Chapter 13

Facilitating Cross-Border Direct and Portfolio Investment

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Executive Summary

China and the U.S. are among the world's largest investment hosts, as well as sources of cross-border direct and portfolio investments. The stock of U.S. direct investment in China amounts to six times China's direct investment in the U.S., while China's direct investment in the U.S. has begun a rapid increase in recent years, as China's economy continues to develop and with Beijing pursuing a 'go global' policy. Although Sino-U.S. cross-border investment has experienced significant growth over the past five years, U.S. and China's mutual foreign direct investment (FDI) only constitute a small part of each country's total outward FDI, indicating significant room for further growth.

Recent Chinese investment in the U.S. also shows positive trends: greenfield investments account for the majority of deals by volume relative to mergers and acquisitions (M&A); the investment focus is diverging from traditional resource and trade, looking to manufacturing and value-added services; and the private sector is becoming an increasingly important source of Chinese FDI in the U.S.

For both the U.S. and China, increased bilateral openness to cross-border investment is mutually beneficial for several reasons: cross-border investments provide capital, create jobs, allow firms to operate more efficiently globally, and reduce production costs and consumer prices. In addition, global integration increases consumer welfare by promoting specialization, achieving greater economies of scale and encouraging healthy competition in the marketplace. Moreover, increased economic cooperation is critical to continuously improving mutual understanding between the two countries and promoting mutual openness.

China's cumulative direct investment overseas is projected to reach US$1tr to US$2tr in the next decade. Annual flows of Chinese investment to the U.S. are likely to exceed U.S. flows to China in the next few years. At the enterprise level – thanks to the transformation of China's economic development pattern, including industrial upgrading and the 'go global' strategy – securing resources, improving global competitiveness, and seeking new markets and strategic assets will become increasingly important drivers of China's investment abroad.

Yet obstacles to the bilateral investment flows remain, with some real, while others perceptional. These include concerns about investments being rejected on national security or strategic industry grounds; operating in an uneven playing field; non-transparent and discriminatory regulations; tight visa restrictions; lack of communications and trust; cultural differences; and interference from domestic politics.

To facilitate bilateral investment flow between China and the U.S., both governments are advised to adopt fundamental changes in strategic thinking and approach. Specific suggestions include, but are not limited to:

- Promoting understanding and bilateral ties through mutual investment review process and cultural exchange.
- Systemizing the promotion of investments via the establishment of local investment promotion agencies and investment funds.
- Improving investment climates in both nations by increasing transparency and the level of communication of investment regulations, removing administrative restrictions, as well as strengthen-

ing the commitment to and application of non-discriminative investment rules.

- Increasing cooperation in financial market development and reform to ensure economic growth and facilitating portfolio investment.
- Leveraging Hong Kong's close connection to both economies and using its expertise in international finance.

Facilitating Cross-Border Direct and Portfolio Investment

Present State of Direct Investment Flows between the U.S. and China

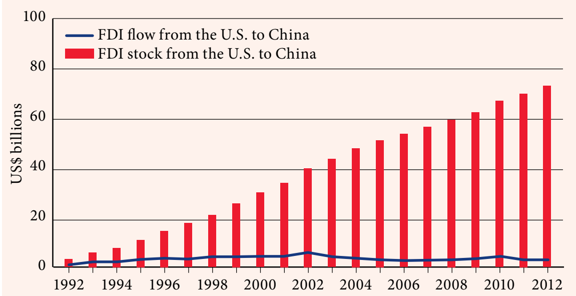
The U.S. was the world's largest host and source of foreign direct investment (FDI) in 2011, while China was the second largest host and seventh largest source[1]. Latest statistics show that China was the world's largest destination of FDI in the first half of 2012[2]. The global financial crisis hit FDI flows in both countries in 2008/09. But they have started to rebound in 2010, though FDI flows to the U.S. have yet to recover to their pre-crisis level.

The U.S. was an early direct investor in China since China's opening up and reform, with the first FDIs made in the mid 1980s. Chinese direct investment in the U.S. probably began in the late 1990s. The U.S. Department of Commerce and the Chinese Ministry of Commerce (and its predecessors) maintain statistics on the flows and stocks of bilateral U.S.-China direct investment. However, the two sets of data often do not completely agree.

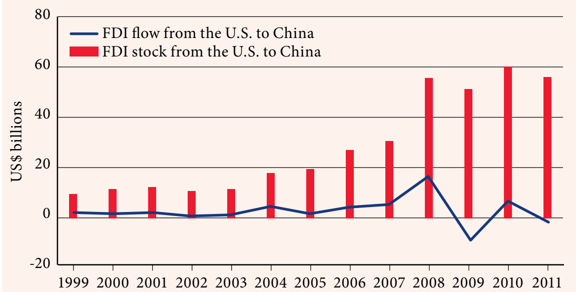
U.S. direct investment in China

U.S. companies have been investing heavily in China for over three decades and held 61,000 direct investment projects in China in 2011, set up over 20,000 enterprises, affiliates or joint ventures (JVs), and employed hundreds of thousands of Chinese workers. By 2011, the stock of U.S. investment in China amounted to US$70.1bn, 7.8 times larger

Figure 1: The Net Flow of U.S. Investment in China



Source: Chinese Ministry of Commerce

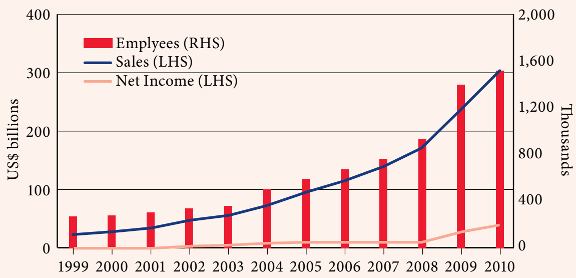


Source: U.S. Bureau of Economic Analysis

1 "China has been the world's largest destination of foreign direct investment in the first half of 2012". United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2012: Towards a New Generation of Investment Policies*, United Nations, 2012.

2 "Foreign Investment in China: A Tale of Two Statistics", Thilo Hanemann, Rhodium Group, 4 January 2013.

Figure 2: **Contribution of U.S. Investments to China's Gross Domestic Product and Employment**



Source: U.S. Bureau of Economic Analysis http://www.bea.gov/international/xls/all_affiliate_cntry.xls

Figure 3: **Top 10 U.S. enterprises investing in China**

Rank	Enterprise
1	Exxon Mobil
2	General Motors
3	Intel
4	Caterpillar
5	Walmart
6	General Electric
7	Coca Cola
8	Procter & Gamble
9	Goldman Sachs
10	Ford

Source: China's Ministry of Commerce, 2012

than Chinese investments in the U.S.[3] This reflects U.S. strength in funding and technology and China's comparative advantage in labor cost and its considerable market potential.

Nevertheless, FDI flows from the U.S. to China have been declining in recent years (see Figure 1), with U.S. direct investment in China amounting to US$4.1bn in 2010, but dropping to US$3bn in 2011, according to the Chinese Ministry of Commerce[4]. This was mainly due to China's slower economic growth in recent years, various concerns expressed by American companies about the investment climate in China and, more importantly, the increasingly tough competition and sometimes excessive capacity in more and more industries in China. Despite this, an annual survey conducted by the United States-China Business Council (USCBC) shows that 89% of U.S. firms operating in China realized profitability, 66% saw their 2011 revenue from businesses in China increase by double digits, 75% expected 2012 revenue to increase and 66% planned to increase investment in the next year[5].

FDI from the U.S. accounted for 9.5% of China's overall FDI stock by the end of 2011[6]. According to the U.S. Bureau of Economic Analysis (BEA), there were 1,189 U.S. shareholding companies in China with total sales of US$304bn and net income of US$39bn, and they employed 1.541 million workers in 2010[7]. According to the Research Institute of China's Ministry of Commerce, U.S.-invested companies in China paid US$14.9bn in taxes in 2010 and employed 1.842 million people. In addition, China has benefited significantly from FDI through both the 'spillover effect' and 'discipline effect'[8], highlighted by the fact that U.S. companies have set up over 250 research and development (R&D) centers in China.

China's direct investment in the U.S.

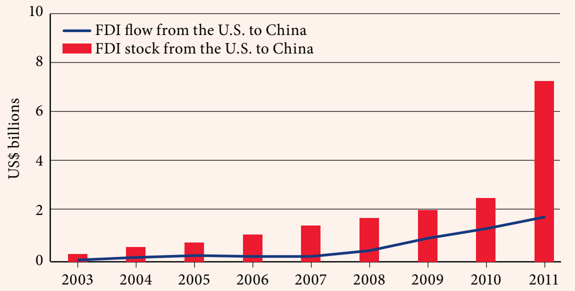
Chinese direct investment in the U.S. is only a recent phenomenon, with an accumulated stock of about US$9bn[9]. However, the balance of investment

3 Sourced from China's Ministry of Commerce (MOFCOM). Since U.S. and Chinese investment data are not completely consistent, if not otherwise specified, all data of two-way investment stock and flow in this chapter are quoted from MOFCOM (Chinese official source). According to the BEA, the investment stock from the U.S. to China amounted to US$54bn.
4 According to the BEA, the amount of U.S. net investment flow in China declined by US$1.6 bn.
5 "USCBC 2012 China Business Environment Survey Results: Continued Growth and Profitability; Tempered Optimism Due to Rising Costs, Competition, and Market Barriers", USCBC, 2012. This is conducted every year to survey member companies of USCBC to gauge business climate in China and to assess the top concerns of doing business in China.
6 According to *2012 World Investment Report* from UNCTAD, the total stock of Chinese inward direct investment amounted to US$712bn in 2011.
7 These statistics only count the affiliates with assets, sales or net income greater than US$25m http://www.bea.gov/international/xls/all_affiliate_cntry.xls
8 "The benefit analysis and future outlook of Sino-U.S. trade cooperation", The Research Institute of the Ministry of Commerce, October 2011.
9 Data sourced from the US BEA.

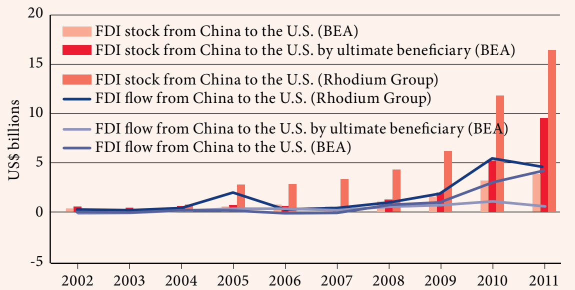
flows between the U.S. and China is changing, with rapid growth of Chinese direct investment into the U.S. but slowing U.S. flows to China. Chinese direct investment in the U.S. increased almost 28 fold between 2003 and 2011 – from US$65m to US$1.8bn[10]. When accounting for flows through offshore financial centers, the increase was even more significant: by nearly 1300% over five years, according to U.S. data[11]. According to statistics compiled by the Rhodium Group[12], the amount of Chinese investment in the U.S. reached a record US$6.5bn in 2012. Chinese companies operated in at least 35 of the 50 U.S. states in 2010 (see Figure 4)[13].

10 Data sourced from MOFCOM.
11 The BEA figures are likely to be underestimated because they do not account for flows through offshore financial centers. "Foreign Investment in China: A Tale of Two Statistics", Thilo Hanemann, Rhodium Group, 4 January 2013.
12 "Foreign Investment in China: A Tale of Two Statistics", Thilo Hanemann, Rhodium Group, 4 January 2013.
13 "An Open American Door? Maximizing the Benefits of Chinese Foreign Direct Investment," Daniel H. Rosen and Thilo Hanemann, Center for U.S.-China Relations, Asia Society, and Kissinger Institute on China and the United States, Woodrow Wilson International Center for Scholars, May 2011.

Figure 4: The Stock and Flow of China's Investment in the U.S.



Source: Chinese Ministry of Commerce



Source: U.S. Bureau of Economic Analysis, Rhodium Group

Case Study: General Motors

General Motors (GM) is one of the earliest foreign automobile makers to enter China, in 1991. Unlike most foreign automobile makers, GM established operations in manufacturing and sales as well as in automobile research, design, financing, distribution, and automobile security and communication through 11 JVs.

Today, GM is the leader in China's automobile market, with 14.6% market share. China has become GM's largest market, contributing over 30.53% of 2012 global sales by volume and 51.7% of GM's global net income. GM's JV partners in China also provided much needed cash flow during GM's restructuring in 2009 with China's state-owned automotive manufacturing company SAIC purchasing a 1% stake in GM for US$85m. GM's JV operations in China also generated US$1.52bn in income equity. In addition, GM's China operations serve as an R&D, manufacturing and testing platform for other Asian countries, introducing several new automobile models to the Asia market and supplying products for other Asian countries such as India.

China also benefited tremendously from GM's investment. In addition to GM's significant capital injection, its JVs in China created 35,000 new jobs and provided the Chinese market with access to modern automobile products, manufacturing expertise, technology and repair services. GM's JV partners in China, such as SAIC and Wuling, also significantly increased their manufacturing, R&D and operational capabilities through collaboration with GM.

Figure 5: **Top 20 Destinations for Chinese Direct Investment in the U.S., 2003-10**

Rank	State	Total investment (US$ millions)	Number of deals	Rank	State	Total investment (US$ millions)	Number of deals
1	Texas	2719	20	11	Missouri	170	5
2	New York	1874	24	12	Georgia	154	12
3	Virginia	1771	5	13	Minnesota	151	1
4	Illinois	1540	7	14	Maryland	118	4
5	California	824	55	15	Hawaii	95	2
6	Michigan	599	12	16	New Mexico	80	1
7	Oregon	282	5	17	Florida	77	4
8	Delaware	264	12	18	Idaho	62	1
9	New Jersey	227	6	19	Arizona	61	3
10	Mississippi	175	1	20	Nevada	59	6

Source: "An Open American Door? Maximizing the Benefits of Chinese Foreign Direct Investment", Daniel H. Rosen and Thilo Hanemann, Center for US-China Relations, Asia Society, and Kissinger Institute on China and the United States, Woodrow Wilson International Center for Scholars, May 2011, p. 32.

Figure 6: **Sector Distribution for Chinese Direct Investment in the U.S. by Number of Deals, 2007-12**

Number of deals	2007	2008	2009	2010	2011	2012	2007-12
Information technology	7	13	10	19	21	6	76
Industrial and electronic equipment	12	6	15	14	12	12	71
Energy	6	3	14	20	15	10	68
Automotive and aviation	11	4	8	10	14	7	54
Consumer products and services	6	6	13	9	13	3	50
Finance and business services	3	6	6	6	7	6	34
Basic materials	7	4	5	4	9	3	32
Health and biotechnology	1	8	5	7	8	3	32
Entertainment and real estate	1	2	1	5	7	5	21
Transport and construction	5	0	0	8	1	3	17
Agriculture and food	1	2	0	2	3	4	12

Source: China Investment Monitor, Rhodium Group

Chinese investment in the U.S. exhibits several unique and positive trends. First, the preferred entry mode is greenfield investments, accounting for the majority of deals by volume. There were 436 greenfield investments completed from 2000 to 2012, compared with 184 non-greenfield deals[14]. This trend continues to increase, although greenfield investments still lag behind in terms of U.S. dollar value (US$3bn in greenfield investments versus US$19bn in non-greenfield investments)[15]. Greenfield projects create more employment opportunities and contribute more to the community, including tax income and consumer welfare compared to traditional mergers and acquisitions (M&A) investments.

Second, industry selection is gradually changing. Unlike earlier Chinese investment in the U.S. which focused on energy-related fields, there has been a growth in manufacturing-related industries since 2008. Although there have been cases of ac-

14 Data sourced from China Investment Monitor, Rhodium Group. http://rhg.com/interactive/china-investment-monitor

15 Ibid

Figure 7: **Sector Distribution for Chinese Direct Investment in the U.S. by Deal Value, 2007-12**

Deal value (US$ millions)	2007	2008	2009	2010	2011	2012	2007-12
Energy	245	28	214	2,977	2,079	2,966	8,509
Entertainment and real estate	8	4	6	222	931	2,795	3,966
Industrial and electronic equipment.	84	20	422	1,298	108	69	2,001
Automotive and aviation	101	9	127	478	591	213	1,519
Basic materials	37	9	1,043	43	126	173	1,431
Information technology	22	105	15	199	535	14	890
Health and biotechnology	1	381	10	61	84	3	540
Finance and business services	41	92	25	154	38	165	515
Consumer products and services	15	215	62	51	52	15	410
Agriculture and food	1	16		30	29	34	110
Transport and construction	6			16	1	5	28

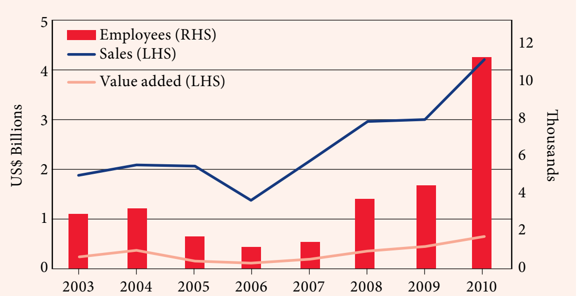
Source: China Investment Monitor, Rhodium Group

quisition for the purpose of transferring assets back to China, the majority of Chinese firms continue to expand local facilities purchased in the U.S. Chinese investments are not only seeking resources, they are becoming an increasingly important part of the U.S.'s new industrial strategy. Past Chinese tertiary-industry direct investment was aimed at facilitating massive U.S.-China merchandise trade flows such as wholesale services and trade finance. Today's service sector investments target higher-value-added services such as software development. Investment in real estate and infrastructure remains small, but interest is growing quickly.

Finally, there is a misconception that all investments made by Chinese firms are state related. The reality is that ownership in China is diverse and this is reflected in Chinese investment abroad. The majority of sources of Chinese outward FDI is from the private sector rather than state-owned enterprises (SOEs) – 435 private deals versus 185 SOE deals with values of US$14bn and US$8bn respectively[16]). In addition, Chinese SOEs are becoming increasingly more profit oriented and commercial in their investment decision-making[17].

16 Ibid
17 "China Goes Global: The Implications of Chinese Outward Direct Investment for Canada", Yuen Pau Woo and Kenny Zhang, Vancouver: Asia-Pacific Foundation of Canada, 2006.

Figure 8: **Contribution of Chinese Investment to U.S. Gross Domestic Product and Employment**



Source: US Bureau of Economic Analysis

Similar to capital inflows from other countries to the U.S. and U.S. investments in China, China's investments into the U.S. not only offer investment funds and create jobs, they could also improve product competiveness in the U.S. market and promote bilateral trade. For example, the entry of China's largest white-goods producer, Haier, into the U.S. has fostered greater competition and improved product choice in the U.S. white-goods market, bringing cheaper and more innovative products. Haier's mini fridges are now standard items in American college dorms and hotel mini-bars.

In terms of job creation, the U.S. Department of Commerce estimated that over the last decade, inward direct investment into the U.S. – totaling over

US$1.7tr – has created over 5 million high-end jobs and raised staff incomes by 30%[18]. Although the number of jobs created by investment from China remains small – because China is still in the early stage of developing its outward investments – it has been growing rapidly. The BEA shows that Chinese non-bank U.S. affiliates obtained sales income of US$4.2bn, created value added of US$663m and hired 11,200 employees in 2010 – 5.6 times more than five years ago (see Figure 8). According to a study by the U.S.-China Economic and Security Review Commission, jobs created by investments by Chinese SOEs in the U.S. increased by 10,000-20,000 over the last five years[19].

A study by a private company[20] also shows that there were fewer than 2,000 jobs associated with Chinese investment 12 years ago, and this figure has grown to 27,000 in 2012. Of this total of 27,000, US$3.5bn worth of greenfield investments has created about 8,000 U.S. net jobs since 2000[21]. Although the jobs created by Chinese FDI – only accounting for less than 1% of the six million jobs provided by U.S.-based foreign affiliates – is still relatively small compared to long-time foreign investors such as Germany and Japan, the potential is tremendous. According to the study, if Chinese investment remains on track, Chinese firms will employ 200,000-400,000 U.S. workers by 2020.

For example, Haier – which invested US$30m in a refrigerator plant in Camden, South Carolina – now employs about 600 people. Wanxiang Group – an auto-parts manufacturer that started investing in the U.S. in 1994 – created 5,600 jobs in its 28 operations across 14 states in the U.S. It paid US$32.4m in U.S. tax and US$250m in local employee benefits in 2010[22]. Sany – a private Chinese heavy machinery manufacturing enterprise – employs 200 people in its R&D/manufacturing factory in Peachtree, Georgia[23]. The number of jobs created would be higher by several thousand if firms with Chinese minority equity stakes are also included.

Other indirect benefits from Chinese direct investment in the U.S. can be demonstrated by Lenovo's acquisition of IBM's personal computer business, which enabled IBM to dispose of its misaligned business lines and re-focus its business on more promising areas[24]. Tianjin Pipe Corporation (TPCO) is estimated to have employed 1,000-2,000 construction workers to set up a new steel plant in Texas[25]. Even the analysis and preparation of making an investment can benefit U.S. businesses as Chinese investors need to employ U.S. consultants and professionals to provide legal, tax, accounting, technical, financial and other services – as illustrated by the case of TPCO's investment in Texas[26]. Tax paid by the Chinese enterprises will also benefit local education which is funded by local government revenue. According to the Rosen and Hanemann Study (2011), U.S. local communities have as much to gain or lose from Chinese FDI as they do from other nations' FDI: so far, there is no evidence that the effects will be qualitatively different[27].

In addition to the economic benefits, Chinese investments also bring a positive intangible impact.

18 "New Commerce Department Report Shows Foreign Direct Investment Supports Millions of High-Paying Jobs", Gary Locke, press release, U.S. Department of Commerce, 14 June 2011, http://www.commerce.gov/news/press-releases/2011/06/14/new-commerce-department-report-shows-foreign-direct-investment-suppor

19 "An Analysis of Chinese Investments in the U.S. Economy", Andrew Szamosszegi, *Capital Trade FDI Study*, U.S.-China Economic and Security Review Commission, October 2012.

20 "The Employment Impacts of Chinese Investment in the United States", Thilo Hanemann and Adam Lysenko, Rhodium Group, 27 September 2012, http://rhgroup.net/articles/the-employment-impacts-of-chinese-investment-in-the-united-states

21 Ibid.

22 "Case study on China Wanxiang Group's investment in the U.S.", Wang Tianlong, unpublished manuscript.

23 "An Open American Door? Maximizing the Benefits of Chinese Foreign Direct Investment", Daniel H. Rosen and Thilo Hanemann, Center for U.S.-China Relations, Asia Society, and Kissinger Institute on China and the United States, Woodrow Wilson International Center for Scholars, May 2011, pp. 45-46.

24 Ibid.

25 "The Employment Impacts of Chinese Investment in the United States", Thilo Hanemann and Adam Lysenko, Rhodium Group, 27 September 2012, http://rhgroup.net/articles/the-employment-impacts-of-chinese-investment-in-the-united-states

26 See SelectUSA video about doing business in the U.S. at http://beijing.usembassy-china.org.cn/doing-business-usa.html

27 "An Open American Door? Maximizing the Benefits of Chinese Foreign Direct Investment", Daniel H. Rosen and Thilo Hanemann, Center for U.S.-China Relations, Asia Society, and Kissinger Institute on China and the United States, Woodrow Wilson International Center for Scholars, May 2011, p. 45.

Chinese firms investing in the U.S. inadvertently absorb the global business norms and habits characteristic of the markets of the Organisation of Economic Co-operation and Development (OECD). As these firms' global presence increases, it is reasonable to expect them to lobby for stricter compliance with global business norms as they realize that this is required to give them a stronger competitive advantage over homebound rivals. Another benefit of Chinese companies moving abroad is that they have to comply with local laws and regulations, and they are subject to litigation in U.S. courts brought about by their competitors if they engage in improper behavior. Such exposure to foreign regulations and a compliance culture should create a positive feedback loop back into China, putting pressure on the Chinese government to increase the pace of reforms in order to help Chinese companies successfully compete overseas.

Growing Chinese investment in developed economies may also accelerate the new opportunities in the Chinese market. China still maintains significant controls on capital inflows and many sectors of the economy remain closed to foreign investment, especially in services. The Chinese government emphasizes that it will continue to open these sectors to private and foreign investment, but in a gradual manner. The growing interest in outward investment in developed economies is an incentive for China to accelerate the pace of investing at home, leading to wider opportunities for foreign multinational companies in industries which were previously off-limits.

Present State of Portfolio Investment Flows between the U.S. and China

The U.S. is the world's top cross-border non-reserve portfolio investor and recipient, holding US$6.7tr in non-reserve portfolio assets and received US$8.3tr in foreign portfolio investment at the end of 2010[28]. In contrast, China's position in cross-border non-reserve portfolio investment lags far behind the U.S. ranking seventeenth at the end of 2010 with US$498bn portfolio inflows, about 6% that of the U.S. There is no official data on China's non-reserve portfolio outflow,

28 "Coordinated Portfolio Investment Survey, 2011", International Monetary Fund, http://cpis.imf.org

Case Study: Wanxiang Group

Wanxiang Group is a China-based global automotive and clean energy company. Wanxiang America was established in 1994 and is based in Elgin, Illinois, with the aim of establishing manufacturing, research and sales operations in the U.S. Currently, Wanxiang America operates 27 manufacturing facilities across 14 states, combining expertise in manufacturing and sourcing with local U.S. talent in engineering, design and technology partnerships to deliver industry leading products in automotive parts, industrial components and clean technology such as solar panels. Today, one in every three vehicles running on the roads in America is using components made by Wanxiang's U.S. operations – becoming a model successful Chinese greenfield investment in the U.S.

As of 2011, Wanxiang has invested over US$500m in its U.S. operations, creating 5,600 new jobs. In 2010, Wanxiang America paid US$32.4m in taxes and US$250m in U.S. employee benefits. In addition, Wanxiang America is a strong supporter of local communities – for example, undertaking a program in San Francisco to train teachers in clean energy and supporting President Obama's '100,000 Strong Initiative', which aims to send 100,000 American students to study in China over four years.

Figure 9: **China Portfolio Holdings of U.S. Securities in 2011 (US$ millions)**

Types	Total	Treasury	Agency	Corporate
Long-term equity	158,781	/	/	/
Long-term debt	1,562,948	1,302,405	244,747	15,796
Short-term debt	4,891	4,571	41	279
LT+ST total	1,726,621			

Source: U.S. Federal Reserve, 2012.

but it is likely to be very small given tight capital account restrictions and China's relatively short history of outward investment. However, China is the world's largest holder of international reserves, amounting to US$3.31tr at the end of March 2012.

Given China's capital controls, bilateral portfolio investment flows between China and the U.S. are highly regulated. Out of the US$6.7tr non-reserve portfolio assets held by the U.S. at the end of 2010, China only accounted for US$102bn or 1.5% of the total. However, the U.S. – with US$77bn of portfolio assets in China – is China's second largest portfolio investor, accounting for 31% of the total foreign portfolio holdings at the end of 2011[29]. Like other foreign portfolio investors, U.S. portfolio investment in China is mainly channeled through the program of Qualified Foreign Institutional Investors (QFII) that permits certain licensed international investors to participate in China's financial markets. By the end of 2012, 33 U.S. companies – out of a total of 201 companies[30] – have obtained QFII qualifications. Many of these companies have reached the investment cap of US$1bn.

The Chinese government's holdings of portfolio assets, however, have experienced explosive growth over the last decade with an average annual growth rate of 35.8%. China has surpassed Japan as the world's largest holder of U.S. government securities since 2008. Portfolio assets held by China are classified into four types: treasury securities, agency securities, corporate bonds and stocks. In June 2011, China's holdings of the U.S. portfolio assets amounted to US$1.7tr, about 54% of total foreign exchange reserves. Of this total, long-term treasury securities and long-term agency securities amounted to US$1.3tr and US$0.24tr respectively, representing almost 90% of China's total portfolio investment in the U.S.

Looking back at the last decade, China's large purchase of U.S. securities has been well recognized as a double-win strategy that provided benefits to both sides. It is consistent with China's interest in reducing its foreign exchange reserves risk and maintaining financial stability in terms of liquidity and credibility. On the other hand, China's persistent investment in U.S. securities provides strong demand for treasury securities to drive down the long-term rate of interest and the necessary funding to finance large U.S. budget deficits. This was particularly important to help the U.S. deal with the 2008/09 global financial crisis. From 2008 to 2010, China's government has lifted the holdings of U.S. securities by US$577bn, an equivalent of 73.3% of total expenditure of the U.S. stimulus package in February 2009.

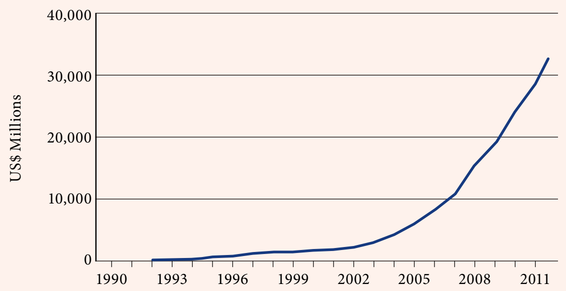
Drivers of U.S.-China Bilateral Investment

FDI, including those from the U.S., played a very important role in China's successes in the earlier part of its reform and opening-up process since 1978. Foreign investors brought not only funds that China desperately wanted, but also manage-

29 The U.S. data is obtained from U.S. Department of Treasury and the Chinese data is obtained from China's State Administration of Foreign Exchange (SAFE).

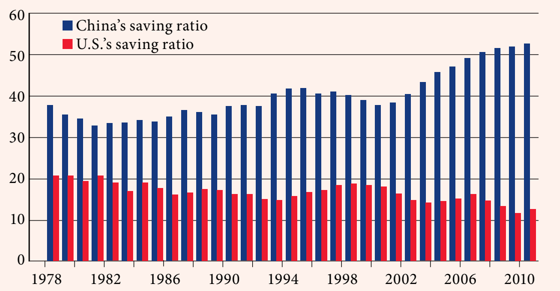
30 The complete QFII list as of November 2012 is on: http://www.china.com.cn/guoqing/zwxx/2012-12/14/content_27412677.htm

Figure 10: **Growth of China's Official Foreign Reserve**



Source: State Administration of Foreign Exchange (SAFE), China

Figure 11: **Comparison of China and U.S.' Savings Ratio**



Source: U.S. Bureau of Economic Analysis; National Bureau of Statistics of China

ment and technical expertise, export markets for China's products or goods that China needed for its domestic market. Foreign investors also benefited in the process, as China helped to enhance their global competitiveness by reducing their costs of production or providing the resources or products they needed. Furthermore, foreign investors gained significantly from the rapid growth in the domestic market, particularly for companies such as General Motors and Procter & Gamble.

As China enters the second decade of the twenty-first century and becomes a middle-income country, conditions in China have changed and a new complementary relationship of investment flows between China and the U.S. is called for.

China's excessive savings versus the U.S.'s need for more savings

China has accumulated over US$3tr of official foreign exchange reserves (see Figure 10). Furthermore, as wealth is created in China, private-sector savings has also increased. China is now a nation of surplus savings. According to the National Bureau of Statistics of China, China's saving ratio was about 35% in the 1980s, rose to around 40% in the 1990s and up to 52.6% in 2010. Meanwhile, China's investment ratio averaged 45% of gross domestic product (GDP) during 2002 to 2011. In the ten years between 2002 and 2011, China ran an average net saving surplus – or current account surplus – of 5.7% of its GDP despite a high investment rate.

In the U.S., according to data from the U.S. BEA, the U.S.' savings rate has dropped from about 20% of gross national income (GNI) in the early 1980s to about 12.4% in 2010 (see Figure 11). During 2002 to 2011, the U.S. investment rate averaged 18.1% of GNI. This means that in the ten years between 2002 and 2011, the U.S. had an average net savings deficit – current account deficit – of 4.5% of GNI.

As highlighted by the 2008/09 global financial crisis, many countries in the West will have to deal with a high level of public and private sector debts. To restore market confidence, deleveraging in the private sector and fiscal consolidation in the public sector are called for. These adjustments will typically take a long time. Meanwhile, China has been dealing with the problem of having too much savings. Surplus saving is the underlying reason for China's current account surpluses, which in turn – given China's desire to maintain exchange rate stability – encourages an excessive growth in money supply.

Therefore, a new complementary relationship of investment flows has gradually emerged as China exports its surplus savings to the West where new sources of foreign investment funds could help to mitigate the contractionary effects of fiscal consolidation and private sector deleveraging, and stimulate the sluggish economies.

China's need to 'go global'

The surge in China's outward investment in recent years has been stimulated by favorable policies. The implementation of the government's 'go global' strategy has gradually led to an improvement in the business environment for Chinese companies to invest abroad, such as the simplification of the approval procedures, easier financing arrangements and better foreign-exchange services. The *Overseas Investment Management Regulations*, announced in 2009, states that most outward investment projects are not required for review by MOFCOM.

China's outward investment is primarily driven by the country's needs at the macro level and the business needs of companies on an enterprise level. As the country becomes more developed, many Chinese companies have matured, become much bigger in terms of assets and much stronger financially. China needs to look overseas to buy natural resources – including energy, minerals and agricultural products – to support the country's rapid growth, and investing in such sectors abroad is a good way to secure long-term supplies. Having become the world's largest exporter, China needs to explore new markets and to better grow its overseas markets by relocating production to foreign countries or fostering global partnerships with overseas companies. Investing in new markets also helps Chinese firms to reduce costs of logistics, learn more about overseas markets, react faster to changes in demand in foreign markets and reduce the impact of trade restrictions. Cross-border M&As also enable many Chinese companies to acquire technological, management and operational skills. The appreciation of the RMB in recent years has also increased the financial capabilities and raised the cost advantages of many Chinese companies to invest overseas. The much stronger capability of Chinese banks to support financially Chinese companies to go overseas is also important.

The new investment opportunities in China

As costs rise, China is no longer attractive as a base for low-cost production. But rising incomes of workers is turning China into a more important market. Based on decades of investment experience in China, the target of U.S. firms in China is straightforward: the great potential of the Chinese market and strong consumption ability by the rising middle class. A more developed economy and rising prosperity also led to an increase in demand for various kinds of producer or consumer services, sectors in which many U.S. firms are strong. The rapid increase in the availability of Chinese workers with higher levels of education and more sophisticated technical skills have also led more U.S. companies to tap into this large pool of knowledge workers.

USCBC's survey shows that China is estimated to be a US$250bn market for U.S. companies, and 94% of companies conduct business in China to primarily access the domestic Chinese market, instead of developing an export platform. A similar percentage of U.S. companies consider China as either their top global market priority or among their top five priorities[31].

The Potential of U.S.-China Investment Flows in the Future

U.S. direct investment in China

China's national development strategy of economic transformation and structural adjustment provides greater potential for bilateral investment. China's economy is going through fundamental restructuring: from an export-driven, labor–intensive, energy-intensive, industry-based economy, to one that is driven more by innovation and technology, domestic consumption and the service sector. This will no doubt result in a larger appetite for high-tech products and services. The Chinese government could also be expected to introduce more favorable policies to encourage direct investment into these sec-

31 "USCBC 2012 China Business Environment Survey Results: Continued Growth and Profitability"; Tempered Optimism Due to Rising Costs, Competition and Market Barriers, 2012.

tors so as to promote the process of economic structuring and upgrading.

Urbanization – another of China's crucial development strategies in the next decade – probably presents the greatest growth potential for China's economy. China's urbanization rate just surpassed 50%, 20 percentage points lower than the average level of developed countries. The continuous urbanization process will drive RMB40tr of investment including RMB1tr of infrastructure investment in the next decade[32]. This will create many new opportunities for FDI.

Chinese direct investment in the U.S.

China's 12th Five Year Plan stated that promoting the 'go global' strategy will be extremely important in the country's future development. The government is set to provide strong support to companies in various industries – including finance, energy, construction, wholesale and education – to invest abroad. With abundant financial resources and the investment experiences built up over the past years, there is no doubt that China's outward investment will speed up in terms of amount and scope. A study by a U.S. private company projected that over US$1tr of Chinese direct investment could flow overseas in the decade 2010 to 2020, with a significant share likely to be heading to the U.S.[33]

The U.S. consumer market continues to be of interest to Chinese enterprises. Following the successful entry of Haier and Lenovo – who manufacture their products in the U.S. – there will be similar FDI into the U.S. in those industries. Investment in energy and agriculture – whether in collaboration with science and technology research or with production – will attract Chinese FDI into the U.S. Real estate is another area where there may be keen Chinese interest. The U.S. needs to build new infrastructure, or rebuild infrastructure, which will be very attractive to Chinese companies. It is entirely possible that, within a few years, China's annual FDI flows into the U.S. will match or exceed U.S. annual FDI into China[34].

The potential of job creation from the inflow of Chinese investments should not be underestimated. According to estimates made by the Office of the U.S. Trade Representative, each US$500,000 of foreign investment would create around 10 job opportunities in the U.S.[35] Therefore, if Chinese enterprises' investments in the U.S. reach US$200bn in 2020, it will create four million job opportunities.

Portfolio investment flows between China and the U.S.

Portfolio investment flows into the U.S. from China are likely to remain dominated by Chinese sovereign wealth funds such as the China Investment Corporation (CIC) and State Administration of Foreign Exchange (SAFE), given China's large foreign-exchange reserves and capital restriction. Such investment will keep rising as long as U.S. national credit remains strong and equities are attractive.

The great potential of Chinese households' foreign investment will be realized as foreign-exchange control regulations are gradually relaxed. Chinese household wealth has been growing fast as household incomes rise and the size of high-income groups increase, but most of their wealth is in RMB because of foreign-exchange controls.

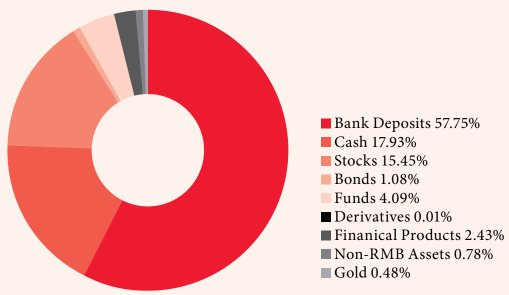
32 *National Plan of Promoting Urbanization Healthy Development (2010-2020)*, Chinese National Development and Reform Commission (NDRC), 2012.

33 "An Open American Door? Maximizing the Benefits of Chinese Foreign Direct Investment", Daniel H. Rosen and Thilo Hanemann, Center for U.S.-China Relations, Asia Society, and Kissinger Institute on China and the United States, Woodrow Wilson International Center for Scholars, May 2011.

34 According to the U.S. BEA, Chinese FDI into the U.S. was US$3.2bn in 2010, which is already greater than the U.S. FDI into China of US$3.02bn. However, the Chinese Ministry of Commerce reported a different story: Chinese FDI into the U.S. was only US$1.3bn in 2010, while U.S. FDI into China was US$4.05bn in the same year. The discrepancy in data from both governments is nothing surprising as they adopt different definitions and are based on different sources. Yet, both sets of data indicate the same trend, i.e. Chinese FDI flows to the U.S. is rising and the gap between flows is narrowing.

35 *Chinese FDI in the U.S., Causes, Case Studies, and the Future*, The American Chamber of Commerce in Shanghai, 2010.

Figure 12: Chinese Households' Financial Assets Allocation



Source: "Investigation Report of Households' Financial Assets", Investigation and Research Center of China's Household's Financial Assets, Southwest University of Finance and Economics, China.

According to the 2012 China's "Investigation Report of Households' Financial Assets"[36], the total amount of households' financial assets is estimated to be US$9.5tr[37], very little of which is invested overseas. Of the total, deposits account for the highest proportion (57.75%), followed by cash (17.93%), stocks (15.45%), funds (4.09%) and banking and financial products (2.43%).

The large proportion of risk-free asset holdings reflects not only the conservative investment habit of many Chinese families and the poor performance record of the Chinese stock market in the past two decades, but also the lack of channels to investing abroad. Given the fact that the Chinese government is gradually relaxing foreign-exchange restrictions, the portfolio diversification of Chinese households will result in a rapid growth in demand for investments in foreign currencies, if only because of portfolio re-balancing needs. The approximate projection of such investments could be estimated by comparing with the trends of Japanese households that have similar savings habits: about 55% of total Japanese household assets are held in bank deposits, and the amount of their foreign assets is about US$502bn or 3% of total financial assets[38]. If China's foreign-exchange restrictions are highly relaxed in next decade – and Chinese households hold the same proportion of foreign assets in their portfolios as the Japanese – the amount of foreign assets held by this group will amount to US$570bn[39], with the average growth rate estimated to be roughly 28.8%[40]. It is obvious that the U.S. – with a developed financial market and abundant financial products – will attract a substantial proportion of such investment flows from Chinese households.

Concerns of the U.S.-China bilateral investment

The U.S.'s main concerns on investment in China

Despite their historical success in investing in China, U.S. companies have become increasingly concerned about the investment climate in China. According to the 2012 survey of the USCBC[41], 45% of company respondents are less optimistic about China's current business climate than they were three years ago.

Figure 13 shows that the major U.S. investors in China face significant difficulties in finding, training, hiring and retaining employees, especially for skilled technical and managerial talent at reasonable salary levels, dealing with licensing and approvals, fighting against increasing competition and rising costs. According to the survey, 57% of

36 "Investigation Report of Households' Financial Assets", Investigation and Research Center of China's Household's Financial Assets, Southwest University of Finance and Economics, China.

37 The *2012 China Statistical Yearbook* shows that the total amount of Chinese households' banking deposits is US$5.5tr and the China's 2012 Investigation Report (ibid) indicates that banking deposits account for 57.75% of the total households' financial assets. Moreover, the data from the speech of the 2013 Chinese People's Political Consultative Conference (CPPCC) shows that China's household financial assets and banking deposits amount to RMB50tr (US$8tr) and RMB41tr (US$6.6tr) respectively, which is not very different from our estimates.

38 Data sourced from: http://business.financialpost.com/2011/03/29/why-japan-wont-repatriate/

39 According to the report of the eighteenth National Congress of the Communist Party of China, households' income will double by 2020. Given the fact that the purchase of financial assets mainly depends on the households' income, it is thus reasonable to assume that the total amount of households' financial assets will double as well.

40 According to China's 2012 "Investigation Report of Households' Financial Assets" (see note 4), the proportion of non-RMB assets in total households' assets is 0.78%. Because of the restrictions of capital outflow and foreign exchange, most of the households' foreign assets are believed to be in foreign-currency deposits, and the amount of households' foreign assets is estimated to be roughly US$31.2bn in the base year for calculating the average growth rate in the next decade.

41 "USCBC 2012 China Business Environment Survey Results: Continued Growth and Profitability; Tempered Optimism Due to Rising Costs, Competition, and Market Barriers", U.S.-China Business Council, 2012.

Figure 13: **The U.S.'s Top Concerns on Investment in China**

1	Human resource – talent recruitment and retention
2	Administrative licensing; business and product approvals
3	Competition with Chinese enterprises (state-owned or private)
4	Cost increases
5	Intellectual property rights enforcement
6	Inconsistent local enforcement and implementation of laws and policies
7	Investment restrictions
8	Competition with foreign companies in China
9	Competition with foreign or Chinese companies not subject to U.S. Foreign Corrupt Practices Act
10	Standards and conformity assessment

Source: "USCBC 2012 China Business Environment Survey Results: Continued Growth and Profitability; Tempered Optimism Due to Rising Costs, Competition, and Market Barriers", U.S.-China Business Council, 2012.

companies experienced wage increases between 5% and 10% in 2012. Despite the higher salaries, turnover rates of qualified workers still reached 10-20%.

Five of the top concerns are related to unfair competition, protectionism and restrictions on market access (points 2, 3, 6, 7 and 10). The survey indicates that half of the companies that reduced or stopped planned investment in China did so because of increased market access restrictions. Furthermore, 85% of companies said they have yet to see any improvement in discriminatory practices arising from 'indigenous innovation' policies, though this policy has officially been dropped by China's central government and local government is supposed to treat foreign companies in a fair and open manner in government procurements.

Regulatory transparency and intellectual property rights (IPR) protection continue to remain top concerns because improvements have been slow, even though many U.S. companies agreed that progress has been made in the last few years. 95% of companies indicated they are either somewhat concerned or very concerned about IPR enforcement, with trade secrets, trademarks and patents as the top three intellectual property infringement concerns. The lack of a practical criminal deterrent is seen to be a significant obstacle for China to develop an effective intellectual property protection regime.

China's *Catalogue Guiding Foreign Investment in Industry* has been a particular focus of market access and foreign ownership restrictions. It categorizes investment in different sectors as 'encouraged', 'restricted' or 'prohibited', and imposes ownership restrictions on over 90 sectors (enumerated in a recent USCBC publication[42]). As the U.S. Chamber of Commerce noted in an April 2011 submission to China, "China's approach towards foreign investment is frequently changing, somewhat unpredictable, and seemingly reveals an undue skepticism to foreign investment except insofar as it advances China's economic development goals at the time."[43]

U.S. companies have also expressed concerns about China's new system of national security screening for inbound M&As outlined under the *State Council Notice Regarding the Establishment of a Security Review Mechanism for Foreign Investors Acquiring Domestic Enterprises*. In addition to a lack of procedural transparency, the U.S. Chamber also stated that the criteria to determine which transactions will be subject to screening are not clearly defined[44]. For example, sectors such as 'important agricultural products', 'important energy

42 "China's Ownership Restrictions on U.S. and other Foreign Investors", USCBC, May 2011.
43 U.S. Chamber of Commerce and American Chamber of Commerce in China Submission to the National Development and Reform Council (NDRC) and Ministry of Commerce (MOFCOM), April 2011.
44 Ibid

and resources' and 'key technologies' are described as 'related to national security'. The U.S. Chamber argues that these terms suggest the application of an economic interest test rather than the narrow criteria of national security.

China's response and moves

China has been working actively to address some of the U.S. concerns. The most recent example looks at the concerns on market access. China committed in the May 2012 U.S.-China Strategic and Economic Dialogue (SED) that it will focus its "security review over mergers and acquisitions (M&A) by foreign capital solely on national security concerns and adhere to specific timelines and review standards."[45]

China has committed to improve IPR-related laws and regulations, and further consider strengthening measures for the pursuit of criminal liability for IPR infringement. It would also continue efforts to impose the use of legitimate software by government agencies, and to implement its earlier commitment that technology transfer and technology cooperation is to be decided by businesses independently and not to be used by the Chinese government as a pre-condition for market access. China also agreed to include trade secret misappropriation in the 2012 Annual Work Plan of the State Council Leading Group on Intellectual Property Enforcement[46].

Furthermore, China would continue to approve applications by qualified auto financing companies (AFCs) and financial leasing companies – including foreign-invested entities – to issue financial bonds in China at the same SED meeting. It would offer impartial treatment of foreign and Chinese-invested financial institutions in issuing credit asset-backed securities during the trial period of asset securitization in China. The Chinese authorities agreed to amend relevant regulations to allow foreign investors to hold up to a 49% equity stake in securities JVs, which are allowed to engage in underwriting and sponsoring the listing of stocks – including common shares denominated in RMB and foreign shares – and the issuing of bonds – including government bonds and corporate bonds. China would also allow qualified securities JVs that have been operating continuously for a minimum of two years to acquire additional licenses and broaden their business scope. In the SED meeting, China also committed to allow foreign investors to hold up to a 49% equity stake in futures brokerage JVs[47].

In response to incessant requests for China to open up the country further to foreign investment, China has insisted that this has to be gradual to ensure economic stability, given China's immature markets. For example, there has been criticism from both in and outside China about the government's conservative attitude towards liberalizing and opening up the financial sector. However, the Chinese government has pursued a cautious approach to the process of liberalization and opening up as China's financial markets are still underdeveloped and fragile. The government's regulatory and supervisory capabilities, and the market's risk management and governance systems have yet to meet the demands of fully open markets. Successive financial crises around the world in the past few decades have highlighted the perils of prematurely opening up financial markets and therefore China should adhere to a prudent pace of reform.

China's main concerns on investment in the U.S.

The main concerns of Chinese investors regarding direct investment in the U.S. are government regulations and policies that restrict foreign investment in specific sectors. For example, foreign investments are prohibited or restricted in some energy sectors, telecommunications, public media, railway construction, mining exploration and water and electricity utilities. Foreign-built and foreign-owned

45 Joint U.S.-China Economic Track Fact Sheet, May 2012, p. 6.
46 Joint U.S.-China Economic Track Fact Sheet, May 2012, p. 4.
47 Joint U.S.-China Economic Track Fact Sheet, May 2012, p. 9.

Figure 14: China's Top Concerns on Investment in the U.S.*

1	Market access and foreign ownership restrictions
2	Unpredictable national security screening
3	SOE discrimination
4	U.S. visa policy
5	U.S. domestic politics
6	Compliance with the same laws and regulations that apply to U.S. firms

** Author's own research; not listed in order of priority.*

vessels are prohibited from engaging in passenger or commercial transport business within and between U.S. ports. Foreign entities are not allowed to own more than 25% of the voting interest of any U.S. airline or control the U.S. airline by other means. There are also complaints about strict U.S. regulations on foreign banks to establish subsidiaries in the U.S. and/or acquire U.S. banks, which have limited Chinese investment in U.S. finance[48].

Some investors in China have raised concerns that the legislatively mandated process for screening FDI transactions managed by the treasury-chaired Committee on Foreign Investment in the United States (CFIUS) is unpredictable. Some acquisition cases that encountered strong adverse reaction from a coalition of congressmen, businesses and media failed while similar cases passed with little public comment[49]. Such unpredictability and ambiguous standards of assessment have caused Chinese investors' concern – from the potential rise in pre-investment costs, uncertainties and possible damage to their reputation, thus discouraging them from investing.

It is not uncommon for governments to restrict foreign investment in 'strategic' industries or sectors sensitive to national security. Unlike China, the U.S. does not publish a formal list to guide foreign investment into domestic industries, relying instead on the general principle that it welcomes all kinds of investment except those that involve national security issues. To many Chinese investors, however, this approach seems more ambiguous and lacks transparency because many high-tech or energy deals could be refused on the pretext of national security.

Such concerns are complicated by the active role played by Chinese state-owned enterprises (SOEs) in China's outward investment, as not many private companies in China have the scale, resources and capacity to make large-scale investments overseas, particularly in asset-heavy investment projects. A highly politicized environment in the U.S. towards China makes the situation worse, particularly when the U.S. enters election seasons[50]. For example, the last U.S. mid-term election saw at least 29 candidates engaged in some form of anti-China campaign. The handling of a few high-profile transactions in the past few years – notably China National Offshore Oil Corporation's (CNOOC) withdrawal of its bid for Unocal in 2005 in the face of political opposition

48 "The State, Issues and Reasons of China's FDI in the U.S.", Development Research Center of the State Council, June 2011, http://bbs.jjxj.org/thread-1087112-1-1.html.

49 Refer to"An Open American Door? Maximizing the Benefits of Chinese Foreign Direct Investment", Daniel H. Rosen and Thilo Hanemann, Center for U.S.-China Relations, Asia Society, and Kissinger Institute on China and the United States, Woodrow Wilson International Center, May 2011, p. 62. CNOOC's bid for Unocal (2005) vs CNOOC's bid for shale gas extraction in Texas (2010); Huawei's bid for 3com (2007) vs Lenovo's bid for IBM (2005); Anshan Steel's bid (2010) vs Tianjin Steel's bid (2010).

50 One recent case that may be seen as an example reflecting a highly politicized environment is the "Investigative Report on the U.S. National Security Issues posed by Chinese telecommunication companies Huawei and ZTE," published on October 8, 2012 by Chairman Mike Rogers and Ranking member C.A. Dutch Ruppersberger of the Permanent Select Committee on Intelligence of the U.S. House of Representatives. The report concludes that 'the risks associated with Huawei's and ZTE's provision of telecommunication equipment to the U.S. of critical infrastructure could undermine core U.S. national security interests'. Among the report's various findings behind its conclusion was that 'neither company was forthcoming with detailed information about its formal relationships or regulatory interactions with the Chinese authorities.'

in the U.S. – has fed negative Chinese investor perceptions of the U.S. investment climate. According to a Rosen and Hanemann study, interference in the approval of China-related deals appears to have increased in recent years, often due to concerns about 'national security' and/or due to lobbies by specific groups in the U.S. with vested interests[51].

While Chinese SOEs account for a large amount of China's outward direct investment, the SOEs' share of Chinese outward investment is shrinking and they are outnumbered by private investors. According to the Chinese Ministry of Commerce, the share of China's outward direct investment conducted by SOEs in 2010 dropped by 3 percentage points to 66.2% in 2009[52]. Meanwhile, the Rosen and Hanemann study reported that 170 out of 230 (or 74%) recorded Chinese investment in the U.S. between 2003 and 2010 actually originated from private firms[53].

Another major concern of Chinese investors is the U.S. visa policy. Complaints focus not just on the application process, but also on the attitude of U.S. immigration officers. Among the frequent complaints are the long visa application period, its complex and user-unfriendly procedures, the permitted short durations of stay, the small visa quota, high refusal rate and ambiguous approval criteria. Occasional reports of unfavorable encounters with U.S. immigration officers also reinforce the Chinese perception of a discriminatory visa policy in the U.S. Some of these problems have been addressed by the U.S. government in recent years. According to U.S. Ambassador to China Gary Locke, over the past two years, wait time for a U.S. visa interview has been cut from 100 days in Beijing and 70 days in Shanghai to two days anywhere in the four U.S. visa-issuing offices in China, despite a 40% increase in visa demand and zero staff increase during that period[54]. While this is a commendable achievement, it also underlines the room for improvement in the visa application and processing arrangements, such as increasing the number of visa issuing offices.

U.S. response and moves

At present, China's investment in the U.S. flows to a wide range of industries, including the strategic and high-tech areas, natural resources and infrastructure. The vast majority of actual and prospective Chinese investments in the U.S. – including all greenfield investments and most acquisitions – do not need to go through the CFIUS process, and those that do are rarely blocked. Some independent observers argue that "there is no indication that Chinese firms formally were discriminated against when their investments were subject to a CFIUS screening."[55]

The U.S. regards the CFIUS regime of screening well designed and "reflects a tradition of openness to both the economic benefits and enhanced competition from foreign firms that it entails."[56] The responsibility of CFIUS was enhanced in 2007 by providing a legislative mandate and was extended to review critical infrastructure and foreign-government-controlled entities unless it is exempted by the Treasury Department or the CFIUS' lead agency. The right that CFIUS is authorized to review all suspicious deals is then clarified.

In the fourth meeting of the SED held in Beijing last May, the U.S. reiterated its policy to "welcome

51 "An Open American Door? Maximizing the Benefits of Chinese Foreign Direct Investment", Daniel H. Rosen and Thilo Hanemann, Center for U.S.-China Relations, Asia Society, and Kissinger Institute on China and the United States, Woodrow Wilson International Ce 2011,p. 59-64.

52 MOFCOM, *2010 Statistical Bulletin of China's Outward Foreign Direct Investment*, September 2011.

53 "An Open American Door? Maximizing the Benefits of Chinese Foreign Direct Investment", Daniel H. Rosen and Thilo Hanemann, Center for U.S.-China Relations, Asia Society, and Kissinger Institute on China and the United States, Woodrow Wilson International Center, May 2011, p. 33.

54 Information sourced from: http://www.carnegieendowment.org/2012/09/13/forging-u.s.-china-relations-with-ambassador-gary-locke/do64

55 "An Open American Door? Maximizing the Benefits of Chinese Foreign Direct Investment", Daniel H. Rosen and Thilo Hanemann, Center for U.S.-China Relations, Asia Society, and Kissinger Institute on China and the United States, Woodrow Wilson International Center, May 2011, p. 61.

56 "An Open American Door? Maximizing the Benefits of Chinese Foreign Direct Investment", Daniel H. Rosen and Thilo Hanemann, Center for U.S.-China Relations, Asia Society, and Kissinger Institute on China and the United States, Woodrow Wilson International Center, May 2011, p. 65.

foreign investment in all sectors, including the financial sector, and remains committed to apply the same prudential and regulatory standards to applications made by Chinese banks, securities, and fund management companies as they apply to other foreign financial institutions in like circumstances."[57] The U.S. authorities also committed to act expeditiously on pending applications by Chinese banks that are under active review and consideration. Both sides also committed "to strengthen cooperation on information of financial market infrastructure and specialized financial institutions, and enhance communication and collaboration on building exchanges and the exchange system."[58]

The U.S. has set up SelectUSA, a program to encourage, facilitate and accelerate foreign and domestic firms investing in the U.S. Furthermore, many investment promotion programs at different levels have been organized to help Chinese investors to overcome the endemic difficulties. Chambers of business – including the U.S. Chamber of Commerce and the U.S.-China Business Council – also helped to foster two-way investments between the U.S. and China.

U.S.-China portfolio investment concerns

To complement the country's economic reform and opening-up policies since 1978, China started to introduce financial sector reform gradually since the 1980s. However, financial market liberalization over the years has been widely seen to be lagging behind the rapid pace of China's modernization. Today, China still maintains a comprehensive system of capital controls that regulates the flow of capital both into and out of China. Financial markets in China are also generally underdeveloped in comparison to the needs of the country at the current level of development. Portfolio investment flows into and out of China, particularly by the private sector, is very small in comparison to the scale of China's economy and the size of China's savings.

But given the rapid accumulation in wealth by the Chinese people, and the needs of a rapidly modernizing economy, the potential of a significant surge in portfolio investment, both into and out of China, have been built up. Indeed, while China's capital markets are still immature and generally closed to outside investors, the size of many markets and the amount of turnover involved are already amongst the largest in the world. For example, in the A-share market, there are 78 million retail investors with over 168 million trading accounts, and the electronic trading technology adopted is one of the most advanced in the world[59]. Meanwhile, China has over 13 million incorporated enterprises, more than 40 million self-employment businesses and a great deal of innovative start-up activities that need to raise funds in the capital market[60].

Giving more freedom to capital flows into and out of China will encourage a more efficient allocation of capital that is important in China's next stage of modernization, providing not only more channels for Chinese savings to invest profitably, but also new sources of risk capital to finance the growth of many different kinds of businesses.

The significant potential of a rapid surge in cross-border portfolio investment flows will be realized as China continues to liberalize its capital flow restrictions and as China continues to reform and modernize its financial markets.

Response and moves

In the May 2012 SED, China committed to increase the total quota for QFII to US$80bn and to raise the quota for Renminbi Qualified Foreign Institutional Investors (RQFII) to RMB70bn (US$1.13bn). It also promised to expand financial cooperation with U.S. institutions into the insurance business.

57 Joint U.S.-China Economic Track Fact Sheet, May 2012.
58 Ibid

59 Speech by Guo Shuqing, Chairman of China Securities Regulatory Commission, at the Asian Financial Forum on 14 January 2013. (http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201301/t20130114_220400.htm)
60 Ibid

The same SED meeting has seen China reaffirming its commitment to follow the generally accepted principles and practices of Sovereign Wealth Funds (SWFs), while the U.S. reaffirmed its commitment to upholding the open and non-discriminatory principles toward sovereign wealth funds as described in the Declaration on Sovereign Wealth Funds and Recipient Country Policies announced by the OECD in June 2008.

Regarding the recent instances of reverse mergers, little evidence shows that Chinese SOEs were directly involved. Most reverse mergers are small and medium private firms simply set up for raising capital and thus few U.S. valuable assets were purchased with strategic intention. This approach seems to be a symptom of shallow capital markets in China instead of a threat to U.S. economic security. Besides, discussions and communications between the Public Company Accounting Oversight Board (PCAOB) and MOFCOM are in progress for tighter supervision of Chinese accounting and auditing firms[61].

Proposals on China-U.S. Cooperation to Facilitate Cross-Country Investment

Other than strong complementarities of the two countries, it is also very important that both the Chinese and U.S. governments have publicly committed to an open, non-discriminatory investment climate and have taken recent action to promote this objective. In their joint statement issued after the May 2012 SED meeting, the two governments "reaffirmed the importance of fostering open, fair, and transparent investment environments to their domestic economies and to the global economy." The U.S. said it "welcomes business investment from all countries, including China, and including from state-owned enterprises." Both governments stated that their investment screening processes are focused exclusively on national security and agreed to discuss each other's concerns in this regard through the U.S.-China Investment Forum. And the two sides agreed to schedule a seventh and subsequent round of negotiations on a bilateral investment treaty (BIT) and to 'intensify negotiations'.

Following through on these statements and taking additional steps to improve the investment climate in both countries will be critical to the U.S. and China's ability to maximize the benefits of their economic relationship in the decade ahead. Removing these and other FDI impediments will bolster U.S. business support for Chinese investment in the U.S., making it a 'win-win' proposition for both sides.

It is hard to overestimate the benefits of investment cooperation between the U.S. and China. The challenges lie in how to overcome the hurdles and promote bilateral investment flows. We hereby briefly outline some of the key suggestions, divided again by direct and portfolio investments. Some of them are being raised and tackled by the authorities, especially through the SED platform, but clear progress and breakthrough may require a more fundamental change in strategic thinking and approach.

Promote further mutual understanding

Protect the investment review process from interference from politicization

The U.S. investment screening process is generally well designed. However, efforts should be made to better protect the screening process from politicization and further improve the transparency of the formal decision-making process. For instance, terms such as 'national security', 'critical infrastructure' and 'foreign-government control' are somewhat loosely defined and ambiguous. It is important to ensure that investment screening outcomes accord with the goal of openness, and not be jeopardized by spurious arguments against such investments.

61 Ibid

Enhance cultural exchange to develop bilateral ties and avoid misunderstanding

No relationship between two countries in this century is more important than that of China and the U.S. With different cultural backgrounds, people from China and the U.S. have to carry out educational, cultural as well as political and commercial exchanges in order to enhance their long-term collaboration and strive for an in-depth understanding. Non-profit organizations may organize programs to improve the language skills of both sides. Legal terms – definitions and terminology – need to be clarified to avoid legal disputes.

Systemize the promotion of investment

Review and improve investment guides

China's *Catalogue Guiding Foreign Investment in Industry* and other investment guides are seen as too broad and vague to serve as clear references for investors. Specifically, review process is long and complex, while the scope of assessment stretches into sensitive but poorly defined areas like economic security, business confidentiality and social order. The U.S. could also consider compiling some user-friendly investment guidelines – for example, Chinese-translated versions – addressing issues commonly encountered or raised by Chinese investors, including labor, tax, visa, IPR and other regulatory and operating issues.

Establish local government investment promotion agencies

Aside from top-level official dialogues, there is a need to strengthen cooperation and dialogue between the local governments and between local business groups from the two countries. Currently, each U.S. state has its associations stationed in China, which mainly consist of representatives from the state government, municipal government, tourism bureau and harbor authority. The main purpose of these agencies is to promote U.S.-China cooperation in various areas. Both countries can consider setting up local investment promotion agencies and form a network of local investment and promotion agencies. The U.S. government recently launched an effort known as SelectUSA to assist Chinese and other foreign investors in the U.S. market, and has committed to encouraging subnational cooperation between Chinese provinces and municipalities and U.S. state and local governments. Such moves are encouraging and need to be reinforced.

Convene investment project meetings

Both governments may encourage the organization of regular or ad-hoc U.S.-China direct investment project meetings, for local governments and enterprises, with special incentives to encourage participation.

Encourage the establishment of investment funds

Both governments may encourage the establishment of specific funds to support bilateral investment. Specifically, China may consider supporting the development of more sophisticated venture capital and private equity funds to play a more active role in corporate restructuring and financing in China, and to encourage qualified foreign investors to be listed on the Chinese stock markets.

Improve investment climates in both nations

Publish 'safe harbor' lists and raise policy transparency and its communication

Both governments may consider publishing their own 'safe harbor' list of industries or criteria for foreign investment – such as an ownership ceiling for the investment in question – that will be free from regulatory scrutiny. Improving U.S. policy transparency – both by means of publishing more refined policy guidelines and applying more user-friendly and effective communication channels – in areas like national security, environment and antitrust – could reduce investor uncertainties and perception about undue discrimination to Chinese investors. Similarly, China should also improve its transparency in investment-related policies.

Remove foreign investment restrictions in certain industries

China's *Catalogue Guiding Foreign Investment in Industry* still has a number of restrictions over multiple sectors such as energy, infrastructure, finance and media among others. Even in those off-limits sectors, regulations do not ensure fair competition for foreign investors. China should create a more FDI-friendly environment by giving foreign investors more market access and by creating a more level playing field in the local market.

Accelerate the negotiation and signing of a bilateral investment treaty

U.S.-China relations are the most important bilateral relations in the world and a U.S.-China bilateral investment treaty (BIT) could reflect that. While both governments have committed themselves in the latest SED meeting to schedule a seventh and subsequent negotiating round, it would be prudent to use this as an opportunity to intensify BIT negotiations following the conclusion of the U.S. model BIT review in April 2012. However, it remains unclear how long the process will take and how the two governments will put into practice their commitment to foster open, fair and transparent investment environments to their domestic economies and to the global economy. To complete a BIT with the U.S., China will need to reduce its foreign ownership restrictions, in order to meet the 'pre-establishment' national treatment standard. Clear progress in the signing of a U.S.-China BIT could raise mutual trust and send a strong message that the two largest economies in the world are committed to working together for the mutual benefit of both countries. Both sides may also consider leveraging development in other bilateral or multilateral investment platforms, such as the recently concluded Canada-China Foreign Investment Promotion and Protection Agreement (FIPA), the ongoing Trans-Pacific Partnership engagements, or even the proposal to explore a U.S.-China-EU trilateral investment treaty.

Relax visa rules

Both sides should work on clarifying and expediting visa application procedures for residents from both – as well as other – countries. It would also be beneficial to look at simplified procedures and longer duration or pilot schemes to be offered to frequent and/or business visitors.

Cooperation in financial market development

The U.S. has some of the world's largest and most sophisticated and internationalized capital markets. Lessons learnt from the recent financial crises are also highly valuable. While China's financial system stays strong and stable in the global crisis, its capital market remains underdeveloped. To ensure economic growth and financial stability/security, both countries have a lot to learn through cooperation. Broadly speaking, there are three aspects of cooperation:

- Domestic capital market development: Financial systems in both countries are undergoing significant changes and reforms. In the U.S., the latest financial crises have exposed many fundamental weaknesses of the U.S. financial system and raised new challenges to regulators and market participants. In China, external shocks and uncertainties also add pressure to its efforts to steadily promote and deepen a market-based financial system. While each country will have to adopt reforms and changes according to its own reality and fundamentals, the fact that these two largest economies in the world will ultimately have their financial systems interacting with and influencing each other closely means they need to work and cooperate as closely and as early as possible, especially at times of systemic reforms. Issues such as China's interest rate liberalization, supervisory and risk management reforms, financial system deregulation, capital market deepening and the improvement of the monetary policy transmission mechanism may benefit from U.S. experience and support. Conversely, China's improved understanding and support of U.S. monetary policy and management, fiscal consolidation and financing, and other issues will help to foster better cooperation and policy coordination.

- External finance and bilateral exchange rate stability: This has always been an eye-catching topic in U.S.-China bilateral relations. In the latest SED, China specifically stated that it remains committed to continue exchange-rate regime reform, enhance RMB exchange-rate flexibility in both directions, and allow market supply and demand to play a more basic role in the formation of the exchange rate. While the development of a market-based exchange rate system is important, it is also critical that monetary authorities of major currencies work together to avoid undue financial market volatility. China's effort to internationalize the RMB is an important development of international finance that needs close cooperation with other major economies, especially the U.S. Conversely, the trend of Chinese companies listing overseas as well as the opening up of China's fast-growing financial markets should not be missed by the U.S. authorities.

International financial reforms

Development of new and better international financial architecture cannot succeed without active participation and close cooperation of the world's two largest economies. In the latest SED, both countries have reinstated their support to Europe's efforts to restore financial stability and growth. They also reaffirmed their support to the IMF's role and efforts in promoting global economic and financial stability, including the timely implementation of 2010 reforms with the IMF, and efforts to improve surveillance on exchange-rate policies, global liquidity, capital flows and other external sector analysis. The two governments promised at the SED to effectively implement the international financial regulatory framework based on the G-20, including the supervision of systemically important financial institutions and risk resolution, develop effective resolution regimes for financial firms and enhance the regulation of the financial derivatives, deepen the compensation reform of financial institutions, and support the objective of a single set of high-quality global accounting standards. They also agreed to enhance cooperation in combating money laundering, counterfeiting and the proliferation of terrorist activities.

Better leverage on Hong Kong's Experience and Resources

Hong Kong's close connection with both economies and its expertise in international finance and business is a unique and invaluable asset for both countries. For China, Hong Kong is building on its traditional role as a major trade and finance center to become a key offshore market for the RMB and a conduit for 'go global' Chinese investors. For the U.S., Hong Kong not only remains a major outpost for China/Asia-related business, but also gaining new importance in connecting China with the global financial system. If China's entry into the WTO in 2001 signifies China's formal integration with the global trading system, China's recent move to internationalize the RMB and gradually open up its capital account can be seen as its next important move to formally integrate with the global financial system. In this respect, Hong Kong's emerging role as the key offshore RMB center and the testing ground for China's capital account opening is highly significant in the economic development of China, the U.S and the world.