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THE CHANGING US-CHINA INVESTMENT RELATIONSHIP

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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 direct investments by Chinese firms have risen steeply, with Beijing signaling greater support for portfolio investment outflows as well. This article describes the nascent shift in patterns of Chinese investment in the United States and uses the case of direct investment to examine the implications for US-China relations. We discuss current and future policy issues presented by Chinese foreign direct investment (FDI) in the US, including national security, market access and antitrust.

Key Words: International Investment, International Economic Order, Foreign Direct Investment, FDI, Foreign Exchange.

JEL codes: F21, F02, F31, P16.

1. 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 reserves into US government securities. China maintained capital account restrictions, which limited foreign portfolio investment inflows. Deterred by the restrictions and challenges of operating abroad (particularly in an advanced economy such as the US), China's firms made few direct investments abroad.

Today this long-standing 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 2015 to 2020 (Kriel 2013). 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 now includes significant volumes of

direct investment outflows managed by enterprises. While negligible in the past, outbound foreign direct investment (OFDI) is now growing rapidly, and the US and other developed economies have become primary destinations for these flows.

Understanding the drivers behind Chinese direct investment flows to the US and the implications of the advent of these investments is key to comprehending the fundamental forces shaping the US-China relationship. It is also crucial for anticipating and managing the short-term policy imperatives confronting Beijing and Washington. This paper describes the beginning shift in the US-China investment relationship, and explores the recent growth of Chinese OFDI in the US and the new policy considerations arising from this trend.

2. The Evolution of the US-China Investment Position

China's distinct development choices shaped the build-up of its international investment position. 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 (see for example Rosen 1999; Naughton 1995). After joining the World Trade Organization (WTO) in 2001, China became the world's second-largest recipient of foreign direct investment. In 2012, accumulated foreign direct investment in China amounted to US$2.2 trillion, or

63% of total liabilities in China's international investment position (IIP).[1] Other capital inflows remained tightly controlled, in particular portfolio investment, which only amounted to a stock of US$336 billion in 2012 (10% of China's total liabilities). Liabilities of trade credit and other cross-border lending captured under the 'Other investment' category approximately balance out claims on the asset side, with large swings in recent years as this channel is used for speculative short-term flows (27% of liabilities in the 2012 IIP).[2]

The composition of China's international assets is very different from the liabilities. Official reserves account for the vast majority of China's international assets (65% at the end of 2012). 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' (around 20% of assets in 2012). Portfolio investment accounts for a relatively small share of China's global asset position (5%). Outward FDI assets form a small part of

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[1] The FDI, portfolio investment, and other investment figures in this and the following paragraph refer to balance of payments and international investment position data collected by the People's Bank of China. The database is published on the State Administration of Foreign Exchange official website at http://www.safe.gov.cn/.

[2] The international investment position (IIP) is a statistical statement that shows at a point in time the value of: financial assets of residents of an economy that are claims on non-residents or are gold bullion held as reserve assets; and the liabilities of residents of an economy to non-residents. The main components of IIP include: Assets (Direct Investment Abroad, Portfolio Investment, Other Investment, Reserve Assets) and Liabilities (Direct Investment, Portfolio Investment, Other Investment). For additional information see the International Monetary Fund's Balance of Payments and International Investment Position Manual.

China's global portfolio as well (10%). In short, China's global portfolio is dominated by reserves, trade-related credit and other low-risk holdings on the asset side (holdings mostly controlled by the central bank and other state-related entities), while equity portfolio investment and FDI are minor positions. The liabilities side is dominated by inward FDI assets by private companies.

(Figure 1)

The US-China 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.[3]

The US investment position in China has long been dominated by foreign direct investment by US multinationals in China, but portfolio investment has grown faster in recent years (Figure 2). By the end of 2011, US firms had around US$55 billion of FDI assets in China, six times as much as 10 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, the 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)

[3] The following figures are the best available snapshots. They are by no means complete, as no reliable statistics exist due to difficulties capturing financial flows.

program.[4] By the end of 2011, US investors held around US$75 billion of portfolio equity stakes in China, down from a peak of approximately US$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.

(Figure 2)

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 US$1.56 trillion in long-term debt and US$5 billion in short-term debt.[5] 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.[6] 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.[7]

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[4] The Qualified Foreign Institutional Investor (QFII) program allows licensed foreign investors to trade RMB-denominated securities in China's mainland stock exchange. The program was first introduced in 2002.

[5] The figures in this paragraph are estimated using data from the Bureau of Economic Analysis and US Treasury's International Capital (TIC) System.

[6] 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.

[7] For a discussion of this phenomenon, see Setser and Pandey (2009).

State-related entities and investors under the Qualified Domestic Institutional Investor (QDII) program[8] have also gradually expanded their holdings of US equities, amounting to US$159 billion by year-end 2011.[9] FDI is the smallest position with an accumulated stock of US$9.5 billion at the end of 2011, according to official estimates from the BEA.[10] Holdings through third countries also pose data collection problems to equity investments and FDI, so these figures likely underestimate the real value of Chinese holdings in the US.

(Figure 3)

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, China's next stage of economic development requires a different growth model and China has begun a structural adjustment process that will also alter the country's global investment position (Lardy 2012; He and Kujis 2007). Officials from the People's Bank of China (PBOC) have repeatedly hinted at intentions for a free capital account by 2016,

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[8] The Qualified Domestic Institutional Investor (QDII) program allows approved domestic institutional investors such as fund management institutions, securities companies, and commercial banks to invest in foreign securities markets. The program was introduced in 2007.

[9] The figures in this paragraph are estimated using data from the Bureau of Economic Analysis and US Treasury's International Capital (TIC) System.

[10] This figure is based on the BEA dataset on FDI by ultimate beneficiary ownership. For a detailed discussion of available data sources for Chinese investment in the United States, see Rosen and Hanemann (2011).

which would boost outward FDI and two-way portfolio investment flows. Figure 4 presents the result of a modeling exercise attempting to project China's international investment position in 2020 under the assumptions that the capital account is fully liberalized by then and China's external position follows the patterns of other emerging economies going through similar processes (see He et al. 2012). The results are a more than three-fold growth of China's international assets and liabilities from 2004 to 2020 and a significant change in the composition of holdings on both sides.

(Figure 4)

The process of rebalancing China's international investment position has already begun, as two-way flows between the US and China since the global 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 20 times higher than in 2007.[11] And recent policy changes are signaling fast growth of two-way portfolio investment flows, albeit from a low base.

3. 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

[11] For detailed data, see Chinese Ministry of Commerce's Statistical Bulletin of China's Outward Foreign Direct Investment in 2012 and 2007.

Chinese narrative 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 was in 2005: 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 the hopes of increasing supply security and sharing in profits. Despite a volatile global FDI environment, Chinese outward FDI flows grew from less than US$20 billion annually before 2006 to more than US$80 billion in 2012.[12] China's share of global OFDI flows grew from around 1% in 2007 to almost 5% in 2012, making China the world's third-largest outward direct investor.[13]

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 US$9.5 billion and US$8.99 billion respectively.[14] This is already a significant increase compared to five years ago,

[12] For detailed data, see Chinese Ministry of Commerce's Statistical Bulletin of China's Outward Foreign Direct Investment in 2012 and 2006.

[13] For detailed data, see United Nations Conference on Trade and Development (UNCTAD) database on foreign direct investment (UNCTAD 2013).

[14] The figures come from BEA international economics data and the Chinese Ministry of Commerce's Statistical Bulletin of China's Outward Foreign Direct Investment. The BEA figure refers to data compiled following the Ultimate Beneficiary Owner

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 (Rosen and Hanemann 2009).

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.[15] Among them is Rhodium Group's China Investment Monitor (CIM), which covers acquisitions and greenfield projects by Chinese-owned firms in the United States with a value of US$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 the lack of accounting for offshore financial centers – and allows for a detailed, real-time assessment of Chinese investment flows and ownership in the United States.[16]

(UBO) principle. Foreign multinational firms may own their US affiliates through ownership chains that extend across multiple countries. UBO data provides FDI statistics classified by country of the entity that ultimately owns or controls the US affiliate.

[15] For example, the Heritage Foundation's China Investment Tracker, the Antwerp Management School's Euro-China Investment Report, TAC Consulting's ChinaObs FDI Monitor.

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

The Rhodium Group dataset records 620 Chinese deals in the United States between 2000 and 2012, amounting to US$22.8 billion (Figure 6).[17] 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 (US$19.45 billion) and greenfield projects for the remaining 15% (US$3.35 billion).

The figures underline the recent growth spurt of inflows. Before 2008, Chinese FDI flows into the United States typically stood below US$1 billion annually, with the singular exception of Lenovo's US$1.75 billion acquisition of IBM's personal computer division in 2005. Since 2008, Chinese investment has steadily gained momentum, growing to just under US$2 billion in 2009 and US$5.6 billion in 2010.[18] In 2011 Chinese investment came in slightly lower at US$4.6 billion, but reached a new record high of US$6.7 billion in 2012. In the first six months of 2013, Chinese firms spent almost US$5 billion on M&A and greenfield projects in the US. With another US$10 billion worth of deals announced or pending, 2013 will likely be another record year for Chinese direct investment in the United States.

(Figure 6)

[17] See Rhodium Group (2013).

[18] The figures in this paragraph come from the Rhodium Group dataset. See Rhodium Group (2013) for details.

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.

First, the unconventional energy boom has made the United States a prime frontier for global oil and gas investments, attracting Chinese firms eager to expand their overseas production bases and involvement in cutting-edge extraction techniques. The failed 2005 CNOOC-Unocal deal 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.[19]

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 competiveness at home and preserve access to US customers abroad. A growing number of acquisitions and greenfield projects in industrial machinery, electrical equipment and components, the automotive industry, alternative energy, medical devices and

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[19] For example, CNOOC's acquisition of stakes in Chesapeake Energy projects in 2010 and 2011 worth US$1.7 billion and Sinopec's acquisition of Devon Energy in early 2012 valued at US$2.5 billion.

communications equipment illustrates the pressure 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 are a result of similar motivations.[20]

A third important factor is the greater readiness of Chinese firms to go abroad. After three decades of inward orientation, Chinese firms were ill-prepared to operate in mature economies, but have since grown more sophisticated. Firms increasingly recognize the importance of localizing foreign management and workforces (for example, Minmetals in Australia, Haier in the United States and Volvo in Sweden). They are also more familiar with the political environment in overseas markets (see CNOOC, which has found the right strategy to buy into North American energy assets with its recent US$15 billion takeover of Canadian oil producer Nexen). Chinese firms now 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 being opposed to, to highly supportive of, FDI in overseas markets. This reversal was driven by a mix of

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[20] 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 to support regional customer requirements including product configuration, distribution services, returns management and some light assembly.

motives across different bureaucracies, including awareness of the importance of global operations for firm competitiveness (Ministry of Commerce and State-Owned Assets Supervision and Administration Commission), fading concern about maximizing foreign exchange reserves (Ministry of Finance and People's Bank of China), and increasing awareness of the strategic vulnerability entailed in a US debt-heavy portfolio of external assets (National Development and Reform Commission, People's Bank of China and others). While the ODFI 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.

(Table 1)

4. 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 the violation of intellectual property rights (IPR) (Morrison 2008). Investment-related disputes arose mostly from existing Chinese restrictions on inward FDI and the treatment of foreign companies (Department of State 2009). Some US officials also voiced concerns about Chinese holdings of US Treasury bonds (Jensen 2007). Chinese concerns mostly related to the safety of their US Treasury holdings, agency bills related to Fannie Mae and Freddie Mac, and small equity stakes in US companies in light of the global financial crisis (Mason 2011). 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.

4.1. 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 is in many cases a complement to trade (Markusen 1983). OFDI 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 (Mundell 1957; Markusen 1997). 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,[21] but the scope is still low; it remains to be seen whether we will see significant localization of manufacturing and other operations.

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[21] For example Tianjin Pipe Corporation's manufacturing facility for steel tubes in Texas.

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.[22] 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 US$1.5 trillion in recent years. Bilaterally, meanwhile, the US paid around US$40-50 billion in investment income to China in recent years, while income payments on Chinese assets added up to around US$10 billion a year (Figure 7).

This is a significant gap, but still remarkably low given that Chinese US assets are more than 10 times higher than US assets in China. A greater relative share of FDI and other higher-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.[23] This would put additional pressure on the US to rebalance its trade

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[22] In recent years, foreign returns on Chinese assets were on average 2-4% higher than Chinese returns on foreign assets, using the Balance of Payments and International Investment Position figures as a proxy. The Balance of Payments and International Investment Position database are accessible from the State Administration of Foreign Exchange official website at www.safe.gov.cn.

[23] Of course a greater share of OFDI is no guarantee for more profitability. It depends on the profitability of those FDI projects.

relationship with China to ensure the sustainability of its net international investment position.

(Figure 7)

4.2. 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 (SOEs) 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 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 new initiatives.[24] In 2011 US Under Secretary 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' (Hormats 2011). Concrete US steps to address those concerns have included adjusted terms for bilateral investment treaties (BITs) and newly

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[24] Internationally, the US is supporting ongoing efforts by the Organization for Economic Cooperation and Development (OECD) and the United Nations Conference on Trade and Development (UNCTAD) to develop competitive neutrality frameworks.

proposed 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' (Hanemann 2012b). Domestic proposals range from increased monitoring and transparency requirements to an expansion of the review process by the Committee on Foreign Investment in the United States (CFIUS) to include economic considerations (a net benefit test, like in Canada) and post-market entry performance assessments.[25]

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, reciprocity in market access is becoming an item on the US policy agenda 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 China in recent years. At the APEC meeting in November 2011, President Obama warned China that 'the United States can't be expected to stand by if

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[25] The US-China Economic and Security Review Commission held a hearing on Chinese SOEs on 15 February 2012. Details on the proceedings and testimonies presented are available at: http://www.uscc.gov/hearings/2012hearings/written_testimonies/hr12_02_15.php.

there's not the kind of reciprocity in our…economic relationships that we need' (Obama 2011). In a March 2012 speech, then 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' (Clinton 2012). The timing of the Federal Reserve's approval of ICBC's takeover of the Bank of East Asia (during the Strategic and Economic Dialogue in 2012, 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 (Nasiripour, Braithwaite, and Sender 2012).

(Figure 8)

4.3. 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 the rule of law.

Antitrust or competition 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's State-Owned Assets Supervision and Administration Commission (SASAC) as a single corporate entity for the purposes of assessing market share, since they ultimately report to the same controlling shareholder – the Communist Party of China (European Commission 2011). 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 (European Commission 2012b; Bradsher 2010).

Aggravating these concerns is the fundamentally different role and implementation of competition policy in China and the OECD economies. For the past three decades China's firms have operated in a producer-oriented environment, and a credible competition policy program oriented towards consumer welfare still does not exist. SOEs 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 (Xinhua News Agency 2011). While there are signs of possible change in these regards, they are a way 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 allegations of price-fixing in trials in the United States. They defended their actions by pointing to requirements by the Chinese Ministry of Commerce to coordinate production and fix export prices (Chicago Tribune 2012). It is likely 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.

4.4. Regulatory Compliance and Transparency

Disputes between China and the US over fraudulent claims by US-listed Chinese firms illustrate another major concern that arises from the advent of new forms of cross-border investment: dissimilar degrees of transparency and regulatory supervision.[26] 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 the other top five global investors, the quality of corporate governance in China is low (Figure 9), 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

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[26] A recent example is China Media Express, who was charged by the US Securities and Exchange Commission of 'fraudulently misleading investors about its financial condition'. See Yuk (2013).

welfare, complicating cross-border regulatory cooperation.[27] A related problem is that China does not generally enforce foreign court orders, making it more difficult for foreigners to hold Chinese citizens and firms accountable for potential damage caused abroad (Department of State 2013).

(Figure 9)

4.5. 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 four concrete national security threats: control of strategic assets (for example, ports and 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.[28]

Given China's 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 clear why the

[27] The State Secret Law covers secrets involving state safety and interests, which, if leaked, could cause damage to the state's safety and interests in politics, economy, national defense, foreign relations, and other areas. The law was last amended in 2010. The official document is available at: http://www.gov.cn/flfg/2010-04/30/content_1596420.htm.

[28] 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.

United States harbors national security concerns toward China that were not present to the same degree in other bilateral investment relationships.[29]

The CFIUS screens foreign investment for national security threats, and is generally well designed and has a tradition of openness to foreign investment with few limitations. The CFIUS only has a mandate to screen for narrow security concerns, not for 'economic security' or net benefits to the US. The 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.[30] Those transactions that are submitted to the CFIUS generally receive fair hearings and are usually approved.[31]

At the same time, technological change is forcing the 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 proposed investments, especially in the telecommunications and information technology sectors. Recent attempts to politicize investments were less successful than in the

[29] This paragraph draws heavily from Graham and Marchick (2006), chapter 4.

[30] Rhodium Group database (Rhodium Group 2013); Committee on Foreign Investment in the United States (CFIUS) Annual Reports to Congress.

[31] In recent years the CFIUS approved Chinese takeovers in a broad range of sectors, including aviation, power generation and resource extraction.

early years of Chinese investment, but the 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 the CFIUS depends 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 far broader review criteria, including 'national economic security' and even 'social stability' as grounds to block foreign investment (Ministry of Commerce, People's Republic of China 2011). 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 threaten to erode investment openness. Clearly, strategic trust that obviates the need for a more elaborate 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 that they can be resolved.

5. Conclusions

The US-China 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, politically, and for security.

Greater Chinese FDI offers enormous opportunities for the US in the form of fresh capital, job creation and maintenance, taxes and innovation spillovers (Rhodium Group 2013). It solidifies 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 on 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 SOEs 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, and improve market access for foreign firms. They should also 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 risk 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 are not worth the cost. 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. Yet indisputably, the global economy will be better off if mutually satisfactory solutions to ensure future investment openness can be implemented.

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Table 1. China's FDI in the US by Industry, 2000-2012

USD Million and Number of Deals

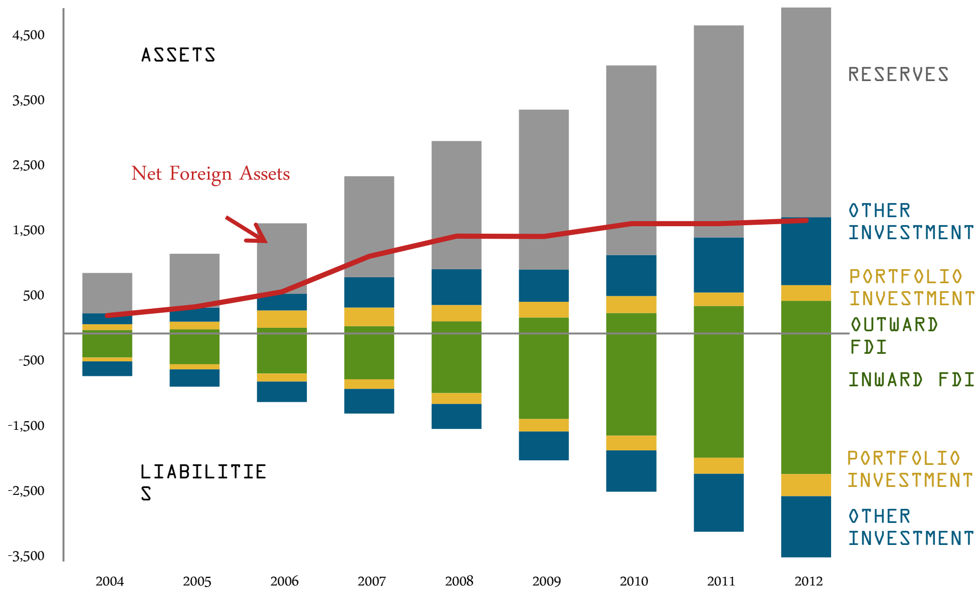
			Value (USD mn)			Number of Projects		
			Greenfield	M&A	Total	Greenfield	M&A	Total
1	Coal, Oil and Gas	Primary	6	5,250	5,255	4	11	15
2	Farming, Logging and Husbandry	Primary	15	64	79	1	7	8
3	Paper, Rubber and other Materials	Primary	111	0	111	15	0	15
4	Aerospace Equipment and Components	Secondary	106	460	566	4	5	9
5	Automotive Equipment and Components	Secondary	422	739	1,160	45	22	67
6	Chemicals	Secondary	5	4	9	5	1	6
7	Consumer Products and Services	Secondary	189	2,050	2,239	56	18	74
8	Electronics and Electronic Parts	Secondary	55	88	143	33	9	42
9	Food Processing and Distribution	Secondary	8	33	41	6	2	8
10	Healthcare and Medical Devices	Secondary	13	279	293	7	4	11
11	Industrial Machinery and Tools	Secondary	197	1,711	1,908	39	13	52
12	IT Equipment	Secondary	221	190	411	36	6	42
13	Metals and Minerals	Secondary	1,256	70	1,327	14	4	18
14	Other Transportation Equipment	Secondary	51	5	55	9	1	10
15	Pharmaceuticals and Biotechnology	Secondary	65	192	257	20	6	26
16	Renewable Energy	Secondary	483	204	688	44	13	57
17	Semiconductors	Secondary	1	212	213	1	5	6
18	Business Services	Tertiary	43	318	361	20	15	35
19	Construction Services	Tertiary	6	0	6	4	0	4
20	Entertainment, Media and Publishing	Tertiary	9	2,614	2,623	4	5	9
21	Financial Services and Insurance	Tertiary	58	344	402	10	3	13
22	Hospitality and Tourism	Tertiary	13	345	358	1	5	6
23	Real Estate	Tertiary	0	992	992	0	10	10
24	Software and IT Services	Tertiary	176	612	788	45	21	66
25	Transportation Services	Tertiary	31	0	31	21	0	21
26	Utilities	Tertiary	1	2,813	2,814	1	2	3
	Total		**3,540**	**19,590**	**23,130**	**445**	**188**	**633**

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

Source: Rhodium Group (2013).

Figure 1. China's International Investment Position, 2004-2012

USD Billion, Total Stock (IIP)

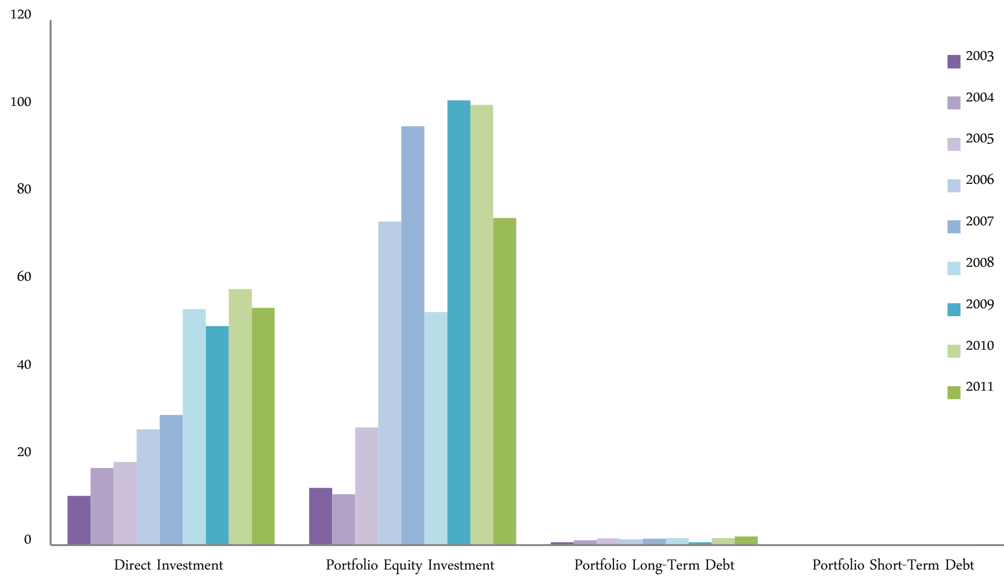


*Other Investment category includes trade credit, loans, currency and deposits and other investment.

Source: PBOC/SAFE (2013), Rhodium Group (2013).

Figure 2. The US Investment Position in China, 2011*

Billions of US Dollars, Total Stock

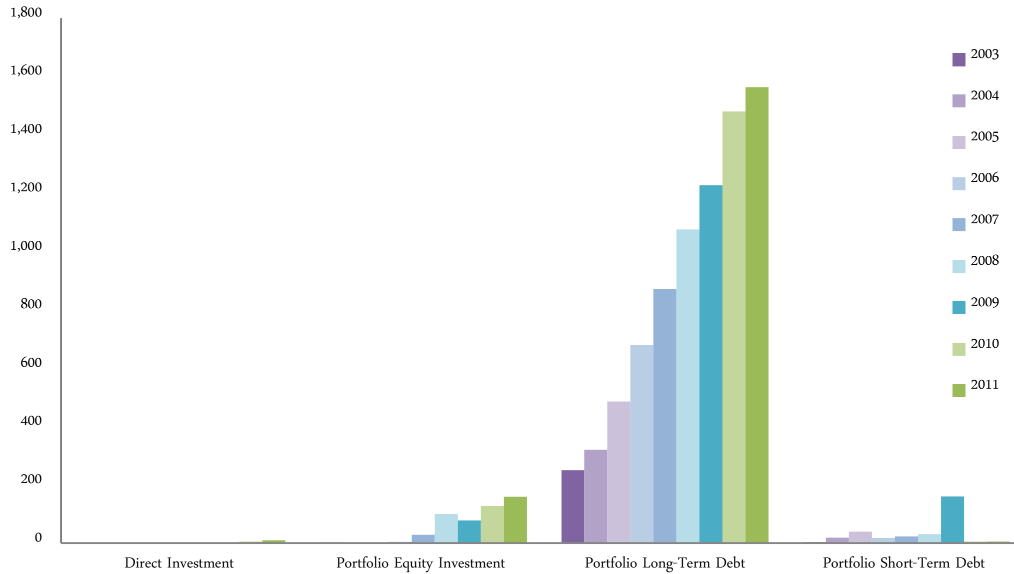


*These figures refer to direct holdings only and do not include holdings through international financial centers.

Sources: FDI figures based on data from the Bureau of Economic Analysis (BEA 2013); other figures from the US Treasury International Capital System (TIC) (US Treasury 2013).

Figure 3. China's Investment Position in the United States, 2011*

Billions of US Dollars, Total Stock

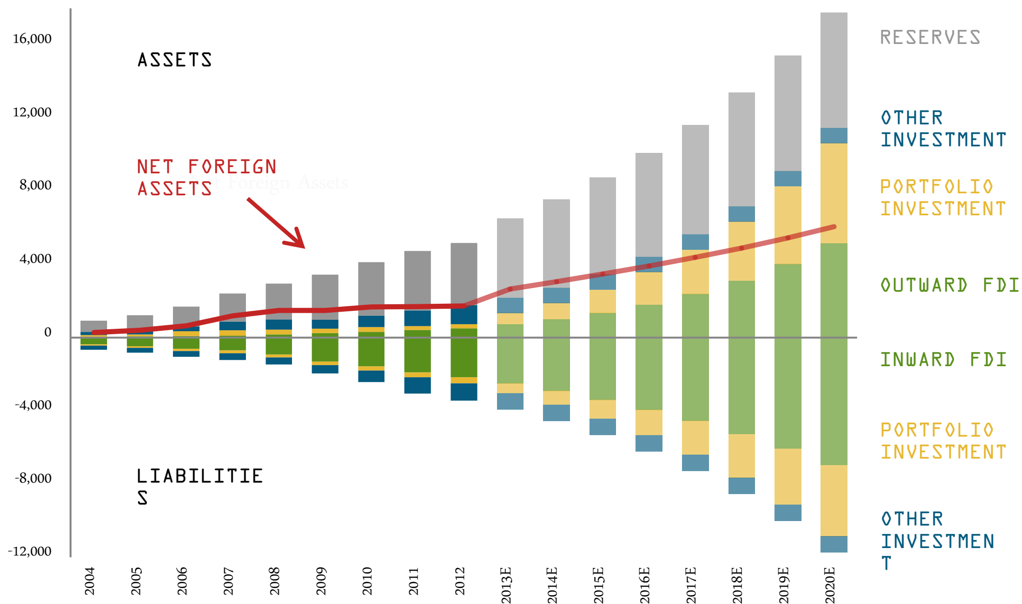


*These figures refer to direct holdings only and do not include holdings through international financial centers.

Sources: FDI figures are based on ultimate beneficiary owner data from the Bureau of Economic Analysis (BEA 2013); other figures are from the US Treasury's International Capital System (TIC) (US Treasury 2013).

Figure 4. Projections for China’s IIP if Capital Account is Fully Liberalized

USD Billion, Total Stock (IIP)

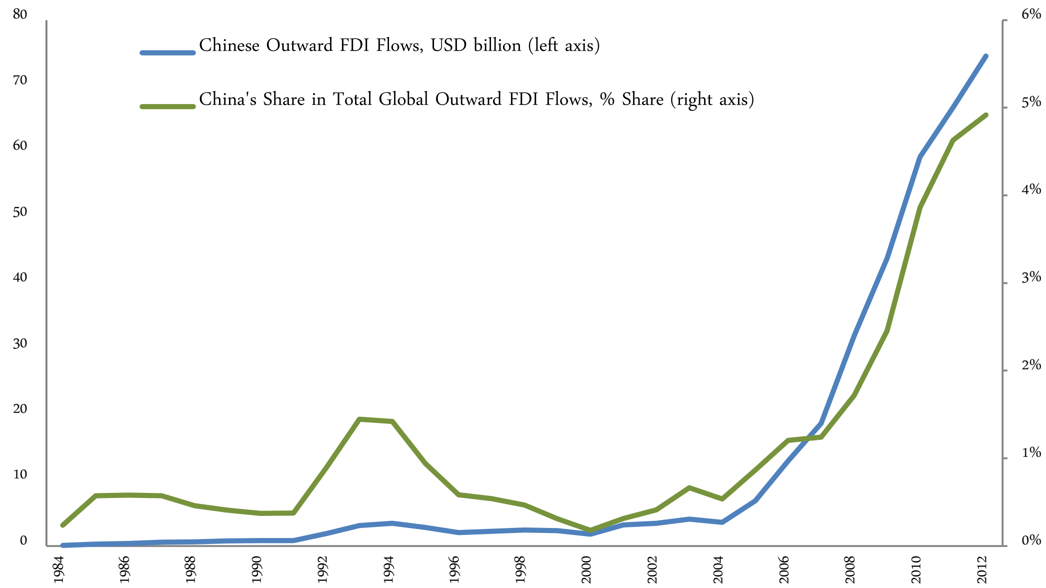


*The model does not project the evolution of the ‘other investment’ position, therefore it is held constant at 2011 levels.

Source: He, Dong, et al. 2012. “How Would Capital Account Liberalization Affect China's Capital Flows and the Renminbi Real Exchange Rates?” *China & World Economy* 20(6): 29-54.

Figure 5. Chinese Outward FDI in the Global Context

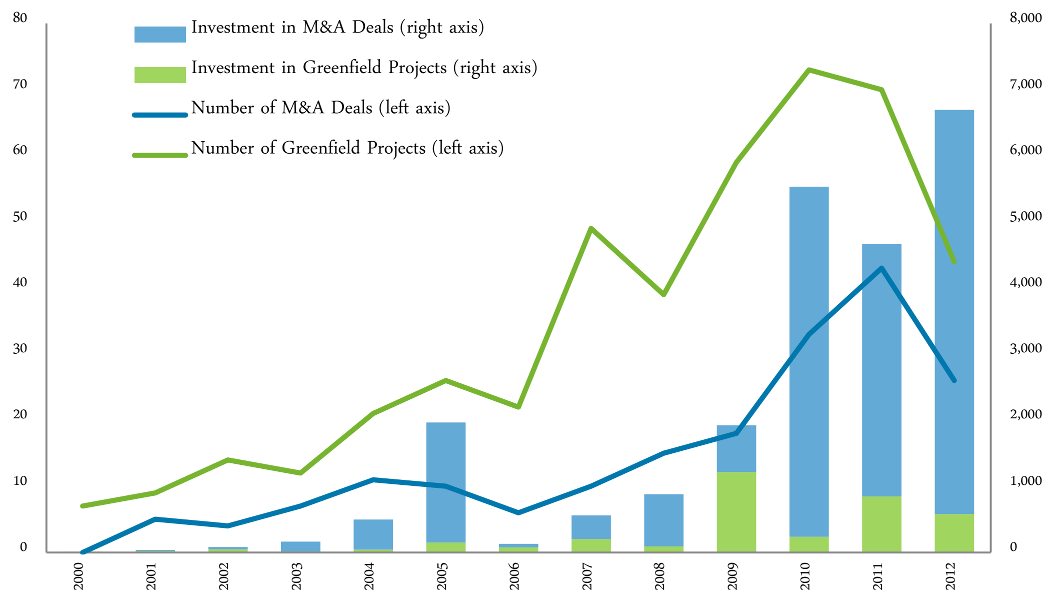
USD Billion, % Share of Total Global OFDI, 3-year Averages



Source: PBOC/SAFE (2013), UNCTAD (2013), Rhodium Group (2013).

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

Number of Deals and USD Million

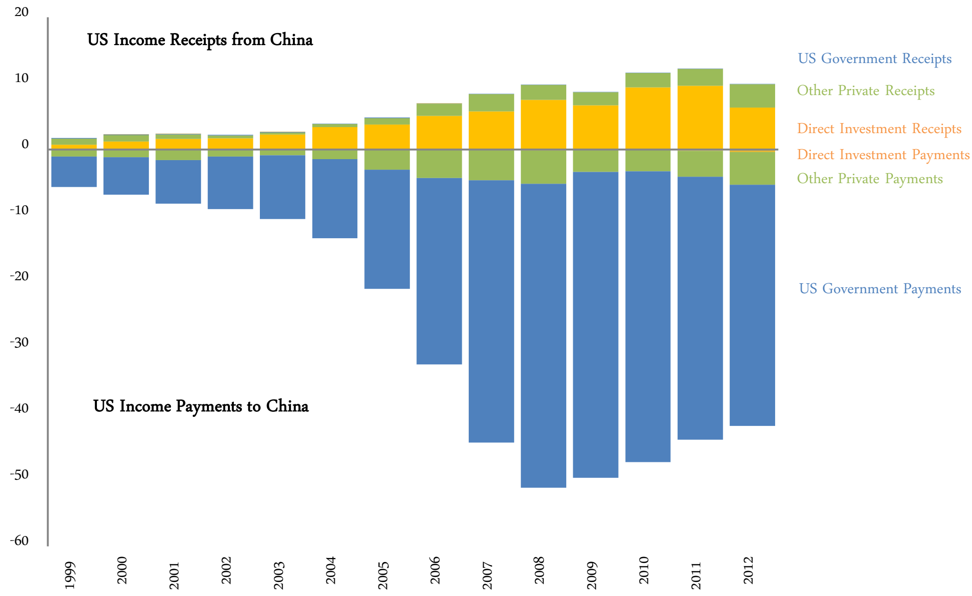


For updates and information on methodology see http://rhg.com/topics/cross-border-investment.

Source: Rhodium Group (2013).

Figure 7. Investment Income Flows between the United States and China

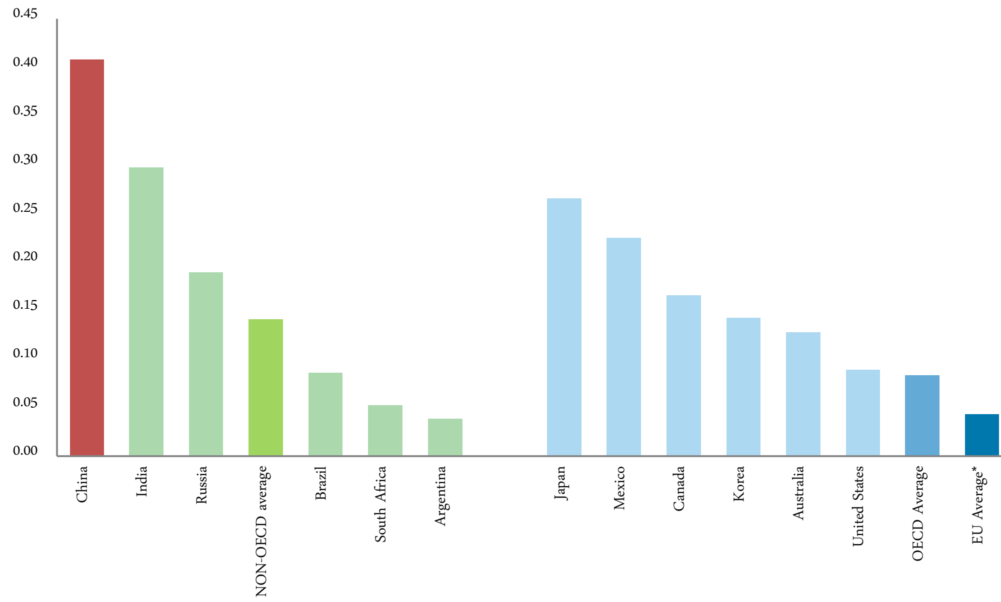
USD Billion



Source: BEA International Transactions (BEA 2013).

Figure 8. Formal FDI Restrictiveness, 2012

Index, 1=Closed; 0=Open

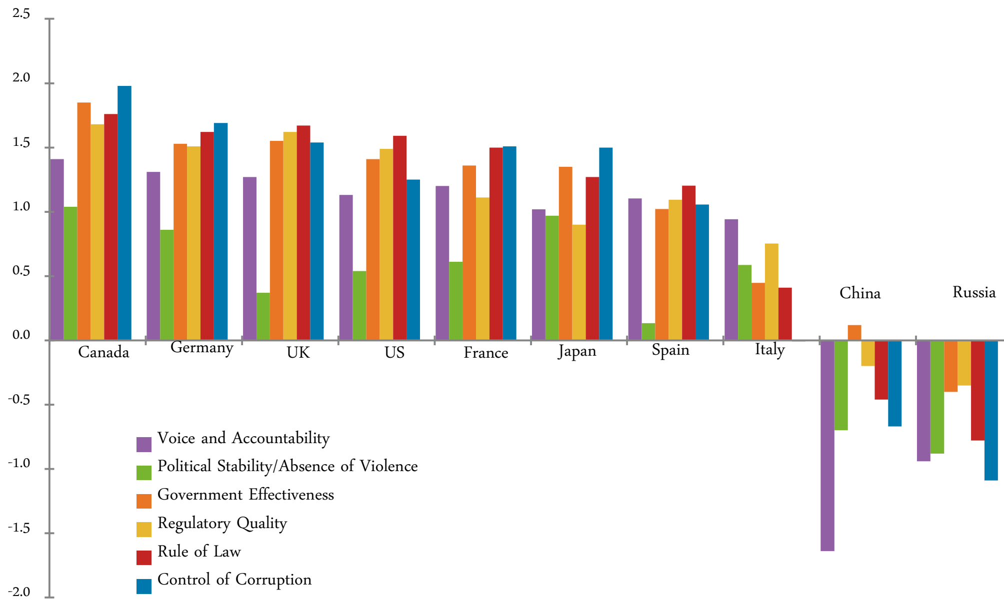


*Calculated based on available OECD data for 24 of 27 EU member countries.

Source: OECD (2013), Rhodium Group.

Figure 9. Governance Quality in the Top 10 Global Outward Investors, 2011*

Index, 2.5=High; -2.5=Low



*Based on average outward FDI flows in 2009-2011 and excludes smaller economies used for tax optimization such as Hong Kong, Belgium or Switzerland.

Source: World Bank (2013), UNCTAD (2013), Rhodium Group (2013).