Two-Way Street: 2018 Update

US-China Direct Investment Trends

EXECUTIVE SUMMARY

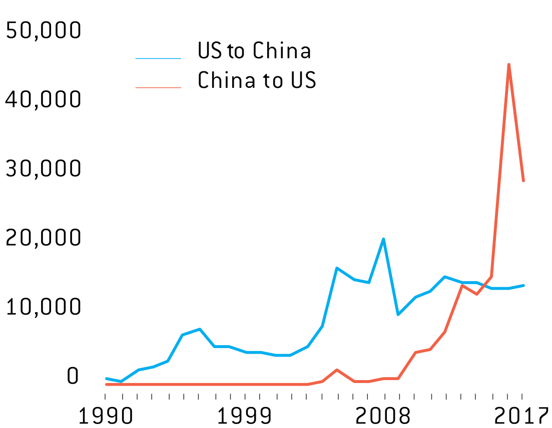
The US-China FDI Project clarifies trends and patterns in foreign direct investment (FDI) flows between the world's two largest economies. This report updates the picture with full year 2017 data and describes the outlook for 2018. The key findings are:

(1) Two-way US-China FDI declined by almost one-third in 2017 compared to 2016, due to a drop in Chinese investment in the US.

- Consummated 2017 FDI transactions between China and the US reached $43.4 billion. This represents a 28% drop from the $60 billion we recorded for 2016, but is still the second highest year on record.
- The reason for this drop was a decline in Chinese investment in the US to $29 billion in 2017 from $46 billion in 2016. This decline would have been much steeper without the $18 billion of Chinese acquisitions that were announced in 2016 but completed in 2017. American investment into China was almost unchanged over the previous year, at $14 billion (compared to $13.8 billion in 2016).
- Flows remained unbalanced with Chinese FDI in the US at twice the level of US investment in China ($29 billion vs. $14 billion). In terms of stock, US companies still have significantly more historical investment in China ($256 billion) than their Chinese counterparts have in the US ($140 billion).

FIG ES-1: Annual Value of FDI Transactions between the US and China, 1990-2017

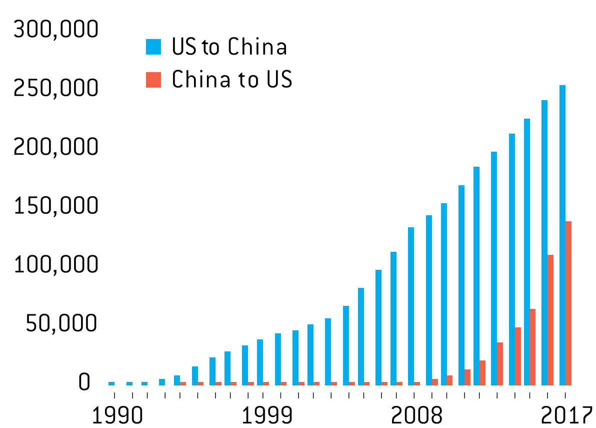
USD million



Source: Rhodium Group.

FIG ES-2: Cumulative Value of FDI Transactions between the US and China, 1990-2017

USD million



Source: Rhodium Group.

(2) Policy and politics in China and the US – rather than commercial forces – are mostly to blame for the two-way investment decline.

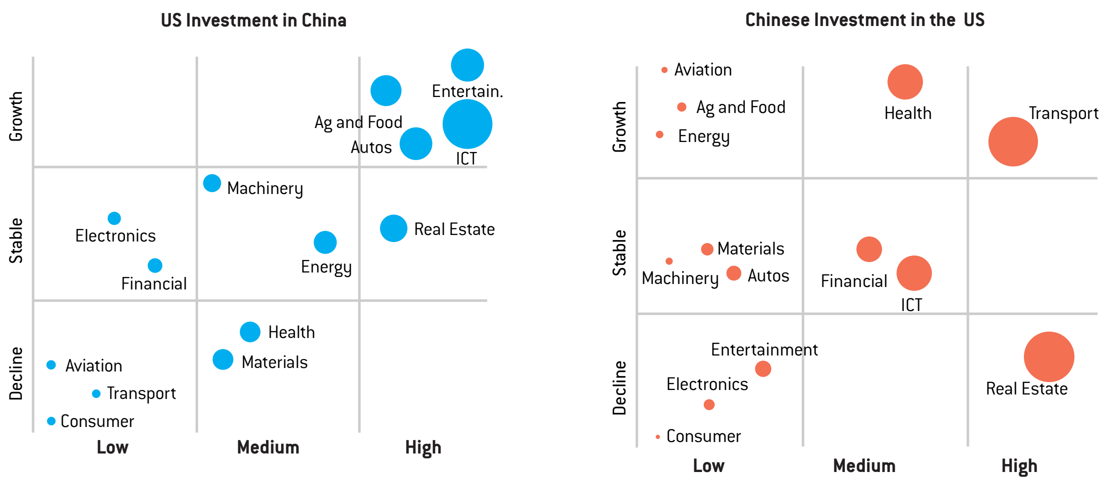
- Chinese investment in the US was curtailed by Beijing tightening controls over outbound investment and a crackdown on leveraged private investors, which caused China's global outbound FDI (OFDI) to decline for the first time in more than a decade.
- Chinese acquisitions in the United States were also pruned by increased investment screening by the Committee on Foreign Investment in the United States (CFIUS), a result of both changing threat assessments and a longer than usual leadership vacuum during the transition to a new administration. We estimate that deals worth more than $8 billion were abandoned in 2017 due to unresolvable CFIUS concerns.
- US FDI to China remained largely flat in 2017 as Beijing delayed market reforms and meaningful liberalization of market access for foreign investors. Investment momentum was strong in unpenetrated consumer-related industries (such as entertainment parks) and sectors promoted by industrial and localization policies (such as electric vehicles, semiconductors and information and telecommunications (ICT) services).

(3) Policy interventions impacted the industry composition of investment, in both directions.

- The 2017 industry mix for Chinese FDI in the US was impacted by deals carried over from 2016, but deal-making in the second half of the year showed a clear shift toward sectors supported by policy. The big losers from China's new outbound investment rules were entertainment, real estate and hospitality, and consumer products and services. Investment remained stable or grew in many high-tech sectors (health and biotech, ICT) and industries related to China's global infrastructure push (transport and infrastructure).
- While endorsed by Beijing, Chinese acquisitions in high-tech sectors were increasingly scrutinized by CFIUS, especially in areas seen as relevant to current defense capabilities (semiconductors) or future defense applications ("emerging critical technologies"). The safety and integrity of personal data of US citizens has also taken a greater role in CFIUS assessments of Chinese acquisitions.

FIG ES-3: Two-Way FDI between China and the US by Industry, 2017

Stylized display of growth momentum (y axis) and investment value in 2017 (x axis, bubble size)



Source: Rhodium Group.

- China made some progress on improving investment market access for foreign investors in 2017, but these changes were not substantial enough to materially impact foreign investment patterns. US companies and other foreign investors remain focused on existing consumer-related opportunities (food and theme parks). Investment appears to be increasingly driven by industrial policy (such as the push for electric vehicles, the desire to nurture a domestic semiconductor industry and localization requirements for ICT firms).

(4) Policy developments are reshaping the investor mix in both directions.

- New outbound restrictions reduced overseas activities by large, heavily leveraged private Chinese conglomerates that had been major drivers of Chinese investment in the US over the past three years. While these players retreated in 2017, small- and medium-sized investments by real economy firms remained resilient. Private equity funds and other established financial investors were less impacted by capital controls, especially those with offshore funds. Sovereign and certain state-owned players have also proved better able to navigate the new regulatory environment, though their investments in the US remain small.
- For US FDI in China, private equity firms and other financial players remain important, but they continue to focus on small- and medium-sized transactions. The big-ticket investments in 2017 were all made by major multinationals in the automotive, ICT and consumer sectors, often driven by industrial policies (semiconductors) or localization requirements (cloud computing).

(5) Venture capital and other non-FDI investment grew rapidly in recent years but also slowed in 2017.

- Direct investment has traditionally dominated two-way US-China flows, but other types of investment – and particularly venture capital (VC) – are becoming important.
- US firms were early investors in many Chinese startups and have participated in more than 1,500 funding rounds over the past 15 years. However, activity peaked in 2015 and has slowed since, partially because Chinese firms became a more viable alternative. One interesting trend in 2017 was that American and other foreign private equity firms geared up to invest in Chinese distressed assets.
- Chinese venture capital was barely existent in the US just a few years ago but has swelled rapidly in Silicon Valley and other US technology clusters in the past three years. This activity also slowed in 2017, but not nearly as sharply as FDI flows.

(6) The outlook for two-way investment is fragile as Washington and Beijing re-assess the foundations of the economic and political relationship.

- China is signaling it will take a more relaxed view on outbound investment as capital outflow concerns have subsided. However, temporary restrictions were formalized into new OFDI rules permitting intervention in transactions at any time, a step backwards from 2014 liberalization.
- On the inbound side, China's commitment to further market reforms is less certain than it was in the years after the 2013 Third Plenum initiative was announced, leaving potential foreign invstors with doubts about Beijing's seriousness about leveling the playing field for non-native businesses.
- In the US, Congress plans to overhaul the US investment screening regime, the White House plans action against Chinese FDI as part of its Section 301 case on Chinese intellectual property threats, and traditional advocates of moderation including the business community are less willing to push back. While there is room for continued two-way investment growth even

with heightened security screening, risks of strategic conflict are threatening that growth prospect.

(7) There is still room for two-way investment flows in non-sensitive areas if current concerns are managed properly.

- In the US, the extent of strategic re-orientation will make a huge difference for future two-way flows. If it were just a matter of narrowly defined national security, the US could redouble its diligence screening for risks and still enjoy a great expansion of Chinese investment: today's levels are not high in proportion to the size of our two economies. But a draconian effort to push back on China's economic footprint in America in ways that transcends discreet national security concerns will forfeit these opportunities.
- China's preference for convergence or divergence with advanced economy norms is the other essential determinant of future US-China two-way investment potential. Economic interaction – in FDI, trade and other areas – is dependent on like-mindedness about the future. In 2017 Beijing stressed the non-convergent aspects of its policy plans, triggering new debate about the prospects for investment under different assumptions. Past FDI volumes, and even existing deals, cannot be taken for granted in either direction if convergence is off the table.

(8) The US-China investment relationship will be an important determinant for how other countries handle investment relations with China.

- While many of the Trump administration's threats to be tougher on China are loathsome to US allies, many of the direct investment considerations under review in the US are in line with consideration of other advanced economies.
- As other advanced economies look at their bilateral investment relationships with China through the same lens as Washington, it is possible that shared approaches to managing security concerns will emerge. Ultimately, a multilateral framework for managing concerns about cross border direct investment is likely to be the most effective approach.

LEAD ORGANIZATIONS

National Committee on U.S.-China Relations

The National Committee on United States-China Relations is an American nonprofit, nonpartisan educational organization that encourages understanding and cooperation between the United States and Greater China in the belief that constructive Sino-American relations serve the interests of both countries and the global community. Since 1966, the National Committee has conducted programs on politics and security, governance and civil society, economics and finance, education, and transnational issues such as energy and environment. It carries out its mission via conferences and forums, public education programs, professional exchanges, and collaborative projects. The National Committee's membership of more than 800 Americans and 80 corporations and professional firms represent many viewpoints, but share the belief that productive U.S.-China relations require public education, face-to-face contact, and the forthright exchange of ideas.

Rhodium Group

Rhodium Group (RHG) is an economic research firm that combines policy experience, quantitative economic tools and on-the-ground research to analyze disruptive global trends. It supports the investment management, strategic planning and policy needs of clients in the financial, corporate, non-profit, and government sectors. RHG has offices in New York, California, and Hong Kong, and associates in Washington, Singapore, and New Delhi. RHG's cross-border investment practice analyzes the rise of China and other emerging markets as trans-national investors. RHG senior staff publish frequently on the growth and impact of Chinese outbound FDI in the United States, Europe, and other economies.

IN PARTNERSHIP WITH

American Chamber of Commerce in Shanghai

The American Chamber of Commerce in Shanghai, known as the "Voice of American Business" in China, is the largest American Chamber in the Asia Pacific region. Founded in 1915, AmCham Shanghai was the third American Chamber established outside the United States. As a non-profit, non-partisan business organization, AmCham Shanghai is committed to the principles of free trade, open markets, private enterprise and the unrestricted flow of information.

China General Chamber of Commerce USA and CGCC Foundation

Founded in 2005, the China General Chamber of Commerce – U.S.A. (CGCC) is the largest nonprofit organization representing Chinese enterprises in the United States. Its mission is to promote Chinese investment in the U.S., support the legal rights and interests of our members, and enhance cooperation between Chinese and U.S. business communities.

The CGCC Foundation is an IRS 501(c)(3) charitable organization affiliated with the China General Chamber of Commerce – U.S.A. It is dedicated to fulfilling social responsibilities by giving back to local communities and enhancing mutual understanding between the people of China and the United States.

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