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Writing New Rules for the  
U.S.-China Investment Relationship

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## Introduction

Chinese outbound investment is on the rise, and much of it is finding its way into the United States. Between 2010 and 2015, China's foreign direct investment (FDI) inflows to the United States grew by an average of 32 percent annually.<sup>1</sup> Within the past two years alone, Chinese foreign investment inflows to the United States increased four-fold, and available data suggests 2017 will see the second highest annual investment on record, after 2016.<sup>2</sup>

This is not a two-way street: the United States and other foreign investors do not enjoy similar open market access in China. China maintains a dizzying assortment of formal and informal barriers to foreign investment—from outright restrictions and quotas to mandatory joint ventures, forced localization measures, and domestic licensing regimes. Despite years of negotiations, these barriers are, if anything, growing more cumbersome in many sectors. U.S. firms paint a darkening picture of the business climate they face in China. U.S. FDI in China has slowed considerably in recent years: after growing roughly 180 percent from 2002 to 2007 (albeit from a low baseline), U.S. FDI flows into China have declined since 2012.<sup>3</sup>

The one-way surge of Chinese investment into the United States comes against a backdrop of strategic mistrust between Washington and Beijing. Ongoing accusations of state-sponsored cyber predation of U.S. firms, Beijing's increasing aggressiveness over territorial disputes, its systematic efforts to undermine the U.S. alliance system in Asia, and mounting tensions over North Korea all contribute to a darkening mood in the U.S.-China relationship. And, like so much involving China, this investment is simply different. Rarely, if ever, has the United States seen an increase in investment of this magnitude—especially from a non-ally and especially from one where the lines between state ownership and private ownership are so inherently blurred. For all the concern surrounding Japanese investment in the United States in the 1980s—coming as it did amid fierce economic competition—those debates ultimately remained under the umbrella of the U.S.-Japan military alliance.

All of this raises questions about whether the United States needs to tighten its stance on Chinese inbound investment; proposals to that effect have bipartisan support in the Congress. The Donald J. Trump administration has signaled its desire for a tougher approach in its economic dealings with China, which U.S. businesses seem to welcome.

One foundation for such an approach is the principle of reciprocity. Roughly two dozen sectors in China—construction, mining, banking, insurance, and so on—remain effectively off-limits to American investment, because the Chinese government protects its domestic companies through regulations and financial subsidies. Even in sectors that technically allow foreign investment, discriminatory industrial policies tilt the playing field in favor of Chinese firms. Until this changes, Washington would be justified—even obligated—to limit Chinese investment in the U.S. market.

However, U.S. policymakers do not have a consensus on what a policy of reciprocity would entail, and different policy interpretations could spell quite different economic and foreign policy consequences for the United States. The United States should aim for a version of reciprocity that allows it the flexibility to maximize pressure on the broad range of Chinese industrial policy concerns while leaving a clear route to negotiations. The United States should also encourage European and other Western countries, many of which are seeing similar increases in Chinese investment, to adopt this new approach.

## U.S.-China Investment Flows: Increasingly Lopsided

The U.S.-China investment relationship suffers from two major problems.<sup>4</sup> First, the United States' current, largely open investment framework was built for an era when foreign investment was the domain of developed countries, which were themselves largely open to foreign investment. As a result, it simply does not address many of the challenges specific to the current influx of Chinese investment. Second, this recent surge in Chinese investment in the United States magnifies the disparity between market access in the United States and China; U.S. investors, watching as China embarks upon a U.S. buying spree while they are denied similar access to Chinese market, are losing patience.

### *BEIJING'S U.S. BUYING SPREE*

Chinese investment of all kinds in the United States has surged, especially in high-technology sectors and new companies. Chinese firms invested nearly \$18 billion in the United States during the first half of 2017—nearly three times the amount invested over the same period in 2015 and more than total Chinese FDI in the United States for all of 2015 (\$15.3 billion).<sup>5</sup> Research and development (R&D) operations and even greenfield investments (investments by a parent company in a new venture) are attracting interest; in 2015, Chinese greenfield investment in the United States amounted to \$1.8 billion, a seven-fold increase from 2010.

And it is still relatively early days. Certainly, increased Chinese investment in the United States is partly a cyclical story—the result of Chinese investors parking money abroad to ride out turbulence in China's domestic market. But it is mostly a structural trend, with a long way to go. After years of growth, relatively sheltered from competition within the sprawling domestic market, Chinese companies are now mature enough to venture abroad. They are also increasingly willing to do so, thanks to rising input costs and shrinking margins at home. By some estimates, China's global outbound FDI stock could triple to \$3 trillion by 2025.<sup>6</sup>

Although these investments have yet to produce results, they clearly align well with directives and resources from Beijing. China's current five-year plan and its official outbound FDI catalogue prioritize greater outbound investment into energy, commodities, and technology, naturally directing Chinese investors toward the United States. Take the semiconductor industry, for example, in which in 2015 alone, Chinese investors were party to twenty-one different deals attempting to acquire an overseas chipmaker (up from eight in 2010).<sup>7</sup> One of these high-profile bids involved Fairchild Semiconductor International, which is among the pioneering companies “that first brought silicon to Silicon Valley.” Fairchild ultimately rejected “a superior offer” worth about \$2.5 billion from Chinese state-backed buyers in favor of a smaller bid from an American rival, citing concerns that federal regulators might reject the Chinese deal.<sup>8</sup>

The unsuccessful Chinese bid for Fairchild was just one of more than a dozen such offers in recent months for international semiconductor businesses, mostly in the United States. The heightened interest in semiconductors traces back to direct orders from Beijing. China's current five-year plan identifies semiconductors as a core industry, and since the plan's release, Chinese companies with varying ties to the government have moved aggressively to acquire foreign technology in the sector, often

backed by massive state subsidies. In fact, Beijing plans to spend as much as \$150 billion in public and private funds to cultivate China's domestic semiconductor industry over the next decade.<sup>9</sup>

### *THE ILL-EQUIPPED U.S. OPEN DOOR*

This wall of Chinese investment has found its way to the United States in part because it could. The United States' traditional open-door stance on investment means that the country is broadly open to investment from China. The Committee for Foreign Investment in the United States (CFIUS) remains the primary mechanism by which the U.S. government reviews incoming investments, but its mandate remains limited to national security concerns, which to date have not been construed to include considerations of economic security.

The recent surge in Chinese investment has stress-tested the existing CFIUS framework, highlighting several problems. First, because most filings are voluntary, the overall magnitude of Chinese inbound investment is not clearly known. Second, CFIUS only covers mergers and acquisitions, leaving other kinds of foreign investment, such as greenfield and venture capital, unregulated; perhaps not coincidentally, greenfield and venture capital are among the fastest-growing types of Chinese investment in the United States. Third, because CFIUS adopts a "slice in time" approach—evaluating a given deal only at the time of proposed merger or acquisition—U.S. policymakers cannot evaluate how a proposed deal would affect overall Chinese market share within a given industry or re-review an approved deal should Chinese officials integrate it with other deals at a later stage.

Moreover, because CFIUS is confined to national security concerns, it does not touch the range of valid economic concerns this investment raises. One such concern is China's penchant for "vertical industrial integration"—the growing tendency, especially prevalent among Chinese state-owned enterprises (SOEs), to assume greater control over all parts of a given value chain. Vertical integration allows a company to exercise more influence over price in negotiations with upstream and downstream suppliers. As such, it sits uncomfortably with long-established principles of competition policy in the United States and Europe.

Another, arguably larger economic concern is that this Chinese investment will lead to a premature hollowing out of the United States' "innovation commons." When SOEs or national champion firms accrete market share through distortion rather than fair competition, existing remedies often cannot address the issue. And even when a distortion is remedied, there is no guarantee that competitors will rebound. Indeed, these distortions themselves could prove temporary, either dismantled via existing multilateral remedies or simply abandoned by the country in question. But production and manufacturing questions are less elastic than often appreciated. And as the current state of U.S. solar manufacturing suggests, by the time a given playing field is re-equilibrated, it may be too late for competing firms. (Between 2008 and 2012, state subsidies to Chinese SOEs depressed world prices on solar panels by 75 percent, forcing widespread bankruptcies among firms that had not been heavily subsidized).

Further, the risk is not simply that the United States loses market share in a certain class of current products. Rather, it could lose the ability to migrate from these products to new products or processes; with enough erosion of production processes and their related skills, U.S. capacity to create new high-tech products and services could be adversely affected. These losses of the so-called industrial commons represent not a relative shift but an absolute subtraction from the total assets of the productive base of the U.S. economy.

*CHINA STILL SIGNIFICANTLY CLOSED TO FOREIGN INVESTMENT*

China remains relatively closed to foreign investment, even by developing country standards (China ranks as the most restrictive investment regime among the BRICS [Brazil, Russia, India, China, and South Africa], for example).<sup>10</sup> Some three hundred investment items—ranging from golf courses to theme parks—remain either heavily restricted or closed entirely to foreign investors out of “strategic or national security” concern. Whereas the CFIUS investment review process maintains a narrow definition of national security that excludes economic security, China’s definition of national security includes economic, cultural, and societal security, as well as public morality.

More problematic, in China all proposed foreign investments are evaluated by government regulators on a case-by-case basis. It is this so-called investment tollbooth that enables Chinese officials to insist on a host of discriminatory terms as part of approving a given deal: everything from forced joint ventures with SOEs to minority ownership ceilings and technology transfer. Often, partnering—even under less-than-voluntary circumstances—is not an option. When a U.S. firm wants access to China’s market badly enough and partnering is not on the table, the only way to enter the Chinese market is through acquisition. Take, for example, Smithfield Foods. Investment restrictions in China prevented any joint venture, leaving Smithfield executives with the view that the best way to expand into China would be to be acquired by a Chinese firm.<sup>11</sup> Smithfield CEO Larry Pope insisted the deal would preserve “the same old Smithfield, only with more opportunities and new markets and new frontiers.”<sup>12</sup> Apparently the acquiring firm, Shuanghui Foods, was keen to acquire American pork to capitalize on growing demand for foreign food products in China after recent food scandals. It would have been far better—for Smithfield and for U.S. interests more broadly—had Smithfield simply been permitted to import directly into China.

The situation appears to be less slow progress and more of an outright backsliding on Beijing’s part. U.S. companies find it increasingly difficult to operate in China, citing unclear laws and inconsistent regulatory enforcement, policies that favor domestic competitors, and industrial overcapacity. A 2016 survey by the American Chamber of Commerce in China suggests a darkening picture of China’s business climate, with over three-fourths of surveyed U.S. companies claiming that foreign businesses now feel less welcome in China than in the past years.

China’s foreign investment climate is particularly bleak for companies in strategic industries, thanks to the government’s focus on domestic innovation goals. Unveiled in 2015, President Xi Jinping’s Made in China 2025 (MIC 2025) strategy is a ten-year blueprint aimed at catapulting China into a technology and advanced manufacturing leader. MIC 2025 identifies ten strategic industries—including information technology (IT), aviation, and new energy vehicles—bolstering Chinese companies in these sectors through preferential government procurement, domestic regulations designed to stifle foreign competition, and cheap financing to support R&D projects and overseas acquisitions. As a result, even if China were to lift its formal restrictions on foreign investment in these sectors, the mix of industrial policy supports would sufficiently prevent U.S. firms from entering Chinese market. Alongside MIC 2025, Beijing has intensified efforts to shed China’s dependence on foreign technology over national security concerns, introducing stricter IT requirements and cybersecurity laws—moves that Western firms regard as protectionism by another name.<sup>13</sup>

In theory, a successful conclusion to the ongoing negotiations between Washington and Beijing on a bilateral investment treaty could grant foreign investors the same investment rights as domestic Chinese companies, a concept known as pre-establishment. But negotiations have been painfully slow.

And even if they are successful, enforcement prospects remain unclear. Indeed, the chief lesson that Beijing (and to a lesser extent, other governments) seem to have taken from the outcry over indigenous innovation and forced technology transfer requirements is to avoid putting anything in writing. Verbal instructions and requests to “volunteer” one’s technology are commonplace, with Chinese firms frequently informing U.S. investors that regulators would be unlikely to approve pending transactions unless more—or more modern—technologies were transferred to a Chinese entity as part of the deal.

More than fifteen years into China’s membership of the World Trade Organization (WTO), the U.S. government’s efforts to open China’s markets to foreign investment have borne little result. And, much like Japanese industrial policy in the 1980s, formal restrictions on foreign investment are but a fraction of the problem: Beijing continues to pump government subsidies, discounted production inputs, and favorable lending into otherwise nonviable companies while sheltering them from foreign competition in domestic market. As a result, SOEs remain the backbone of China’s economy despite taking on significant and ongoing losses. If anything, China’s foreign investment restrictions in several high-value areas, along with MIC 2025 and its cybersecurity laws, mark significant steps backward in China’s openness to foreign investment.

## Time for Reciprocity

Washington needs to rethink its current approach and use new leverage with Beijing. Trading the traditional open-door stance for reciprocity could help the United States address several concerns raised by the influx of Chinese investment into the United States while also forcing long-overdue progress on China's stated commitments to liberalize to foreign investment.<sup>14</sup>

### *THE CASE FOR RECIPROCITY*

It is important to recognize that reciprocity may not be much of a shift from present U.S. practice.<sup>15</sup> Reciprocity has been an established principle of U.S. international economic policy and a recognized element of its investment policy. The United States' entire statutory framework governing the inflow of foreign investment grew out of concerns about the influx of FDI from Japan at a time when Japan maintained policies that denied reciprocal market access.<sup>16</sup> "The largest underlying cause of friction over Japanese FDI in the 1980s," Professor Curtis Milhaupt of Stanford Law School reminds "was the perception that, while the United States was wide open to Japanese investment and imports, U.S. firms faced substantial barriers to investment and trade in Japan."<sup>17</sup>

In fact, reciprocity could be especially important in adversarial relationships. For scholars of international relations such as Robert Keohane, not only is reciprocity crucial for explaining state behavior, but under low-trust conditions it can even allow "cooperation to emerge in a situation of anarchy."<sup>18</sup> Most of the interactions among the United States, the Soviet Union, and China during the Cold War were reciprocal in the extreme, each country's action carefully calibrated to match prior actions that one or another major power in the Cold War had visited upon it.<sup>19</sup>

The most basic arguments for reciprocity tend to argue some variant of the "golden rule."<sup>20</sup> "More and more," Beijing-based journalist Michael Schuman writes, "Chinese companies are taking advantage of the openness that the U.S.-led global economic system ensures, but Beijing isn't reciprocating by allowing foreign companies similar liberties in China."<sup>21</sup> The problem is not just that this discrepancy in market access violates basic understandings of fairness; it is that this in turn undermines the U.S. public support necessary to sustain the current U.S.-led open global economic order. To many Americans, allowing China to discriminate against U.S. investors without consequence is one more example of Washington putting principles above its interests, leaving the costs to fall upon disaffected people across the country. Adam Chilton and co-researchers have found that a lack of reciprocity increases public opposition to foreign acquisitions of domestic firms.<sup>22</sup> Indeed, lack of reciprocity produced a larger increase in opposition than did other economic considerations tested, such as domestic economic conditions or degree of exposure to foreign competition.<sup>23</sup>

Moreover, the stakes are hardly confined to China's domestic market. It is largely by shutting out foreign competition that China has managed to build up national champions, which once created, do not tend to stay at home. Firms, such as the credit card monopoly China Union pay, which owe their market dominance to the years of protection they enjoyed in China's home market, are now world leaders and are venturing abroad, driving much of China's current outbound investment. These deep-pocketed Chinese national champions are proving to be fierce competitors in third-party markets

across Asia, Latin America, and elsewhere. Having enjoyed years of exclusive access within their home market, China's largest banks—known as the Big Four—are now among the largest in the world and are growing rapidly overseas. A similar story can be told of China's mining and telecommunications sectors. In short, China's protection of its home market is causally linked to the wave of Chinese out-bound investment the world is now witnessing.

Finally, the United States' current window to impose reciprocity will not last forever. The closed nature of China's economy forces U.S. firms to make concessions that reverberate back home, changing U.S. political economy in ways that make it harder for Washington to press for reforms. U.S. corporations that once pressed Washington to address distortions favoring Chinese SOEs now find far fewer reasons to protest after pairing with the same SOEs as the only means of entering local markets.<sup>24</sup> “[U.S.] companies are intimidated against filing cases or even being seen as supportive,” as one American trade attorney with a long history of U.S.-China disputes put it. “They are either intimidated or bought off, and usually a combination of those two things.”<sup>25</sup> Imposing reciprocity sooner than later is necessary to keep U.S. domestic political economy from warping under Chinese pressure in ways that constrain Washington's ability to enact tougher policies in the future. Already, the steady erosion of U.S. domestic pressure (as U.S. firms are forced into Chinese joint ventures and inherit mixed incentives) and China's rapidly growing economic influence together suggest that the window for constructive U.S. pressure is steadily diminishing.<sup>26</sup>

#### *RISKS OF RECIPROACITY MANAGEABLE*

Of course, China could retaliate against U.S. restrictions. But the fact that Washington would be shifting to reciprocity within the context of negotiating a bilateral investment treaty (BIT) with Beijing gives the United States much-needed leverage for that negotiation while also taking advantage of a bounded time horizon. Completion of a BIT with China will necessarily entail lifting the vast majority of reciprocity-related restrictions, if not all such restrictions, thereby containing the possibility for spiral. In fact, whether the U.S. Congress would approve an investment treaty with China in the current political environment is a concern. Reciprocity could be necessary before a skeptical Congress would consider approving a BIT as a way of countering claims that China is being merely rewarded for bad behavior.

Another reason that risks of retaliation can be mitigated is simply that China has more at stake than the United States does. China's growth prospects increasingly depend on its ability to invest abroad, and in the United States in particular. If China hopes to maintain good economic growth rates and stave off potential civil unrest, access to global investment opportunities, new technologies, and competition in overseas markets is crucial. Within a framework of reciprocity, this dependence on U.S. investment access should curb Beijing's impulses toward retaliation.

Beyond retaliation concerns, economists often oppose reciprocity on the grounds that inbound investment is economically beneficial, especially for countries like the United States that have large and persistent current account deficits. U.S. jobs are among the most frequently touted benefit.<sup>27</sup> While it is certainly true that Chinese investment in the United States supports some domestic employment—according to Rhodium Group data, roughly one hundred thousand Americans are employed by Chinese companies (up from thirty thousand in 2012)—these benefits need to be considered against several countervailing factors. First, roughly 80 percent of these jobs were acquired via mergers and ac-

quisitions rather than created anew through greenfield investment. There is little evidence that Chinese companies have shut down operations in the United States after acquisitions or that these acquisitions have spared jobs that would have otherwise been eliminated.

Second, the larger question is how this employment picture compares to a scenario in which U.S. firms enjoy reciprocal or at least far greater access to Chinese markets than they currently do.<sup>28</sup> After all, several of these inbound acquisitions have targeted sectors (such as entertainment) that are growing rapidly inside China. And when considered against a first-best scenario of freer U.S. investment in high-growth sectors within China, the economic and employment benefits of Chinese inbound investments—for instance, the Smithfield deal or the acquisition of U.S.-based AMC Theatres by a Chinese entertainment conglomerate—diminish considerably. In other words, had Smithfield or AMC enjoyed entry routes into China other than by simply being acquired by a Chinese company, such expansion into China would have presumably brought various economic benefits—from potential jobs to greater overseas market share for a U.S.-based firm—that would weigh on any decision to press for more reciprocal market access.

Finally, some of this inbound Chinese investment is occurring in sectors in which overcapacity in China has resulted in U.S. job losses. This in turn raises the question of how Chinese dumping should factor into U.S. treatment of new Chinese investment in affected sectors. Perhaps the clearest example is the U.S. steel industry, which has lost upward of nineteen thousand jobs due to Chinese steel overcapacity.<sup>29</sup> The absence of economic security considerations in the current U.S. investment review process means that little can halt Chinese investment in U.S. steel manufacturing. Consider China-based Tianjin Pipe's \$1 billion investment in a Texas plant in 2009, which remains one of the largest Chinese investments in any American manufacturing facility. These questions become even trickier when these investments are greenfield. On the one hand, such deals have the potential to bring back some fraction of lost U.S. jobs. On the other hand, by growing China's overall market share and worsening the underlying overproduction problems, such deals make life even tougher for remaining U.S. steel manufacturers.

## Weighing Different Models of Reciprocity

A policy shift toward reciprocity raises several questions, not least of which is how to go about it. The most frequently cited models for reciprocity each depart from somewhat different policy rationales and imply different risks for U.S. interests. More fundamentally, it is unclear if any of the three most popular options would successfully address the challenges presented by the surge in Chinese investment in the United States and the still-closed nature of China's own market.

- *Restrict SOE investment.* One version of reciprocity would be to focus on the not-so-invisible hand of the Chinese government directing outbound investment decisions. To protect the U.S. economy from becoming an easy target for Chinese-state directed capital, several critics are calling on Washington to ban inbound FDI by all Chinese SOEs.<sup>30</sup> Yet, on surveying the factors most commonly thought to distinguish SOEs from private firms—market access, receipt of state subsidies, proximity to state power, and execution of the government's policy objectives—one finds little difference between the two.<sup>31</sup> The same is true of equity and ownership structures: private capital can be injected into a bundle of state assets, or a wholly state-owned corporate shareholder can be found in the upstream ownership chain of a company with private investors.<sup>32</sup> Thus, a policy of limiting two-way investment flows to private companies does little to address the real problem: private firms in China can no more deny Beijing's policy directives than state-owned firms can.
- *Impose Strict Reciprocity.* Other versions of reciprocity focus on basic fairness, advocating a strict regime that would deny any Chinese investment in the United States for sectors that U.S. investors are denied in China. As China expert Jim McGregor puts it, “no Chinese-connected entity should be allowed to invest in or acquire U.S. assets unless American companies have equal market and acquisition access in China.”<sup>33</sup> While seemingly straightforward, strict reciprocity could prove at once to be overly broad and too narrow, denying U.S. policymakers crucial bargaining leverage. It could turn away inbound Chinese investment in areas that would be economically beneficial—certain kinds of commercial real estate, for instance—even when these might be areas in which U.S. firms would not invest in China even if they could. Similarly, other areas, such as semiconductors, might not be closed to U.S. investment either technically or practically, even though they are among the most valuable from China's perspective. Under a strict reciprocity regime, U.S. officials would be unable to target these areas and would forfeit valuable leverage. Moreover, insofar as the driving purpose of a strict reciprocity approach is fairness, it does nothing to address one of the largest sources of unfairness underlying the U.S.-China investment relationship: the range of Chinese industrial policy practices—state subsidies, preferential state-financing, and more—driving so much of China's outbound investment.
- *Broaden CFIUS.* A third set of proposals seeks to effect reciprocity by enlisting CFIUS: effectively broadening its mandate to include economic security. The urge to focus on economic security is warranted, given the range of concerns—from Chinese firms effectively cornering certain markets to a premature hollowing of the United States' innovation base. Yet, introducing these concerns as considerations within the CFIUS review process would undermine years of diplomacy aimed at assuaging the fears of China and several other countries that CFIUS is simply a pretext for curbing certain foreign investments on largely economic grounds. If anything, it is precisely because such

economic concerns are worth taking seriously that U.S. policy should address them squarely and in their own right, and not smuggle them into a preexisting, ill-fitting framework for national security concerns.

## Recommendations

For the past three decades, U.S. policy has sought to bring China into the existing global economic order, betting that the system would change China more than China would change the system. That has not been the case. The costs of the U.S.-China economic relationship have proved to be higher than expected—Chinese imports have taken a steep toll on U.S. employment, labor force participation, and wages—while the benefits have fallen well short of initial expectations.<sup>34</sup> Economists also expected that the steep competition would be offset by export and investment opportunities in the vast Chinese market, expectations that have largely failed to materialize. Now, as China’s economic model begins to depend less on export opportunities and more on overseas investment opportunities, the United States should leverage this to rewrite the terms of its investment relationship with China. There are four ingredients to such a strategy.

### *USE THE 1974 TRADE ACT TO ENFORCE RECIPROCITY*

First, the United States should adopt a policy of reciprocity in the treatment of inbound investment from China. U.S. policymakers should view reciprocity as a means of achieving overall balance in the U.S.-China investment relationship rather than considering versions focused on limiting state-owned investment, imposing strict tit-for-tat restrictions, or broadening the scope of national security. Achieving overall balance in bilateral investment requires a model of reciprocity that aims not merely to open China’s market to U.S. investment but to dismantle the greater scope of Chinese industrial policies; it is these policies, after all, that are behind both the lack of access to China’s market and the surge of state-driven Chinese investment in the United States.

To do so, the Trump administration—led by the U.S. trade representative, along with the State and Commerce Departments—should inform Beijing that Washington will restrict or condition Chinese investments until certain designated industrial policy abuses are lifted or specific conditions are met. For example, U.S. officials could ban or heavily curtail Chinese investment in all ten of the Chinese government’s designated priority areas for investment under the MIC 2025 guidelines until the Chinese government removes preferences for indigenous innovation in its domestic market, adopts transparent and nondiscriminatory licensing requirements for U.S. investment in these sectors, shows substantial progress in allowing non-joint venture U.S. investment in these sectors, and provides a comprehensive accounting of state financing and subsidies that privilege Chinese outbound investment in these sectors. Similarly customized stances should be developed for other areas: in manufacturing, for example, Washington should ban new investment in sectors such as solar and steel in which the United States has filed antidumping claims against China.

The most effective tool to administer this form of reciprocity could be section 301(b) of the 1974 Trade Act. Whereas section 301(a) addresses violations of specific U.S. rights under trade and investment agreements, section 301(b) deals with issues not otherwise covered by existing international agreements, which might materialize in the future. Because investment restrictions would not violate existing U.S. WTO obligations, a reciprocity regime that invoked section 301(b) to limit Chinese investment access to U.S. markets could be structured so as to remain WTO compliant. Indeed, the

Trump administration appears to be moving in this direction, opening a section 301 investigation against Chinese technology transfer. If the investigation culminates in trade restrictions, it would be the U.S. government's first such actions under section 301 since the creation of the WTO in the mid-1990s. It is unclear, however, whether the Trump administration intends to consider action under section 301(b), and debates over whether section 301(b) applies to investment or merely to goods and services remain unresolved.

To clarify these questions, the Trump administration should immediately review the president's scope of authority under section 301(b) and related laws to determine the president's authority to restrict inbound foreign investment pursuant to an affirmative 301 determination and, if necessary, ask the Congress for supplemental 301 retaliatory tools that would be consistent with U.S. obligations under the WTO.<sup>35</sup> To the extent that new legislation is warranted, Congress should explicitly designate new economic security authorities under section 301, instructing the executive branch to consider the economic security concerns discussed earlier—degree of vertical integration by Chinese firms within a given sector, risk of premature hollowing to the U.S. innovation base, and compliance with U.S. law and international obligations—as factors for screening inbound Chinese investment.

#### *REFORM CFIUS TO INCREASE OVERSIGHT*

Second, U.S. policymakers should address the current loopholes in CFIUS while confining its mandate to traditional national security concerns.<sup>36</sup> The notification process, currently voluntary, should instead be made mandatory for categories of filings that involve certain kinds of technologies or parties from a designated list of countries that would include China. This way, all investments by Chinese firms would be automatically flagged for U.S. officials. To address the increasingly varied forms of Chinese investment, the scope of CFIUS-covered transactions requiring notification should be extended to greenfield investments, venture capital, and other acquisitions of minority stakes (at least in certain sectors), not simply mergers and acquisitions. Notification requirements should also be put in place for whenever an existing investment undergoes a material change (e.g., changes to projected manufacturing plans, R&D, technology transfers, and integration).

#### *WORK WITH EU COUNTRIES TO CREATE SIMILAR FRAMEWORKS*

Third, as Washington establishes this reciprocity regime and overhauls CFIUS, it should do so in cooperation with European countries grappling with similar challenges resulting from an influx of Chinese investment. This is especially true of Germany, where Chinese investment has risen from \$530 million in 2015 to some \$12.6 billion in 2016, much of it targeting Germany's technology-intensive manufacturing base.<sup>37</sup> Under German law, Berlin can block foreign investments in defense industry or investments related to IT security. But German officials are pressing the European Union, which retains jurisdiction on investment policies of its member states, to vastly expand the discretion national governments have to block certain investments. Thus far, Germany, France, and Italy have signed a proposal that would create a legal basis for national governments to "intervene in direct investments which are state-controlled." According to one German official, the ultimate aim of the new EU measures would be to force foreign companies to "show that their investments in Germany are not driven by the state, and that financing for their deals is in keeping with the market."<sup>38</sup> U.S. policymak-

ers should encourage the EU to adopt such a framework, equipping it with intelligence-gathering capabilities that could form the basis of enhanced intelligence sharing between U.S. and EU officials regarding Chinese investments that involve economic or national security concerns.

#### *UPDATE THE 1980S JAPAN PLAYBOOK FOR CHINA*

Finally, U.S. officials should act on lessons learned from the influx of Japanese investment during the 1980s to increase public investment in R&D and incentivize the kinds of Chinese investment that would create U.S. jobs and benefit the economy. Skeptics often invoke comparisons to Japan to suggest that state-led industrial policies have their natural limits. Certainly, U.S. companies improved their quality and productivity in response to the trade wars of the 1980s. But these gains came alongside a series of strong U.S. government policy responses: Washington negotiated a 20 percent reduction in the value of the dollar and an assurance that U.S. semiconductor producers would have at least 20 percent of the Japanese market. It launched the High Speed Computing Initiative, invested \$1 billion in a public-private semiconductor consortium (known as Sematech) widely seen as being instrumental to the development of Silicon Valley, and initiated antidumping actions that prevented Japanese producers from selling below cost in the U.S. market. Through these and other measures, Washington made clear to Tokyo that Japan would not be allowed to recycle its current account surplus with the United States into a series of acquisitions aimed at the core of U.S. high-value manufacturing; instead, if Japan wished to invest in the United States, it would have to make greenfield investment—Toyota and Honda factories, for example—which employed significant numbers of Americans. Nearly forty years on, Japan remains the United States' second largest investor, responsible for nearly eight hundred thousand U.S. jobs, while Japanese cars continually rank among the top sellers in the United States.<sup>39</sup>

The United States should update its 1980s Japan playbook to meet its current challenges with China. In particular, Washington should significantly increase public investment in foundational technology R&D, returning it to Reagan-era levels of 1.4 percent of the federal budget (up from just 0.6 percent today). This investment should create institutions that would do for artificial intelligence and advanced manufacturing what Sematech has done for semiconductors. To address Chinese dumping concerns, the Trump administration, led by the Department of Justice, should revise U.S. antidumping laws to eliminate recoupment in cases in which the investor enjoys subsidies and financing from a foreign government (freeing plaintiffs from the need to prove that such defendants, after selling below market, drive up prices to recoup losses). Finally, the Trump administration should also affirmatively encourage Chinese greenfield investments in certain industries; to qualify, investments should create some threshold of U.S. jobs, pose minimal risk of technology transfer, and occur in sectors in which there is no evidence of Chinese dumping.

## Conclusion

China is the second largest—and soon to be the largest—economy in the world. It is already the world's largest trading nation. Simply put, China is too large for U.S. investors to opt out of. After more than fifteen years of stalled negotiations aimed at opening China's relatively closed domestic market to U.S. investors, Washington needs new leverage. A policy of reciprocity—whereby U.S. officials restrict inbound Chinese investment to maximize pressure on Chinese industrial policy abuses—can provide such leverage, reaching Beijing through the thousands of Chinese individuals and companies with a growing interest in maintaining access to the U.S. economy. Soon to be the world's largest net creditor, China's growth prospects increasingly rely on its ability to access overseas investment opportunities, especially in the United States; Beijing will be acutely sensitive to policies that begin to curb its largely unfettered access to U.S. markets.

Shifting to a policy of reciprocity would not be without risks. China may well retaliate. Yet, economically and especially in investment terms, China needs the United States more than the United States needs China.<sup>40</sup> This upper hand will not last forever—China's asymmetric economic dependence on the United States is waning and could disappear altogether within the next five to ten years—but while it exists, Beijing's impulses toward retaliation will be chastened. Moreover, enacting reciprocity within the context of negotiating a BIT with China would enhance U.S. leverage for that negotiation while also containing risks of escalation, because successfully completing a BIT with China will necessarily mean ending all or nearly all reciprocity-related restrictions.

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35. I am grateful to Chuck Levy for his guidance in developing this language and proposal. There are signs that the Trump Administration is beginning to look broadly to Section 301—in late 2017, the White House began considering whether to launch a 301 investigation into China's Made in China 2025 program. As of this writing, however, the Trump Administration has yet to reach a conclusion or specify possible remedies.
36. As of Fall 2017, Congress is preparing at least two different CFIUS bills, neither of which has been formally introduced as of this writing. While both proposals contain elements of progress, neither is sufficient. One bill, led by Sen. Cornyn (R-TX), would potentially curb investment in joint ventures, as well as create a presumption against allowing investment by certain countries; it would not, however, extend CFIUS' scope to cover greenfield investment, nor is it likely to allow CFIUS opportunity for re-reviewing certain deals that undergo material changes after CFIUS approval. The other proposed legislation, led by Sen. Schumer (D-NY), would reportedly broaden CFIUS' mandate to include "economic security" considerations. Both bills would face long odds of passage.
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