AN AMERICAN OPEN DOOR?

Maximizing the Benefits of Chinese Foreign Direct Investment

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SPECIAL REPORT

Executive Summary

The coming decade will bring an unprecedented boom in Chinese capital seeking investment opportunities abroad, and will require Americans to respond to those flows. Foreign direct investment into China—mergers, acquisitions and greenfield investment in new facilities—played a major role in China's economic boom, and U.S. firms today account for $50 billion of nearly $1 trillion in such investment in China. Chinese direct investment abroad, on the other hand, has been slow to take off and, to date, mostly has been focused on securing raw materials. In past decades, few Chinese firms dreamed of direct investment in the United States: with their home market taking off and the challenges of operating in the United States daunting, they had little reason to do so.

Because competition and profitability in China now are changing rapidly, incentives for Chinese firms to invest in America also are changing. Indeed, the takeoff already has begun, and Chinese direct investment in the United States is soaring, both in value and number of deals. Businesses from China have established operations and created jobs in at least 35 of the 50 U.S. states and across dozens of industries in both manufacturing and services. Official data tend to obscure the exciting reality that the United States is open to Chinese investment and that that investment is, in fact, arriving in increasingly larger amounts—more than $5 billion in 2010 alone. The actual number of jobs that Chinese investors have created likely exceeds 10,000—many times the official estimate. And this is just the beginning. If China follows the pattern of other emerging nations, more than $1 *trillion* in direct Chinese investment will flow worldwide by 2020, a significant share of which will be destined for advanced markets such as the United States.

However, surging Chinese investment has triggered anxieties as well as excitement among Americans. Major Chinese investment overtures have foundered in recent years, creating uncertainty and ill will between the two nations. Though the legally mandated screening organ for national security risks, the Committee on Foreign Investment in the United States (CFIUS), generally has operated in a fair manner, bad publicity stirred up by the threat of congressional interference is having a chilling effect on Chinese readiness to invest in the United States by sending confusing and unclear messages. Nowadays, whenever a Chinese investment proposal is announced, the first question the media poses is not how many jobs it might create, but whether groups in Washington will try to block it, with little regard for whether there is actually any threat entailed. This is ironic, as most China-backed deals are not covered by CFIUS, and those that are almost always receive proper hearings. Moreover, because such hostile receptions scare away needed—and legitimate—investment, invite retaliation against U.S. firms abroad, and distract Americans from the serious task of assessing *real* security concerns, they are dangerous to the national interest. Here, the example of Japan is instructive. Japan's first investments in the United States during the 1980s were almost as controversial as China's, but in the following years, U.S. affiliates of Japanese companies invested hundreds of billions of dollars in the United States, and today employ nearly 700,000 Americans.

We conclude that the recent growth of Chinese direct investment in the United States is proof of its great potential, but given the parade of political fearmongering seen so far, those benefits likely will be squandered if steps are not taken to restore clear thinking. Therefore, we offer a series of recommendations intended to alleviate the risk of diverting Chinese direct investment from the United States by maintaining the best possible security screening process, keeping America's door open to the benefits of a China going global, and actively attracting the right investments from China so that the benefits for Americans are assured.

We summarize these recommendations here and elaborate on them at the conclusion.

1. Send a clear and bipartisan message that Chinese investment is welcome.

Though the annual numbers are doubling, there is a growing perception in China that the United States is not enthusiastic about Chinese investment. Washington must recapture the high ground on this topic by pointing to the healthy growth in those investment flows to date and by making clear that U.S. policy will remain accommodative. A bipartisan congressional–executive statement is needed to send an unequivocal message of support for increased investment from China. It is especially important that the U.S. Congress plays a positive role in this messaging given its oversight role and recent activism on foreign investment.

2. Systematize the promotion of FDI from China and elsewhere.

A review of U.S. efforts to attract investment from China and other countries is needed. The current laissez-faire approach stems from an era when the United States dominated global FDI flows; it assumes that the United States remains unrivaled in its attractiveness and functions as though all foreign investors come from similar countries that do not need much on-the-ground assistance. That situation has changed. More proactive measures are needed, not just at the state and local level, where earnest efforts are afoot, but also at the national level, where formal and informal barriers to foreign investment arise.

3. Protect the investment review process from interference.

The formal U.S. process of screening for national security concerns is generally well designed, but it is in urgent need of protection from politicization. If political interference is not tempered, some of the benefits of Chinese investment catalogued in this study—such as job creation, consumer welfare, and even contributions to U.S. infrastructure renewal—risk being diverted to U.S. competitors.

Some in China suggest that the United States publish a catalogue of open industries, just as the Chinese government does. While that suggestion is understandable in light of their recent experience, this approach is not suited to the United States. Within a given industry, there are acceptable and unacceptable investments, and it is impossible to anticipate all eventualities in advance. CFIUS is right to ask not whether China has hidden agendas and ambitions or whether a particular industry can be sensitive, but whether a specific deal constitutes an actual national security threat. In short, the existing U.S. review policy process is worth protecting.

CFIUS should further improve the transparency of its decision-making process and find ways to offer even better assurance that it is keeping to its mandate of solely screening investment for national security threats. Calls to alter the review process in ways that would allow *further* interference—by allowing national *economic* security questions to be subject to review, for example—must be rejected.

4. Work to better understand Chinese motives.

Many Americans—including many officials in Washington—believe that because China has so many state-owned enterprises, market forces and profit motives do not necessarily apply in that country. Therefore, they suspect that if a Chinese firm is coming to America, it must be for some political purpose rather than simply to make money.

This conclusion is wrong, and if we are to maximize U.S. interests, such misapprehensions must be corrected. But making clear that behind all of the rhetoric of statism and central planning, China's firms typically put self-interest and profit above else, is no easy task. The proponents and beneficiaries of Chinese investment in the United States—including deal makers, venture partners, sellers, and localities—need to bear more of the burden of demonstrating this market orientation. By issuing the kind of bipartisan statement suggested earlier, U.S. policy makers can contribute to this reappraisal of Chinese objectives. And, of course, economists and policy analysts must redouble their efforts to make China comprehensible to both U.S. leaders and the general public.

5. Communicate to China its share of the burden.

China very much shares responsibility for the breadth of American misgivings. After all, at state-related firms, especially the major state-owned enterprises, which make up almost half of all industrial assets, business decisions routinely are subjected to political considerations and executives are beholden to the dictates of the Chinese Communist Party. Even at private firms, nontransparent governance practices are common. And while this opacity may be about shrouding the profit streams of privileged individuals more than anything else, American screeners cannot discreetly avert their gaze as Chinese regulators and bureaucrats do. If China wants a more straightforward hearing for its firms in Washington, it must improve corporate governance at home.

We recommend that U.S. officials reclaim the high road from commentators who allege that Washington is unfairly blocking foreign firms, and call for a major improvement in Chinese corporate transparency so that regulators can do their jobs more easily. Other measures can help as well. A clearer separation between Chinese regulators and the firms they oversee would help alleviate foreign suspicions. A consumer-oriented welfare test in China's competition policy also would help ensure that market performance, not other state objectives, is the determinant of a given Chinese firm's behavior.

Of course, if China were to dismantle its system of state capitalism, U.S. officials would be far less worried about Chinese corporate intentions and the prospect of predatory intent from the firms under Beijing's influence. But Americans should not expect China to change overnight. In the meantime, it should be clear that while Chinese investment is more than welcome, U.S. regulators have a legitimate interest in who is investing in the United States.

6. Remain open to "what if" scenarios.

In terms of nontraditional economic threats, U.S. concerns that China could become a large enough economy to be a *price maker* instead of a *price taker* are legitimate. If China's sheer size, combined with its artificial pricing structures (e.g., the cost of capital arising from financial repression) were to "poison" global markets in the future, as Chinese outflows make up an ever more influential share of world totals, then a subsidy-disciplining regime for global direct investment akin to that for trade would become necessary. We suspect that China's existing statist preferences will break down prior to that point, but we cannot be sure. There is no consensus on how to assess "unfair" influence of one nation's domestic capital costs on world prices. Therefore, we recommend an international effort to think through these questions now, because answers may well be needed in the near future.

7. Do not play the reciprocity game.

The term "reciprocity" has been used too frequently in the context of Chinese investment—namely, if China is discriminatory against U.S. investment, the United States should reciprocate in kind. We recommend greater caution. China does maintain significant inward investment restrictions, but Beijing has been a leader in direct investment openness for decades, and the notion of withholding U.S. investment access for more access in China is both foolish and against American interests. Yes, U.S. negotiators must press China to open wider to U.S. investors. But it is emphatically in America's interests to separate that effort from whether to permit cash to flow from China into the United States. The United States should welcome capital from China, regardless of what Beijing's state planners have to say about foreign investment in China. For 30 years, China has grown stronger by opening its door wider to FDI, irrespective of overseas openness. The United States should do the same, or risk Chinese firms setting up plants in Ontario instead of Michigan, or Juarez instead of El Paso.

8. Get our own house in order.

Finally, a review of history reveals that inward investment indicates neither weakness nor strength. Foreign investment, Chinese or otherwise, has long entered the United States, and it has done so for multiple reasons. Investors looking for fire sale steals will swarm around properties in bankruptcy. On the other hand, for a century and a half, investors have flocked to the United States because of the vibrancy and stability of our economy. In the future, the United States will attract the most desirable forms of foreign investment as long as it addresses its economic and policy problems at home.

Some are concerned that China will cash in its U.S. debt holdings and make direct investments instead. We do not see this happening. China is growing both its portfolio and direct holdings in the United States at the same time. Whether it continues to do so is a business question—does the United States present a superior investment opportunity?—rather than a political question.

The United States and China are at a turning point in their economic relationship. In the past, direct investment flowed predominantly from the "developed world" to the "developing world," from countries such as the United States to China. In the future, China will invest sums abroad as vast as those that foreigners continue to place in China. How well the United States adjusts to this sea change will have a profound impact on its economic interests in the decades ahead, and set the tone for the larger U.S.–China relationship. This study will help America maximize its benefits from the boom without sacrificing security by dissecting the patterns and motives behind China's direct investment flows and discussing their potential impacts on the United States.

The China Investment Monitor

Parallel to the release of this report, the Rhodium Group (RHG) has launched the China Investment Monitor (CIM), an interactive web application that allows users to explore the patterns of Chinese FDI in the United States. The CIM website will provide regular updates on Chinese investment in the United States and commentaries on specific deals and related topics. Please visit **cim.rhgroup.net**