Strategy Research Project

Chinese Foreign Direct Investment into the United States

by

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Class of 2014

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REPORT DOCUMENTATION PAGE		*Form Approved--OMB No. 0704-0188*

The public reporting burden for this collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing the burden, to Department of Defense, Washington Headquarters Services, Directorate for Information Operations and Reports (0704-0188), 1215 Jefferson Davis Highway, Suite 1204, Arlington, VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to any penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number. **PLEASE DO NOT RETURN YOUR FORM TO THE ABOVE ADDRESS.**

1. REPORT DATE *(DD-MM-YYYY)* 15-04-2014	**2. REPORT TYPE** STRATEGY RESEARCH PROJECT	**3. DATES COVERED** *(From - To)*
4. TITLE AND SUBTITLE Chinese Foreign Direct Investment into the United States		**5a. CONTRACT NUMBER**
		5b. GRANT NUMBER
		5c. PROGRAM ELEMENT NUMBER
6. AUTHOR(S) Lieutenant Colonel Mark Alan Sexton United States Marine Corps		**5d. PROJECT NUMBER**
		5e. TASK NUMBER
		5f. WORK UNIT NUMBER
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) Professor John F. Troxell Strategic Studies Institute		**8. PERFORMING ORGANIZATION REPORT NUMBER**
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES) U.S. Army War College, 122 Forbes Avenue, Carlisle, PA 17013		**10. SPONSOR/MONITOR'S ACRONYM(S)**
		11. SPONSOR/MONITOR'S REPORT NUMBER(S)

12. DISTRIBUTION / AVAILABILITY STATEMENT
Distribution A: Approved for Public Release. Distribution is Unlimited.

13. SUPPLEMENTARY NOTES
Word Count: 6,225

14. ABSTRACT
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15. SUBJECT TERMS
State Operated Enterprises, CFIUS, FDI

16. SECURITY CLASSIFICATION OF:			**17. LIMITATION OF ABSTRACT**	**18. NUMBER OF PAGES**	**19a. NAME OF RESPONSIBLE PERSON**
a. REPORT UU	**b. ABSTRACT** UU	**c. THIS PAGE** UU	UU	36	**19b. TELEPHONE NUMBER** *(w/ area code)*

Standard Form 298 (Rev. 8/98), Prescribed by ANSI Std. Z39.18

USAWC STRATEGY RESEARCH PROJECT

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This manuscript is submitted in partial fulfillment of the requirements of the Master of Strategic Studies Degree. The U.S. Army War College is accredited by the Commission on Higher Education of the Middle States Association of Colleges and Schools, 3624 Market Street, Philadelphia, PA 19104, (215) 662-5606. The Commission on Higher Education is an institutional accrediting agency recognized by the U.S. Secretary of Education and the Council for Higher Education Accreditation.

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Abstract

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Page Count: 36

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Classification: Unclassified

The wave of Chinese Foreign Direct Investment (FDI) into the United States serves as a means to address the current trade imbalance, reduce U.S. unemployment, and even encourage economic growth. However, U.S. critics point to the current Chinese policy of using subsidized State Operated Enterprises (SOEs) and using devalued currency to gain an unfair competitive advantage. In addition, there is an anxiety that the Chinese desire for economic transformation will facilitate the theft of U.S. intellectual property and technology. Understanding how the Chinese came to rely on SOEs and a devalued currency is crucial to understanding the current international economic environment. In addition, the U.S. historical and current reaction to FDI requires analysis as the two nations embark on an era of economic interdependence. In order to navigate the challenges and opportunities of this new reality, U.S. policy makers and the Communist Party of China will be required to foster economic strategies that not only maintain, but also advance the interest of both nations.

Chinese Foreign Direct Investment into the United States

For much of recorded history, China was the largest and most sophisticated economy in the world. This single country usually produced over 25% of the global collective Goss Domestic Product (GDP). China's civilization was supported by a self-sufficient economy and was a leading innovator of modern developments throughout most of its existence. Around 1600, the economic trajectories of the Western world and China began to significantly diverge.[1] The Chinese rulers failed to detect the relative decline of their civilization and remained convinced that the rest of the world (i.e. "barbarians") visited their kingdom solely to pay tribute or demonstrate fealty. In 1792 Chinese emperor Qianlong famously responded to King George III of England, arguably the most powerful man in the western world, that he should reframe from attempts at trade and "tremblingly obey and show no negligence" towards Chinese leadership.[2] Due to many factors combined with this arrogance, China would spend more than a century humiliated as an economic colony of imperial western powers and her GDP dipped below 10% of the global economy. In 1949 the victorious Communist Party granted China a reprieve from foreign influence. Three decades later, in 1979, China initiated economic reforms that generated an average annual GDP growth of 10%.[3] In addition, in 2000 China began making investments external to their own economy.[4] This Foreign Direct Investment (FDI) represents China's attempt to catch up and eventually surpass the economies of the western world, and by 2012 China has surpassed Japan to become the world's second largest economy. China has endured for over 4000 years as humankind's oldest and most remarkable civilization, and it seeks a return to its rightful place as the "eternal nation" and the most dynamic civilization that our species has ever produced.[5] The economic progress that China has experienced in recent decades is impressive. But in order to evaluate China's more recent "going-out" campaign, evidenced by extensive outward FDI, one must first understand China's approach to economic development since 1979.

Chinese Economic Development

In order to influence the new economic growth that began in 1979, the Chinese government leveraged state owned enterprises (SOEs) that accounted for almost 75% of the industrial production. Prior to the 1979 reforms, the government was careful to forbid private enterprises and foreign firms from controlling industrial output.[6] The SOE's operated in a closed, centrally planned economy. Foreign capital inflows and international trade was restricted to Soviet-block nations. The SOEs gained prominence and success through government support and provision. As a result, the economic power of SOEs was established and set the tone for the method in which China would choose to manage its economic growth going forward.

Following the death of Chairman Mao in 1976, the Chinese government began an economic reform focusing on the introduction of free market principals and the encouragement of foreign investment. They started with a relatively small step of allowing some carefully picked farmers to sell their crops on the free markets. In 1979 they initiated a larger move and created four economic free trade zones along the coast. The purpose of these zones was to attract foreign investment, boost exports, and serve as a conduit for importing technology into China.[7] The central government reduced economic control of the massive SOEs and delegated authority to regional and local level politicians. More importantly, state imposed price controls were relaxed and Foreign Direct investment (FDI) from developed economies began to slowly flow into

China.[8] From this point, the economy of China began to accelerate. On average since 1979, the economy of China has doubled every eight years.[9]

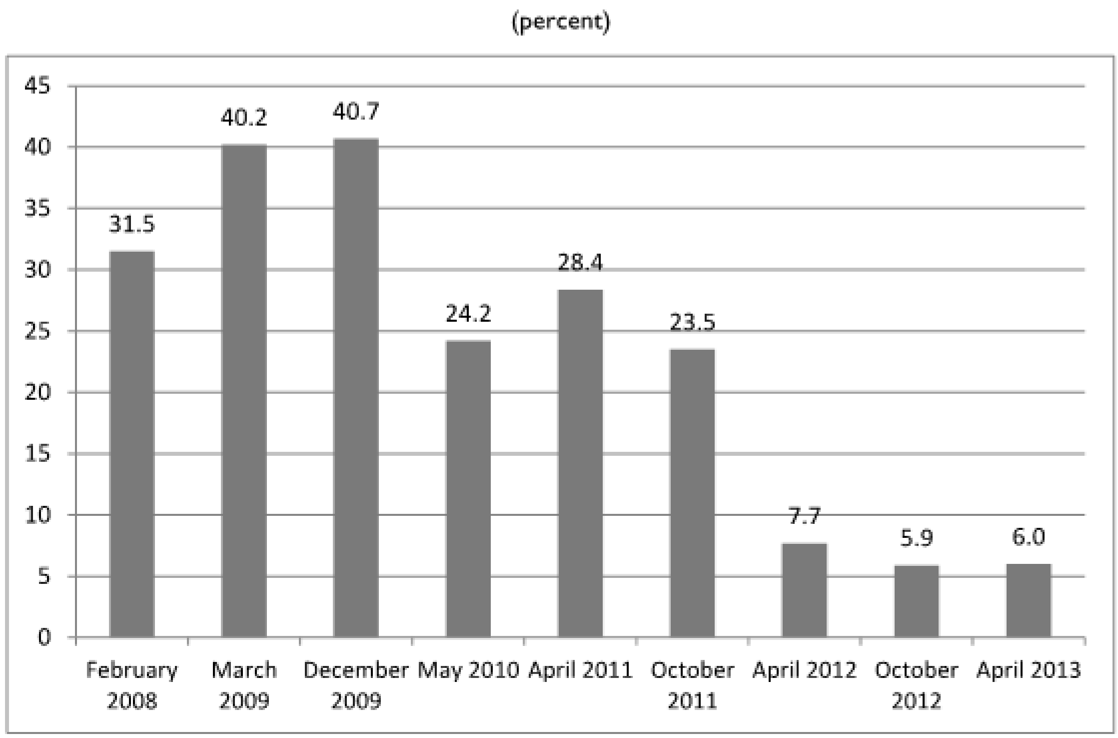
Most economists feel there were two main financial drivers, external to the government controls of the Chinese government, responsible for the auspicious rise in economic activity and prosperity of China during this period. Large amounts of foreign capital and domestic savings combined with a rapid rise of productivity growth drove the economic reemergence of China. Capital contributions merged with an energetic and productivity focused workforce and allowed China to transition from a strife weary and impoverished nation to a major global economic force in just over three short decades.[10]

Background on Currency Peg

In addition to the two main financial drivers of foreign capital and domestic savings, China also incorporated an aggressive monetary policy. In order to facilitate the investment of external capital in 1979, China developed a dual exchange rate system. The Chinese government artificially maintained the official rate while traders on the swap market maintained the market-based exchange rate. Most importers and exporters insisted on using the market-based exchange rate and naturally, the two separate rates diverged significantly. The Chinese government required the use of the official exchange rate for any domestic transactions involving foreign currency. As a result, a large black market developed around Chinese currency resulting in an inability of the Chinese government to maintain the fiction of a synthetic exchange rate. By 1993, the official exchange rate was 5.77 Chinese Renminbi Yuan (CNY) to the U.S. dollar, while the CNY was actually trading at 8.70 on the international currency markets. After repeated criticism by the U.S. government, China abolished the dual exchange rate system in 1994 and established the current peg at the market rate of 8.70 CNY to the U.S. dollar.[11]

Many investment analysts are concerned that China used monetary manipulation techniques, as opposed to the development of innovation and increased efficiency, to facilitate the investment capacity of Chinese capital. Reliable and transparent currency values are crucial when engaging in FDI. Especially in terms of ensuring a nation has adequate access to another nation's debt or company assets.[12] Direct manipulation of the CNY is considered by many investors to be a detractor in conducting business with Chinese SOEs and even non-government firms. The perception of an unfair financial advantage undermines the confidence that western investors place in Chinese companies. It makes them reluctant to invest and even skeptical of receiving Chinese capital. As Chinese FDI continues to play a role in the global economy, it will be important that western firms perceive the CNY as being relatively free of CCP (Communist Party of China) control and subject to the economic realities of the global marketplace.

Despite western financial media commentary, in 2005, the Chinese government actually took an unprecedented step and allowed the CNY to slowly appreciate. Although China set the benchmark against the exchange rate movements of a specific basket of currencies rather than the U.S. dollar, there was an appreciation. By 2008, the CNY was trading at 6.83 to the U.S. dollar, a significant appreciation from previous years. Essentially the Chinese government manipulated the currency through a 'managed float'. The CNY was allowed to fluctuate up to 0.3% and eventually 0.5% on a daily basis against the basket of currencies. In 2008, the Chinese government halted this appreciation in response to the global financial crisis and held the CNY at 6.83 until 2010. In 2010, China allowed the CNY to continue its rise within previous parameters; however, the CNY is still not a free-floating currency as the Chinese government carefully manages its appreciation.[13] In fact, in recent years, the Chinese government has actually allowed the CNY to appreciate rather significantly in terms of the USD. This relative appreciation has received little attention in the popular media. Currency manipulation was instrumental in the early economic development of China. As the role of FDI into China increased, concerns about the manipulated exchange rate grew. However, in the past two years, the impact of the manipulated rate has diminished and consequently receives less discussion. U.S. commentators complain about the Chinese currency peg, however this phenomenon tends to provide some benefits to both sides of the trade and is often more of a political concern than a genuine economic trepidation. For more clarity on the appreciation of the CNY in recent years, reference Figure 1 that illustrates its significant revaluation in the past few years. Currently the CNY trades at 6.05 to the U.S. dollar.[14]



Source: William R. Cline, Estimates of Fundamental Equilibrium Exchange Rates, Peterson Institute for International Economics, various years.

Figure 1: Timeline of Esitmates of the CNY's Undervalutaion Relative to the Dollar Using the FEER Method: 2008-2013[15]

<u>Predominance of State Operated Enterprises</u>

The real economic contention between China and the United States revolves around the artificial support and subsidies granted to the SOEs. The Chinese claim that China is a socialist-market economy and that financial and government support provided to SOEs is appropriate and proper. It is estimated that SOEs account for 50% of China's GDP and that they tend to dominate the crucial industries such as energy, telecommunications, and transportation. Of the 58 Chinese firms on the Fortune 500 list in 2011, the government had controlling equity interest in 54.[16]

SOEs experienced tremendous reform from 1979 to 1992 when the economy of China transformed from communist based to market based. Initially established to comply with government dictates in a command economy, SOEs transferred their focus from ‘plans and targets’ to ‘markets and profitability’. In order to raise capital, the newly reformed SOEs began to rely on loans from state banks as opposed to grants from the CCP. In addition, SOEs no longer brought workers and employees on board for life, but instead hired them with relatively shorter 5-year contracts. These reforms were incredibly successful and China experienced high economic growth and productivity output during this period. In fact, the success established a persisting mindset in the Chinese leadership and people during this time that a focus on competition and markets was more important to economic prosperity than individual private property rights.[17]

The second period of SOE reform occurred in 1993. The success of the Asian Tigers combined with the political unrest of the Tiananmen Square incident encouraged Chinese leaders to initiate additional reforms to the SOEs. The Company Law of 1994 initiated the policy of ‘grasping the large and letting go of the small.’ Essentially the CCP allowed lower level officials to manage and dispose of small unprofitable SOEs. Approximately 82% of the smaller SOEs underwent some form of restructuring. The government consolidated the larger and more important SOEs under the oversight of the State Asset Supervision and Administration Commission (SASAC). These companies became stock issuing corporations in which the CCP sold shares directly to employees or listed them on the Shenzhen, Shanghai, and Hong Kong stock exchanges. Private ownership was restricted to one third of the outstanding equity with the government retaining the remaining two thirds of ownership. Beginning in 2005, SOEs increased the amount of private ownership to two thirds.[18]

The overall intent of this pseudo privatization of SOEs was to bring in external capital to the firms. However, a study conducted by Jefferson and Su (2006) observed that although the assets of many prominent SOEs increased during this period, the CCP did not proportionately reduce their ownership in the firms. In effect, China simply took the money of foreign investors in exchange for highly diluted, lower tiered, equity that in reality had little to no value. Even more interesting, there are indications that the SOEs used the influx of capital to focus on more labor-intensive initiatives and consequently become more efficient without affecting their overall bottom line. As a result, the profitability of SOEs increased as a measure of return on investment. However, their profitability did not correspondingly increase as a profit-to-sales ratio. In essence, during this second period of reform, the CCP has been successful in using the private capital of its citizens and foreign investors to improve the productivity of its SOEs without significantly reducing its control stake or management of its SOEs.[19] These equity adjustments created a sense of unease and apprehension about conducting business with SOEs in the minds of many western investors. As China currently seeks to engage in increasing external global investments, these worries continue to resurface and must be addressed. Global investors will be skeptical of using FDI from Chinese firms if they feel these companies have misstated historical capital structures.

Perhaps the most distressing aspect of SOEs is their relationships with state sponsored Chinese banks. The CCP exercises tremendous control over the banking system and ensures that it maintains capital flows to selected SOEs. These fortunate SOEs generally receive lower interest rate loans and often are not even required to repay the loans. It seems that in some ways the banking system of China has difficulty understanding the basic concept of a commercial loan. Instead of adequately relying on risk, asset, and duration metrics for reviewing a loan, Chinese banks often think of loans as government grants or subsidies and rely more on political or policy metrics in reviewing loans to SOEs. As a result, government backed Chinese firms often saddle banks with a tremendous amount of bad debt. In 2009, SOEs accounted for over 85% ($1.4 Trillion) of all loans granted by the Chinese banking system. The World Bank estimates that more than 25% of Chinese SOEs actually loose money, but few, if any, become restricted or go bankrupt.[20] Even more disconcerting, the IMF published a report in 2013 estimating that the local government debt of China – or loans made by local banks to SOEs – is approaching $2 Trillion or 24% of China's GDP.[21]

Integrating SOEs into the western economy epitomizes the most difficult and contentious part of the Chinese and U.S. economic relationship. Because of the political and economic influence inherent in SOEs, they often have a significant advantage over a western firm that relies solely on its own economic prowess. In addition, China prefers to initiate the majority of its foreign investment through SOEs and is reluctant to trust private individuals with the investment of its national capital outside of its borders. As a result, the U.S. government often views Chinese investment into the United States with suspicion and western firms are often reluctant to engage in prospective deals with Chinese SOEs. In order for the U.S./China relationship to reach maximum utility the inherent controversy over SOEs will have to be resolved.

If indeed Chinese Foreign Direct Investment into the United States (FDIUS) is to be more attractive and palatable to the U.S. government as well as the market, SOEs need to transform into more acceptable business establishments. The SOEs need to be organizations based on economic principals as opposed to government institutions with political agendas. Unfortunately, this is not the case and most U.S. businessmen, for good reason, perceive Chinese SOEs as politically focused. Many critics of Chinese FDIUS point out that SOEs tend to focus on mergers and acquisitions that create a strategic advantage for the CCP – as opposed to the purchase and building of new factories that would create jobs and boost the local economy.[22]

The challenge for the CCP leadership is how to best ensure that SOEs remain viable entities for conducting FDIUS. If they continue to remain as state sponsored agents of economic influence, it will inevitably result in continued U.S. restrictions on Chinese investments. Much as the method employed for Chinese currency (e.g. a managed float), Chinese leadership needs to continue with a reform policy for SOEs. Some suggested reforms include an increased reliance on international debt and equity markets for capital as opposed to the current reliance on the state. Another reform could be to divest or break up some of the larger, more inefficient SOEs. It could be a relatively simple process to divest specific departments or divisions from the SOE and transfer them to private stockholders. This reform could have two positive effects. It would place more confidence in the economic intentions of SOE FDI as it could no longer be initiated simply for strategic reasons. SOE executives would have to consider economic and business requirements in light of market forces as opposed to government relationships. This would address the accusation that SOEs engage in FDIUS for political reasons only. In addition, and more pertinent to the survival of the CCP, it would relieve some pressure and responsibility of the CCP for management and target any domestic dissatisfaction with the poor performance of these firms away from the Chinese government.

Another area of SOE reform could be to initiate a recruiting and hiring process for international talent. Many executives of U.S. Multi-National Corporations (MNCs) are not originally from the U.S. and have foreign backgrounds and families. Although not usually led by non-citizens, most foreign MNCs employ diverse workforces comprised of individuals from many nations. Not only does this diversity allow the MNC to extend its aperture of critical and creative thinking, but also ensure that there is a significant trust factor when it deploys capital into foreign markets. Chinese SOEs should consider expanding their workforce to include other nations – especially for firms involved in some form of FDI.

In many ways, the necessity of relinquishing control of the SOEs is probably a little confusing and disconcerting for CCP leadership. As they embark on this next phase of economic development – “the going out campaign” – they may abandon the very techniques and practices that actually allowed the recent development of China thus far. One final and encouraging change in the outbound investment policy of China has been the recent impact of private Chinese firms. Although they have usually accounted for the majority of FDI deals, their capital contributions have naturally been relatively minor. For much of the past thirty years, SOEs typically dominated the arena and drew much of the U.S. government’s attention and angst. But, since 2012, private Chinese firms have begun to account for more than 50% of the Chinese FDI into the United States. [23] The consequences of this transformation are yet to be determined. Perhaps in the future it will be more important for smaller U.S. investment firms to understand and leverage FDI than in the past. Regardless U.S. policy makers must adjust to this new feature of FDI and ensure they update any antiquated methods derived from working solely with Chinese SOEs and large U.S. investment firms for the past three decades. Figure 2 illustrates the increased investments of private Chinese firms in comparison to SOEs in recent years.

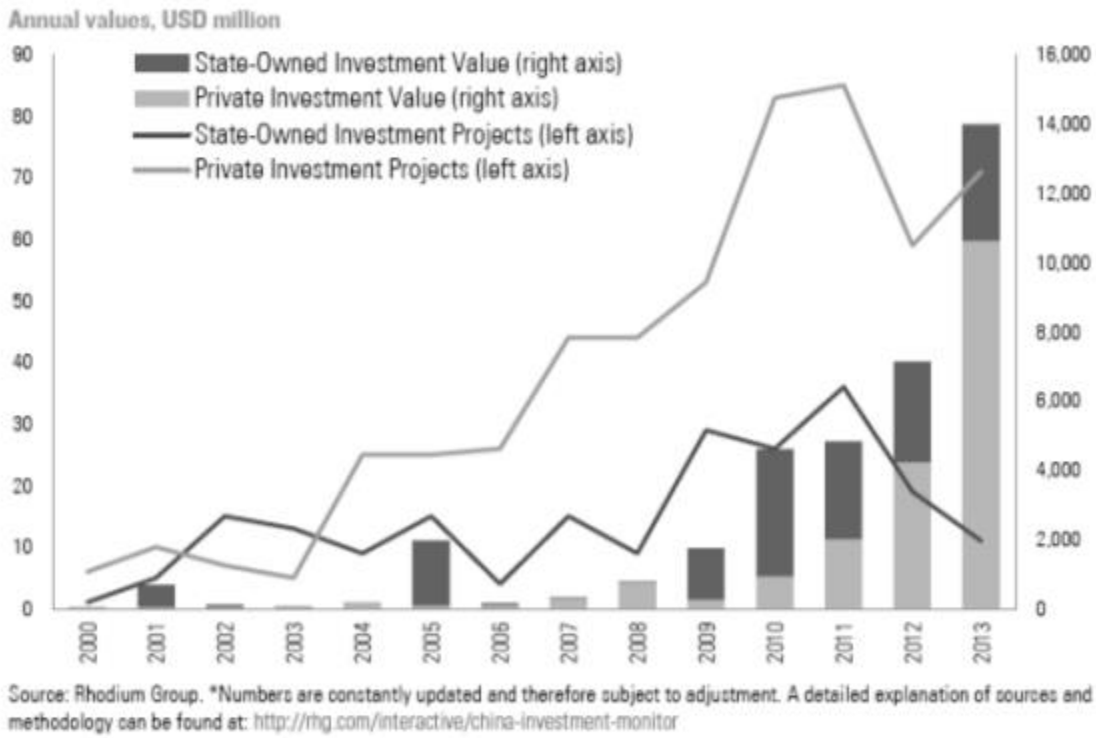


Figure 2: Chinese Direct Investment in the US by Ownership, 2000-2013[24]

Regardless of the investment vehicle, FDI is crucial to the economic relationship between China and the United States. China's past methods of conducting FDI primarily revolved around SOEs and, to a certain extent, through the control of its currency. The United States response has naturally been an attempt at regulation. As FDI deals shift from SOEs to private firms and the CNY ultimately appreciates, both nations will have to adjust. They will need to ensure their individual political policies, largely established for past realities, do not interfere with their mutual economic growth in the future.

Recent Historical Examples of FDI

A purely competitive environment would not allow FDI as local firms would be able to take advantage of time and geography to prevent foreign firms from gaining market share. Factors affecting FDI tend to revolve around market size, host country resources – both physical and cognitive, exchange rates, property rights, and artificial government incentives. For over half a century, the U.S. has been the dominant economic player in FDI. The conventional wisdom holds that the nation exporting capital and funds gains an economic advantage over the host nation and is able to impose its economic will on the country that accepts the FDI. However, despite its obvious economic advantage after World War II, the U.S. was unable to consistently manage its FDI to ensure an economic hegemony. Instead, it appears the more that U.S. MNCs attempted to exploit their advantage through FDI, the more they increased the economic competitiveness of their host nations and reduced their chances for monopolistic control. Today, the multi national economic world has many players, all able to compete and thrive in the economic market place.[25]

There are many examples of FDI that can provide insight and hopefully perspective into China's direct investment into the U.S. The first, and often overlooked, example occurred in the late 1960s when the U.S. made substantial investments in Europe. J.J Servan-Schreidber, a French writer in the 1960s, argued that these investments would establish a U.S. economic dominance of Europe and result in a world ruled by the U.S., the Soviet Union, and the MNCs controlling Europe. His predictions proved to be inaccurate, but it is interesting to note a xenophobic fear tends to accompany any sort of economic investment into a region or nation's economy.[26] As it turns out, the investments made by the U.S. firms into post-war Europe actually did, for a short and limited period, exploit the comparative advantage that the U.S. had over European nations in terms of process technology and managerial skills. The U.S. MNCs were able to take advantage of European inefficiencies and generate profits for themselves. However, the investments from the MNC, in the end, actually condensed the productivity and economic divergence between the two regions. Ultimately the positive spillover effects of FDI from the U.S. into Europe resulted in a reduction of the European inefficiencies and an increase in European competiveness. In essence, much like a riskless trading arbitrage that exploits a price divergence, the influx of investment compressed the divergence between the two economies, bringing both enterprises to the same level.[27]

Another analogy that analysts more commonly use in discussing Chinese FDIUS is the Japanese FDI into the U.S. during the 1980s. As early as 1980 the size of Japanese FDIUS was over $4 Billion accounting for 6.2% of all FDIUS. By the end of the decade that figure had risen to over $83 Billion and 21% of all FDIUS.[28] In correlation with the European reaction a decade earlier, the U.S. culturally resisted the process. Although many U.S. commentators at the time expressed concern about Japanese acquisition of physical assets, the real worry, was the size and magnitude of actual Japanese investments. Many Americans felt that U.S. firms were not competing directly with Japanese firms but were competing with 'Japan, Incorporated'. Japan's economic success was determined to be a function of its relationship between its corporations and its Ministry of International Trade and Industries. Much like the commentary today concerning Chinese FDIUS, U.S. politicians decried the erosion of U.S. political and economic sovereignty as money flowed into the U.S. economy from Japan.[29]

Accusations aside, many studies now suggest that the Japanese motivation for engaging in FDI was indeed economic, not political. Evidence seems to indicate that there was in fact no conspiracy by a corporation posing as a nation/state to take over the U.S. economically. Instead, the Japanese MNC investments were making sound economic decisions based on distortions in balance of payments, saving rate differentials, and nationally imposed corporate constraints.[30]

Typically, until this time, the U.S. government encouraged FDIUS and was slow to react to the impending economic 'threat' of the Japanese. It was not until the 1990s that the U.S. implemented administrative policies and encouraged trade reciprocity with Japan. Although slow to react, the eventual government reaction to Japanese FDI did illustrate that, contrary to popular opinion at the time, Japan was unable to use their growing economic power to influence lobbyists or politicians. The United States eventually imitated and inculcated appropriate management practices from Japan to become more productive. In effect, the U.S. economy used Japanese capital to increase the utility of domestic expenditures. Much like the phenomenon in Europe twenty years earlier, the comparative advantage of the Japanese MNCs eventually eroded and they retrenched in Japan.[31]

However, the Japanese FDIUS did bring about some policy changes for the U.S. government. The U.S. Congress amended The Defense Reduction Act of 1950 to include provisions that granted the President authority to suspend any FDI that threatens national security. In addition, they also permitted the divestiture of any foreign investment by executive order. Most importantly, for the coming exchange with China, a committee was established in 1975 that oversaw an FDI screening process that was significantly empowered to review FDIs for any security implications. The Committee on Foreign Investment in the United States (CFIUS) grew teeth and became a key organization for evaluating and managing FDIUS.[32]

There are in fact key similarities between Japanese FDIUS in the 1980s and Chinese FDIUS today. The most obvious is the motivation. China, like Japan in1980, views FDIUS as a means of protecting market share gained through exports. Also it is likely that both periods of FDIUS had or have some political motivation for engaging in the activity. Finally, the trade surplus experienced by both countries incentivized each of them to seek ways to diversify their excess capital into other areas besides U.S. bonds or securities.[33]

Although it is tempting to directly compare Japanese FDIUS to Chinese FDIUS, there are actually some key differences. Most obvious is that China is not an ally of the United States. Furthermore, China is not a liberal democracy. In short, there are significant ideological differences between the nations. The U.S. is inherently and naturally more uncomfortable in allowing investments from a nation that does not share its political values. Furthermore, although there was some anxiety that Japan was using a mercantilist system to finance its FDI, in hindsight, the investments were clearly made by private firms for economic reasons.[34] The reliance of Chinese SOEs on CCP endorsement and state banking support is a different story. The Chinese conduct business with a significant amount of government collusion and the U.S. is aware of its implications to Chinese FDIUS. As a result, a direct comparison with Japanese FDI in the 1980s is not completely valid and the U.S. is slightly more resistant to Chinese FDI, as well, it should be, as opposed to Japanese FDI in the 1980s.[35]

Balanced with the wariness of accepting FDI from subsidized SOEs is the realization that foregoing these opportunities results in a loss of opportunity. In terms of size, analysts estimate that the economy of China is in excess of $9 trillion and on track to surpass the $16 trillion economy of the United States in 2016.[36] At the end of 2013, China's treasury holdings of U.S. debt reached $1.317 trillion.[37] By these staggering figures, the total approximate FDI of $150 billion that flowed into the United States in 2013 is almost insignificant. Finally, even out of that relatively small number, only $14 billion came from China in 2013.[38] Refer to Figure 3 for a ranking of nations that insert FDI into the United States. As demonstrated by the chart, China's FDI is actually quite small in comparison to other nations. Yet, it is important to remember that Chinese total outbound FDI to all external nations approached $90 billion for 2013 and that FDI to the United States actually doubled for that year.[39] Based on these figures, it also means the United States failed to capture more than $76 billion of Chinese FDI as it went to other geographic areas. Some analysts speculate that Chinese FDI will total more than $2 trillion in the next eight years.[40] The implication of this figure is staggering, especially if the United States continues to be bypassed for other regions.

1	Netherlands	$29.9 bn
2	France	$21.7 bn
3	United Kingdom	$20.5 bn
4	Japan	$19.2 bn
5	Canada	$16.5 bn
6	Belgium	$11.9 bn
7	U.K. Islands, Caribbean	$7.7 bn
8	Luxembourg	$6.2 bn
9	South Korea	$5.2 bn
10	Hungary	$3.6 bn
11	Germany	$3.1 bn
12	Mexico	$2.8 bn
13	Sweden	$2.7 bn
14	Singapore	$2.7 bn
15	Italy	$2.0 bn
	* * *	
20	China	$1.4 bn

Source: BEA, International Transactions Account data.

Figure 3: 2012 FDI into the United States[41]

<u>The Committee on Foreign Investment in the United States (CFIUS)</u>

President Ford established CFIUS in 1975 to oversee foreign investment into the U.S. economy and determine national security implications. In addition, he also signed the International Investment Survey Act of 1976 that authorized the President to collect and use information on foreign investments in order to provide analysis to Congress, executive agencies, and the public.[42] However, by 1980 and potentially in response to Japanese FDIUS, most congressional members began to question the veracity of CFIUS. As a result, CFIUS stepped up its investigations and was instrumental in determining outcomes of various Japanese FDIUS deals that either ensured factories remained located in the U.S. and that classified projects remained firmly in the control of U.S. parent companies.[43] By 1988, congress approved the Exon-Florio provision of the Omnibus Trade and Competitiveness Act that granted authority to the President to block foreign investments due to national security concerns. In effect, the provision completely transformed CFIUS. Using Executive Order 12661, President Reagan delegated authority to CFIUS and converted the largely administrative body into an organization that possessed a powerful mandate and tremendous authority to make direct recommendations to the President as to which foreign transactions he should block.[44] Ultimately, in 1990 President George H.W. Bush made use of CFIUS and ordered the divestiture of the China National Aero-Technology Import and Export Corporation (CATIC) in its acquisition of MAMCO Manufacturing.[45]

Due to the proposed Dubai Ports World acquisition in 2006, President George W. Bush increased the administrative control of CFIUS by allowing the organization to reopen a review of any deal involving foreign investment. Up until then, international firms considered a positive review by CFIUS to be final and consequently most willingly submitted their prospective deals for scrutiny. However, the increased authority of CFIUS added tremendous uncertainty to foreign investments and drew extensive criticism from the international business community.[46]

Nevertheless, President Bush continued with his strengthening of CFIUS and signed the National Security Foreign Investment Reform and Strengthened Transparency Act of 2007 on January 23, 2008. Henceforth, the Secretary of the Treasury would be required to serve as Chairman of CFIUS and the Committee would consist of the Secretaries of State, Defense, Homeland Security, Commerce, and Energy as well as the Attorney General, the U.S. Trade Representative, and the Director of the Office of Science and Technology Policy. Also the law added the Director of Office and Management and Budget, the Chairman of the Council of Economic Advisors, the Assistant to the President for the National Security Affairs, the Assistant to the President for National Security Affairs, the Assistant to the President for Economic Policy, and the Assistant to the President for Homeland Security and Counterterrorism. In effect, the law transformed CFIUS from a developing administrative body that oversaw bureaucratic investment processes to a powerful, concentrated entity that contained incredible political influence in order to defend the economic power of the United State.[47]

<u>CFIUS Influence on Chinese FDIUS</u>

With a de facto mandate to simultaneously encourage yet at the same time scrutinize Chinese FDIUS, CFIUS was instrumental in denying several acquisitions by Chinese firms. Notably in a six month period between 2009 and 2010 CFIUS blocked acquisitions by Northwest Nonferrous International Investment Corp and Tangshaen Caofedian Investment Corporation. Both of these firms were subsidiaries of larger SOEs and their acquisitions had targeted either real estate in close proximity to sensitive U.S. military bases or controlling interest in a firm that developed fiber optic technology.[48] The most disturbing acquisition in 2013 of Chinese FDIUS involved the Wanxiang Group's purchase of A123 Systems, a manufacturer of lithium-ion batteries, for a cash value of $257 million. Before filing bankruptcy, A123 Systems had received half of a $250 million grant from the federal government. Without a doubt, the Wanxiang Group was able to use some of this U.S. taxpayer cash to finance the acquisition. Despite repeated protests from Congress and the Strategic Materials Advisory Group, CFIUS approved the purchase. Although this type of government inefficiency and miscommunication exposes the thoughtlessness of the federal government, it was determined that the acquisition did not threaten national security and CFIUS was powerless to block the acquisition.[49]

CFIUS also did not block the acquisition of Smithfield Food Inc. by Shuanghui International Holdings Ltd. for $4.7 billion. There was considerable public interest regarding this deal as Smithfield controls 26% of the domestic U.S. hog market. The National Farmers Union and the Center for Rural Affairs opposed the deal due to the concentration of the food market and because certain state laws prohibit the ownership of agricultural land by foreign entities. Many critics view the production of food as a security issue. They argued that a foreign firm –- especially if it is a SOE of a confrontational nation – should simply not have that much control over the well being of the U.S. population. A more compelling reason for blocking the deal was a concern over the genetic research used by Smithfield to produce particularly lean pigs and protecting the intellectual property rights of that research. Regardless, CFIUS did not oppose the deal and subsequently was criticized for being out of touch with what constitutes national security and ineffective in protecting U.S. interests.[50] This type of criticism encouraged the perception that CFIUS was often more concerned with developing FDI as opposed to overseeing concerns regarding national security. However there was really no indication that CFIUS failed to ensure national security.[51] In essence CFIUS followed its proper mandates and facilitated

The possibility that CFIUS was potentially ineffective combined with a rising number of Chinese investments in the United States prompted Congress to increase their scrutiny of Chinese FDIUS. On October 08, 2012, the House Permanent Select Committee on Intelligence provided some policy guidance for CFIUS. Most notable, a focus of the policy was an encouragement to block acquisition deals by Huawei and ZTE in order to protect U.S. telecommunications and other national security interests. In addition, CFIUS gained an expanded role to also monitor purchase agreements in addition to acquisition bids. One month later, the U.S. – China Economy and Security Review Commission published a report that indicated many Chinese companies often made investments into the U.S. for strategic reasons as opposed to economic reasons. In addition, the Chinese firms executing these transactions were insulated from market forces because of state sponsorship and thus not fully susceptible to economic influence. As a result, it recommended that CFIUS conduct reviews of all SOE acquisitions into the U.S. and determine not only if the deal threatened national security but also ensure that it comprised an economic benefit to the contributor. In addition, CFIUS should verify that the Chinese government did not prohibit acquisitions in similar Chinese industries by U.S. MNCs. Finally, the report indicated that Congress should enact legislation to extend the jurisdiction of CFIUS to include Chinese investments in new industrial plants and facilities or ‘greenfield’ projects that did not involve acquisitions of parent companies. Many of these recommendations may be difficult and costly to implement. However, as FDI from China continues to grow, the U.S. government will need to adopt more robust and stronger measures for overseeing this inflow of capital. Many of these recommendations should at least be given strong consideration at possibly implemented. Ultimately analysts predict the authority of CFIUS is likely to increase as critics become concerned that Chinese SOEs pose a risk to the national security of the U.S.[52]

Figure 4 illustrates the amount of all FDI deals reviewed by CFIUS in recent years. Although reviews of Chinese deals do indeed occur, other nations elicit scrutiny as well. The current small percentage of Chinese deals reviewed by CFIUS in comparison to other nations may surprise most commentators. However, it is likely that as Chinese FDI continues to rise in the coming years, CFIUS will review an increasing percentage of Chinese investments. The challenge for CFIUS will be to develop an environment that encourages Chinese FDI but at the same time protects the interests of the United States.

Country	Manufacturing	Finance, Information, and Services	Mining, Utilities, and Construction	Wholesale Trade and Retail Trade	Total
United Kingdom	44	37	8	2	91
France	14	4	4	3	25
Israel	13	9		2	24
Canada	3	9	10	2	24
Japan	4	8	6	1	19
China	8	3	4	1	16
Russian Fed.	6	3	2	1	12
Italy	8	2			10
Netherlands	2	4	1	1	8
Sweden	3	5			8
Total	**129**	**99**	**57**	**28**	**313**

Source: *Annual Report to Congress*, Committee on Foreign Investment in the United States, December 2011.

Figure 4: Country of Foreign Investor and Industry Reviewed by CFIUS, 2008-2012[53]

Conclusion

China is in the midst of a significant economic transition. The economic gains that it has experienced in the last few decades have been a function of its reliance on SOEs and a pegged currency. However, in order to ride the next wave of economic development it must be able to modify its economic practices to develop and incentivize private Chinese firms to execute FDI into the free markets of the west. These business modifications will require Chinese economic policy changes.

For their part, the policy makers of the United States will need to ensure the development of two, often conflicting, agendas. CFIUS will need to continue its vigilance in protecting the security of the United States. It cannot allow SOEs and other strategic initiatives from China to gain an unfair economic advantage in the domestic economy of the United States. From the other perspective, FDI capital from China that bypasses the United States for other regions could put the United States at a distinct economic detriment relative to other areas of the world. Encouraging FDI from China to the United States will be an imperative for present and future policy makers. Ultimately, maintaining the proper balance and tension between the two conflicting agendas will be a requirement for ensuring the prosperity and security of the United States.

FDI promises to be the economic unity of effort for China and the United States. Although the two nations will continue to have divergent political and social goals, they can both appreciate and understand the value of FDI in encouraging economic cooperation and prosperity. In essence, both nations will be able to reap benefits from Chinese FDI into the United States. It enables economic growth in the United States by providing investment and ensuring a rise in employment and capital expenditures. China, on the other hand, is able to benefit from the advantages of property rights and free markets of the west plus the innovative and technologically focused economy of the United States. In many ways, FDI represents the hope and promise of an international order that it is free of geopolitics and the adverse effects of nationalism. If managed correctly, it sets the stage for an era of cooperation and mutual prosperity as opposed to a period of strife and unbridled national competition.

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