Hearing on "Trends and Implications of Chinese Investments in the United States"

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Good morning. I'd like to thank to the Commission for having me here today to discuss the rationale for China's investment in the United States. It is an honor to appear not only before you, but also on a panel with Derek and Thilo. My focus this morning is on the motives underlying Chinese investments in the United States and on the role played by the Chinese and U.S. governments.

The Role of the Chinese Government

Chinese investments in the United States are motivated by both market forces and government policies and guidance. Despite China's indisputable liberalization in the areas of trade and investment during the past 34 years, Chinese enterprises continue to take their cues from government. The Chinese government has by varying degrees controlled the pace, direction, and composition of China's outward direct investment ("ODI").

This is largely a legacy of China's hard core communist past. Although Chinese multinational enterprises existed prior to 1949, China's ODI took a thirty-year hiatus following the formation of the Peoples Republic. Since then, the government has gone from the cautious liberalization of the late 1970s and early 1980s to limited promotion of the 1990s to the official embrace of ODI with the "Go Out" policy enunciated in 2001. China's past avoidance of ODI placed the government in the role of gatekeeper once Beijing decided to allow outward investments, and it did not open the door and walk away.

As a gatekeeper, the Chinese government has had a pronounced impact on where China invests and in what sectors. When China first announced its "Go Out" policy, it was a major exporter with growing shares in advanced country markets, such as the United States. But rather than focus on those markets, China initially directed the bulk of its investments toward resource-rich countries, many of which were in Africa or members of OPEC. Indeed, Jiang Zemin's announcement of the "Go Out" policy identified Africa, Central Asia, the Middle East, Eastern Europe, and South America as favored destinations for Chinese investments.

The proclivity for resource-oriented investments is also evident in China's preference for investing in resource-rich advanced economies. According to OECD partner data, more than three quarters of China's FDI stocks in OECD countries were located in Australia and Canada, as opposed to the larger economies in Europe or the United States.

In general, there is a sense in China's government that ODI should also serve national aims, not just corporate ones. The Chinese government influences investments through a variety of policy documents, including the Overseas Investment Industrial Guidance Policy, which sets forth the broad parameters for investors; the Overseas Investment Industrial Guidance Catalogue, which provides specific details on the sectors where investments are encouraged; and the Five-Year Plans, which provide overall guidance on favored sectors. For example, China's latest five-year plan calls for developing strategic emerging sectors, such as electric cars and biology-based industries, and clean energy technologies, such as the development and utilization of coal-bed gas and shale gas. These sectors feature prominently in China's U.S. investments.

Main Drivers of China's Investments in the United States

So, why are Chinese enterprises investing in the United States now? I'd like to start with the big picture: they have no choice. The United States has been a large net importer of goods and services over the past 35 years, and for the past 13 years, our largest deficits have been with China. This means that the United States must import capital and that China has trillions of dollars that it must recycle into U.S. assets. The Chinese government traditionally invested these dollars in U.S. government debt but several years ago decided to diversify its asset base into other U.S. investments. It created two large sovereign wealth funds to take make portfolio investments but these funds are passive investors, invest globally, and in any case cannot reasonably be expected to invest all of China's excess dollars. The only other alternative was to allow Chinese enterprises to significantly increase ODI to the U.S. market.

Sticking with the big picture, Chinese enterprises invest in the U.S. market because they can. Firms must have sufficient financial resources to invest abroad, especially when the host country is an advanced economy where asset prices are high. Twenty years ago, profits at Chinese firms were much smaller and the Yuan was weaker. Under those conditions, the number of Chinese firms that could have invested in the United States was fairly limited. Today, the Yuan is stronger relative to the dollar, the absolute level of profits in China is much higher, and Chinese investors are more sophisticated. They also have access to top M&A legal talent in Hong Kong. Thus Chinese enterprises today are much more capable of investing in the United States than was the case even a decade ago.

My final "big picture" reason for Chinese investments in the United States is that the financial crisis and subsequent recession created many bargains for Chinese investors.   For example, Morgan Stanley was selling at a 40 percent discount when one of China's sovereign wealth funds obtained a nearly 10-percent stake in December 2007. CIC and other private investors have also made many investments in U.S. real estate, either directly through property purchases or indirectly through property funds. But bargain hunting also took place in the manufacturing sector in industries such as solar, auto parts, and advanced batteries.

Aside from the big picture explanations, there are a number of industry and firm-specific reasons why certain Chinese firms are investing in particular U.S. industries.   These include:

- maintaining or increasing U.S. market share in the face of trade remedies, such as antidumping and countervailing duties;
- acquiring technology and other strategic assets (such as distribution networks and brands);
- participating in U.S. sectors deemed important to the Chinese government; and
- making money.

Chinese firms from certain industries have invested in order to insulate their U.S. exports from trade remedies. Chinese producers are currently subject to 121 antidumping and countervailing duty orders. Chinese firms in some industries have sought to avoid the consequences of trade remedies by shipping to the United States illegally through third markets or by establishing export platforms outside of China. Other Chinese firms from the steel, aluminum, and solar panel industries have attempted to invest in the United States to avoid existing trade remedy orders or preempt an investigation.

Firms in industries favored by Chinese government policies have also sought to expand in the U.S. market through FDI. Two recent examples are Anshan, a major state-owned steel producer, and Suntech, a private manufacturer of solar panels. Anshan's efforts were unsuccessful and it never invested, while Suntech established a facility in Arizona.

It is worth dwelling on Suntech's investment because it provides a vivid illustration of how the intersection of Chinese government policies and market forces can lead to foreign investments and market distortions that are harmful to U.S. industries.

China's five-year plans have been promoting the expansion of renewable energy industries in China since the mid-1990s. The 11th Five-Year Plan and other contemporaneous measures explicitly encouraged production of renewable energy and continued industry incentives. The government funded national R&D efforts aimed at solar and other renewable technologies and provided financial incentives. As described by Keith Bradsher in one of his excellent New York Times articles on China's solar industry, "Chinese governments at the national, provincial and even local level have been competing with one another to offer solar companies ever more generous subsidies, including free land, and cash for research and development. State-owned banks are flooding the industry with loans at considerably lower interest rates than available in Europe or the United States."

Even more important than government funding in my view is the signal that such official imprimatur sent to private investors. Major Chinese producers were able to leverage government support into hundreds of millions of dollars' worth of private capital. This in turn fueled a reckless expansion in China that caused solar panel prices to drop precipitously worldwide, leading to plant shutdowns and insolvencies in the United States, Europe, and even China.

Though Suntech closed its Arizona facility, local governments in China and China's policy banks have been keeping the major producers in China afloat with subsidized access to capital, prolonging depressed prices in the United States and Europe.

The recent experience with the Chinese solar industry is very instructive and something that we should be mindful of going forward. As distortive as China's subsidies and targeting have been in the past, the solar industry has shown what can happen when you throw vast sums of private capital into the mix. The effects can be dramatic and have devastating consequences to firms in emerging industries that are being targeted by Beijing in China's 12th Five-year Plan.

Another reason why Chinese firms invest in the United States is because the amount of red tape is less of a problem in the United States than it is in China. Unless there are national security concerns, or investments in sensitive U.S. sectors by state-owned enterprises or their subsidiaries, investing in the United States is not very difficult. Also, if you are a privately owned firm, you probably have a more level playing field for accessing capital in the United States than you do in China, where state-owned banks continue to give favorable treatment to state-owned firms.

Gaining access to U.S. capital markets seems to be the primary motive of enterprises that have purchased listed U.S. shell companies through reverse mergers. From 2007 to 2011, more Chinese firms entered U.S. capital markets through reverse mergers than through IPOs by a ratio of three to one. In the typical reverse merger, a Chinese enterprise purchases a listed firm that has few if any assets. This technique is typically used by private firms that have difficulty accessing capital in China or by provincial SOEs trying to support restructuring efforts in China.

There have been a series of de-listings and huge drops in the share prices of more than two dozen Chinese firms that initially listed in the United States via reverse mergers. As a result of numerous instances of poor financial reporting and outright fraud involving Chinese reverse mergers, the SEC approved new rules in November 2011 and the Public Company Accounting Oversight Board has tried to negotiate with China's Ministry of Finance (MOF) to allow more oversight of Chinese accounting firms. Many investors have been burned, but there is also research showing that Chinese reverse mergers have performed better than reverse mergers in which the purchasing entity was a U.S. firm.

The point I want to make is that although the initial purchase of U.S. assets by Chinese firms may seem like Chinese FDI in the United States, the flow of money is more likely to be from the United States to China.

Aside from making money, the main motivations for investing in the United States are technology acquisition and market access. Technology acquisition is a major goal of Chinese government policies. These days the focus is on cyber espionage, but Chinese policies toward inward and outward FDI are also geared to promote the flow of technology from advanced countries to China. Technology related investments frequently involve firms with state ties;

some notable examples include government-owned Anshan Iron and Steel and Huawei, which has long been suspected of having ties to the Chinese military. Chinese firms have also made a number of investments in which the goal was obtaining energy-related technology, advanced battery technology in particular. Examples include:

- Yingtong Energy's Altair Nanotechnologies, a producer of lithium titanate batteries;
- Wanxiang's purchase of A123, a U.S. producer of lithium ion batteries for automotive and utility applications;
- A private equity purchase of lithium battery maker Boston Power, a deal that triggered financial incentives provided by the Chinese government;
- Sinopec's purchase of Syntroleum, which operated a gas-to-liquid demonstration facility and supplied military bases with fuels;
- Sinopec's purchase of a stake in certain Devon Energy shale gas fields; and
- CNOOC International Limited's purchase of an ownership stake in Chesapeake Energy's shale oil plays in Wyoming, Colorado, and Texas.

I think that the hand of the government is plainly visible in all these investments, with the possible exception of Wanxiang's investment in A123. In some cases, the investing companies stated unequivocally that the investment was made to acquire technology and know-how. In others, production was moved to China.

U.S. Government Policies and Chinese Investors

At first blush, U.S. policy toward Chinese investment seems schizophrenic. On the one hand, there is the Committee on Foreign Investments in the United States (CFIUS), which examines the national security aspects of potential investments and has had a hand in derailing investments by CNOOC (Unocal) and Huawei (3-Com and 3Leaf Systems). Various members of Congress have criticized specific Chinese investments and expressed their concerns about investments by Chinese state-owned enterprises quite forcefully.

On the other hand, SelectUSA of the Department of Commerce is courting Chinese investments and working with states to attract Chinese FDI. Other politicians are trumpeting their roles in bringing Chinese investments to their states.

Oddly enough, this hodgepodge makes perfect sense. The federal government is responsible for national security and has put in place a system to review transactions with potential security implications. China presents new challenges because investments by SOEs can blur the line between national and economic security. Congress has responded by strengthening CFIUS through the Foreign Investment and National Security Act of 2007.

State governments are more concerned with attracting investments to support jobs and economic growth and do not care much if the investor is a state-owned enterprise. For Congressmen with limited constituencies in manufacturing industries, attracting Chinese investments has little downside.

So, there is obviously a tension here, but it is a healthy one that can weed out potentially threatening investments.

The response of the Security and Exchange Commission and the Public Company Accounting Oversight Board to the problems caused by reverse mergers involving fraudulent accounting by Chinese firms is also noteworthy. Some may say that it is unfair to single out Chinese reverse mergers when all reverse mergers are risky. Here again, the policy response has been a healthy one; from what I have seen in my work, the concerns expressed about the credibility of audited financial statements are well founded. Washington has not prohibited reverse mergers, but instead taken steps to ensure that the Chinese companies which enter the U.S. capital markets via reverse mergers are legitimate.

Chinese investments in the United States are subject to the same set of rules and regulations as investments from other foreign countries in the areas of foreign corrupt practices, export administration, sanctions, and antitrust. If Chinese firms run afoul of these rules, they should expect to pay the price, as ZTE has done due to its business with Iran. The one area where Chinese firms are subject to additional scrutiny is in the networking sector, where cyber-security and other concerns with Huawei and ZTE have led to greater scrutiny of those firms and legislation that requires federal agencies to get approval from cyber-espionage investigators before buying IT systems from Chinese companies.

Closing Thoughts

Historically, foreign direct investments in the United States have emanated from advanced, market-oriented economies or oil exporters recycling petrol dollars, neither of which posed much of a national security threat. China is different and U.S. policies have had to adjust. By and large, these measured responses have created an environment that allows investments from China to continue, while reducing the potential for adverse security and economic outcomes.