulative flows of Chinese direct investment could very well reach $1 to $2 trillion by 2020.

Moreover, Chinese outward investment is maturing and evolving beyond natural resources. As structural adjustment at home intensifies, Chinese firms will need to branch out from midstream manufacturing activities and move up and down the value chain to capture more of the value added in these segments. This necessitates overseas investment in local operations, distribution channels, brands, know-how and technologies. An increasingly large portion of China's future OFDI will therefore be destined for developed economies, where such higher value-added economic functions and expertise are principally concentrated. The changing patterns are already visible in the uptick of Chinese OFDI flows in the United States and Europe since 2008.[3]

In recipient countries, heated debates over whether to embrace rising Chinese investment are raging. Surging investment from China has the potential to make up for diminished inflows from traditional sources, re-ignite growth by providing fresh capital to troubled firms, increase competition and consumer welfare, and expand access to one of the biggest and fastest-growing markets in the world. On the other hand, the unique nature of China's state and economy and China's sheer size are creating uncertainty and provoking negative political reactions to Chinese investment.

[3] See Rosen and Hanemann (2011) and Hanemann and Rosen (2012).

This article explores these questions from an American perspective. We start with a description of historical and more recent patterns of Chinese investment in the United States. For the latter we use a proprietary dataset that offers a detailed and timely perspective on Chinese OFDI flows. We then summarize the debate on the economic, political and security impacts of Chinese investment. One key question is the extent to which China is different from other countries and how these differences impact the broader consensus about the benefits and risks of foreign direct investment. Finally, we describe the political response to Chinese investment in the United States to date, focusing on the emergence of "next generation" policy issues beyond initial national security concerns.

II. Patterns of Chinese Direct Investment in the United States

China and the United States have a long history of economic interaction, including cross-border capital flows. Chinese capital has flown to America in a massive way over the past decade, but FDI remains a very small part of China's U.S. portfolio. By the 2000s China was attracting huge capital inflows and running massive trade surpluses, but Beijing's practice of forcing businesses that earned foreign exchange to hand it in for yuan (in order to tightly manage the value of its exchange rate) repressed significant outward FDI from the 1980s until the mid-2000s. Additionally, for most of this period Chinese firms were utterly unprepared to invest directly in regulated, advanced marketplaces like the United States. Beijing had to reinvest all of these dollars itself, leading to massive purchases of U.S. government securities.

As a result, 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. In 2011, the Chinese government owned at least $1.4 trillion in U.S. government obligations,[4] as well as $80 billion in equities and $16 billion in corporate debt (Figure 2).[5] The official estimates from the U.S. Bureau of Economic Analysis (BEA) put the accumulated stock of Chinese FDI in the United States at $9.5 billion at the end of 2011.[6] This is an increase of 700% since 2008, but still very small compared to total FDI stock in the United States. China accounts for only 0.4% of the total FDI stock in the United States of $2.5 trillion in 2011. This puts the world's second-largest economy in the same league as countries like Denmark and Saudi Arabia. It is also small compared to the FDI stock of American firms in China of $54 billion in 2011.[7]

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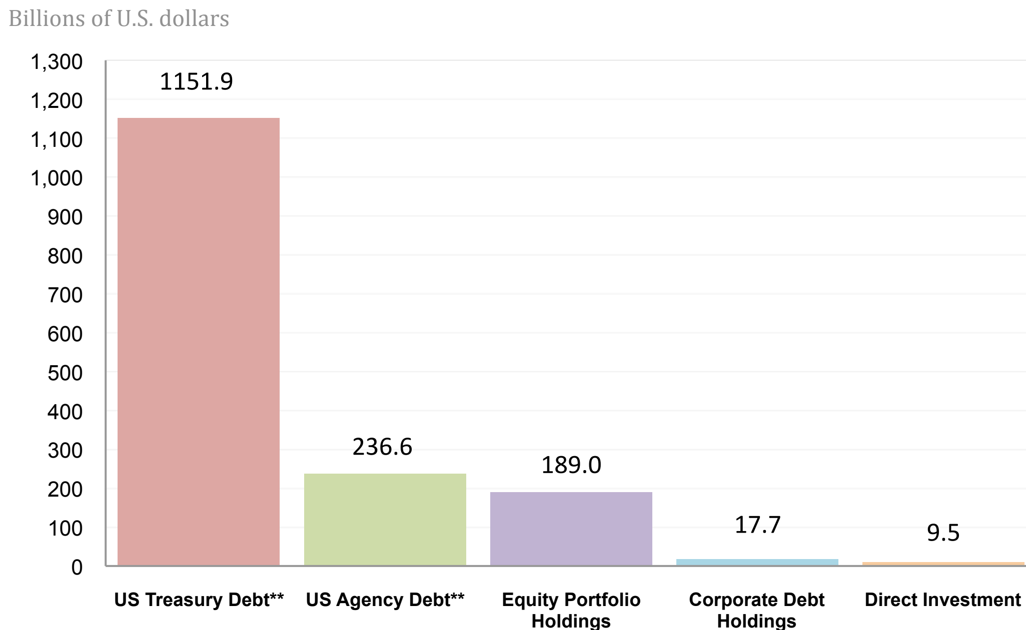
[4] Treasury securities are debt instruments issued by the U.S. Department of Treasury. Agency securities are debt instruments issued by government-sponsored corporations (such as Ginnie Mae or the Federal Home Loan Banks), and therefore enjoy an implicit or explicit government guarantee.

[5] These figures are as of year-end 2011. For the newest monthly numbers of Chinese holdings of Treasury and other securities, see the Treasury Department's Treasury International Capital system. Also, note that China's actual holdings of U.S. government securities should be even higher than the direct numbers indicate because of indirect purchases through third countries; 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).

[7] All figures from the Bureau of Economic Analysis.

Figure 2: Chinese Portfolio Holdings versus Direct Investment in the United States, 2011*



Sources: Bureau of Economic Analysis; U.S. Treasury International Capital System.
* Portfolio investment and FDI data as of December 2011; FDI position based on ultimate beneficiary owner data from the Bureau of Economic Analysis.
** Direct holdings only.

A New Dataset on Chinese FDI in the United States

While these official figures provide an important historical perspective, they are not very helpful in describing recent trends and assessing drivers and impacts of Chinese investment. Not only are official figures published with significant delay, but there are also concerns about data quality: global cross-border investment transactions have become increasingly complicated by the extensive use of offshore financial centers and tax havens, making it very difficult for statistical agencies to accurately track them. This is particularly true in the case of Chinese investment, which for legal and practical reasons often goes through Hong Kong, Singapore and Caribbean tax havens. In addition, official statistics repress information for confidentiality reasons, and often lack important metrics such as distribution by industry *and* country, ownership of the ultimate beneficiary owner, or operational characteristics such as assets, revenue or jobs created.

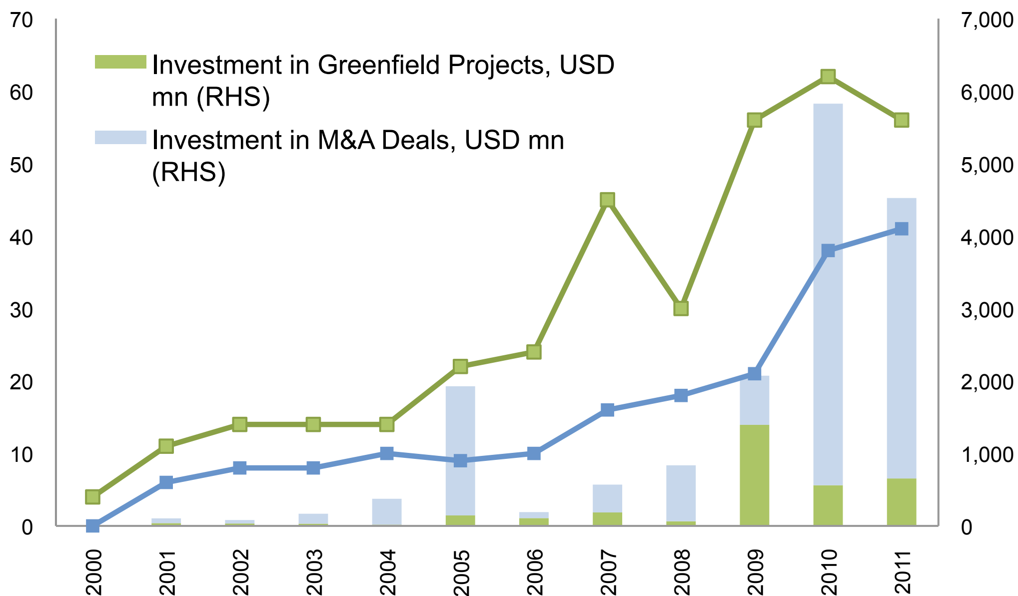
For these reasons, we compiled our own statistics on Chinese investment in the United States and European Union. Using a bottom-up approach, we put together a database covering acquisitions and greenfield projects by Chinese-owned firms in the United States with an estimated value of more than $1 million. The data stemming from this approach are not directly comparable to the traditional balance of payments approach to collecting FDI data, as they neglect reverse flows and miss intra-company loans and other follow-up flows. However our method overcomes many of the weaknesses of the traditional approach – such as of the lack of accounting for offshore financial centers– and allows a detailed, real-time assessment of Chinese investment flows and ownership in the United Sates. [8]

[8] For a detailed review of existing data sets and their advantages and weaknesses, see Rosen and Hanemann (2011) or Hanemann and Rosen (2012).

Between 2000 and 2011, we recorded 538 Chinese deals in the United States worth a total of $16.7 billion (Figure 2). These 538 deals include 352 greenfield projects – factories, offices and other facilities built from scratch – and 186 mergers and acquisitions of existing companies and assets. Acquisitions account for 81% of total investment value ($13.4 billion) and greenfield projects for the remaining 19% ($3.2 billion).

Before 2008, Chinese FDI flows into the United States typically stood well 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 a record $5.8 billion in 2010. In 2011 Chinese investment came in slightly lower at $4.5 billion. However, this lull in no way indicates declining Chinese interest in America. The first half of 2012 saw over $3.5 billion in consummated deals and the second half of the year is poised to be just as big, which would make 2012 a record year for Chinese investment in the United States.[9]

Figure 3: Chinese Direct Investment in the United States, 2000-2011



Source: Authors' compilation. For updates and information on methodology see http://rhgroup.net/topics/cross-border-investment.

These numbers are higher than the official data but still fairly small. A few large-scale transactions -- and alarming headlines -- have left some with the impression that China is "buying up" America.[10] This is not the case. Using official figures for total FDI inflows (since our data does not include FDI from *other* countries into the United States), China's $4.7 billion would have accounted for a mere 2% of total U.S. FDI inflows in 2011.[11] Chinese direct investment also remains tiny when compared to China's other investments in the United

[9] For a detailed analysis of Chinese investment activities during the first half of 2012 based on our dataset, see Hanemann (2012b).

[10] See *Time*, "Will Asia "buy up" America?" August 30, 2011, available at: http://business.time.com/2011/08/30/will-asia-buy-up-america/.

[11] According to the OECD, the US registered $227.9 billion of inward direct investment flows in 2011.

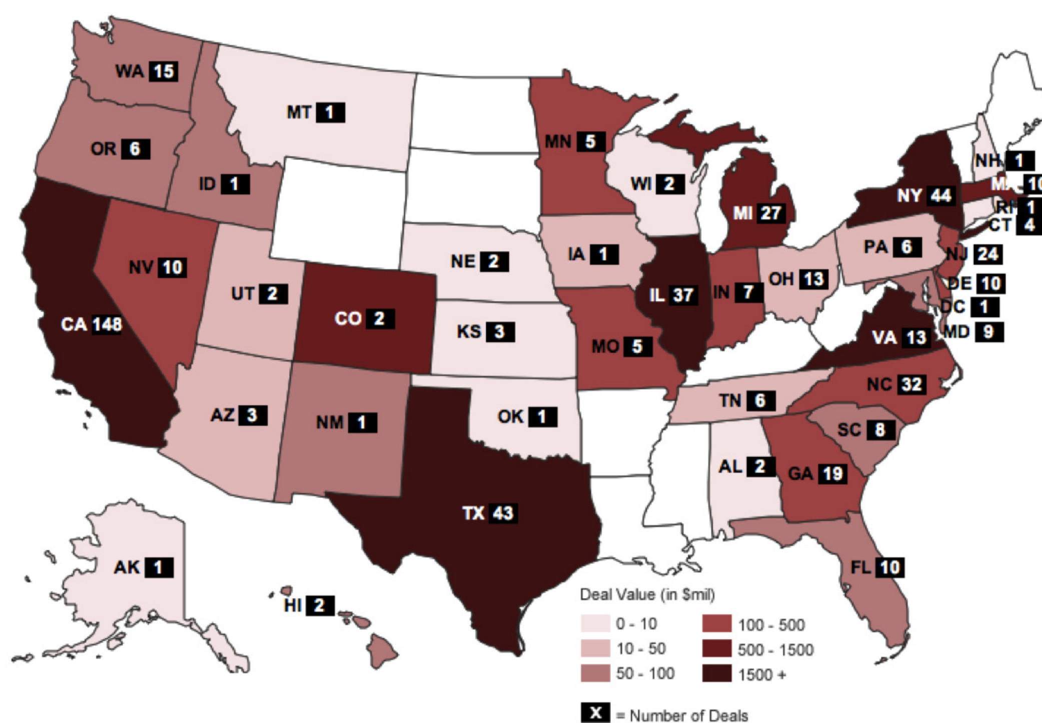
States: the average annual increase in Chinese holdings of U.S. Treasury securities was more than $90 billion between 2000 and 2011.[12]

Distribution of Chinese Investment by State and Industry

Unlike official FDI statistics, our dataset also provides a detailed breakdown of Chinese investment by state. Today, Chinese direct investors are operating in at least 40 of 50 states (Figure 5). California is by far the number one destination for Chinese investment by number of deals, with just under 150 transactions between 2000 and 2011, or roughly one quarter of all Chinese direct investments in the United States. The other top recipient states by number of deals are New York, Texas, Illinois, and North Carolina. In terms of total investment value, New York, Texas, Illinois and Virginia are leading the pack, followed by California. This reflects the fact that California has not – unlike the other top recipients– attracted large-scale takeover deals worth more than $500 million.

Figure 4: Chinese Direct Investment in the United States, 2000-2011

(Accumulated deal value from 2000-2011, USD million)



Source: Authors' compilation. For updates and information on methodology, see http://rhgroup.net/topics/cross-border-investment.

The distribution of Chinese investment by industry underscores the changing drivers of Chinese outward FDI. Chinese firms are not concentrated in one or even a few strategic industries, but are making inroads across the spectrum of commercial America. In 14 industries, we find more than $200 million in Chinese deals, of which about half are in industrial and half in service sectors.

[12] Source: US Treasury International Capital System, available at: http://www.treasury.gov/resource-center/data-chart-center/tic/Pages/index.aspx

Despite the political sensitivity surrounding natural resource deals, the oil and gas sector has become one of the biggest and fastest-growing industries targeted by Chinese investors. The 2005 CNOOC-Unocal debacle chilled Chinese enthusiasm about natural resource deals 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.[13]

Table 1: China's FDI in the US by Industry, 2000-2011
(USD million and number of deals)

	Sector	Value (USD mil)			Number of Projects		
		Greenfield	M&A	TOTAL	Greenfield	M&A	TOTAL
1	Industrial Machinery, Equipment & Tools	1,216	1,702	2,918	41	16	57
2	Utility and Sanitary Services	0	2,831	2,831	0	5	5
3	Coal, Oil & Gas	3	2,302	2,305	3	9	12
4	Electronic Equipment and Components	124	2,060	2,184	25	9	34
5	Real Estate	0	909	909	0	7	7
6	Automotive OEM and Components	247	624	871	24	11	35
7	Software & IT services	25	743	768	15	26	41
8	Alternative/Renewable energy	497	148	645	31	7	38
9	Communications Equipment & Services	242	199	442	44	9	53
10	Aerospace, Space and Defense	9	400	410	4	3	7
11	Healthcare and Medical Devices	9	372	380	6	3	9
12	Leisure & Entertainment	15	310	325	3	6	9
13	Metals Mining and Processing	249	63	311	16	3	19
14	Transportation Services	229	0	229	18	1	19
15	Furniture and Wood Products	61	116	176	14	7	21
16	Textiles and Apparel	18	134	152	9	5	14
17	Chemicals, Plastics and Rubber	40	108	149	15	9	24
18	Pharmaceuticals	51	95	146	12	4	16
19	Financial Services and Insurance	59	82	141	9	16	25
20	Semiconductors	0	81	81	0	3	3
21	Food, Tobacco and Beverages	6	64	70	5	7	12
22	Business Services	32	30	62	15	9	24
23	Consumer Electronics	43	14	57	12	3	15
24	Biotechnology	10	32	42	6	4	10
25	Consumer Products and Services	25	6	31	17	2	19
26	Paper, Printing & Packaging	21	0	21	1	0	1
27	Engines & Turbines	4	9	13	1	1	2
28	Construction Services	1	10	11	1	1	2
29	Other Transport Equipment	6	0	6	4	0	4
30	Minerals Mining and Processing	1	0	1	1	0	1
	Total	3,242	13,443	16,684	352	186	538

Source: Authors' compilation. For updates and information on methodology see http://rhgroup.net/topics/cross-border-investent

Accelerating structural adjustment at home has also fueled investment in higher value-added manufacturing and services. The high number of acquisitions and greenfield projects in industrial machinery, electrical equipment and components, automotive, alternative energy,

[13] 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.

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 such as research and development, customer service and retail illustrate the move up and down the value chain.[14]

Finally, FDI stakes in the United States are increasingly becoming part of the asset management strategies of Chinese individuals, firms and institutional investors. Given recent price levels, residential and commercial real estate has become an attractive target for these investors.[15] Other industries that traditionally offer stable long term returns such as utilities have also attracted significant Chinese interest.

Investors and Ownership Structures

Finally, our dataset also allows for an in-depth analysis of Chinese investors in the United States. Many Americans erroneously assume that all Chinese firms are connected to the government. The reality is that ownership in China is diverse, and this is reflected in Chinese investment abroad. The range of investors in the United States includes China's sovereign wealth fund (China Investment Corporation), state-owned enterprises (e.g., Sinopec), firms with hybrid ownership structures (e.g., Lenovo), and wholly private firms (e.g., Wanxiang).

State-owned enterprises historically accounted for 70-80% of China's global OFDI, reflecting the head start they had getting approval, financing and policy support. Because state-owned firms dominate natural resources in China, their percentage of overseas deals also tends to be far larger than for private firms.[16] In the United States, privately held Chinese businesses represent a greater share of the deals made. Table 2 shows that 398 of 538 recorded investments between 2000 and 2011 (74%) originated from private firms—which we define as having 80% or greater nongovernment ownership. However, in terms of total deal *value*, the picture is reversed: state-owned firms account for 60% of the total.

Sovereign investment entities are making portfolio investments in the United States but have kept a low profile to date when it comes to direct investment stakes. However, their interest in FDI stakes is picking up. China's primary sovereign wealth fund, the China Investment Corporation (CIC), is an active investor in the United States, but has only made one investment in the U.S. that meets the direct investment threshold.[17] Several other high-profile government-controlled entities such as the State Administration of Foreign Exchange (SAFE) and the National Social Security Fund (NSSF) have portfolio investment positions in the United States, but have not yet ventured into FDI stakes, mostly due to capacity constraints.

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[14] 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.

[15] Both official statistics and our database underreport Chinese investment in U.S. real estate. However, recent examples of large-scale real estate grabs in the United States by Chinese firms include Shenzhen New World Group's dual acquisitions of Sheraton and Marriott hotels in Los Angeles in 2010 and 2011, and HNA Group's purchase of a New York City office building in 2011.

[16] According to the Chinese version of the Ministry of Commerce's 2009 report on Outward Foreign Direct Investment, state-owned enterprises accounted for around 70% of total Chinese OFDI stock in 2009. The authors' interviews with economists and researchers at China's State-Owned Assets Supervision and Administration Commission suggest that the share of state-owned enterprises in total OFDI stock could be higher.

[17] This refers to CIC's 2010 $1.58 billion investment of Virginia's AES Corporation. Details of the deal can be found at: http://investor.aes.com/phoenix.zhtml?c=76149&p=irol-newsArticle&ID=1402516.

Table 2: China's FDI in the US by Ownership of Investing Company, 2000-2011
(USD million and number of deals)

Number of Deals

	Greenfield	% share	M&A	% share	All Deals	% share
Government Controlled	104	30%	36	19%	140	26%
State-Owned Enterprises	*104*	*30%*	*35*	*19%*	*139*	*26%*
Sovereign Wealth Fund	*0*	*0%*	*1*	*1%*	*1*	*0%*
Private and Public*	248	70%	150	81%	398	74%
	352		**186**		**538**	

Total Investment (USD mn)

	Greenfield	% share	M&A	% share	All Deals	% share
Government Controlled	2,074	64%	8,017	60%	10,090	60%
State-Owned Enterprises	*2,074*	*64%*	*6,436*	*48%*	*8,510*	*51%*
Sovereign Wealth Fund	*0*	*0%*	*1,581*	*12%*	*1,581*	*9%*
Private and Public*	1,168	36%	5,426	40%	6,594	40%
	3,242		**13,443**		**16,684**	

Source: Authors' compilation. For updates and information on methodology see http://rhgroup.net/topics/cross-border investent *May include minority stakes by government-owned investors below 20% of voting shares.

III. Impacts: Benefits and Risks

There is a broad consensus that welcoming foreign direct investment is beneficial to an economy in the aggregate. That is why most developed economies – including the United States – follow an approach of openness towards foreign investment, with regulatory gate-keeping limited to antitrust or national security concerns. However, China's rise as a global investor is challenging this consensus due to its size and the special characteristics of its political and economic system.

The impacts of Chinese OFDI in the United States can be divided into three categories: economics, politics and national security. Empirical evidence is rare due to the short track record of Chinese investment. Our database helps to answer some questions, but often the impacts on market functioning, political discourse and national security can only be discussed qualitatively.

Economic Impacts

In the aggregate, Chinese FDI should provide the same benefits as other direct investment flows. Foreign direct investment increases the welfare of both producers and consumers. It allows firms to explore new markets and operate more efficiently across borders, reducing production costs, increasing economies of scale and promoting specialization. Foreign direct investment also means better prices for firms looking to divest assets, thanks to a bigger and more competitive pool of bidders. For consumers, foreign investment increases the contest for buyers' attention, leading to more choices, lower prices and innovation. And in local communities, foreign investment brings new jobs, tax revenue, and knowledge spillovers from worker training, technology transfers and R&D activities.

1. New capital: With the United States entrenched in a protracted period of tepid economic recovery and structural reform likely to require reduced headline growth for some years to come, external capital infusions are more important than ever. While OFDI from traditional

investors has fallen off severely—global FDI flows fell from a peak of $2.2 trillion in 2007 to $1.1 trillion in 2009 and recovered to only $1.6 trillion in 2011[18]—Chinese OFDI is growing rapidly, amplifying China's importance to developed nations like the United States as a source of capital.

2. Employment: By injecting capital into the U.S. economy, either via new greenfield projects or positions in existing ones, foreign investment is generating employment. Majority-owned U.S. affiliates of foreign firms employed 5.3 million Americans in 2009, out of a total civilian workforce of 154 million (i.e., 3.4% of U.S. employment). According to the latest available BEA figures from 2009, majority-owned U.S. affiliates of Chinese companies employed about 4,300 people in the United States. However, these figures were released just prior to the massive surge in Chinese investment. Our own data indicate that Chinese firms presently provide more than 25,000 jobs in the United States, or six times the latest official BEA figure.[19] While this figure is still small compared to the total U.S. workforce, other historical examples illustrate the potential for job creation. Greeted with the same skepticism in early years, majority-owned affiliates of Japanese companies today employ more than 660,000 Americans with a total payroll of $49 billion.[20]

3. **Consumer welfare**: Through gains from trade, Chinese firms deliver U.S. consumer welfare in the form of lower prices, product diversity and selection, and faster innovation cycles. These gains extend beyond traditional goods trade to product segments that require a more active presence in consumer markets, and – especially – to services. Chinese firms have already developed strong global positions in several service industries. For instance, the market entrance of Haier America fostered greater competition in U.S. white goods markets, bringing American consumers lower prices and more innovative products. Haier's mini-fridges are now standard items in American college dorms and hotels and Lenovo laptops have become almost as commonplace.

4. Shareholder value: Greater investment interest from China increases competition for assets, and thus raises prices for American sellers. China National Offshore Oil Corporation's (CNOOC) failed acquisition of Unocal in 2005 is an example of this. Unocal attracted an acquisition bid of $18.5 billion from CNOOC in mid-2005, compared to an initial bid of just $16.5 billion from Chevron. Although the Chinese bid ultimately was scuttled for political reasons, Chevron's winning bid ended up being raised by $600 million (which, in turn, increased the profit for pension funds and other holders of Unocal shares).

5. Productivity effects: Given their lower starting level of technology and more modest management skills, it might seem premature to expect Chinese firms to bring to the United States the intellectual property and business know-how that fuels total factor productivity growth.[21] However, Japan is a historical example of how quickly emerging market firms can swing from students to leaders. Japanese auto and electronics firms were dismissed as primitive when they arrived in the United States in the 1960s and 70s, but little more than a decade later they were at the forefront of technology, promoting important new management

[18] Source: OECD.

[19] This estimate refers to majority-owned affiliates only and does not include the thousands of jobs in firms in which Chinese firms own only minority stakes or provide financing.

[20] Source: Bureau of Economic Analysis.

[21] Studies of business innovation in China generally conclude that manufacturers take low-tech approaches, reverse-engineer foreign innovation rather than make breakthroughs, and rely on foreign talent and inputs for a high share of advanced capabilities. See, e.g., the OECD's review of China's innovation system (OECD 2008b).

techniques, such as just-in-time logistics. A few Chinese firms such as Huawei have already moved beyond reverse engineering and imitation toward technological leadership in their industries, and they are investing heavily in U.S. R&D capacities.

6. Keeping China's market open: There are several important indirect impacts associated with growing Chinese FDI in the United States. By keeping its door open to Chinese investment, the U.S. encourages China to keep its door open to American investment. While China has embraced an exceptionally open stance toward foreign investment since the late 1980s, the U.S. has been outspoken about recent signs of backsliding as China's firms graduate from relying on partnerships with multinationals to possessing more homegrown capabilities. These concerns are not hallucinatory: there are indeed factions in China counseling less liberal treatment for foreign firms in the domestic economy. We are optimistic that pro-international arguments will prevail, but their success – and the plethora of economic and security benefits dependent on continuing Chinese convergence with liberal international norms – relies in part on America's continuing demonstration of the virtues of openness.

7. Convergence: Finally, Chinese firms investing in the U.S. by necessity absorb the global business norms and habits characteristic of OECD markets. These practices will spread across China as firms realize that being able to comply with stricter regulatory supervisions gives them a strong competitive advantage over their homebound rivals. If Chinese firms holding assets in the U.S. fail to internalize Western business norms, they will be more vulnerable to litigation in U.S. courts, something they were immune from when serving the U.S. market solely through exports.

Along with benefits come risks, which spring from the exceptional size and velocity of China's growth, its residual non-market elements, and the revival of interest in state capitalism and nationalism as alternatives to Western consumer-centric models. Non-democratic politics are not unique to China, but in combination with state ownership of globally active businesses this factors into the analysis of economic impacts as well. Six major concerns are fueling anxiety in the United States.

1. Exposure to macroeconomic volatility: FDI can cause macroeconomic volatility by leading to overinvestment in a particular sector, causing asset price inflation and a decline in a nation's manufacturing sector. Sometimes called "Dutch Disease" or "Resource Curse," this threat is mostly related to investment in natural resources, as the proportionately large values of resource projects are more likely to cause these distortions.[22] In the longer term, higher levels of Chinese investment could also expose recipient countries to China's macroeconomic swings. If China's economy falters through its complex rebalancing process, its firms could pull money back from overseas to fill gaps at home, thus having a destabilizing effect on recipient economies. This danger appears especially acute in the case of China due to the outsized growth of Chinese OFDI and the potential severity of the Chinese rebalancing process. At the same time, direct investment from China is still fairly small in most economies, and (like elsewhere) it is largely illiquid and immobile. Moreover, Chinese FDI has shown a unique resilience through the global financial crisis while FDI flows from other nations have fallen significantly.

[22] Numerous scholarly papers have been written on the causes and effects of the "Dutch Disease"/"Resource Curse" phenomenon. For example, see Sachs and Warner (2001) for a thorough treatment.

2. Balance of payments effects: Greater Chinese outward FDI will also have a long-term impact on China's net international investment position (NIIP) and the country's balance of payments (BOP). First, more investment in FDI assets is one way for China to diversify away from government securities and other low-yielding assets. This may in turn slow down the demand for the latter, particularly if such diversification comes at a time of slower growth of total reserves. Second, a greater share of FDI assets should lead to higher returns on China's total overseas assets, which would inflate China's current account surplus and other countries' deficits as their investment income payments to China rise. From the view of the United States, higher investment income payments to China would further push up the current account deficit with China unless the trade deficit is reduced more significantly.[23] Of course portfolio outflows and FDI are not ready substitutes and at this point the scope of Chinese outward FDI is not large enough to justify such concerns. However, if outflows continue to rise at the pace of past years, we will soon reach a crossing point, where such concerns become more acute. Another caveat is that the investment income effect depends on the performance and return of Chinese OFDI projects, which is too early to tell.

3. Headquarters effects: While research shows that "asset stripping" concerns related to foreign direct investment are generally overstated, due to the unique nature of China's political economy, there are anxieties that Chinese firms are more likely than investors from elsewhere to acquire U.S. firms, move valuable assets back home, and shut down U.S. operations. However, examples of Chinese firms acquiring assets in developed economies to vacuum out technology and shut down local operations are rare. Prized American technology in most cases relies heavily on intangible skilled staff and know-how, which do not travel well. In most cases in our database, Chinese acquirers of American high-tech assets have actually injected additional capital to increase local staff.[24]

4. Risks for market-based competition: There are concerns that China's state capitalism will undermine the market-based valuation of assets globally as it becomes influential enough to be a price maker. The structure of China's state-controlled financial system and industrial policy differ vastly from the United States, resulting in very different costs of capital, risk-taking incentives and consequences for behaviors that might be harmful to shareholder interests or other stakeholders. This was the central argument in congressional objections to CNOOC's proposed acquisition of U.S. oil firm Unocal, and it has surfaced in other debates as well.[25] For the time being, China's FDI outflows are not large enough to distort aggregate global asset prices. However, this will change in coming years, and in specific niche areas China's price-setting dominance is already apparent. Moreover, Chinese leaders have de facto control over both state-owned (through ownership and nomination of executives) and private (through financial system domination, capital controls, and regulatory control) firms when they want to exert it. Now that China's firms are capable of competing abroad, the unequal non-market elements not yet liberalized in China such as formal and informal barriers and discrimination against foreign firms are a real and growing concern.

5. Downward convergence: China's brand of capitalism often depends less on law than on the interpretation of law by one's powerful friends, and its regulatory environment is still not on par with those of modern market economies. There are therefore concerns that Chinese firms will bring those attitudes to foreign markets, breeding regulatory weaknesses and

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[23] For a careful discussion of the NIIP and its implications for future U.S. sustainability, see Mann (2009).

[24] Some recent examples include the acquisitions of Cirrus in 2011 or Nexteer Automotive in 2010.

[25] For example, in the case of Chinese steelmaker Anshan in a slab steel factory in Mississippi in 2010. For an in-depth academic discussion of capital subsidies in cross-border mergers and acquisitions, see Hufbauer, Moll, and Rubini (2008).

inhibiting the healthy function of market economies. The wide-spread transparency problems and cases of outright investor fraud at U.S.-listed Chinese firms have aggravated such concerns among the U.S. public and regulators. We believe that these cases do not provide evidence of systematic attempts to undermine the healthy function of the U.S. economy, and that U.S. regulatory agencies should be able to combat such abuses. At the same time, there are doubts about the readiness of Chinese authorities to cooperate with foreign regulators and increase corporate transparency, as this would make firms vulnerable and expose the profit streams of privileged individuals and families.

Political Impacts

Rising Chinese OFDI in the U.S. has political impacts as well. Political science liberals argue that conflict is less likely between countries with high mutual FDI.[26] Cross-border ownership of assets can stabilize relationships as engagement deepens beyond mere facilitation of goods and services trade. Firms can stop trading with one another in short order, and portfolio investments can be withdrawn, but direct factory and warehouse investments cannot be removed overnight. Firms with direct investments are pressed into closer alignment, and FDI promotes understanding on the individual level through multiethnic workforces and collaboration between different cultures. Countries with a significant FDI stock abroad also tend to have a greater interest in political stability in recipient countries. The European Union is a prime example of such a peace dividend from greater FDI flows and economic integration.

Taking this *liberal* view, increasing Chinese investment offers plenty of political opportunities for the United States. Seeing America as a destination for direct investment rather than a market for exports will require Beijing to take a more holistic and nuanced perspective on bilateral relations with the United States. Consider the efforts of American multinationals with operations in China lobbying Washington for moderate China policies, and imagine a future in which Chinese multinationals do the same in Beijing to protect the value of their U.S. operations.

Economic interdependence can also have positive feedback loops for the Chinese political system. For instance, having assets worth hundreds of billions of dollars in foreign jurisdictions for the first time should affect firms' appreciation of the merits of law-based limits on political power. Greater levels of Chinese investment also have the potential to further align foreign policy interest and make Beijing a more responsible stakeholder in the global arena. It becomes clear that overseas investment interests increasingly undermine Beijing's long-held foreign policy dogma of not interfering in other states' internal affairs and keeping a low international profile. Greater presence of Chinese firms abroad will also make Beijing more vulnerable to economic sanctions and other political pressures – just imagine Beijing's dilemma in the current Iran crisis if its banks had significant operations in Europe and the United States. This new situation will give the U.S. more opportunities to work with China on bilateral and multilateral levels.

From a *realpolitik* perspective, on the other hand, the story is virtually the opposite. The influx of investment from far-flung overseas commercial interests is a strategic move to project political and military power from home shores. In addition, the source country might use FDI inflows, or the threat of withholding them, in an attempt to influence the target country's domestic politics or foreign policy. OECD economies have used influence over FDI to pursue

[26] See Mansfield and Pollins (2003) for an overview of liberal and realist arguments on economic interdependence and conflict.

foreign policy objectives, with fairly limited success.[27] China's outward FDI is too small at this stage to exert substantial leverage, but the country has a record of trying to use financial firepower for foreign policy goals. In 2007, China reportedly bought $300 million of Costa Rica's sovereign debt to persuade the country to shift diplomatic recognition from Taiwan to the PRC.[28] China has also employed economic leverage to compel European political behavior on Taiwan, relations with the Dalai Lama and Uyghur political activists; security policy issues such as the post-Tiananmen Square arms embargo; and economic policy preferences such as market economy status.[29]

National Security Impacts

Finally, foreign ownership of assets also presents a narrow set of concrete national security threats, which must be considered separately from domestic and foreign policy concerns. 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.[30] International investment agreements and bilateral investment treaties respect exceptions to the free movement of capital for security grounds.[31]

China presents particular concerns to the United States for at least five reasons.[32] First, China will likely be the world's largest economy within two decades, lending it huge leverage and power to shape global national security. Second, China is a one-party authoritarian state with values and commercial norms at variance and sometimes at odds with those of OECD countries. State ownership and influence creates special concerns about government-driven, non-commercial motives for investing. Third, unlike other FDI majors such as Japan or Europe, China is not an ally of the United States, but an emerging power with a rapidly modernizing military. China and the U.S. generally have good relations but there is uncertainty about Beijing's direction. China has a stated aspiration to displace the existing global power balance in favor of a greater strategic role for itself as well as greater voting share in international organizations, most likely at the expense of Western votes. Fourth, China has a troubled record on export control rules, and a reputation as a major proliferator of sensitive technologies to rogue regimes such as Iran, North Korea, and Pakistan.[33] Finally, China is considered a heightened threat for economic and political espionage by the intelligence communities in Europe and North America, and not without reason. The unclassified and classified records of Chinese espionage in the West are extensive.[34] These concerns are real and legitimate and need to be addressed appropriately.

IV. Policy and Politics: The U.S. Response to Chinese Investment

The US political response to Chinese investment during the last decade reflects this complicated mix of opportunities and concerns. After an initial period of reluctance and

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[27] See, for instance, Hufbauer et al (2007).
[28] See *The New York Times*, "Cash Helped China Win Costa Rica's Recognition", September 12, 2008, available at: http://www.nytimes.com/2008/09/13/world/asia/13costa.html.
[29] See *The New York Times*, "China Ties Aiding Europe to Its Own Trade Goals", September 14, 2011, available at: http://www.nytimes.com/2011/09/15/business/global/china-ties-aiding-europe-to-its-own-trade-goals.html.
[30] See Graham and Marchick (2006) for an extensive discussion of national security risks from FDI and Moran (2009) for an analytical framework for assessing national security risks from foreign investment.
[31] See, for example, Yannaca-Small (2007).
[32] This paragraph draws heavily from Graham and Marchick (2006), chapter 4.
[33] See Kan (2011).
[34] See Metzl (2011), and Graham and Marchick (2006).

hesitation, American policymakers are increasingly acknowledging the huge opportunities of increased Chinese investment and have started to actively promote Chinese capital inflows. At the same time, China's emergence as a direct investor continues to raise questions in the national security community, provoking concerns due to its unique and opaque economic structure.

Promoting Chinese Investment

Before Chinese investment took off in the United States, skepticism and ambivalence characterized the popular attitude towards Chinese capital. Few politicians stood up for Chinese investors facing domestic opposition and there was very little effort to actively promote Chinese investment. However, in recent years, America has woken up to the potential benefits of these new capital flows and public and private sector players have taken a more active stance in promoting Chinese investment.

The Obama administration is eager to repair the damaged reputation of the United States as an investment destination after the CNOOC-Unocal debacle. High profile representatives including the President himself, Vice President Biden and US Ambassador to China Gary Locke have repeatedly reaffirmed the United States' commitment to openness to Chinese investors.[35] Their rhetoric has been complimented by concrete efforts to bring down administrative barriers for Chinese investors, including simplified visa procedures for business travel and tourism in the United States and networking events in China to link potential Chinese investors with U.S. firms, officials and service providers.

The most active efforts to promote Chinese investment are originating from U.S. states and municipalities. At least 30 states are now operating trade and investment offices in China and investment promotion is becoming an increasingly important task for state representatives. Many states have also begun to hold regular investment conferences, organize trade and investment missions led by their governors, and support local private and academic initiatives aimed towards strengthening investment ties with China. Initiatives to promote Chinese investment can also be found on the municipal and regional levels.[36]

The arrival of new emerging market investors like China has compelled the United States to create a more effective institutional framework for federal investment promotion. The traditional laissez-faire approach to foreign investment stems from an era when the U.S. economy was unrivaled in its attractiveness to foreign investors and when those investors did not need much on-the-ground assistance. The situation has changed now, and the difficulties potential Chinese investors face due to their inexperience or U.S. policy barriers has reinforced the need to take a more active approach to investment promotion. In 2007, George W. Bush created the "Invest in America" program under the U.S. Commerce Department's International Trade Administration to better coordinate investment promotion efforts in the United States. In 2011, "Select America" was founded to further increase the profile of federal efforts.

[35] See Locke (2012); China Daily, "US VP Biden encourages Chinese investment," August 20, 2011, available at: http://www.chinadaily.com.cn/bizchina/2011-08/20/content_13155232.htm; China Daily, "Chinese investors 'can help create jobs' in the US," September 21, 2011, available at: http://www.chinadaily.com.cn/usa/business/2011-09/21/content_13753066.htm

[36] For example ChinaSF in the San Francisco Bay Area (http://www.sfced.org/CHINASF) or the Southern Governor's Association's American South – China Partnership Forum (http://www.southerngovernors.org).

National Security: Minimizing Politicization

The U.S.'s procedures for screening inward FDI for national security threats are generally equitable and impartial, but various groups – mostly those with vested commercial interests who capitalize on Sinophobia, and security hawks who are bent on excluding Chinese firms without reference to specific threats - have managed to politicize the screening process in the past. Recent attempts to politicize investments were less successful than in early years, but remain a serious threat to U.S.-China investment relations.

The Committee on Foreign Direct Investment in the United States (CFIUS), which screens foreign investment for national security threats, is generally well designed and reflects a tradition of openness to foreign investment with few limitations. CFIUS only screens investment for narrow security concerns, not for "economic" security concerns, and it treats foreign investors equally. CFIUS's recent track record reflects the United States' openness to Chinese investment: of the more than 500 investments between 2000 and 2011, most did not require any approval whatsoever. Those transactions that are submitted to CFIUS receive fair hearings and are usually approved. In recent years CFIUS approved Chinese takeovers in a broad range of sectors, including aviation, power generation and resource extraction. At the same time, technological change is forcing CFIUS to adapt to new realities, and recalibrating the definitions and criteria of the screening process review will take time. This process has left some investors uncertain about the prospect of their investments, especially in the telecommunications and information technology sectors.

Attempts to politicize Chinese investment transactions on national security grounds have been less successful since the 2005 CNOOC-Unocal case. Irresponsible claims are rebutted publicly, such as in the case of the Congressional Steel Caucus' call for blocking an investment by Anshan in a rebar steel project in Mississippi[37] or the recent opposition by a group of Senators and Congressmen to the CNOOC-Nexen acquisition.[38] Also, Chinese firms have become savvier in managing political risks in developed economies. Learning from past failures, firms are pursuing deals that cause fewer tensions and are working with local partners and advisors.

Next Generation Policy Issues: Grappling With the Right Response

National security concerns once dominated the domestic debate about Chinese investment in the United States, but now economic concerns are getting more attention. Unlike many other countries, including China, Canada, and Australia, the United States has resisted making "economic security" a direct concern of the review process. The search for solutions to address these "next generation" issues outside of the CFIUS process could add to political risks for Chinese investors in the United States in the years ahead.

One of the primary economic concerns is the asymmetry in investment openness between China and the United States. Despite its policy of opening up, China remains the most restrictive G20 country when it comes to formal openness to inward FDI (Figure 5). Given the low level of Chinese OFDI in the U.S., this was not a major problem in the past. However, in light of increasing Chinese investment 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 important item of the U.S. policy agenda. At the APEC meeting in November 2011, President Obama warned China that "the

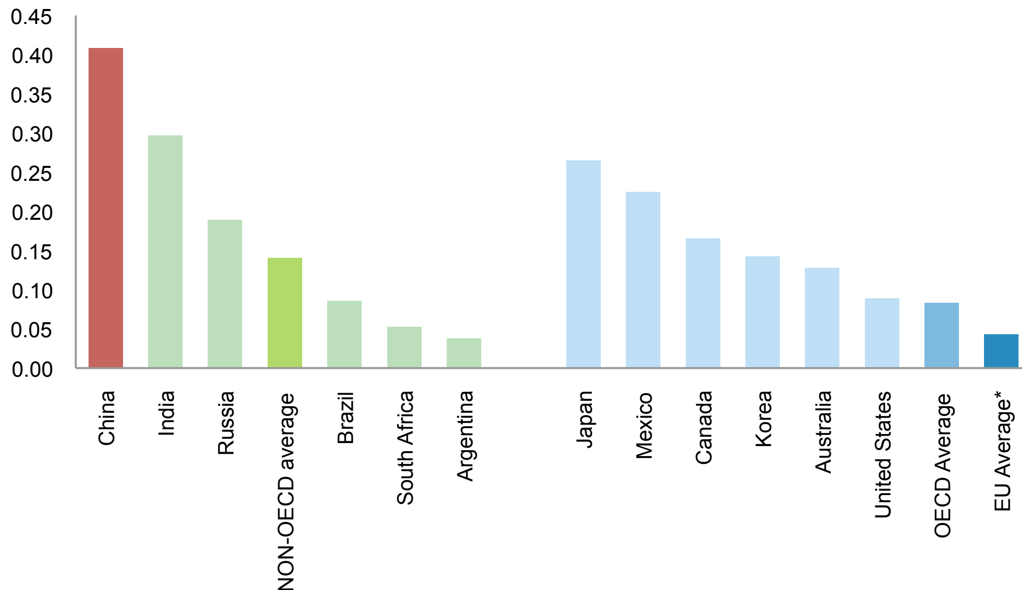
[37] See *The Wall Street Journal*, "Anshan's Deal Is in America's Interest," August 16, 2010, available at: http://online.wsj.com/article/SB10001424052748704868604575432811628948970.html

[38] See *AEI*, "Senator Schumer's very bad idea to expand CFIUS," August 21, 2012, available at: http://www.aei-ideas.org/2012/08/senator-schumers-very-bad-idea-to-expand-cfius/

United States can't be expected to stand by if there's not the kind reciprocity in our (...) economic relationships that we need".[39]

In a March 2012 speech Secretary of State Clinton announced that U.S. officials are increasingly ready to use Chinese investment interests in the U.S. as leverage for achieving broader goals in U.S.-China economic relations, including "an end to discrimination against U.S. companies".[40] 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 U.S. government is indeed ready to use its existing regulatory leverage to elicit such concessions from China.[41]

Figure 5: Formal FDI Restrictiveness, 2012
(Index, 1=Closed; 0=Open)



Source: OECD, Rhodium Group. *Calculated based on available OECD data for 24 of 27 EU member countries.

In addition to demands for greater reciprocity in market access, the debate on the potential negative impact of Chinese investment on market-based competition and asset pricing has clearly picked up. The behavior of state-owned enterprises (SOEs) and options for ensuring "competitive neutrality" are at the center of this debate, with proposals ranging 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.[42]

Internationally, the U.S. is supporting ongoing efforts by international organizations such as the Organization for Economic Cooperation and Development (OECD) or the United Nations

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[39] President Obama's remarks at the APEC CEO Business Summit on November 12, 2011 can be found at: http://www.whitehouse.gov/the-press-office/2011/11/12/remarks-president-obama-apec-ceo-business-summit-qa.

[40] Secretary Clinton's remarks at the U.S. Institute of Peace China Conference on March 7, 2012 can be found at: http://www.state.gov/secretary/rm/2012/03/185402.htm.

[41] See Financial Times, "First US approval for Chinese bank purchase," May 10, 2012, available at: http://www.ft.com/intl/cms/s/0/26d2c476-9a0d-11e1-accb-00144feabdc0.html#axzz24DtnqRaw

[42] The U.S.-China Economic and Security Review Commission held a hearing on Chinese SOEs on February 15, 2012. Details on the proceedings and testimonies presented can be found at: http://www.uscc.gov/hearings/2012hearings/written_testimonies/hr12_02_15.php

Conference on Trade and Development (UNCTAD) to develop new frameworks to ensure "competitive neutrality" between SOEs and private sector firms. In addition, the Obama administration is pressing ahead with new initiatives to address such concerns. In 2011, Undersecretary Hormats announced that the United States sees "state capitalism" as "a new challenge to the global consensus on open markets and private investment".[43] Concrete efforts include an adjustment of negotiating texts for bilateral investment treaties (BITs) and free trade agreements such as the Trans-Pacific Partnership (TPP) agreement. In May 2012, the U.S. 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".[44]

Finally, Chinese companies are increasingly raising concerns with regard to antitrust and competition policy. For the past decades, China's firms have operated in a producer-oriented environment, and a consumer welfare-oriented competition policy regime is still in its infancy. These contrasting competition policy philosophies combined with statements by Chinese officials to "avoid unhealthy competition" among Chinese firms for overseas assets is raising red flags with competition authorities in developed economies.[45] The EU Commission is already considering treating 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 report to the same controlling shareholder and are disciplined by no pro-competitive agency to prevent collusion or other abuse of market power.[46] Chinese firms are also increasingly running in to trouble with U.S. courts and antitrust authorities. In 2012, several Chinese producers of vitamin C faced trials in the United States on price-fixing allegations, defending their actions by relaying requirements by the Chinese Ministry of Commerce to coordinate production and fix export prices.[47] It seems inevitable that the Department of Justice and the Federal Trade Commission will take these special characteristics into account when reviewing future Chinese M&A transactions in the United States.

V. Conclusions

China was not a significant direct investor in U.S. assets until recently. In 2008 OFDI flows from China started to take off, with annual investment value surpassing $5 billion in recent years. This new investment boom is commercially driven, motivated both by the pressure cooker of competition inside China and by attractive deals to be had in the United States. There is enormous welfare potential from Chinese investment. We estimate that through 2020 Chinese firms will distribute $1-2 trillion in FDI around the world. $100 to $300 billion of that capital could be destined for the United States if it is able to attract 10-15% of the total.[48] This investment would yield the same benefits as FDI from other countries: fresh capital, jobs, taxes and innovation spillovers.

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[43] Undersecretary Hormats' remarks at AmCham-China's Annual DC Dialogue on May 3, 2011, can be found at: http://www.state.gov/e/rls/rmk/2011/157205.htm.

[44] See Hanemann (2012b).

[45] See: MOFCOM and SASAC Signed Cooperation Memorandum to Regulate State-owned Enterprises' Going-out (商务部、国资委签署《协作备忘录》规范央企 "走出去"), Xinhua News Agency, August 23, 2011, available at: http://news.xinhuanet.com/politics/2011-08/23/c_121900567.htm.

[46] See European Commission (2011).

[47] See *Chicago Tribune*, "Chinese vitamin C maker to settle antitrust lawsuit," 21 May 2012, available at: http://articles.chicagotribune.com/2012-05-21/news/sns-rt-us-newyork-vitamin-cbre84l02e-20120521_1_chinese-government-antitrust-lawsuit-settlement.

[48] In recent years, the United States was the top recipient of global FDI flows, accounting for around 15% of the total.

At the same time, there are risks that are particularly pronounced in the case of China, due to the special characteristics of the Chinese state and economy. National security has been the primary policy focus thus far, and will remain important. At the same time, new economic concerns are arising. Chinese firms operate in a different political and economic environment than firms from other countries, and bring additional political and economic risks that merit attention: a distortion of global asset prices, unfair competition through abuse of market power, and damage to consumer welfare. As Chinese investment increases across in OECD nations, these issues will become more and more important and bring the risks of protectionist abuse.

OECD economies must increase efforts to coordinate and find appropriate solutions. This starts with an initiative to more systematically explore the extent to which outward FDI might export some of China's specific characteristics and market distortions and define implications for the global economy. For example, there is no consensus on how one should define, measure, or observe an *unfair* influence of one nation's domestic capital costs on world prices. Additionally, recipient countries must think about strategies to pressure China on legitimate goals without putting investment openness at risk. Outright reciprocity demands for example are a poor strategy to achieve greater equality in market access.

Finally, China must be part of the solution. The concerns about Chinese investment in target countries are not imagined, but rooted in the special character of China's current 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.

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