An Allied Response to Chinese Investment

ROD HUNTER

The Chinese investment is raising concerns across advanced countries. With Chinese outbound investment approaching $200 billion in 2016, Chinese investors are increasingly seeking to acquire companies in sensitive industries, with investment patterns tracking Chinese government industrial policy. Meanwhile, the Chinese government restricts access for foreign investors to its own market, often imposing technology transfer obligations where investments are allowed.

The influx of Chinese investment into advanced markets combined with restrictions at home is stoking concerns ranging from national security to fairness. Chinese investment bring benefits for advanced markets, but the Chinese state's involvement and the lack of reciprocity undermine support for the open investment regimes of advanced economies. Europe, Japan, and the United States should coordinate to address security, competitiveness, and reciprocity concerns.

Chinese investment has raised concerns across advanced markets as investors from China have sought to buy assets in sensitive and politically salient sectors ranging from semiconductors, to robotics, to food and agriculture. In 2016, outbound Chinese investment reached nearly $200 billion, with roughly half of that amount going to Europe and North America.[1] The influx of investment into advanced markets has prompted concerns ranging from national security, to competitiveness, to lack of reciprocal access to the Chinese market, and even to food security. While the investment flows are a positive trend reflecting China's economic integration, Europe, Japan, and the United States should coordinate to address legitimate national security risks and to seek reciprocal access to the Chinese market.

Investment Flows, Stock, Restrictiveness

Chinese outbound investment is reaching new heights, and in many respects these investment flows reflect a normal balancing given the size of the country's economy. In 2016, $94 billion in Chinese outbound investment went to the advanced markets of North America and Europe. Chinese investments in the United States tripled and in Europe doubled in 2016 over 2015. Before 2008, North America and Europe received less than $1 billion per year. The great increases of investment into advanced markets has prompted a number of concerns around issues of national security and sensitive industries to food security and competitiveness. Further, there is the issue of fairness, as access to investment in the Chinese market is much more guarded. The increased investment flows are positive overall,

1 DeFranco, Michael F., and Dr. Thomas Gilles, "Rising Influence: Assessing China's Record FDI Surge in North America and Europe," Baker McKenzie, March 7, 2017.

and indicate that China is continuing to integrate into Western economic systems. However, there are legitimate national security risks. Europe, Japan, and the United States should coordinate to address these challenges and to seek reciprocal access to the Chinese market.

In the United States, Chinese investment in 2016 concentrated on real estate ($17.4 billion); transport, utilities and infrastructure ($6 billion); consumer products and services ($5.7 billion); and entertainment ($4.8 billion); electronics ($4.3 billion); and health and biotechnology ($1 billion). In Europe, Chinese investors' biggest targets were information and communication technologies ($13.7 billion); transport, utilities and infrastructure ($12.2 billion); industrial machinery ($6.2 billion); entertainment ($2.9 billion); real estate ($2.9 billion); and consumer products and services ($1.9 billion).[2]

While the numbers are impressive, the Chinese outbound investment flows as a share of China's Gross Domestic Product are in conventional ranges. Looking at 2015 OECD data,[3] Chinese outbound investment flows represented 1.73 percent of Chinese GDP, while the United States' outbound investment represented 1.79 percent. The European Union (3.22 percent of GDP) and Japan (3.13 percent) had higher outbound investment flow percentages.

A look at foreign investment stocks, or accumulated foreign direct investment, provides further context. 2015 OECD data on FDI stocks as a percentage of GDP indicate the following[4]:

European Union

- Outward FDI — 55 percent
- Inward FDI — 47 inward

Japan

- Outward FDI — 30 percent
- Inward FDI — 4 percent

United States

- Outward FDI — 32 percent of GDP
- Inward FDI — 31 percent

China

- Outward FDI — 10 percent
- Inward FDI — 26 percent

In short, given the size of its economy, China has a relatively low level of direct investment stock in other countries at 10 percent of GDP. While its inbound investment is at a higher level than Japan's very low four percent, it is also still relatively low at 26 percent when the international average is close to a third.

The OECD's index of foreign investment restrictiveness may point to why China's inbound FDI is relatively low, and why international businesses complain about lack of access. The OECD has collected data on the restrictiveness of countries toward foreign direct investment, taking into account foreign equity restrictions, discriminatory screening mechanisms, restrictions on key foreign personnel and operational restrictions.[5] The OECD index rates countries on a scale of 0 to 1, with 0 being open and 1 being closed. Japan (0.052), the United States (0.089) and European countries (e.g. France at 0.045, Germany 0.023) all rate as open to foreign investment. By contrast, China (0.327) has one of the world's most restrictive investment regimes, surpassed only by the likes of Myanmar, Saudi Arabia and the Philippines. Even India is more open to foreign investment than China, according to the OECD index.

Benefits of Foreign Investment

There are good reasons for Chinese outbound investment into the advanced markets of Europe, Japan, and the United States. As noted, China's current stock of overseas investment, at 10 percent of GDP, is low relative to the size of its economy, so it is not surprising that there would be "catch-up" outbound investment. Moreover, for individual Chinese investors, there are many sound commercial reasons for such foreign investments: diversification

2 Ibid

3 OECD, FDI flows (indicator), 2017. doi: 10.1787/99f6e393-en.

4 OECD, FDI stocks (indicator), 2017. doi: 10.1787/80eca1f9-en.

5 OECD, FDI restrictiveness (indicator), 2017. doi: 10.1787/c176b7fa-en.

of assets and markets, getting closer to consumers, creating production platforms behind tariff and other trade barriers, acquiring know-how to move up the value chain, etc.

Conversely, foreign investment brings important benefits to host markets. As the Obama administration outlined in 2013,[6] value-added by majority-owned U.S. affiliates of foreign companies accounted for 4.7 percent of total U.S. private output in 2011. These firms employed 5.6 million people in the United States, about 4 percent of private-sector employment. These affiliates account for 10 percent of U.S. private investment and 16 percent of U.S. private research and development spending. Finally, compensation at U.S. affiliates is higher than the U.S. average. The positive implications of foreign investment in other markets are similar.[7]

Concerns with Chinese Investment

For all the benefits, Chinese capital flows have brought into high relief political and policy concerns, especially given the expansive role of the state in the Chinese economy. Security concerns have attracted attention of officials in the United States and in other advanced markets. For example, the U.S. President's Council of Advisors on Science and Technology (PCAST) released earlier this year a report on semiconductor innovation, competitiveness and security.[8] That report outlined Chinese industrial policies to achieve, for economic and security purposes, the commanding heights of the semiconductor industry through government spending, including $150 billion in public and state-influenced funds over a decade. PCAST recommended a series of policy actions, including closer scrutiny of Chinese investments in the tech sector.

6 Office of the Press Secretary, "New Report: Foreign Direct Investment In the United States," October 31, 2013.

7 Mathur, Aparna and Robert J. Shapiro, "How India Can Attract More Foreign Direct Investment, Create Jobs, and Increase GDP: The Benefits of Respecting the Intellectual Property Rights of Foreign Pharmaceutical Prodcuers," Sonecon, January, 2014.

8 President's Council of Advisors on Science and Technology, "Report to The President Ensuring Long-Term U.S. Leadership in Semiconductors," January 2017.

Relatedly, President Obama blocked last year the sale of the U.S. assets of Aixtron SE, a German semiconductor-equipment supplier, to a Grand Chip Investment GmbH, a Chinese-owned firm. "The national security risk posed by the transaction relate[d], among other things, to the military applications of the overall technical body of knowledge and experience of Aixtron," according to the Treasury Department.[9] While the Presidential order related only to the U.S. part of Aixtron, the Chinese firm ultimately walked away from the entire transaction after the German government reopened its own review process.

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Chinese investments have also heightened industrial policy and competitiveness concerns, not least given the alignment of the investment patterns described above with industrial policies set out in Five Year Plans.[10] Recent Five Year Plans have prioritized information and communication technologies, industrial machinery, and biotech, each being high on the U.S. and European acquisition tallies. Policymakers and businesses worry that Chinese companies, often state-owned or supported, are buying up technologies developed in advanced economies. Indeed, the German, French and Italian governments wrote to the European Commission in February 2017 arguing that EU member states should have broader latitude under EU law to block foreign acquisitions that are "unfair…because they rely on state funds or are aimed at buying up important technologies."[11]

These concerns are exacerbated by the lack of reciprocal access to the Chinese market. As noted, the OECD investment restrictiveness index rates

9 U.S. Department of the Treasury, "Statement on the President's Decision Regarding the U.S. business of Aixtron SE," December 2, 2016.

10 Larres, Klaus, "China and Germany: The Honeymoon Is Over," The Diplomat, November 16, 2016.

11 Chazan, Guy, "EU capitals seek stronger right of veto on Chinese takeovers," Financial Times, February 14, 2017.

China as one of the world's most restricted markets. Advanced economy companies have found that whole sectors are off-limits in China. Some sectors involving information technology that were open for competition previously have been effectively closed over the past five years. Lack of access to the Chinese market has led to calls for making access to advanced markets conditional on China (and other restricted markets) providing equal investment opportunities.[12]

There have been earlier waves of concern about foreign investment, certainly in the United States. In the 1980s and early 1990s, the focus was on Japanese and Middle Eastern investment. Indeed, President Trump was at the time critical of what he viewed as a lack of reciprocal access to the Japanese market for U.S. investors.[13] Similarly, there have been periodic eruptions in Europe and Japan over foreign acquisitions. What makes Chinese investment so sensitive, however, is the role of the state and a perception that China is both an economic and security competitor.

Host Country Investment Regimes

Most advanced countries have some form of foreign investment vetting process, though there is wide diversity in the scope and structure of regimes across Europe, Japan, and North America. Some European countries have powers to review and/or block non-EU origin investments in sensitive or strategic sectors such as defense production (see, e.g., France, German, and the United Kingdom), and policymakers in countries such as Germany, France, Italy and the United Kingdom have suggested it may be time to review those frameworks. Japan similarly has powers to vet acquisitions in designated sectors. The U.S. process focuses exclusively on national security threats, though there is discussion in Congress of modifying the review process to assess economic benefits or reciprocal access. Not only are the legal regimes different, but the approach of regulators varies, with some (e.g., in the United States) being exacting in their scrutiny and others less so.

12 Pittenger, Robert et al., Letter to GAO reviewing CFIUS Report, September 15, 2016.

13 Plaskin, Glenn, "Playboy Interview: Donald Trump (1990)," Playboy, March 14, 2016.

Trilateral Cooperation

As President Ronald Reagan declared when issuing his international investment strategy in 1983, "[i]nternational direct investment plays a vital and expanding role in the world economy."[14] Market-driven investment flows benefit advanced economies as much as emerging markets such as China. Major countries — advanced countries and China included — understandably assess national security implications of investment. However, the Chinese government roles in guiding industrial policy and in restricting access to the Chinese market create a challenge for maintaining support for the openness so essential for the international economy.

Europe, Japan, and the United States should work together on investment policy, to ensure that legitimate security interests are protected while using their joint leverage to encourage China to open its market for investment and trade. The G7 could provide a useful platform for that coordination. First, security. While national security is best dealt with at the national level, there is an opportunity for advanced economies to align their review processes and to share assessments on security vulnerabilities and threats. Common approaches could ensure more effective protection of legitimate national security risks while allaying more far-fetched concerns that unnecessarily impede useful investments. The greater coordination could have the added advantage of creating greater regulatory certainty for Chinese and other investors over time.

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Second, fairness and reciprocal access. As noted, China has one of the world's most restrictive investment environments. Companies from advanced markets find themselves increasingly competing in advanced markets with Chinese firms while China limits access to the its market. Not surprisingly, this

14 Reagan, Ronald, "Statement on International Investment Policy," September 9, 1983. Online by Gerhard Peters and John T. Woolley, The American Presidency Project..

un-level playing field has undermined support for the international trading system. Advanced countries have individually sought to encourage China to provide market access. Japan has already negotiated bilateral investment agreements to facilitate investment, and both the EU and United States are working on their own treaties with China. Moreover, just as Congress is considering revising the U.S. investment regime, Germany, France and Italy have urged the Commission to consider modifications to EU rules to address lack of perceived fairness and access. Coordinating through the G7, the advanced economies could work together to encourage China to open its market to foreign investment, perhaps consolidating their investment negotiations with China into one process to increase leverage.

Advanced markets and emerging markets such as China benefit from the open trading and investment regime. That open international system ultimately depends on a sense of fairness and reciprocity among members. Just as Japan, Europe and the United States can strengthen their own security by coordinating more closely amongst themselves, they can also promote a sustainable open investment environment by working together with China to ensure a level playing field.

This policy brief was originally published as part of the collection, *Cooperation in Times of Uncertain Leadership*.

About the Author

Rod Hunter is a partner with Baker McKenzie and is a non-resident senior fellow with The German Marshall Fund of the United States.

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1744 R Street NW
Washington, DC 20009
T 1 202 683 2650 | F 1 202 265 1662 | E info@gmfus.org
http://www.gmfus.org/