Testimony before the U.S.-China Economic and Security Review Commission

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Regarding Chinese Investment in the United States

Vice Chairman Slane, Commissioner Wessel, members of the Commission: thank you for this opportunity to participate in a very timely hearing.

My colleagues at the Rhodium Group and I have been following and analyzing China's outward investment for more than 5 years. In June 2009, we published a Peterson Institute policy brief on the drivers and policy implications of these new investment flows, which I have submitted to the record. This year we will release 2 more studies on the topic, starting in early May with an analysis of Chinese direct investment in the United States co-sponsored by the Asia Society and the Woodrow Wilson Center for Scholars. Based on this research I can help answer a number of the questions you have set out for this hearing. In this opening statement I will present up to date numbers on Chinese investment and address questions about our policy processes, and then summarize several important conclusions from our current work.

1. The Numbers

It is clear from the questions posed by the Commission that your interest today is in direct investment, as opposed to portfolio investment. Today the value of Chinese direct investment in the US is very modest, representing just 0.1 percent of all foreign direct investment (FDI) in the US. According to official estimates, total Chinese holdings of US treasury bills and other portfolio securities are 700 times greater than China's FDI assets in the US, so the latter is indeed still marginal.

But with the benefit of real-time methodologies such as we have chosen to employ in our current work we can see that an upward inflection in the annual flows has already started. I am happy to go into that methodology later, but it is important to point out at the start that we elect to measure *Chinese controlled assets* in the US, not just net-FDI inflows.

In both 2009 and 2010 China's FDI in the US increased 130% year-on-year. The full year 2010 flow was in the vicinity of $5.3 billion, bringing the accumulated Chinese direct investment in the US to roughly $11.6 billion since 2003. A major virtue of our granular, bottom-up tally of Chinese FDI deals in the US is that we can observe many characteristics and patterns that are hard to see in traditional balance of payments (BOP) data. Let me preview 3 for you:

First, we have found that 75% of the 244 Chinese investments in the US that we recorded between 2003 and 2010 were done by private or publicly held firms, as opposed to government-controlled companies. In terms of value, the government-owned share is higher, but in both cases the share of government-controlled firms is lower than that for Chinese investment globally.

Second, the sectoral distribution of this investment is very broad. There is greater than $100 million in Chinese direct investment in no fewer than 16 different US industries; 10 of these are manufacturing-related and 6 are service. These range from higher-technology industries to less sophisticated.

Third, in terms of the investment structures used, there is also great diversity: there is no indication of a coordinated template for approaching the US investment market. Chinese investments are more or less evenly split between greenfield overtures and mergers and acquisitions (M&A), a somewhat surprising reality given the common assumption that making greenfield investments is too challenging for most Chinese firms.

There are many other data fields in our work which we hope to have completed and available for presentation within 6 weeks. However I wish to add one critical qualitative characterization to these quantitative metrics now: namely, that commercial forces are the most significant driver of the upward inflection in US direct investment by Chinese firms we are observing today.

2. The Policy and Politics

A number of the Commission's questions concern the effectiveness and coverage of US regimes and regulations governing foreign direct investment from China. We explore this topic at length in our forthcoming work and I would be pleased to respond to your specific questions today.

As an initial summary, I would say that Chinese direct investment is well screened for national security considerations under existing US law and policy processes. I do not perceive flaws in US policy which would permit specific threats to slip through, which would be prevented by a "better" regulatory regime. On the other hand, I am greatly concerned that incendiary politicization of specific investments and over-zealous insinuation of mal-intent can and do interfere with efficient functioning of the national security screening process.

When we talk about the adequacy of US policy, we are usually talking about the screening process that I just commented on. However the time has come to add to the discussion an appraisal of the positive side of our policy efforts, that is, whether we are doing everything we should be doing to actively *promote* direct investment, including Chinese, in the United States. We think that a review of our efforts to attract Chinese investment is needed. The current laissez-faire approach stems from an era when the US dominated global FDI flows, and assumes the US is unrivaled in its attractiveness, and that our foreign investors come from similar countries and don't need on the ground assistance. That situation has changed. More proactive measures not just at the state and local level, where earnest efforts are afoot, but at the national level to reduce barriers and increase the attraction of the US economy now need to be considered.

3. Most Important Conclusions

I will finish my initial remarks by summarizing two conclusions from our forthcoming study. The unintended consequences of interference in the screening process is the first. With 2010 Chinese investment in the US up 130% year on year, the Chinese public should be singing the praises of the United States as a role model for international investment openness. Instead, as a result of hostile allegations from various interested parties inside and outside the US government concerning deals which in some cases involve no national security concerns whatsoever, the perception in China today is that the US is using FDI screening to pursue mercantilist objectives. That is highly regrettable, for many reasons, including the irony of such appearances coming from China, and the fact that protectionists in China are handed a perfect excuse to initiate similar screening of US investments in China which have never formally been imposed before. In dollar terms, precise numbers are hard to offer, but I think it is safe to say that poisoning the US atmosphere for Chinese investors would likely divert tens of billions of dollars of capital from American states and towns to beneficiaries in Canada, Europe, Japan and other competing economies between now and 2020.

Second, and finally, I would like to point out that direct investment is not a substitute for portfolio investment. The growth of direct investment in the US by Chinese firms does not imply a reduction in Chinese Treasury bill holdings. One does not simply switch out of bonds and into bricks and mortar assets which must be run in compliance with foreign laws, cultures and business conditions. Further, as our methodology makes explicit, the value of Chinese assets in the US includes local financing, not just cash brought in from Beijing. If US government debt remains the most reliable store of value in the world, then China – both sovereign and private – will continue to hold it; if the US market remains the most innovative, largest and attractive in the world, then Chinese firms – both state-related and private – will seek to make direct investments here. This is not an either/or phenomenon.

There are a great number of other points of interest on this topic which I believe are worth your attention, and I do hope we will have an opportunity to explore many of those in question and answer.

Thank you.