Trends and Implications of Chinese Investment in the United States: Issues for Policymakers

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

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I. Introduction

China's global outbound foreign direct investment ("FDI") reached another record level in 2012, exceeding $77 billion.[2] The United States continues to be the top destination for China's outbound FDI, receiving at least $17 billion in Chinese investment in 2012 according to one estimate.[3] While still a relatively small portion of total inbound FDI in the United States, China's investment activities deserve attention from policymakers for a number of reasons.

As a preliminary matter, investment from China will become an increasingly important part of the country's inbound flows: by 2020, China's global outbound investment stock is poised to reach $2 trillion, more than six times what it was in 2010.[4] Policymakers should thus be approaching Chinese investment not merely on the basis of investments that have already been made, but also on the basis of what is likely to occur in the near future.

Moreover, the Government of China has an explicit policy to encourage and support outbound FDI, and provides significant government support to such investment through state funding and financing from state-owned banks. Domestic firms and workers who enjoy no such support can thus be put at a severe competitive disadvantage if Chinese firms with such aggressive government backing become their closest competitors.

In addition, China's outbound FDI is unique in the extent to which it is dominated by state-invested and state-owned firms (collectively, "SOEs"). In 2012, for example, it is estimated that private firms accounted for only 9.5% of China's outbound FDI to the world.[5] These SOEs continue to be heavily influenced and supported by the state, and they may have a variety of non-commercial motives for their investments. These motivations may raise concerns not only about national security, but also about economic security.

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[1] This testimony reflects the individual views of the author, and not necessarily the views of the Law Offices of Stewart and Stewart or any of its clients.

[2] "The expanding scale and scope of China's outward direct investment," *The Economist* (Jan. 19, 2013).

[3] Heritage Foundation, "China Global Investment Tracker," available on-line at: http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map .

[4] Shuping Liao and Yongsheng Zhang, "Strategies for Managing China's State-Owned Foreign Direct Investment," EABER Working Paper Series Paper No. 76 (Aug. 20, 2012) at 6-7.

[5] "The expanding scale and scope of China's outward direct investment," *The Economist* (Jan. 19, 2013).

While there are potential benefits as well as challenges posed by Chinese investment in the United States, this testimony focuses on three areas in which Chinese investment may undermine U.S. competitiveness and economic opportunities. The three areas are: 1) price competition with Chinese-invested firms in the U.S. market; 2) trade distortions that may result from Chinese investors' supply chain policies; and 3) competition for resources and technology.

This testimony recommends policies to address the challenges posed by increased Chinese investment in each of these three areas. While some of these recommendations could be implemented by adapting current policy instruments, the challenges posed by Chinese investment would be best addressed by a comprehensive U.S. policy response. To the extent that existing policy tools are inadequate, policymakers should consider creating new remedies to ensure that Chinese investment does not distort the competitive playing field for workers and firms in the United States.

I. Price Competition with Chinese-Invested Firms

As noted above, the Chinese government has an explicit policy supporting overseas FDI, and it aggressively supports such investment with government funding and financing from state-owned banks. As part of its "going out" strategy, the Government of China has developed specific investment funds to promote outward investment in natural resources and in fields with technological promise.[6] In addition, China's Export-Import Bank and the China Development Bank have poured billions of dollars into supporting overseas investments, with credits that are reportedly available at highly concessional rates.[7] Furthermore, SOEs that benefit from direct Chinese government funding, and are subject to Chinese government policy direction, make up the vast majority of Chinese investment. These firms do not face the same market discipline or incentives as private firms. They can rely on state support to maintain losses that may never be recouped, and make other operating decisions on a non-commercial basis, in order to meet political or industrial policy goals.

The direct support and involvement of the Chinese government can give Chinese firms (and Chinese-invested firms) important advantages in the U.S. market that their competitors do not enjoy. When a U.S. firm has to obtain credit at market rates to finance its activities, but a Chinese firm can obtain financing at minimal or even zero percent interest from Chinese state-owned banks, it distorts competition in the United States market. Such state support permits a Chinese firm to make investments and acquire resources and technology it otherwise could not if it had to pay market rates for equity and finance. In addition, such state support may permit Chinese firms to make decisions regarding the sales prices of their goods and services that do not reflect market fundamentals and that undercut their U.S. competitors.

[6] Huang Webin and Andreas Wilkes, "Analysis of China's overseas investment policies," CIFOR Working Paper 79 (2011) at 12-13.

[7] *Id. See also* Terence P. Stewart, et al., *China's Support Programs for Automobiles and Auto Parts under the 12th Five-Year Plan* (Jan. 2012) at 60.

Current U.S. law does not adequately protect U.S. workers and firms from this type of unfair competition. Existing antitrust rules, for example, are based on assumptions about the profit-maximizing behavior of market actors that simply may not apply to certain Chinese firms. In the area of predatory pricing, the U.S. applies a recoupment test, under which pricing is only deemed anti-competitive if the predator is likely to eventually collect enough profits to make up for the losses caused by the predatory behavior.[8] The test is based on the theory that a predator who could not recoup its losses would either not engage in the predatory practices to begin with or will eventually exit the market, causing no long-term damage to competitors or consumers. A Chinese SOE, by contrast, may be able to rely on state support to maintain losses that may never be recouped, and engage in predatory pricing in order to gain U.S. market share in the furtherance of political or industrial policy goals. Such a firm could engage in predatory pricing behavior that causes severe damage to its U.S. competitors, but, under current law, such behavior would not be considered anticompetitive as long as the Chinese firm was not expected to recoup its losses.

In addition, existing anti-subsidy disciplines in U.S. countervailing duty law and at the World Trade Organization do not address the harm caused by competition with subsidized investors. U.S. countervailing duty law only addresses the injury caused by subsidized imports of goods, not investments by subsidized firms. WTO rules permit relief on the basis of harm in a range of markets, including third-country markets and the market of the subsidizing government itself, but these rules similarly focus on the harm that arises from competing with subsidized goods, not firms. Finally, though China committed to ensure that Chinese SOEs would make decisions on their purchases and sales on commercial terms when it joined the WTO, these commitments have never been tested. It is highly unlikely that the WTO would enforce such commitments regarding decisions that are made by SOEs operating outside of China.

II. Trade Distortions Linked to Chinese Investment

Several analysts have noted that one motivation for Chinese investment is access to markets that are otherwise restricted by trade barriers.[9] Such barriers may include prevailing tariff rates as well as duties imposed to counteract unfair trade practices, such as antidumping and countervailing duties. While U.S. trade remedy laws allow an antidumping or countervailing duty order to be expanded to cover imported parts that are used to assemble merchandise in the U.S. that would otherwise be subject to unfair trade duties, relief is only available if the assembly in the U.S. is insignificant and if the value of imported components is a significant portion of total value.[10] The Department of Commerce also considers affiliation between the assembler in the U.S. and the component exporter, among other factors. These rules may be inadequate to redress the harm that U.S. workers and firms may suffer if a Chinese company invests in the U.S. to evade trade remedies, especially where the investor's operations in the U.S. are not

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[8] Antonio Capobianco and Hans Christiansen, "Competitive Neutrality and State-Owned Enterprises: Challenges and Policy Options," *OECD Corporate Governance Working Papers No. 1* (2011) at 21.

[9] Nargiza Salidjanova, "Going Out: An Overview of China's Outward Foreign Direct Investment," U.S.-China Economic & Security Review Commission Staff Research Report (Mar. 30, 2011) at 10-11.

[10] 19 U.S.C. Sec. 1677j(a).

insignificant or where the investor is not directly affiliated with the Chinese component producer.

In addition, Chinese SOEs in particular have been known to discriminate against non-Chinese producers in making sourcing decisions. The state-owned wind turbine producer Sinovel, for example, required its American component supplier to agree to a "localization schedule" under which components which it had produced with non-Chinese material would instead be produced with Chinese materials.[11] More recently, as part of an agreement to establish a joint-venture with a Chinese SOE to produce trucks, Daimler similarly agreed to "localize" the production of the truck engines to China.[12] While these agreements pertained to supply agreements and investments in China, the same motivations to fulfill Chinese industrial policies may lead Chinese investors to discriminate against non-Chinese goods when producing in the United States. Increased investment by such firms in the United States could result in increased imports from China, placing U.S. suppliers at a disadvantage.

There are currently no remedies available for workers or producers who may be harmed by such discrimination. WTO rules that prohibit discrimination against non-Chinese goods by the Government of China, for example, apply to its treatment of those goods upon importation into China – they would not apply to discrimination that takes place against foreign goods that are not imported into China. In addition, as noted above, while China committed to ensure that Chinese SOEs would make decisions on their purchases and sales on commercial terms when it joined the WTO, these commitments have never been tested, and it is highly unlikely that the WTO would enforce such commitments regarding decisions that are made by SOEs operating outside of China.

III. Competition for Resources and Technology

Part of the motivation for China's promotion of outward FDI is to gain access to valuable resources and technology.[13] As noted above, the Government of China has established two funds to support outbound investment dedicated specifically for these purposes. Chinese firms that use such government support may be able to outbid U.S. producers for critical resources and technology, negatively impacting U.S. competitiveness. In addition, Chinese firms may not only outbid their U.S. competitors but be able to monopolize access to the technology, harming the U.S. economy as a whole. While private firms operating on a commercial basis also make investment decisions in order to access resources and technology, in some cases decisions by

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[11] American Superconductor Corp. Form 8-K (June 5, 2008) at Ex. 10.1. *See also* American Superconductor Corp. Form 10-Q (Aug. 5, 2010) at 18.

[12] "Germany's Daimler to Make Trucks in China," *Agence France Presse* (Spet. 26, 2011); "Final Approval Issued by Chinese Authorities: Way Clear for Daimler's Truck Joint Venture with Foton," Daimler.com (Sept. 26, 2011).

[13] Huang Webin and Andreas Wilkes, "Analysis of China's overseas investment policies," CIFOR Working Paper 79 (2011) at 9. *See also* Nargiza Salidjanova, "Going Out: An Overview of China's Outward Foreign Direct Investment," U.S.-China Economic & Security Review Commission Staff Research Report (Mar. 30, 2011) at 7-9.

Chinese firms in this regard (especially by SOEs) may be influenced by non-commercial factors such as government policy priorities.

For example, in 1995, a group of companies that included Chinese SOEs sought to acquire Magnaquench, the only U.S. producer of neodymium-iron-boron magnets.[14] The magnets are an important technology for MRIs, wind turbines, automotive motors, and a wide array of other applications. The magnets also have critical military applications, including target lasers, satellite communications systems, radar amplifiers, and more.[15] The investment was approved on the basis of a commitment from the investors to keep production of the magnets in the United States for at least five years.[16] The day after the five-year period expired, the investors closed the facility, laid off the workers, and took the equipment and technology to China.[17] By 2007, China had more than 130 enterprises engaged in manufacturing the critical permanent magnets; the U.S. had none.[18]

Current U.S. policies are insufficient to ensure that U.S. producers will be able to compete on a level playing field to acquire and maintain access to key resources and technologies. The Committee on Foreign Investment in the United States ("CFIUS") process, for example, is designed to screen foreign investment for national security concerns, but not economic security or competitiveness issues. Thus, while CFIUS applies heightened scrutiny to transactions involving SOEs that may impact national security, it does not screen investments for their economic impacts. In addition, while the Department of Justice reviews proposed mergers and acquisitions for potential competitiveness concerns, these typically relate to market dominance in general rather than specific concerns about strategic resources or technologies. Other countries do screen foreign investment for such issues. Australia and Canada, for example, apply a net benefit test when evaluating proposed foreign investment, and the test includes economic, as well as national security, criteria.

IV. Options for Policymakers

There are a number of options policymakers should consider to maximize the benefits, and minimize the potential threat, of Chinese investment in the United States. The U.S. should take a comprehensive approach to ensure, among other things, that:

1) U.S. workers and firms will not be undercut by unfair competition from firms operating in the U.S. that benefit from foreign government support or operate

[14] Cindy Hurst, "China's Rare Earth Elements Industry: What Can the West Learn?" Institute for the Analysis of Global Security (March 2010) at 12. *See also* Karl P. Sauvant, "Investing in the United States: Is the US Ready for FDI from China?" Edward Elgar Studies in International Investment (2009) at 46.

[15] Cindy Hurst, "China's Rare Earth Elements Industry: What Can the West Learn?" Institute for the Analysis of Global Security (March 2010) at 13.

[16] *Id.*

[17] *Id.*

[18] *Id.*

under the control of foreign government entities, including (but not limited to) the Government of China;

2) foreign investment does not undermine the effectiveness of our trade remedy laws nor entail discrimination against United States suppliers of goods and services; and

3) U.S. producers enjoy access to key resources and technologies on commercial terms and are not deprived of such access due to unfair competition with foreign investors.

U.S. policy should also draw on the principle of competitive neutrality, especially with regard to competition with China's SOEs. The *OECD Guidelines on Corporate Governance of State-Owned Enterprises* offer guidance in this area. For example, Chapter I of the *Guidelines* states that governments should ensure a "level playing field" in markets where SOEs and private companies compete "in order to avoid market distortions."[19] Thus, "SOEs should face competitive conditions regarding access to finance," and SOEs' relationships with state-owned banks and other SOEs "should be based on purely commercial grounds."[20] The *OECD Guidelines* also state that SOEs should disclose material information on all matters described in the *Guidelines*, including "[a]ny financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE," material transactions with related entities, and material risk factors.[21]

One way to meet these goals would be to get China to agree to binding obligations regarding its outbound FDI based on the principles of competitive neutrality. While the U.S. already secured some obligations from China regarding the operations of its SOEs in China's accession to the WTO, these obligations apply to those firms' operations within China – not to their investments abroad. New disciplines should, at a minimum, require transparency and disclosure as to the extent of state support, ownership, and control. All firms should be required to operate on the basis of competitive neutrality, with business decisions made on the basis of commercial considerations rather than government policies (whether those decision relate to pricing, sourcing, or acquisition of resources and technology). To be meaningful, such obligations would need to be enforceable through a dispute settlement mechanism and the prospect of economic consequences for non-compliance.

In addition, the U.S. should take proactive steps to seek enforcement of those obligations China has undertaken to date. At the WTO, for example, the U.S. should challenge prohibited subsidies such as export credits on terms that do not comply with the terms of the OECD arrangement, as well as SOEs' use of domestic content and technology transfer requirements in their procurement and investment contracts. If these rules prove to be effective, they may provide an appropriate template for future disciplines on the actions of SOEs outside of their

[19] *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, Ch. I, chapeau.

[20] *Id*. at Ch. I, Sec. F.

[21] *Id*. at Ch. V, Sec. E.

home country boundaries. If not, those disciplines need to be not only expanded in scope but also strengthened in substance. In the context of the on-going Trans-Pacific Partnership negotiations, for example, parties are reportedly discussing the inclusion of rules that would discipline the actions of SOEs and seek to ensure that they behave on commercial terms. Such disciplines should also be included in the model Bilateral Investment Treaty the U.S. relies upon in negotiating investment agreements with other countries. These rules must set a high standard that addresses not only potential concerns with TPP or BIT partners, but also with other major trading and investing countries we may negotiate with in the future, such as China.

Whether or not the U.S. is able to secure binding commitments from China regarding its outbound FDI, the U.S. can take unilateral action to minimize the negative impacts such investment may have on the U.S. economy. Policymakers should first consider improving the process for screening new investments in the U.S., particularly investments by firms that are supported or controlled by foreign governments. Such investments should be reviewed from the standpoint of competitive neutrality, and be reviewed for their economic, as well as national security, implications. As a condition of investment approval, the U.S. should require such investors to disclose material information such as levels of government support and the basis for pricing and procurement practices. The U.S. should require that such firms operate in a manner that is consistent with competitive neutrality principles, meaning that prices, sourcing decisions, and other business decisions are made on a commercial basis and free from foreign government influence. To meet these commitments, the U.S. may also require that directors and officers of the U.S. entity be independent from the foreign government, consistent with Australia's practice in some cases.[22] The U.S. should require regular reporting and monitoring to ensure these commitments are met. In addition, when the Department of Justice reviews proposed mergers and acquisitions for competition concerns, it should take into account whether the investor benefits from foreign government support and whether the investor is owned or controlled by a foreign government entity and thus may operate in a manner that is not consistent with commercial considerations.

There must also be a means for U.S. workers and firms to seek redress where they have suffered competitive harm, or are threatened with harm, due to unfair competition with foreign investors. While certain tools already exist in domestic competition laws, these tools should be re-evaluated to ensure that they adequately address competition with firms that benefit from foreign government support or are controlled by foreign governments. Predatory pricing rules, for example, may need to be revised to permit alternative means of establishing predatory behavior where the firms involved are subsidized by the government or there are other indications that they do not operate on a commercial basis. Instead of applying the recoupment test to determine if prices are predatory, for example, cost benchmarks could be used to evaluate the prices charged. Evidence of foreign government influence on, or support for, pricing decisions may also be relevant to such inquiries. Competition laws should also be reviewed to determine whether discrimination against domestic origin goods on the basis of a purchasing firm's foreign government support or control rather than commercial considerations should be considered an anticompetitive practice.

[22] Greg Golding, "Australian regulation of foreign direct investment by sovereign wealth funds and State-owned enterprises: Are our rules right?" (2010) 38 ABLR 215, 227.

Ultimately, the law should give a private right of action to U.S. firms and workers that have been harmed by subsidized and SOE investment in the United States. Such a right of action should cover harm due to anticompetitive behavior as well as harm stemming from discriminatory and non-commercial purchasing decisions. If harm is shown, the injured party should be entitled to compensation for lost revenues, lost wages, and other damages. Allegations of such behavior should also trigger an investigation by the screening mechanism proposed above to determine whether any of the conditions of investment approval have been breached.

In addition, domestic trade remedy laws may need to be strengthened to ensure they cannot be circumvented through foreign investment, particularly state-backed foreign investment. As noted above, current rules on circumvention of antidumping and countervailing duty orders through investments in domestic production depend, in part, on whether the domestic investment is insignificant and on the affiliation between the investor and the foreign component producer or exporter. To the extent such limitations pose an obstacle to effective enforcement of the unfair trade laws, they should be altered or eliminated.

Finally, policymakers should ensure that the other policy tools we already do have available are being used to the furthest extent possible to minimize the risks that foreign government-backed investment from China (and other countries) may pose. The CFIUS process, for example, should exercise its mandate to protect national security concerns in the broadest sense of the term, and learn from the practices of other countries regarding the undertakings that state-owned investors are required to agree to when investments implicate national security concerns. Buy America rules may need to be examined to determine whether the fact that a bidder is an SOE or a subsidized firm should be taken into account when determining contract awards. Finally, the SEC should clarify that state support for, and control over, an enterprise are material items that require disclosure in the interest of protecting private investors. The terms of state assistance and financing to SOEs, the terms of supply and procurement contracts with state-owned suppliers and purchasers, and the relationship between a firm's directors and officers and the government should all be considered material information for which disclosure is required.