IS THE U.S. READY FOR FDI FROM CHINA?: ECONOMIC CONSIDERATIONS

Steven Globerman
Western Washington University
College of Business and Economics

and

Daniel Shapiro
Simon Fraser University
Segal Graduate School of Business

November 2007
INTRODUCTION

Notwithstanding its rapid and sustained economic growth over the past two decades, China has not yet emerged as a major source of foreign direct investment (FDI). By way of illustration, outward FDI from China totaled US$3.6 billion in 2004 (excluding computer giant Lenovo) with accumulated outward FDI reaching US$37 billion (Hua, 2005). These amounts represent less than 1 percent of the world totals in that year. Nevertheless, outward FDI from China is increasing rapidly, and that country is emerging as one of the top FDI exporters among developing countries. Outward FDI growth is expected to accelerate in the future given, among other things, China’s large and growing holdings of foreign exchange reserves and the apparent determination of Chinese authorities to diversify holdings of foreign exchange reserves away from fixed income assets towards equity assets.

Chinese outward FDI has historically concentrated on Greenfield and joint venture investments, although the pace of acquisition activity has picked up in recent years. For example, Hemerling, Michaels and Michaelis (2006) estimate that since 1986, Chinese companies have invested some $30 billion in non-Chinese companies, and nearly a third of these acquisitions occurred in 2004 and 2005. Indeed, several recent attempted acquisitions of U.S. companies by multinational companies (MNCs) headquartered in emerging economies, including China raised a storm of political protests in the United States. One such acquisition was the attempted takeover of Unocal by the Chinese National Offshore Oil Company (CNOOC). Strong opposition to this takeover on the part of U.S. politicians, along with the prospect of a prolonged approval process, led to CNOOC withdrawing its takeover bid. While the rationale for the opposition was (arguably) never clearly articulated, the opposition signaled suspicion and concern about takeovers of domestically owned companies by MNCs headquartered in China and in other emerging economies populated by state-owned enterprises (SOEs) or state-supported companies. Moreover, there is some indication that the strong opposition to the
attempted Unocal takeover might be discouraging inward FDI to the United States from emerging economies.¹

While there has always been political opposition to inward FDI, particularly when it takes the form of large acquisitions of host country firms, legal barriers to inward FDI have been substantially weakened in both developed and emerging economies in recent decades reflecting a broad assessment, supported by research, that the economic benefits of inward FDI to the host economy generally exceed any associated economic costs. Hence, the growing opposition to outward FDI from China and other emerging economies presumably reflects a perspective that the net benefits of such FDI differ substantially from the net benefits of earlier generations of outward FDI, mainly originating in developed countries.² In addition, while acquisitions of domestic companies by Chinese MNEs can be reviewed by the U.S. government, there is currently no procedure for reviewing Greenfield investments by Chinese MNEs, although there have been calls for reviewing all foreign investments by SOEs, as well as by government-owned investment funds (Scannell, 2007).

The broad purpose of this paper is to identify and evaluate arguments for discouraging inward investment (particularly acquisitions of local companies) in the United States by MNCs based in China and, perhaps, other emerging economies. The paper also considers whether relevant concerns are addressed by existing legislation and regulations or whether new policies are appropriate to deal with the relevant issues.³ The study proceeds as follows. Section 2 discusses the conceptual issues associated with inward FDI. In particular, it evaluates potential differences in the economic consequences

¹ The CEO of Abu Dhabi National Energy Co. recently indicated that it is targeting Canada for takeovers in the oil and gas sector because of its political stability and its location next to the United States, a market in which it would like to participate but in which it perceives Middle Eastern investment being frustrated by tight rules. See Cattaneo (2007). German Chancellor Merkel also recently suggested that Europe needed an equivalent of the Committee on Foreign Investment in the U.S. to review takeover bids by government-controlled investment funds from countries like China and Russia. See “Europe Differs on Investors From Overseas”, The Wall Street Journal, July 26, 2007, A3.

² Concern is also being expressed in the United States and elsewhere about equity investments made in those countries by sovereign wealth funds headquartered in China and other emerging markets. See, for example, Davis (2007).

³ This latter focus might be seen as a consideration of whether the U.S. is “ready” for Chinese FDI from a legal and regulatory perspective.
of foreign acquisitions of domestic companies versus Greenfield investments, as well as the evidence bearing upon the potential differences. Since it appears that the primary concern of policymakers is with acquisitions of U.S. companies, it is relevant to consider whether there are economic reasons to favor Greenfield investments relative to foreign acquisitions regardless of the nationality of the foreign investor. Section 3 considers how the conceptual issues identified in Section 2 are qualified if the foreign investor is an SOE. It also assesses potential economic concerns on the part of the host country to inward investments by sovereign wealth funds (SWFs). Section 4 evaluates the relevance of the issues identified in Section 4 against the background of evidence bearing upon the motives, behavior and performance of SOEs. Section 5 considers whether new legislation or regulations are appropriate in light of growing inward FDI from China. Summary and concluding comments are supplied in the final section.

 ISSUES ASSOCIATED WITH INWARD FDI

While inward FDI can take the form of either the establishment of new operating businesses (Greenfield) or the acquisition of existing domestic businesses, most FDI, in fact, takes the form of acquisitions. Among OECD countries, some 80 percent of FDI occurs via mergers and acquisitions (OECD, 2007). A substantial literature exists comparing and contrasting the economic effects on the host country of these two broad modes of FDI. A particular focus of the literature is the spillover productivity benefits for the host economy, since such spillovers are the primary gain to the host country associated with inward FDI (Blomstrom, Kokko and Zejan, 2000). Hence, any distinction between the two forms of FDI from the perspective of the host country should presumably focus particularly on potential differences in host country spillover benefits.

Spillover Efficiency Gains

Spillover efficiency benefits from inward FDI comprise productivity improvements enjoyed by host country firms associated with the activities of foreign-owned MNCs in the home country. The various sources of spillover efficiency benefits are potentially operative in the case of both acquisitions and Greenfield investments by foreigners. For example, innovations introduced to the host economy by foreign-owned
MNCs can be imitated by domestically owned firms whether the innovations were introduced through the operations of a Greenfield’s facility or an already-existing acquired facility. Likewise, learning-by-doing on the part of host country workers and managers can take place in already existing businesses acquired by foreign investors, as well as in new facilities.

Increased competition provided by newly entering foreign-owned MNCs can be an important spur to domestically owned firms improving their efficiency. In this regard, it is sometimes argued that acquisitions of existing firms result in higher resulting ownership concentration compared to Greenfield investments, since the number of separately owned businesses in the relevant market is more likely to increase in the latter case than in the former. As a result, it is often presumed that increased competition is more likely to arise from Greenfield investments made by foreign investors than from foreign acquisitions of domestically owned firms; however, this presumption is simplistic. In particular, foreign acquirers may be willing and able to make investments in the acquired companies which make the latter more formidable competitors than they were under domestic ownership. Furthermore, acquisitions may facilitate quicker and more comprehensive entry into the host economy, so that increases in competition occur earlier and encompass a broader range of product or geographic markets than would be the case if foreign investors were obliged to enter through Greenfield investments.

To the extent that firms undertaking Greenfield investments differ from those acquiring local firms in terms of their underlying productivity and other firm-specific advantages, host country spillover benefits from inward FDI might be indirectly conditioned by the nature of the FDI undertaken, i.e., Greenfield versus acquisition. For example, if foreign companies undertaking Greenfield investments are, on average, more efficient than those acquiring local firms, host country spillover benefits might be greater in the former case than in the latter. This is because the superior efficiency of firms undertaking Greenfield investments suggests the greater availability of technical and managerial expertise that, in turn, might be transferable to domestic firms. To be sure, available evidence suggests that host country spillover benefits are also a function of the
“absorptive” capacity of local firms, where absorptive capacity is essentially the ability of local firms to adopt and exploit information and technology spillovers made available through the activities of foreign-owned affiliates in the host country. To the extent that absorptive capacity itself depends upon the nature of accumulated inward FDI, the linkage between spillover benefits and the mode of FDI is likely to be subtle and complex. For example, local firms might be better able to absorb technology transferred from foreign firms that enjoy comparable levels of productivity rather than substantially higher levels.

Other Consequences of Inward FDI

While spillover productivity gains to domestically owned producers are the main conceptual benefit of inward FDI, there are other relevant potential consequences for the host economy including capital investment and employment levels. While not necessarily directly related to spillover efficiency benefits, domestic policy makers would undoubtedly prefer higher levels of employment to lower levels of employment in the domestic economy. Higher levels of “non-inflationary” employment will, in turn, be related to the production capacity of the domestic economy. Increases in an economy’s capacity to produce output allow for increases in the demand for labor without generating concomitant increases in inflationary pressures. In the long-run, an economy’s capacity to utilize labor more efficiently will be tied to capital investments. In this regard, Greenfield investments are sometimes seen as adding new plant and equipment capacity to the host economy, whereas foreign acquisitions do not. Again, this perspective is simplistic. If acquired domestic firms grow more quickly than they would have done under continued domestic ownership, the overall capital stock of the host economy is also likely to grow faster than it would have in the absence of the foreign acquisitions. This will certainly be true in cases where domestically owned firms are in danger of failing.

Benefits from inward FDI can also be experienced by domestic owners of assets, as well as host country consumers. To the extent that foreign owners can operate acquired assets more efficiently than incumbent domestic owners or any other potential domestic investors, they can afford to bid higher prices for those assets than would be the case in
the absence of foreign investment. Competition among foreign investors should therefore result in some or all of the anticipated improvement in efficiency being captured by the prior (host-country) owners in the form of an acquisition price premium. In principle, an acquisition price premium can be paid for an already existing enterprise or for individual assets such as land or skilled management that are assembled into a Greenfield operation. In practice, the need to pay a “takeover” premium for an already existing acquisition likely means that domestic shareholders will be primary beneficiaries of any efficiency advantages that foreign investors enjoy relative to domestic investors in operating host country assets.

Finally, it also seems likely that at least some portion of any productivity gains associated with ownership changes will be passed on to domestic consumers in the form of lower prices. The stronger the degree of domestic competition, the more likely it is that consumers will be beneficiaries of any productivity improvements associated with a change of ownership from domestic to foreign investors. As noted above, it is not necessarily true that Greenfield investment leads to more effective competition than do acquisitions. As a consequence, it seems likely that both modes of inward FDI will contribute, at the margin, to host country benefits in the form of lower prices for consumers.

Acquisitions versus Greenfields: The Evidence

In the preceding sections, a number of conceptual arguments in favor of greater economic benefits from Greenfield investments compared to acquisitions were considered. The broad conclusion drawn was that there are no compelling theoretical reasons to expect the host country benefits of Greenfield investments to exceed those of acquisitions. In effect, the issue is an empirical one. Unfortunately, the available evidence is fragmented and limited. In particular, there is no evidence of which we are aware that identifies host country spillover efficiency benefits from Greenfield FDI separately from those associated with acquisitions of host country firms.
Several studies focus on the characteristics of foreign investors who undertake Greenfield investments versus those who undertake acquisitions. For example, Volcke and Yeaple (2005) conclude on the basis of a theoretical model that firms engaged in Greenfield investments will be systematically more efficient than those engaging in cross-border acquisitions and argue that this inference is consistent with available evidence. In a similar vein, Raff, Ryan and Staehler (2005) propose that, controlling for industry and country-specific characteristics, the most productive firms, i.e., those owning the most assets, will enter through Greenfield investments, while less productive ones will choose mergers and acquisitions. They confirm this prediction in an econometric analysis of firm-level data.

Notwithstanding any differences in the underlying efficiencies of foreign investors entering through the Greenfield versus the merger and acquisition mode, there is no consistent evidence that the host country effects of the two modes of FDI differ. As noted earlier, Greenfield investment involves the creation of new production capacity which, other things constant, should increase domestic competition, at least in the short-run. Indeed, UNCTAD (2000) found that the most significant distinction between the two modes is that acquisition-FDI is associated with a persistent “concentration effect” relative to Greenfield-FDI. Hence, one would expect Greenfield FDI to make greater contributions to increased competition in host country markets than FDI through acquisitions. Claeys and Hainz (2006) find supportive evidence for this inference in a sample of banks from ten transition countries of Eastern Europe for the period 1995-2003. Specifically, they find that competition is stronger if market entry occurs through Greenfield investment with a consequence that domestic banks’ interest rates are lower, On the other hand, Chung (2001) finds that mode of entry for FDI into the United States over the period 1987-1991 has no significant impact on industry price-cost margins. That is, there is no identifiable difference in the competitive impacts of FDI depending upon whether the mode of entry is Greenfield versus acquisition.

With respect to domestic wages, Heyman, Sjoholm and Tingvall (2004) find that foreign-owned firms entering Sweden through Greenfield investments have to pay higher
wages to attract new workers. In contrast, foreign acquirers tend to target higher wage firms but increase wages at a slower rate than non-acquired firms after the change in ownership.\textsuperscript{4} Conversely, Bloningen and Slaughter (2001) find that Japanese Greenfield investment in the United States in the 1980s was associated with lower not higher relative demand for skilled labor.

Ambivalent evidence on the effects of Greenfield FDI versus foreign acquisitions exists with respect to other manifestations of behavior and performance. For example, while Mata and Portugal (2000) find that Greenfield entrants are more likely to be shut-down than acquisition entrants, McCloughan and Stone (1998) find that Greenfield entrants face a lower risk of failure than acquisition entrants. With respect to innovation, Bertrand, Hakkala and Norback (2007) find that controlling for parent, affiliate, industry and country characteristics, acquired affiliates of Swedish multinational firms are, on average, more likely to do R&D and have a higher level of R&D intensity than affiliates created by Greenfield investments. This result persists over time and with the age of affiliates, as well as for different firm types and industries. They interpret their findings as suggesting that discriminating against cross-border acquisitions in order to promote Greenfield investments may be counter-productive for a host country aiming at increasing R&D investments. Ferrett (2005) shows that when an acquisition prompts R&D investment that would not otherwise occur, acquisitions dominate Greenfield investments in terms of their economic welfare effects for the host country. This is because there are gains in consumer surplus in the home country, as well as higher industry profits associated with the concentration effect. On the other hand, Brouthers and Brouthers (2000) offer evidence that organizations which have developed strong intangible capabilities may be more able to “leverage” those capabilities through Greenfield start-ups than through acquisitions.\textsuperscript{5}

\textsuperscript{4} In contrast, Huttunen (2007) finds for a sample of Finnish establishments that foreign acquisitions result in a decreased share of highly educated workers in the plant’s employment.  
\textsuperscript{5} Vermeulen and Barkema (2001) argue that acquisitions, unlike Greenfield expansion, broaden a firm’s knowledge base and enhance the viability of its later ventures.
As noted, there is no consistent empirical evidence on the host country effects of FDI via Greenfield investments versus acquisitions. Moreover, there is virtually no evidence bearing upon this issue for FDI undertaken by Chinese or other emerging market MNEs. Mathieu (2006) discusses several Chinese acquisitions of large French companies. In one acquisition, Marionnaud was taken over by A.S. Watson Group, part of the Hutchison Whampoa Corporation. The French company was struggling to stay in business prior to the acquisition. After the acquisition, its operations expanded at a brisk pace with the opening of new stores and the hiring of a substantial number of new employees. In a second acquisition, Blue Star acquired Adisseo, a world-scale producer of animal-feed supplements. In association with this acquisition, Blue Star announced plans to set up an R&D center in France specializing in biotechnology for the production of amino acids used in animal feed. Apparently the French experience with Chinese acquisitions has been sufficiently favorable that the Invest in France Agency is increasing the number of employees at its office in China to raise awareness of opportunities in the French market.

In summary, based on the currently available evidence, we cannot conclude that the host country benefits of Greenfield FDI investments differ from those of foreign acquisitions. Hence, policymakers should be cautious about distinguishing between the two types of FDI for purposes of screening inward FDI or approving certain types of inward FDI and not other types. We also note that in its survey of the impacts of foreign takeovers on host countries, the OECD also concludes that “it makes little economic sense” for policy makers to distinguish Greenfield investment from cross-border acquisitions (OECD, 2007, p.86). The broader and more relevant issue is whether the host country impacts of inward FDI from emerging economies, particularly China, differ from those of inward FDI from developed economies.

CONCERNS ABOUT ACQUISITIONS BY COMPANIES BASED IN CHINA

As noted in the preceding section, most of the available evidence on the host country effects of inward FDI involves acquisitions made by MNCs headquartered in developed countries. There is also some evidence focusing on MNCs from emerging
economies acquiring companies based in other emerging economies; however, there is virtually no evidence documenting the experience of MNCs from emerging economies acquiring firms in developed countries. Yet this latter phenomenon is at the heart of the policy conflict surrounding the FDI process in the United States and Europe at the present time.\textsuperscript{6}

In the absence of reliable evidence bearing upon the economic impacts of foreign acquisitions by MNCs based in emerging economies including China, a policy evaluation of the phenomenon must draw largely upon conceptual analysis. The latter should identify why the economic impacts on the host economy from foreign acquisitions might be different in the case of acquirers from China, as well as the appropriate policy response to the differences identified. The identity of the foreign acquirer might be related to the anticipated economic effects because the motives of acquirers may differ, as well as the market and non-market disciplines that different acquirers face.

Motives of Acquirers

In most economic models of merger and acquisition activity, it is assumed that the acquiring firm is driven to maximize the wealth of the firm’s owners. Hence, firms will attempt to acquire other firms only if the acquiring firm’s management believes that the acquisition will increase the long-run profitability of the firm. To be sure, principal-agent problems in large, widely held public companies can encourage and allow management to pursued acquisitions that are not necessarily consistent with long-run profit maximization; however, competitive capital markets provide a potentially strong disciplinary force on managers who systematically fail to make efficient decisions. Ultimately, managers who sacrifice the interests of shareholders in favor of other goals face the prospect of being replaced through takeovers of their companies. In contrast, managers of SOEs, as well as family owner-managers of diversified businesses face no such threat from capital markets. The takeover threat is not

\textsuperscript{6} It might be noted parenthetically that several emerging economies have been expressing concerns about inward FDI and have implemented policies to restrict such investments; however, the concern surrounds all inward FDI and not specifically inward FDI from other emerging economies or acquisitions by state-owned enterprises.
relevant for SOEs because the state is usually the controlling shareholder and sometimes the only shareholder. As a consequence, financial losses can be subsidized from other sources of government finance. In the case of family-owned businesses, continued financial losses may ultimately force a sale of the business; however, there is no necessary compulsion for owner-managers to be ruthlessly efficient if they are willing to trade off profits for other goals such as employment of family members.

Several other differences characterize principal-agent problems in SOEs relative to those characterizing publicly traded companies. For example, an SOE cannot have its board of directors changed via a proxy contest and most SOEs cannot go bankrupt. The absence of proxy contests, like the absence of the threat of takeover, reduces the incentives of board members and managers to maximize the value of the company. The irrelevance of bankruptcy effectively introduces a “soft budget constraint” which reduces pressures to contain costs. Furthermore, an SOE generally has a higher body or bodies that oversee it. This can be one or more ministries, a dedicated government entity, Parliament or frequently a combination of overseers. The complex agency chain through and across various levels of government may present difficulties not present in the relationship between a company’s board and managers on the one hand and its shareholders on the other.7

Where companies are not owned by private shareholders, or where most of those shareholders have little or no ability to influence managerial decisions, and corporate capital markets are not very competitive, there is no reason to believe that managers (or majority owners) will be disciplined, even in the long-run, for decisions that are inconsistent with efficient allocation of the organization’s resources.8 To the extent that goals unrelated to wealth maximization dominate in Chinese MNCs, those MNCs enjoy the leeway to make financially unprofitable foreign acquisitions and to operate acquired foreign companies inefficiently. By itself, the latter outcome raises no concerns for the

7 For a discussion of the unique governance problems facing SOEs, see The World Bank (2006).
8 Goergen (2007) points out that, for most of the world, conflicts of interest are not likely to emerge between management and shareholders but between the major shareholder and the minority shareholders; however, in many emerging market MNCs, major shareholders are either family members or the state and family members or government bureaucrats are often senior managers.
host country, since the subsidies required to perpetuate the inefficient performance of Chinese affiliates in the domestic U.S. economy are presumably provided by China and not by U.S. residents; however, inefficient Chinese-owned affiliates are also less likely to be a source of spillover efficiency benefits to the host economy. For example, inefficient acquisitions are less likely to promote increased competition in domestic industries than are acquisitions that result in the merged firm becoming more efficient than the incumbent firm.

Hoarding Resources

Specific characteristics of large firms headquartered in emerging economies underscore concerns about managers pursuing goals other than wealth maximization. As noted earlier, SOEs are presumably not under pressure to earn profits in order to have the government continue to finance their operations. Hence, SOEs are under no direct pressure to operate efficiently in order to maximize profits. Indeed, SOEs are widely perceived as pursuing public policy goals that may sacrifice efficient performance as conventionally measured. For example, SOEs in China are seen as maintaining employment in order to reduce social tensions that might arise through massive layoffs of workers (reference). While some have argued that making SOEs employers of last resort has social benefits that outweigh the associated inefficiencies, others argue that sustaining the existence of large SOEs unduly impedes the movement of resources from contracting and inefficient sectors of the Chinese economy to the expanding and efficient sectors.

It is unlikely that the Chinese government would make “employment preservation” a goal of SOE affiliates operating in the U.S. and other developed countries. That is, there is no reason to believe that affiliates of Chinese SOEs operating in the U.S. would employ U.S. workers whose wages exceeded their contributions to

---

9 This assertion has been disputed by some SOEs. For example, the CEO of the Abu Dhabi National Energy Company recently stated that the Company, while formed by the government in 2005 to diversify the emirate’s portfolio globally, is “run like a private concern.” See Cattaneo (2007).

10 Globally, SOEs account for 20 percent of investment and 5 percent of employment. Their importance varies across emerging economies. For example, 1,200 stock exchange-listed SOEs account for 18 percent of China’s GDP. In Central and Eastern Europe, the state sector accounts for 20 to 40 percent of output. In Asia and Latin America, the state share of output is 8 percent and 6 percent, respectively. See The World Bank (2006, pp.1-2).
profit. A more relevant concern about takeovers of western companies by Chinese SOE is that they are targeted at acquiring “critical” natural resources, and that resources are meant to provide long-run security of supply for the Chinese economy. As such, in the event of an unexpected short-run or long-run disruption of supply for one or more of those natural resources, Chinese owners would presumably refuse to make supply available to non-Chinese buyers, even if the latter are willing to pay more than competing Chinese buyers. In contrast, a wealth maximizing owner of the resource in question would presumably sell to the highest bidder regardless of the nationality of the buyer.

National Security

Another broad concern surrounding acquisitions by Chinese SOEs is that they may impose a security threat upon the host economy. Indeed, national security concerns have been raised by a number of proposed foreign takeovers of companies operating in the United States. One notable example was the proposed acquisition by Dubai Ports of a U.K. company with an affiliate operating a number of major U.S. shipping ports. While the Middle Eastern background of the would-be acquirer certainly figured prominently in the security argument, it is highly likely that a similar “national security” concern would have been expressed by U.S. politicians had a Chinese company proposed the same acquisition. Indeed, several U.S. lawmakers have voiced concerns over Bain Capital Partners buyout of 3 Com Corp. which calls for China’s Huawai Technologies Co. to take a minority stake in 3 Com. The specific concern is that Huawei will gain access to the telecommunications equipment maker’s technology which is used by the U.S. Defense Department, among others.\footnote{See “Will 3 Com Deal Funnel U.S. Secrets to Chinese?”, The Wall Street Journal, October 9, 2007, C3.}

The basic notion underlying a national security concern about acquisitions by Chinese SOEs is that the latter have no political loyalty to the host country while domestically owned shareholders presumably do. Equivalently, Chinese SOEs will be less willing than domestically owned companies to sacrifice their organizational objectives for the sake of the national interests of the host country, including national security. Indeed, in the limit, SOE affiliates might be seen as agents of an “unfriendly”
government whose primary objective is to damage the economic infrastructure of the United States and other Western countries.

Socially Responsible Behavior

A more modest concern about Chinese SOEs in comparison to the concern about national security is that they are characterized by relatively poor corporate governance along with a relatively weak commitment to socially responsible behavior in the host economy. To our knowledge, the ways in which socially irresponsible behavior might be manifested in host economies have never been explicitly articulated; however, one might posit that SOE affiliates will be more inclined than domestically owned firms to act opportunistically toward stakeholder groups in the host economy, including employees, suppliers and customers.

More generally, SOEs may have weaker commitments than their domestically owned counterparts to the local communities in which they operate. This might be manifested, among other ways, in more limited philanthropic contributions, lack of sensitivity to human relations in the workplace, a lesser willingness to work constructively with local governments and regulators in matters involving environmental practices, construction of infrastructure and so forth. To a significant extent, weak corporate governance and socially irresponsible behavior likely hurts the company itself in the form of higher costs of capital and, possibly, higher costs of other inputs; however, to the extent that SOEs act in a socially irresponsible manner, they may contribute to an erosion of “social capital” which, in turn, reduces the productivity of other public and private organizations in the host economy.\(^\text{12}\)

Governance and Transparency

A related issue raised about Chinese SOEs is their lack of transparency of structure and organizational form. A specific concern is that many Chinese SOEs both

\(^\text{12}\) Many observers believe that China has one of the world’s more corrupt business cultures which is manifested in, among other things, a disregard for product safety and a willingness to bribe local officials. See “China’s Moral Infrastructure”, The Wall Street Journal, August 7, 2007, C12. The transference of this type of behavior to the U.S. economy would arguably contribute to an erosion of honesty and trust- major components of social capital.
make losses and do not comply with codes of corporate governance and transparency to which OECD companies largely adhere. Firms acquired by Chinese companies may experience financial difficulties under a politically appointed and motivated management pursuing non-profit motives. To the extent that financial losses and other adverse consequences of inefficient management are borne solely by the parent Chinese company, no broader externality costs are presumably imposed upon the host economy; however, if a lack of transparency makes it relatively difficult for input suppliers, employees and lenders to assess relatively accurately the likelihood of the Chinese-owned affiliate carrying out its contractual and non-contractual agreements, unanticipated financial losses may be suffered by host country entities doing business with the Chinese-owned affiliate. Indeed, the financial failure of relatively large Chinese-owned companies might generate relatively broad-based economic dislocations that affect a wide range of “third party” citizens of the host economy.\textsuperscript{13}

Unfair Competition

Yet another concern about Chinese FDI is that the investment activities of Chinese MNEs are directly or indirectly subsidized by the Chinese government. Hence, Chinese MNEs have an “unfair” capital cost advantage with respect to U.S.-owned companies that must finance their investments at market costs of capital. Put in this context, the complaint is quite similar to concerns expressed about predatory pricing by foreign exporters; however, as Antkiewicz and Whalley (2007) point out, it is difficult to apply arguments of predation to cross-border investment and acquisition activities because asset acquisitions are one-time transactions. Furthermore, foreign subsidization of acquisitions might simply lead to domestic sellers of assets receiving a higher price.

Family-Owned Businesses

MNEs based in China (and other emerging economies) are not exclusively SOEs. Nevertheless, the pyramidal structure of many large privately (often family) owned

\textsuperscript{13} One thinks here of the recent bankruptcies of several large mortgage brokers in the United States that contributed to a reluctance to lend on the part of other financial institutions with attendant disruptions to the normal functioning of capital markets. For a more extensive discussion of this possibility, see Antkiewicz and Whalley (2007).
companies in those economies also arguably insulates the controlling shareholders from the discipline of capital markets. As well, the economic prominence of those companies in their home countries often insulates them from legal sanctions or regulations. Specifically, management is often in a position to buy (directly or indirectly) the support and protection of home country legislators and bureaucrats. In the case of China specifically, it has been argued that local officials are rewarded on the basis of the economic growth rates of their political units. Hence, those officials are willing to tolerate business practices that may inflict large external costs on society, such as producing products containing toxic substances, as long as rapid rates of economic growth are maintained. In this regard, large family owned businesses frequently enjoy the same protected economic positions as SOEs. That is, managers in the former organizations also arguably enjoy protection from capital market discipline.

The pyramid ownership structure of family owned businesses that is particularly common in countries with weak investor protection raises a risk of “tunneling”, whereby majority shareholders effectively expropriate minority shareholders by extracting more cash flow from the subsidiaries than their ownership shares entitle them to. Former owners of the acquired U.S. company would, therefore, face exposure to tunneling if they accepted minority shareholder status in the parent foreign company. On the other hand, if shareholders of the acquire U.S. company accept cash in payment for their ownership shares, no risk of tunneling would arise. It might be noted in passing that there are few family-owned firms based in China that are currently operating abroad, although there are numerous family-owned MNEs headquartered in other Asian economies.

Sovereign Wealth Funds

Unlike FDI, investments by SWFs, in principle, do not involve operating control over the activities of the companies in which equity investments are made. Nevertheless, many of the same concerns about investments in FDI by SOEs have been raised about

14 Khanna and Yafeh (2007) note that the political and economic influences accumulated by business groups often results in the phenomenon of “captured regulators”; however, they also identify cases where individual business groups have lost favor with government authorities. The growth of foreign ownership by business groups headquartered in emerging economies contributes to this loss of favor.
investments by state-owned SWFs. For example, concerns have been raised by U.S. regulators about a lack of transparency that might obscure abuses such as insider trading and other security violations (Scannell, 2007). Such violations, if sufficiently widespread, might undermine confidence in domestic capital markets and lead to higher costs of capital for many domestic companies not affiliated with those in which SWF investments are made. A more general concern is that SWFs do not face the same pressures to maximize risk-adjusted portfolio returns that private sector investment managers face. Hence, financial investments might be made for “non-economic” purposes. To the extent that large equity investments provide SWF managers with access to and influence over the management of the companies in which they invest, there may be no meaningful difference between FDI and equity investments by SWFs. Furthermore, to the extent that SWFs extend capital to domestic MNEs to facilitate the latter’s FDI activities, it may not be meaningful to distinguish the investments of SWFs from those of SOEs. In such cases, the basic concerns raised about Chinese FDI might also be raised about investments by Chinese SWFs.

Summary Comments

SOEs, SWFs and large, family owned businesses are arguably less sensitive than U.S. public companies to the discipline exerted by threats of corporate takeovers, replacement of board members and bankruptcy. As such, the former presumably enjoy more scope than the latter to sacrifice economic efficiency in favor of other managerial objectives. Such behavior might result in the U.S. economy realizing few, if any, spillover efficiency benefits from takeovers of U.S. companies by Chinese companies. Perhaps of even greater concern, the managerial objectives pursued by Chinese managers may be inconsistent with the national interests of the United States. The most obvious possibilities in this regard are an unwillingness of Chinese companies to make natural resources available to U.S. buyers or a willingness of Chinese companies to make “sensitive” commercial or technical information obtained through the activities of their U.S. affiliates available to foreign governments.
It should be emphasized that the potential for Chinese companies to undertake outward FDI inefficiently does not mean that they will do so. Moreover, policies may be in place in the United States to address the realistic concerns raised by FDI from China without sacrificing any economic benefits to the U.S. economy that would result from preventing or discouraging inward FDI from China.

Besides depriving the U.S. domestic economy of potential spillover benefits from Chinese FDI, U.S. policies to prevent or discourage inward FDI by Chinese MNCs might undercut efforts on the part of the U.S. government and U.S. companies to open China’s markets to outward FDI from the United States, including U.S. MNC takeovers of Chinese companies. Indeed, minority investments in U.S. companies by Chinese companies might well facilitate reciprocal investments in Chinese companies by those partially Chinese owned U.S. companies. The experience of the Blackstone Group is a case in point. Following a major minority Chinese investment in U.S.-based Blackstone Group, Blackstone acquired a 20 percent equity stake in China National Blue Star (Group) Corporation, a state-owned chemical company. It might be inferred that China’s ownership stake in Blackstone facilitated the latter’s ability to obtain approval from Chinese officials for the equity investment in Blue Star. While one might argue that it is in China’s own economic interest to be less restrictive toward inward FDI from the United States, it is realistic to assume that any such liberalization on the part of China is unlikely if the United States is perceived as being “closed” to inward FDI from China.¹⁶

The next two sections of the report deal with two broad issues raised by the discussion in this section. Specifically, the next section of the report evaluates the potential benefits and costs to the U.S. economy of inward FDI from China. It does so primarily by evaluating available evidence on the motives and behavior of foreign investments by SOEs, including those headquartered in China. We then assess whether existing laws and regulations in the United States are adequate to deal with the potential costs and risks to the U.S. economy associated with inward FDI from China.

¹⁶ Indeed, Regulatory Commission Chairman Liu Mingkang recently suggested that if his American counterparts approve the applications of Chinese banks to open U.S. branches, China may increase foreign investment limits for its banks. See Chi-Chu Tschang (2007).
BEHAVIOR AND PERFORMANCE OF SOEs

In examining the motives of SOEs for undertaking foreign investments, the major issue is ostensibly whether the motives are consistent with efforts to improve efficiency or otherwise promote the commercially successful performance of the enterprise. While widespread observation of such motives would not necessarily extinguish all of the concerns identified in the preceding section about foreign investments by SOEs and SWFs, it would certainly mitigate those concerns and weaken the perceived imperative to implement specific policies to block or constrain investments by SOEs and SWFs.

Motives of Chinese SOEs

The dependence of China on the global supply of raw materials and energy, along with China’s FDI in natural resources, has been noted by numerous observers. While the first and foremost resource for China is oil, the country also lacks great demand for other minerals such as copper, bauxite and uranium. While Hong and Sun (2004) conclude that access to natural resources is an important motive for outward FDI from China, in the late 1990s increasingly more Chinese firms used FDI to acquire advanced foreign technologies, as well as managerial skills. Furthermore, since the mid-1990s, more and more Chinese firms have listed on overseas stock markets (Hong Kong and New York) to raise equity capital. In short, as the growth of outward FDI has proceeded, it has been accompanied by an increasing range of motives including a desire to gain access to expertise and other inputs.

The range of motives of Chinese companies undertaking outward FDI is underscored by surveys. For example, Wu (2005) reports the results of a survey of Chinese companies regarding their motivation for outward FDI. Three main motivations were identified: 1. seeking new markets (56%); 2. obtaining technology and brands (16%) and 3. securing resources (20%). While it is difficult to assess how much reliance

---

one should put on such surveys, as well as how much to infer about the likely host
country impacts of Chinese FDI, at least one inference might be drawn. Specifically,
concerns expressed about outward FDI from China leading to dominant ownership of
critical natural resources on the part of Chinese SOEs seem unrealistic based upon the
apparent relative unimportance of the “securing resources” motive. As noted earlier,
given the relatively disperse sources of supply for natural resources, outward FDI from
China to this sector would have to be massive, indeed, to create any real threat of control
of supply in the hands of Chinese companies.

Another inference one might draw is that overseas investments by Chinese
companies may, in many cases, augment efforts to increase sales of products made
partially, or wholly, in China. To the extent that exports and outward FDI are
increasingly complementary at the margin for Chinese companies, policies that restrict
the latter will also discourage the growth of Chinese exports to the United States. In this
context, the economic benefits of inward FDI from China might be seen as similar to the
economic benefits of imports from China. A consideration of the latter is beyond the
scope of this report; however, it seems fair to conclude that there is some consensus that
Chinese exports have contributed to higher real incomes for Americans via lower prices
for a wide range of products. Indeed, if Chinese FDI leads to more value added for
Chinese products taking place in U.S. affiliates, the “dislocation” effects on U.S. workers
associated with Chinese exports might well be reduced by increased Chinese FDI in the
United States.

As implied by our earlier discussion, perhaps the most critical consideration in
assessing the implications of the apparent motives of China’s MNEs is the strength of
economic versus political objectives underlying their outward direct investments. In this
regard, Woo and Zhang (2006, p.4) assert that, since 1980, the emphasis on political
objectives in determining Chinese outward direct investment policy has gradually given
way to the primacy of commercial interests. At the same time, the approval process for
outward foreign direct investment has been greatly simplified with decision-making
authority delegated first from the central government to local governments, and more
recently to the enterprise itself. The “devolution” of decision-making authority to the MNE managers is consistent with an increasing emphasis on commercial objectives.

Woo and Zhang (2006) describe the results of a survey carried out in May-June 2005 by the Asia Pacific Foundation of Canada in partnership with the China Council for the Promotion of International Trade (CCPIT). The survey covered 296 member companies of CCPIT. The survey results suggest that respondents’ current investments overseas were driven as much by the Chinese government’s Stepping Out policy and related incentives, as by pure business considerations. When asked about future investments, however, the importance of government policy direction and incentives is given much less weight by respondents. Rather, “business potential” is seen as the primary motivation. Related to this latter point, Li (2007) discusses several cases of Chinese MNEs listing their stocks in Hong Kong not only to raise financial capital but also to seek legal protection of the stock ownership for their top management team and to overcome the ambiguous property rights of either state or collective ownership. In short, for at least some Chinese MNEs, outward FDI might be part of the process of becoming more “market-oriented.”

Performance of SOEs

There is relatively little available evidence on the economic performance of Chinese SOEs, Estrin, et. al. (2007) report mixed evidence regarding the performance of SOEs in China, although their evidence is based on a limited number of studies whose primary focus is productivity.\(^\text{18}\) Perhaps their most important result is that mixed enterprises in China seem to do better than private firms, or wholly state-owned firms. Other studies of Chinese companies also provide equivocal evidence. For example, Aivazian, et. al. (2005) find that corporatization of SOEs results in improved governance and profitability and suggest that corporatization is, therefore, an alternative to mass privatization. Hovey and Naughton (2007) maintain that the evidence suggests that increasing state ownership is negatively correlated with firm performance (measured in

\[^{18}\text{Many studies of SOEs use multiple measures of enterprise performance. Hence, we use the generic term “performance” when a study reports several different measures and the results are consistent. When a study uses only one measure, we identify that measure.}\]

21
different ways). Similar conclusions are drawn by Dollar and Wei (2007) who find that SOEs have lower returns to capital as compared to private firms and foreign-owned firms, and by Shiu (2002) who finds that SOEs are less efficient.

On the other hand, Ma, et. al. (2006) find little evidence that state ownership has a direct impact on firm financial performance, although it does enhance the performance of firms affiliated with business groups in China; however, Carney, et. al. (2007) find that increasing state ownership diminishes the profitability of business groups. Nee, et. al. (2007) also report that state ownership per se has no impact on firm financial performance in China, but government (and party) interventions into management decision-making have a negative effect. Finally, Chen, et. al. (2006) find that privatization in China did not increase either the productivity or the profitability of firms.

Several recent studies examine the innovative activities of Chinese firms. Jefferson, et. al. (2006) suggest that while SOEs are not efficient at knowledge production, once they acquire new knowledge, they are able to use the innovations at least as effectively as private firms. At the same time, Girma, et. al. (2006) find that foreign participation in Chinese SOEs (joint ventures) enhances innovative activity. These studies therefore suggest that some Chinese SOEs are able to capture knowledge spillovers from foreign (and other) partners that will increase their ability to more effectively use new technology. On the other hand, Zhou and Li (2007) find that state participation in international joint ventures increases innovative activity which suggests that state presence may promote the absorptive capacity of the joint venture. In general, therefore, there is little conclusive evidence to suggest that state ownership of China’s largest firms is negatively associated with the innovative performances of those firms.

With respect to non-Chinese SOEs, there seems little doubt that the performance of SOEs in developed countries is generally inferior to that of comparable private sector competitors. The same might be said of SOEs in the transition economies of Central and Eastern Europe; however, it does not appear that SOEs in Russia or the Islamic countries perform worse than their private sector counterparts. For example, Omran (2004)
compared the post-privatization performance of 54 Egyptian firms with a matched sample of SOEs and could find no significant difference in performance measured in various ways. This does not mean that SOEs in these countries are well governed. It may well be that they are better protected, better subsidized and less transparent, all of which might explain the ambiguous results using financial performance measures. It is also likely the case that comparable private sector firms in these countries themselves suffer from serious, albeit different, governance deficiencies so that governance failures are not necessarily confined to SOEs (Estrin, et. al., p.37). Evidence from the privatization experiences of other transition and emerging economies is also somewhat ambiguous which is perhaps not surprising given that the privatizations were often accompanied by other major changes in the political and economic environment. Nevertheless, it seems fair to conclude that privatization seems to have improved an enterprise’s performance in some locations but not in others. In this regard, where privatization appears to have been a success, the nature of how it was undertaken seems to have been of importance. In particular, privatization that entrenched incumbent managers was more likely to fail, while privatization to foreigners was more likely to succeed in terms of improving efficiency (Estrin, et. al., 2007).

Sovereign Wealth Funds

There is virtually no available evidence on the behavior and performance of SWFs. In one available study of Temasek (Singapore’s SWF), Goldstein and Panonond (2007) report that while some companies in Temasek’s portfolio (such as Singapore Airlines) did very well, Temasek’s average shareholder returns over the past ten years were lower than the Straits Times Index.19 In this regard, however, many private sector money managers in developed countries under-perform broad stock market indices.

Summary

While the evidence that SOEs in developed countries do not perform as well economically as their private sector counterparts, the evidence on this phenomenon for emerging economies is much less clear. In particular, there is no consistent evidence that

---

19 Temasek is a holding company for Singaporean SOEs.
Chinese SOEs perform worse than their private sector counterparts. In China, where full-scale privatization of large firms has been limited, state-ownership is relevant primarily in the context of mixed-ownership firms, where the state may or may not be the dominant shareholder. To date, there is no compelling evidence to suggest that the percentage ownership of the state is an important determinant of firm performance in mixed enterprises, although there is evidence that including foreign partners in joint ventures can increase innovative activity and improve the economic performance of those ventures. Thus, Chinese firms are apparently able to capture knowledge spillovers, although the extent to which this makes them internationally competitive remains in doubt (Rugman and Li, 2007).

In summary, the limited available evidence on the motives for outward FDI from China, as well as on the performance of Chinese SOEs, does not provide strong support for treating inward FDI from Chinese SOEs any differently from inward FDI from privately owned MNEs headquartered in emerging economies. Indeed, if anything, the evidence suggests that Chinese SOEs may be closer to privately owned firms in terms of performance than SOEs headquartered in many other countries. At the same time, it can be plausibly argued that the direct spillover efficiency benefits from Chinese FDI in the United States are relatively small, at least for the foreseeable future. As such, policies that directly or indirectly restrict inward FDI from China might have relatively small direct economic costs to Americans; however, there could be significant indirect costs to the extent that such policies lead to Chinese government retaliation which limits the ability of U.S. firms to invest or otherwise do business in China.

The question of whether the U.S. is ready for FDI from China might therefore be posed as follows: assuming that it is not in the economic interests of the United States to block or even discourage inward FDI from China, are there new policies or regulatory initiatives that might be introduced which can mitigate the major concerns raised by FDI from SOEs (including those from China) without unduly discouraging those investments? To answer this question, it is necessary to address each of the specific concerns identified earlier in this report.
THE POLICY ENVIRONMENT IN THE UNITED STATES

In this section, we evaluate whether existing laws and regulations in the United States are sufficient to deal with the realistic risks and concerns associated with takeovers of domestic companies by Chinese companies discussed in earlier sections. Put slightly differently, we consider whether new or revised laws and regulations should be put in place to ensure that such takeovers create positive net economic benefits for Americans. In this regard, it is useful to reiterate the main potential concerns raised by acquisitions of U.S. companies by Chinese companies. Before doing so, we make several policy-related observations. One is that we see no strong argument for discriminating between Greenfield investments and takeovers from the perspective of evaluating foreign direct investments by SOEs. As discussed earlier, there is no strong evidence that the long-run economic effects on the host country differ between the two forms of investment. Furthermore, to the extent that specific acquisitions raise anti-trust concerns, the latter can be addressed by established merger review procedures. A second is that there is no conceptual or empirical basis for discriminating against investments by Chinese SOEs as distinct from investments by SOEs based in other emerging markets. That is, if there are gaps in the current U.S. policy environment with respect to “dealing with” FDI by emerging market SOEs and SWFs, those gaps should be addressed with respect to all such SOEs and SWFs.

Another broad point which might be made is that no global rules apply to interventions in factor flows by government regulators. Issues of subsidization, mutually agreed upon bindings on barriers to foreign acquisitions and transparency of organizational form of acquiring firms are, therefore, relatively new issues for the international community. Hence, while the U.S. government is relatively unencumbered by international treaties in how it addresses these issues, it also needs to be concerned about establishing policy precedents that might be adopted by other countries which, in turn, might prove to be serious impediments to acquisitions of foreign companies by U.S. MNCs.
Refusal to Supply

As noted earlier, one potential, albeit unlikely, concern surrounding acquisitions of U.S.-based natural resource companies by Chinese SOEs, perhaps particularly, is that the latter will withhold supplies of natural resources from U.S.-based buyers in favor of supplying buyers based in China, even if the former are willing to pay more than the latter. At least, this is an interpretation of the apparent imperative of the Chinese government to promote greater “security of supply” for China.

The concern about Chinese companies “refusing to supply” natural resources to U.S. buyers is relevant only to the extent that acquisitions of U.S. companies by Chinese companies conveys sufficient market power upon Chinese companies such that their refusal to supply U.S. buyers results in the latter either doing without the product(s) in question entirely or having to pay higher prices for those products because they must transact with higher cost suppliers. When put in this context, it seems highly unlikely that any acquisition of a U.S. company, or any set of acquisitions, could enhance the market power of Chinese acquirers such that U.S. buyers would face significantly higher natural resource prices in the event of a refusal to supply on the part of Chinese companies. Virtually all natural resources are produced and sold internationally with the U.S. domestic economy being a relatively small source of supply with the possible exception of specific grain products. In the extremely unlikely event that specific acquisitions raised a concern about significant increases in market power, existing antitrust legislation to evaluate the competitive impacts of large acquisitions with the potential to disapprove the acquisitions seems quite sufficient to address the concern. Moreover, “abuse of dominance” provisions in the Clayton Act, among other things, address refusal to supply as a potential abuse of market power. Therefore, with respect to the concern about resource hoarding, existing remedies exist that can be applied to all foreign companies regardless of nationality or mode of ownership. In this regard, the U.S. is certainly ready for FDI from China.
National Security

Issues of national security have arisen in non-Chinese acquisitions of U.S.-owned companies, as well as in the Lenovo acquisition of IBM’s personal computer division. The Exon-Florio amendment to the Omnibus Trade and Competitiveness Act of 1988 makes it possible for the federal government to intervene in virtually any acquisition in the domestic economy for reasons of “national security.” Additional legal safeguards limit foreign control of certain categories of domestic assets deemed vital to national defense also exist. Other laws control the harmful effects of foreign investment that might involve the transfer of classified and sensitive information and technology related to the military. In addition, the Trading with the Enemy Act of 1917 gives the President the power to block military security-endangering foreign investment during a time of war or national emergency (Kang, 1997).

In some sense, the Exon-Florio amendment trumps other laws that can “protect” national security considerations related to foreign acquisitions. This is because the vagueness of the amendment makes almost all sectors of the U.S. economy subject to regulation. Essentially any foreign acquisition of a U.S. company can be subjected to screening by the Committee on Foreign Investment in the United States (CFIUS). Kang (1997, p.304) asserts that the Exon-Florio amendment created a de facto screening mechanism that not only can bar foreign investment but also has the power to set performance requirements for foreign investment in virtually all sectors of the U.S. economy based on vague national security grounds. Indeed, Kang states that prudent mergers and acquisitions advisors recommend that investors report acquisitions of any domestic company that has cutting edge technology or products, even if it does no defense-related business. They also advise reporting investments that the public might construe as being related, even indirectly, to national security.

Greenfield investments, in principle, escape the scrutiny of the Exon-Florio amendment, as do pure portfolio investments by SWFs. As a practical matter, it is difficult to see how Greenfield or pure portfolio investments could raise national security concerns, since ownership control over existing corporate infrastructure in defense and
defense-related industries would not change. As in the aforementioned 3Com case, concerns have been raised that even passive foreign investors might be able to acquire “sensitive” information from a national defense standpoint by “pressuring” management for access to information that is ordinarily not supplied to shareholders. In other cases, it might be argued that a physical presence in the United States, say through a Greenfield investment, might facilitate foreign companies’ efforts to engage in military or industrial espionage.

It is extremely difficult to assess the potential issues identified in the preceding paragraph; however, even a potential for the concerns to be relevant suggests that review of all foreign investments be subject to a national security “screen” and not just foreign acquisitions of U.S. companies. To be sure, most Greenfield and portfolio investments will have no national security implications. Indeed, most foreign acquisitions will also have benign national security consequences. As such, and to avoid onerous administrative and related costs, the relevant legislation should make explicit what the criteria are for raising ex ante national security concerns.

In sum, it would not seem that the U.S. is unprepared legally to address acquisitions by Chinese MNCs that threaten national security. Indeed, a more realistic appraisal is that the main legislative instrument available is insufficiently precise and excessively vulnerable to abuse from domestic economic and political interest groups to serve the interests of Americans. While it may never be possible to define national security with any precision, it does seem possible to make explicit whether the Exon-Florio amendment is meant to address national security concerns or whether it is fundamentally a screening mechanism with the goal of extracting “concessions” from foreign investors as a condition of approval. If the former, it would also seem possible to circumscribe the sectors and markets in which foreign acquisitions raise prima facie national security concerns. Acquisitions which fell outside these designated sectors and markets, including acquisitions by Chinese MNCs, would not be subject to review under the Exon-Florio amendment.
Transparency and System Financial Failures

As noted in an earlier section, a concern might be raised that a lack of transparency combined with insufficient financial discipline exerted by politicians may enable Chinese affiliates operating in the United States to engage in imprudent behavior that is both difficult for public and private sector agents in the United States to identify as well as take appropriate actions, and which ultimately imposes significant third-party costs in the U.S. economy; however, the potential for third party costs to arise from reckless or even fraudulent behavior exists in the case of domestically owned companies. Indeed, current and widespread financial distress in the banking sector associated with defaults on what appear to be, in retrospect, an excessively lax and, in some cases even fraudulent extension of sub-prime mortgages and consumer loans highlights the potential for systemic economic costs to arise from the activities of domestically owned firms operating in even relatively highly regulated industries. The Enron fiasco further underscores the difficulties in preventing corporate financial misbehavior having widespread economic implications, even when the corporation is subject to public accounting rules and regulations associated with a New York Stock Exchange listing.

The preceding examples suggest that to the extent that limited transparency is a relevant concern surrounding inward FDI from China, the appropriate policy response is unclear. One possible approach is to require firms engaged in acquisitions of U.S. companies to follow internationally agreed upon standards of governance and accountability as set out by organizations such as The World Bank or the OECD. If this approach is implemented, it would clearly be in the interest of the United States to have other developed countries adopt this policy in order to discourage “investment diversion” whereby investments are made in geographic regions without the policy, even though the resources involved could be more efficiently used in regions that have implemented this policy.

Another possible approach to problems raised by limited transparency is to impose financial reporting and corporate governance measures mandated by domestic
regulators such as the New York Stock Exchange, even in the case of foreign acquisitions by non-listed entities. Clearly, any such approach would represent a substantial additional cost of acquiring U.S. companies and would presumably have to be applied to all foreign acquirers and not just China-based acquirers. One can imagine that the economic costs of such a measure would substantially exceed any benefits given the presumption that foreign acquisitions, on balance, have net economic benefits for the U.S. economy.

In sum, the United States economy might well face an irreducible risk of corporate misbehavior that, in the limit, has the potential to impose substantial system-wide costs; however, this risk is not unique to Chinese affiliates operating in the United States. In this regard, the situation facing the United States also confronts other countries. To the extent that a minimum standard of corporate governance can be agreed upon by major host countries for foreign investors, requiring the adoption of this standard as a condition of approval for taking over a large domestic company might be a pragmatic, if not especially robust, policy response to the transparency concern. To be sure, major host countries may well disagree about the appropriate standards for financial reporting and other accounting matters as exemplified by regulatory differences that exist across national stock market regimes. Political pressure exerted on emerging market MNEs by developed countries for the former to adopt some “common denominator” standard of governance, such as the OECD’s Principles of Corporate Governance might be tractable, although the associated benefits of conditioning approval of foreign investments on a company’s adoption of those principles are speculative. As noted above, even companies that are subject to stringent reporting requirements of the New York Stock Exchange have engaged in behavior that has led to adverse and substantial third-party financial impacts.

The U.S. Treasury has urged the adoption of a voluntary code of “best practices” with respect to the activities of SWFs (Davis, 2007). Others have suggested that the issue of corporate governance be made a part of global trade negotiations. Still others have called for institutions such as the IMF and the World Bank to examine issues related to the activities of SWFs including the transparency of their operations. As in the case of
FDI, transparency issues surrounding the activities of SWFs are arguably part of a global economic agenda, and it is neither theoretically optimal, nor practical, for the United States to impose its own specific governance standards as a condition of allowing inward investment from China or other emerging economies. In this respect, the U.S. is no less ready for FDI (or portfolio investment) from China than is any other developed country.

Fairness

The complaint that it is unfair to domestically owned firms that Chinese (or other) investors have access to low-cost financing supplied by home country governments is also part of a broader issue about subsidization that seems best addressed at the level of global trade negotiations. As noted above, it is theoretically unclear whether financial subsidies for international investments are analogous to export subsidies in terms of their welfare effects for the host country. Moreover, making the source of financing a condition of whether or not a foreign investment should be allowed opens the foreign investment process to abuse by competing economic interest groups. Specifically, one can imagine that domestically owned rivals interested in acquiring assets that are also sought after by SOEs or SWFs will rely liberally upon a complaint that the latter had access to low-cost capital through direct or indirect loans by their home governments. Such claims will often be difficult to evaluate and, in any case, would likely necessitate consideration of an even more problematic issue. Namely, what constitutes a financial subsidy to overseas investments? As in the case of corporate governance standards, the U.S. would be ill-advised to adopt a unilateral policy stance on the issue of government funded foreign investments.

OVERALL SUMMARY AND CONCLUSIONS

The issue of whether the United States is ready for FDI from China can be decomposed into two sub-issues. One is whether the United States is likely to realize net economic benefits from Chinese investment. A second is whether pragmatic and practical changes to the U.S. regulatory environment are advisable concomitant with increased Chinese investment.
Typically, the benefits of inward FDI to the host economy are identified with spillover efficiency benefits to host country factors of production. To the extent that SOEs are relatively inefficient competitors in the global economy, the spillover efficiency benefits to the U.S. and other host economies associated with Chinese FDI might be relatively small. Based upon available evidence, Chinese SOEs seem no less efficient than SOEs in many other emerging economies or, for that matter, many privately owned emerging market MNEs. Hence, one would need to conclude that all FDI from emerging economies has no net economic benefit for the United States in order to make that argument for Chinese FDI. Such a conclusion is not warranted on the basis of any evidence of which we are aware. In addition, direct and indirect access to China’s domestic market for U.S.-based companies might well be conditioned by the ability of Chinese firms to make investments in and construct alliances with U.S.-based companies. As a practical political matter, therefore, the benefits of inward Chinese investment for U.S. companies and workers are more likely to be related to the linkages between such investment and the future openness of China’s economy to U.S. trade and capital flows. The rapid growth and large size of China’s domestic economy makes it a particularly beneficial trade and investment partner with the United States. In this context, it seems feckless to argue that there is no economic justification for allowing inward FDI and portfolio investment from China.

The second issue is whether specific regulations or policies might be adopted by the United States that would significantly enhance the net economic benefits of inward investment from China, presumably by reducing potential social costs associated with such investment. Evaluation of this issue requires identification of the specific potential costs that might be associated with investments by SOEs and SWFs based in China, as well as existing U.S. laws and regulations in the United States that may already mitigate those potential costs. In this regard, the concern about threats to national security seems to be addressed by existing legislation. Indeed, as discussed in an earlier section, existing legislation allows for such a broad interpretation of national security as to create potentially more problems than it solves. If national security risk is going to be a robust de facto screening device for inward investments by firms affiliated with foreign
governments, it behooves U.S. officials to identify as official policy the specific types of investments that would rise *ex ante* national security concerns. Otherwise, the approval process for foreign investment will invite costly and unproductive lobbying efforts on the part of U.S. firms seeking to protect themselves from the direct or indirect competition of foreign-owned firms. In addition, the associated uncertainty surrounding the foreign investment process in the United States is likely to discourage inward foreign investments of all types, including those that, upon any fair reflection, have no implications for national security.

The one potential problem that is not obviously addressed by existing laws or regulations is the lack of transparency that can be expected to characterize investments made by many SOEs and SWFs. Given the governance problems discussed earlier, this lack of transparency raises concerns about system-wide costs associated with imprudent or even fraudulent business behavior of the part of such investors. Unfortunately, no pragmatic and financially practical solution occurs to us. Specifically, there is no guarantee that imposing U.S. corporate governance mandates on foreign firms operating in the U.S. will significantly constrain imprudent behavior, although it will certainly reduce inward foreign investment in the U.S. in favor of other host countries. Indeed, to the extent that “minimum” standards of governance are going to be incorporated *de facto* national investment policies, it seems preferable to do so as part of a multilateral agreement than as a unilateral policy. Furthermore, it seems reasonable that SOEs and SWFs will find it in their self interest to become more transparent and to implement governance reforms, since to do so would presumably make them more desirable business partners and employers in the United States and other developed countries. Hence, restricting inward FDI might perpetuate corporate governance shortcomings among SOEs and SWFs.

In sum, the future prosperity of the United States will arguably be prominently influenced by the degree to which the economies of China and the United States are integrated through trade and investment. In this context, the relevant question may no be: is the U.S. ready for investment from China? The relevant question might be: can the
U.S. afford not to be ready from China? In our view, there is not much additional cost associated with such readiness. Very few potential problems are currently unanticipated by existing laws and regulations. Furthermore, if one is prepared to take a longer-run perspective, the few potential problems that are not obviously addressed by existing laws and regulations will be mitigated by the continued economic integration between developed and developing economies.
References


