

Testimony of
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Before the U.S.–China Economic & Security Review Commission
on
The Extent of the Government’s Control of China’s Economy,
and its Impact on the United States
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Thank you for the opportunity to testify before the Commission today. I would like to focus on four particular issues:

- First, an update on developments in China with respect to outward investment;
- Second, a discussion on how the United States should react to investments in the United States from China;
- Third, a discussion on how CFIUS might analyze transactions involving Chinese companies; and,
- Fourth, a discussion of the dangers of investment protectionism at home and abroad.²

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² Portions of this testimony were drawn from: Edward M. Graham & David M. Marchick, *US National Security and Foreign Direct Investment* (Institute for International Economics, 2006); David M. Marchick & Richard Mintz, “The Shifting Landscape of CFIUS,” *China Business Review*, Jan.-Feb. 2007, at 42; David M. Marchick & Edward M. Graham, “How China Can Break Down America’s Wall,” *Far Eastern Economic Review*, July-Aug. 2006, at 10; David M. Marchick, et al., “National Security Regulation of Foreign Investments and Acquisitions in the United States,” *China Law & Practice*, June 2005, at 23.

I. Outward investment from China

The evolution of China's economic policies is well known to this Commission. From 1949 until the late-1970s, there were few more isolated, autarkic countries in the world than China. During this period, the Chinese government closed China to virtually all foreign commerce and investment, with the exception of sporadic Soviet and Eastern bloc trade. The Chinese government allowed little trade with the external world, had virtually no outward direct investment, and was almost completely closed to inward investment. Under Mao Zedong, the economy of China was, by almost any measure, among the most isolated on the planet. And in spite of the nation's past power and wealth, at the time of Mao's death China was one of the poorest countries on earth on a per capita basis.

The recent evolution of China's economy began with the growth of inward foreign investment in China that started under Mao's successor Deng Xiaoping. In 1979, China created special economic zones in which foreign investors could operate export-oriented manufacturing activities free from most existing Chinese regulations. The economic zones achieved their purpose of increasing Chinese exports and the amount of foreign exchange. By 1990, foreign investment in China had increased more than 60 times over, from \$57 million in 1980 to \$3.5 billion, with most of this investment flowing into special economic zones. Similarly, Chinese exports more than doubled between 1985 and 1990, from \$27 billion to \$62 billion, and the majority of the growth in exports came from these special economic zones.

In 1992, the success of the special economic zones prompted Chinese authorities to expand export-related privileges to other parts of China and liberalize policies regarding foreign direct investment (FDI). Three years later the government published comprehensive regulations on foreign investment that somewhat increased transparency in state oversight of FDI. This was all part of a process of liberalization of rules on foreign investment that saw China join the WTO in 1999. This economic liberalization has led to explosive growth in Chinese exports and FDI into China since the early 1990s. FDI inflows into China increased from \$3.5 billion in 1990 to \$69.5 billion in 2006.³ Foreign invested firms' exports mushroomed from just under \$8 billion in 1990 to \$444.2 billion in 2005, and total exports increased from \$62 billion to nearly \$762 billion in those same years.

This strong encouragement of inward FDI has recently prompted the Chinese government to institute policies in support of outward foreign investment. In its tenth "Five Year Plan" for economic and social development, the Chinese government in 2001 officially adopted a policy encouraging Chinese companies to invest abroad. Prominent government officials have often repeated in their speeches their call for companies to "go global," and this policy has begun to bear fruit. By 2005, Chinese companies had invested approximately \$30 billion in non-Chinese companies, a third of which originated in 2004-2005.⁴ In 2006, Chinese companies invested

³ See "Foreign Investment in China," US-China Business Council, 2007.

⁴ See "China's Global Challengers, The Strategic Implications of Chinese Outbound M&A," Boston Consulting Group, May 2006.

about \$16.1 billion abroad, a 32% increase in outward investment over the previous year.⁵ Recent overseas investments include Haier's recent acquisition of the refrigerator operations of Japanese electronics company Sanyo; Lenovo's acquisition of IBM's personal computer division in 2004; and the largest acquisition to date, China National Petroleum's \$4.2 billion acquisition of PetroKazakhstan. And Chinese brands have, for the first time, begun to see success in the globalized market, including Haier (home appliances), Konka (color televisions), Tsingtao (beer), Jianlibao (beverages), and Galanze (microwave ovens). Chinese companies have made major acquisitions of natural resource companies in Australia, Canada, South America, and Africa.

While there has been recent growth in outward FDI and M&A by Chinese companies, overall, China remains a very small player in global outward investment. Even with the surge in outward investment in 2006, China's total cumulative FDI stock is still only slightly greater than the inward FDI China received in the *last year* alone. As a percent of GDP, China's outward FDI is much smaller than other important developing countries including India and South Africa. Announcements for new foreign investment in the U.S. in May *alone* was slightly less than the total value of *all* of China's outward investment in from 2004 to 2006.

These small levels of outward FDI could change, however, in the near future. Chinese companies are increasingly looking to go global, attract international talent and leverage their sizable home market and strengths in manufacturing. Interaction with western investment banks and financial advisors has increased in recent years, enhancing Chinese managers' sophistication with respect to M&A. Credit remains accessible at low cost both within China and in international markets. And if you look back at Japan, Korea and other leading Asian economies' growth in outward investment in the late-1980s and 1990s, it would not be surprising if outward investment grows by 30 percent or more for the foreseeable future.⁶ Deutsche Bank reports that outward FDI from Korea and Japan grew, respectively, by 27.8% and 28.3% annually in the 1990s and predicts that China will be the fourth largest source of foreign direct investment within the next five years (behind only the U.S., the UK and Germany).

More recently, China has discussed a plan to create a \$200-300 billion dollar sovereign wealth fund to be used for domestic and foreign investments.⁷ The money will come from central bank reserves and the fund will be managed by a former vice-minister of finance. By most widely accepted measures, Chinese reserves far exceed the level necessary for solvency and liquidity.⁸

⁵ See "China's foreign direct investment up 10.17 pct Jan. through April," *People's Daily Online*, May 17, 2007.

⁶ See "China's Overseas Investments," Deutsche Bank, Jan. 2007.

⁷ See, e.g., "Establishment of China's state forex investment company officially discussed," *People's Daily Online*, Mar. 16, 2007. .

⁸ See, for example, "Opportunities in an era of large and growing official wealth," by Lawrence H. Summers, in which Summers discusses the "Greenspan-Guidotti" rule which suggests that a healthy level of reserves "is enough to cover one year's short-term debt," in *Sovereign Wealth Management* (Central Banking, 2007), at 15,17-18.

Earlier this week, China announced its first major investment from this fund - a \$3 billion non-voting investment in the Blackstone Group, the New York-based investment bank.⁹

While important policy questions are triggered by the creation of this fund, particularly given its potential size, the United States should not react negatively to the move by China. Such sovereign wealth funds have become commonplace in recent years. Countries with sovereign wealth funds range from Norway to Korea to the United Arab Emirates to Singapore to Hong Kong. Others include Kuwait, Brunei, Malaysia, Taiwan, Canada, Botswana and Chile. China's proposed fund will likely be smaller than the UAE's and will be approximately the size of Norway's and Kuwait's. Far from a cause for alarm, sovereign wealth funds such as China's proposed fund are part of a recent and growing trend by central banks and state pension fund managers to add the goal of increasing returns to the longstanding goals of solvency and liquidity. Closer to home, Canada, for example, recently has set aside portions of its reserves for portfolio and direct investment in the Alberta Heritage fund.. The manager of China's new fund recently said that they intended to take small stakes in a number of publicly traded entities as opposed to controlling stakes or acquisitions of Chinese and foreign companies.

In fact, the Chinese fund is particularly unremarkable if we look beyond sovereign wealth funds and consider the many other state-owned funds that invest in companies in the United States and abroad. CalPERS, the Ontario (CA) Teachers' Pension Fund and the Canadian Pension Fund are but three examples of such state-owned investment entities. Alaska and Wyoming have long had funds to invest state national resource revenues, and CalPERS currently invests some 23.8 percent of its portfolio abroad. Some of these state organizations have even taken controlling ownership stakes in prominent corporations: for example, the Alabama state pension plan had a controlling ownership stake in U.S. Airways from 2002 to 2005. Similarly, the Canadian Pension Plan has ownership stakes in numerous foreign companies, including Berliner Verlag (leading German regional newspaper publishing group based in Berlin), Serta (leading U.S.-based mattress maker), Nielsen (U.S.-and Netherlands-based information and media company), Univision (leading Spanish-language media company in the United States), A-Katsastus OY (a leading Northern European vehicle inspection company based in Finland), Avio (Italian jet engine component and subsystem manufacturer), AWAS (Ireland-based aircraft trading and leasing company), Grupo Corporative ONO (a leading broadband service provider in Spain), NXP (a leading developer and manufacturer of semiconductors, based in the Netherlands).

Two key policy issues arise with respect to the creation of this investment fund in China: First, will the fund be professionally run by independent financial and investment experts, or will the investments made to advance industrial policy, political or foreign policy objectives? More specifically, will investment decisions made according to financial criteria, or are they being used as instruments to extend state policy? Second, will investments by the fund in the United States raise any national security issues?

⁹ "Blackstone Boosts IPO as China Takes Stake," *Financial Times*, May 20, 2007; "Chinese foreign exchange investment agency gives US \$3 billion to Blackstone, paper says," *International Herald Tribune*, May 18, 2007.

The answer to these questions will affect how investments by the new fund are viewed in the United States and other countries. In my view, the creation of this fund should be considered a positive development. It has the potential to enhance the market orientation of the Chinese government's policies. It could help spur internal economic reform and contribute to global liquidity (which is already extremely high today). At the same time, it is crucial that the rules governing such a fund are consistent with commercial principles and international financial norms, that China only take risk on funds that are well in excess of that required for solvency and liquidity, and that there be transparency with respect to the fund's investments.

II. How should the United States react to investment by Chinese companies?

With the exception of a narrow set of potential investments that could raise national security concerns, the United States should encourage investment from China into the United States. The United States has a strong interest in continuing to support China's integration into the global economy, and Chinese outward investment is a natural and positive evolution in China's economic development. For close to two decades, through Republican and Democratic administrations, the United States has encouraged China to lower tariffs, eliminate non-tariff barriers to trade, privatize state-owned enterprises, and participate in—and play by the rules of—the global economy. The United States has also repeatedly pressed China to eliminate barriers to FDI by U.S. and other foreign companies. Successive U.S. administrations have correctly pursued these policies, not only for the economic and commercial benefit of U.S. companies, but also in belief that adopting market-based economic policies will facilitate democratic reform in China.

But the United States cannot have it both ways. A U.S. policy that encourages investment by American companies in China while frowning upon Chinese investment in the United States is neither sustainable nor sound from an economic perspective. Rather, the United States should simultaneously encourage China to allow FDI and make clear that Chinese investment in the United States is not only welcome but encouraged. Greater FDI from China would bring substantial economic benefits to the U.S. economy, just as investment from other countries already does. Chinese investment in the United States will create jobs, promote research and development in the United States, and enhance U.S. exports to China, including through intracompany trade.

Additional investment from China would also produce important ancillary benefits for the United States consistent with broader U.S. strategic and political objectives. Chinese direct investment in fixed assets and companies in the United States will further align Chinese and U.S. economic interests beyond mere investment in liquid treasury bills.

Greater Chinese ownership of and investment in U.S. companies, as well as involvement in the world economy, would have the additional benefit of exposing Chinese companies to global legal norms, including requirements for enhanced transparency and, importantly, the protection of intellectual property rights. Chinese companies successfully operating in the United States would help create a new constituency within China for open trade and investment, just as the U.S. business community consistently presses Washington to liberalize trade and investment in the United States because of its substantial commercial interests abroad. Furthermore, the good

business practices that Chinese companies learn and have to follow in the United States, including with respect to transparency, may be replicated in their other operations, both internationally, and in China. The United States stands to benefit substantially, both directly and indirectly, from increased levels of Chinese direct investment within its borders.

Chinese companies will need to become more sophisticated in addressing the potential political opposition that may arise if they wish to be successful in their efforts to enter the U.S. market. They will need to demonstrate their commitment to creating jobs, complying with U.S. laws and regulations, working collaboratively with organized labor, and being good employers. They will need to become involved in their communities in the same way that the best American and foreign companies do.

Indeed, the initial U.S. experiences with Chinese investment have been positive. After acquiring IBM's personal computing division in 2004, Lenovo has retained IBM's senior management, employs an American as their global CEO and has increased purchases of American software for sale in China instead of selling personal computers without software installed. South Carolina Governor Mark Sanford recently spoke at a forum with Chairman Barney Frank and Treasury Secretary Paulson about the beneficial effect that investment by Chinese appliance manufacturer Haier has had on the local economy. South Carolina intends to open a China office to pursue more Chinese direct investment.

As Former Deputy Secretary of State Robert Zoellick has said, the United States must step up its efforts to make China a "responsible stakeholder" in the international system. Encouraging Chinese outward investment will help achieve this goal. For its part, the United States should continue to support China's integration into the global economy. The United States should simultaneously encourage China to continue to allow FDI to flow into its own economy and in parallel welcome Chinese investment in the United States. By doing so, the United States itself will benefit, as will China.

At the same time, the United States should never allow an investment from China or any other country that would compromise our national security. For the narrow set of investments that might raise national security concerns, the Exon-Florio Amendment to the Defense Production Act of 1950, as implemented by the Committee on Foreign Investment in the United States (CFIUS), is an extraordinarily powerful tool to mitigate national security concerns associated with an acquisition, or if necessary, to block an acquisition outright.

III. Chinese acquisitions and CFIUS

Certain acquisitions of U.S. companies by Chinese entities will raise unique issues before CFIUS.

In practice, Chinese acquisitions of U.S. firms already receive substantial CFIUS scrutiny, and under the recent CFIUS reform bills passed by the U.S. House of Representatives and the Senate

Banking Committee, acquisitions of U.S. companies by state-owned entities will receive even more scrutiny.¹⁰ When analyzing such acquisitions, CFIUS considers a number of factors.

The first of these is state ownership (direct or indirect) of Chinese companies. While some government-owned companies, including many owned by pension plans or state investment funds, around the world operate as purely commercial entities, government ownership often raises questions within CFIUS of whether the companies will make decisions based on commercial interests or national interests. While China has made some modest moves to reduce state ownership, the fact remains that most Chinese companies capable of making large-scale investments in the United States are state-owned enterprises (SOEs). CFIUS will also likely treat the new sovereign investment fund as an SOE because its leadership will have ministerial rank and will report to the State Council. CFIUS may even treat certain privately-owned entities in China as state-owned due to the pervasive influence and control that the Chinese government exerts on many aspects of society.

A second factor relates to the acquisition of U.S. export-controlled technologies by Chinese companies. The possibility of sensitive, export-controlled technology being transferred to countries that are seeking to bolster their militaries raises national security concerns for the United States. CFIUS examines this factor in connection with every CFIUS review. With respect to China, CFIUS will remain concerned about the possibility of dual-use technology being used to enhance the capabilities of the Chinese military. Pentagon reports have concluded that the growth and strengthening of China's military threatens U.S. interests. In addition, the Pentagon makes clear that the DOD views Chinese economic and technological development as entwined with the strengthening of the Chinese military.

As a result, CFIUS will scrutinize the acquisition or transfer of any technology that could strengthen China's military capabilities. This is true even if the underlying technology is not critical to U.S. defense capabilities and the technology does not pose foreseeable export-control problems. CFIUS would likely analyze not only the sophistication of dual use technologies owned or developed by a target company, but also the ties of the Chinese acquirer to the Chinese military-industrial complex. Thus Chinese state-owned enterprises that have been involved in the production of military goods in China may face hurdles in clearing CFIUS, depending on the sensitivity of the technology owned by the target company in the United States.

CFIUS also considers the likelihood, in its view, that the acquirer will abide by U.S. export control laws and regulations if the transaction in question is approved. CFIUS is likely to have significant reservations about approving a transaction in which a foreign company that previously violated U.S. export regulations seeks to acquire a U.S. company with controlled

¹⁰ For example, both HR 556 and the bill recently approved by the Senate Banking Committee (no bill number has been assigned) require (a) automatic second-stage investigations of acquisitions by state-owned entities unless certain conditions are met, including specific approval by the Secretary or Deputy Secretary of the Treasury and the Secretary or Deputy Secretary of the lead agency assigned for the review. The lead agency will typically be one or more of the "security" agencies within CFIUS - the Departments of Defense, Justice and Homeland Security.

technology. CFIUS routinely examines reports of Chinese companies running afoul of U.S. export laws and regulations. CFIUS also considers the target company's record of compliance, although this is of less importance than the acquirer's compliance since the acquirer's compliance procedures are typically extended to the target after a transaction closes.

This issue tends to be a particular concern for acquisitions by Chinese companies, in part because of a series of high profile breaches of export control laws in the late 1990s and early 2000s. Since then, China has improved its internal export control mechanisms significantly by publishing new export control regulations, making agreements with other countries on end use verification procedures, and training Chinese companies on the subject. That said, export-control issues will likely remain high on CFIUS's radar screen for Chinese companies, and Chinese acquisitions of U.S. companies with export-controlled technologies will continue to receive extra scrutiny. In this regard, China is not alone, as CFIUS has also demonstrated similar concerns with companies from other countries, including Israel and other Middle East countries.

A third concern that is likely to factor in CFIUS reviews of Chinese acquisitions is China's reported intelligence collection activity against the United States. Concern over such activity remains a priority for CFIUS agencies with counterintelligence responsibilities, including the DOJ/FBI, the DOD, as well as the larger U.S. intelligence community.¹¹ In their 1999 unclassified *Report to Congress on Chinese Espionage Activities Against the United States*, the CIA and FBI described the breadth of China's intelligence network, identifying Chinese companies, students and researchers as a conduit for state-sponsored commercial and military intelligence collection.

Because of this, CFIUS agencies will likely scrutinize a Chinese acquirer's leadership and its ties, or alleged ties, to Chinese government, intelligence agencies and military, particularly the People's Liberation Army. If CFIUS agencies have concerns that an acquisition could provide access to sensitive U.S. information or provide a platform for further intelligence collection, they may block the transaction or impose substantial safeguards to mitigate the risk.

A fourth factor, which is less directly related to security concerns, is whether Chinese government subsidies are helping to finance acquisitions. Historically, CFIUS has not focused on this issue, and in my experience, CFIUS remains vigilant in not injecting economic considerations into their reviews. However, in my experience, CFIUS agencies have come to view heavy state subsidies as a possible indication that the acquisition is not being commercially driven.

In addition, to the extent that any ambiguity exists over whether a company is controlled by the Chinese government, direct state subsidies or non-market-based loans will add weight to the argument that the particular firm is government-owned or -controlled. Finally, noncommercial

¹¹ Jay Solomon, "FBI Sees Big Threat from Chinese Spies," *Wall Street Journal*, August 10, 2005, A1.

loan terms in transactions involving Chinese companies could be a factor in determining whether a particular transaction has political problems in Congress.

Notwithstanding these considerations, the sectors where Chinese acquisitions raise real security issues are fairly narrow. Most Chinese investments in the United States would not implicate CFIUS reviews, which are applicable only when foreign investments are made in sectors that potentially implicate U.S. national security interests. When the Chinese company Haier considered purchasing Maytag during the summer of 2005, for instance, the deal almost surely would not have been reviewed by the CFIUS. Similarly, most Chinese investments in the retail, real estate or auto sectors would not require national security reviews.

And in the narrow sectors where national security concerns arise, in the vast majority of cases the U.S. Government can address these concerns through existing Executive Branch authority, such as through the enforcement of U.S. export-control laws, or through CFIUS mitigation agreements. Only in extremely rare cases will blocking a transaction be necessary or appropriate. Exon-Florio is only supposed to address national security issues that are not adequately addressed by existing law or regulations. In addition, the new House and Senate bills will enhance the scrutiny of acquisitions by state-owned entities. With the exception of an extremely narrow set of acquisitions that could raise national security concerns that can't be mitigated, the United States' message should be clear - we should welcome investment from China.

IV. The danger of protectionism

Worries about protectionism deterring foreign direct investment have arisen both in the wake of the Dubai Ports World controversy and with regard to the mergers and acquisitions restrictions of foreign investment implemented by China in 2006. More than 20 bills were introduced in Congress last year after the DPW controversy, some of which would have completely closed off entire sectors to foreign investment. Fortunately, none of the restrictive bills introduced last year became law, and the Congress now seems poised to pass a tough but balanced bill to amend Exon-Florio, a bill that will strengthen protection of national security without impeding legitimate foreign direct investment.

At the same time, China has recently made moves to tighten regulations on M&A, giving the Ministry of Commerce the power to block acquisitions that threaten China's "economic security." In many respects, "economic security" is a fancy way of giving governments the ability to protect local companies and industries. Similarly, China has recently taken the negative step to maintain complete "asset control" over seven sectors: oil and petrochemicals, telecommunications, power generation and distribution, armaments, coal, aviation and shipping.¹² While some observers have claimed that these new regulations simply increase predictability for investors, in my view, enhanced predictability by restricting foreign ownership in certain sectors is a step in the wrong direction. China does have legitimate national security

¹² See Lauren Hilgers, "Restricted Access," *Insight Magazine*, March 2007, at 20.

interests with respect to certain foreign investments, just as the United States does, but the creation of national champions and walling off of certain sectors advances economic, not national security, policy objectives. I hope that these issues are on the agenda for Secretary Paulson's Strategic Economic Dialogue with Vice Premier Wu Yi for this week.

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Though some hiccups along the way are unavoidable, more Chinese investment in the United States is both welcome and inevitable. Just as certain U.S. investments in China have run into political and regulatory roadblocks, certain Chinese investments in the United States could also face challenges. However, the guiding principle behind U.S. policy should be to promote bilateral investment, thereby further integrating the U.S. and PRC economies for the benefit of both countries.

Thank you for the opportunity to testify today.