Investing in the United States

Is the US Ready for FDI from China?

Edited by

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STUDIES IN INTERNATIONAL INVESTMENT

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1. Is the United States ready for FDI from China? Overview*

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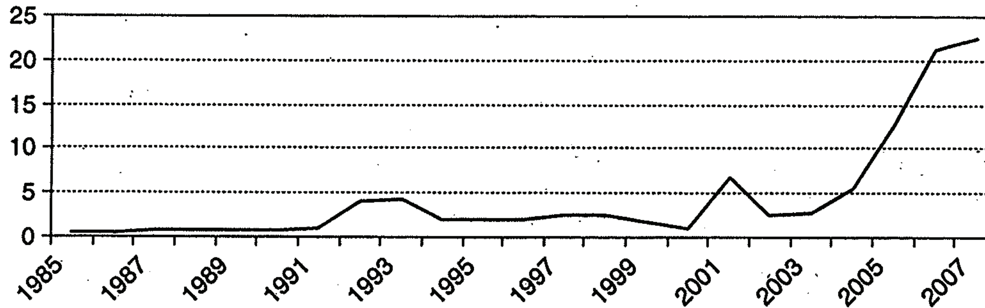
INTRODUCTION

Important new players are entering the world market for foreign direct investment (FDI): firms from emerging markets.[1] While there have always been multinational enterprises (MNEs) based in these economies, it is only recently that their outward FDI has become significant. Thus, in 2007 alone, emerging-market MNEs invested some $300 billion abroad,[2] more than ten times total world FDI outflows 25 earlier. This investment is being undertaken by more than 20,000 emerging market multinationals, in all economic sectors, in all parts of the world.

Among emerging-market MNEs, none have received more attention than those headquartered in China. Within the span of fewer than ten years (2000–2007), they invested an estimated $68 billion abroad, for a total stock of $96 billion at the end of 2007 (Figures 1.1 and 1.2), catapulting China into the ranks of the leading outward investors among emerging markets. This investment takes place in all sectors (and especially services – Table 1.1) and regions of the world (Table 1.2), "through more than 5000 Chinese investment entities hav[ing] established nearly 10,000 overseas enterprises through direct investment across 172 countries and/or economies."[3]

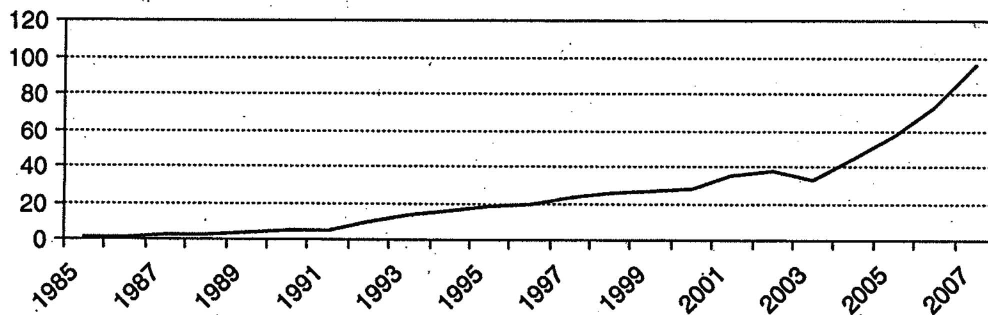
While there are many firms that undertake outward foreign direct investment (OFDI), the great majority of the largest Chinese MNEs consists of state-owned enterprises administered by the central government. They accounted for 83 percent of OFDI flows in 2005; by the end of 2005, their share of OFDI stock was 84 percent.[4] Eighteen among the largest had, in 2006, $79 billion of foreign assets, employed over 120,000 persons abroad and had $79 billion in sales by their foreign affiliates (Table 1.3). Like their competitors from developed countries (and, for that matter, also increasingly from other emerging markets), Chinese firms rely more and more on mergers and acquisitions (M&As) when entering foreign markets, as opposed to greenfield investment (Tables 1.4 and 1.5).

While China's outward FDI position may not look that impressive when compared with that of other, especially developed, countries it needs to be taken into account that it is only recently that Chinese firms have begun their outward expansion and that it is only since the beginning of this decade that the government supports this trend through its "Go Global" policy. Moreover, outflows may well grow considerably in the coming years. During the first half of 2008 alone, non-financial Chinese MNEs invested more abroad ($26 billion) than during all of 2007 ($22 billion), raising the possibility that total outflows in 2008 might be $50–60 billion. If China's sovereign wealth fund, the China Investment Corporation, should become more active in the FDI market, this figure could



Source: UNCTAD, http://stats.unctad.org/FDI/.

Figure 1.1 China's outward FDI flows, 1985–2007 (US$ billions)



Source: UNCTAD, http://stats.unctad.org/FDI/.

Figure 1.2 China's outward FDI stock, 1985–2007 (US$ billions)

rapidly become higher, although the financial crisis and recession may well temporarily slow down outward FDI flows.

These developments raise an important question, namely: is the world ready for FDI – and especially M&As – from emerging markets? To put it differently: can emerging-market MNEs be integrated smoothly into the world FDI market, as part of a broader integration of these economies into the world economy? It is a question that needs to be asked because there are some indications that some countries have difficulties accepting "the new kids on the block."[5] And it is a question to be asked especially for MNEs based in China, as their outward expansion – from Africa to the US – is getting considerable attention in the media and from policy-makers.

This volume focuses on one subset of this question, namely: is the US ready for FDI – and especially M&As – from China? The question is all the more important, as Chinese FDI in the US while still small (Table 1.6 and Figure 1.3), is bound to rise. After all, the US is the single biggest and most attractive market in the world, and most firms think they need to establish themselves there, to include it in their portfolios of locational assets. This applies also to Chinese firms.

Table 1.1 Sectoral distribution of China's OFDI stock, 2006 (US$ millions)

OFDI stock	US$ m	Percentage of total
Primary sector	18718	(25)
Agriculture, forestry, husbandry and fishery	807	(1)
Mining, quarrying and petroleum	17902	(24)
Secondary sector (Manufacturing)	7530	(10)
Tertiary sector	48778	(65)
Lease and business services	19464	(26)
Wholesale and retail	12955	(17)
Transport and storage	7568	(10)
Others	8791	(12)
Total	75026	(100)

Source: OECD (2008), p. 136.

Table 1.2 Regional distribution of OFDI stock from China, 2006 (US$ millions)

OFDI stock	US$ m	Percentage of total
Asia	47978	(64)
Hong Kong, China (as a share of Asia)	42270	(88)
Latin America (LA)	19694	(26)
3 Offshore Financial Centres (as a share of LA)	18977	(96)
Europe	2270	(3)
Western Europe (as a share of Europe)	1050	(46)
Central and Eastern Europe (as a share of Europe)	1220	(54)
Africa	2557	(3)
North America	1584	(2)
Oceania	939	(1)
Total	75026	(100)

Source: OECD (2008), p. 135.

The short answer to that question is "yes." Indeed, the US has one of the most open investment frameworks in the world and its states and many municipalities actively seek to attract FDI. The long answer is still "yes," but with a number of qualifications attached to it, as there are all sorts of tricky and difficult issues that need to be taken into account by emerging-market MNEs in general, and Chinese MNEs wishing to enter the US market in particular. The focus of this volume is precisely on these tricky and difficult issues and how foreign firms can deal with them, in terms of entering the US market, operating in it, and prospering in it.

Table 1.3 FUDAN-VCC ranking of 18 large Chinese multinational enterprises in terms of foreign assets, 2006 (US$ millions)

Rank	Name	Industry	Foreign assets	Foreign sales	Foreign employment
1	CITIC Group	Diversified	17623	2482	18305
2	China Ocean Shipping (Group) Company	Transport and storage	10397	8777	4432
3	China State Construction Engineering Corp	Construction, real estate	6831	4376	5820
4	China National Petroleum Corp	Petroleum expl./ref./distr.	6374	3036	22000
5	Sinochem Corp.	Petroleum and fertilizer	5326	19374	220
6	China Poly Group Corporation	Trade, real estate	5113	1750	n.a.
7	China National Offshore Oil Corp.	Petroleum and natural gas	4984	3719	984
8	Shougang Group	Diversified	4875	2250	n.a.
9	China Shipping (Group) Company	Diversified	4600	4324	2433
10	TCL Corporation	Electrical and electronic equipment	3875	3366	32078
11	Lenovo Group	Computer and related activities	3147	9002	6200
12	China Minmetals Corp	Metals and metal products	1266	2527	630
13	China Communications Construction Corp	Construction	1162	2855	1078
14	Shum Yip Holdings Company Limited	Real estate	972	123	28
15	Baosteel Group Corporation	Diversified	968	4231	170
16	Shanghai Automotive Industry Corporation(Group)	Automotives	442	4133	7175
17	China Metallurgical Group Corporation	Diversified	439	314	745
18	Haier Group	Manufacturing, telecommunications, IT	394	1870	6800
TOTAL			78788	78509	123670

Source: FUDAN-VCC survey of Chinese multinational enterprises, at www.vcc.columbia.edu.

Table 1.4 M&As versus China's OFDI, 1988–2006

	1988–89 (average)	1990–91 (average)	2000–02 (average)	2003	2004	2005	2006
China's deals (US $ millions)	109	430	3561	1647	1125	5279	14904
As a ratio in total OFDI flow (%)	13.9	16.7	43.6	57.7	20.5	43.1	84.5

Source: OECD (2008), p. 75.

1.1 ENTERING THE US MARKET

1.1.1 Mergers and Acquisitions versus Greenfield FDI

For many firms, the typical way to establish themselves in a foreign country is through mergers and acquisitions (M&As), as opposed to greenfield investments (that is, the establishment of new production facilities). In fact, in developed countries, the bulk of FDI takes place through this mode of entry. In 2007, there were 10,145 cross-border M&As globally, valued at $1.6 trillion; of these, 78 percent of the M&As and 89 percent of the total value involved developed countries.[6] This compares with FDI inflows to developed countries of $1.2 trillion in the same year.[7] The US is no exception to this pattern. In 2007, there were 2040 M&As undertaken in this country by foreign firms, at a value of $380 billion; in the same year, FDI inflows amounted to $230 billion.[8] M&As and greenfield investments both have a number of advantages and disadvantages for firms and host countries, an issue examined by Steven Globerman and Daniel Shapiro in Chapter 2.

For firms, M&As have the advantage of allowing them to enter a market rapidly – and in today's globalizing world economy, in which competition is everywhere, speed is often of the essence. Moreover, if the acquired firm controls an extensive distribution network, state-of-the-art research and development (R&D) facilities and valuable brand names, the acquiring firm obtains a portfolio of locational and proprietary assets that are key to international competitiveness. Deep market penetration can be achieved quickly in this manner, which is also useful if the acquiring firm already exports to the foreign market. If experienced staff can be retained in the acquired firm, the acquiring firm minimizes learning costs associated with operating in a new market; in fact, it obtains local knowledge and skills, as well as a network of relationships that can be important for prospering in a new environment.

However, cross-border M&As also involve a number of difficulties and risks. To begin with, the proper target needs to be identified and a deal needs to be negotiated. If the corporate cultures of the acquiring and acquired firms differ substantially – and this is likely to be the case if the acquiring firm is from China (or, for that matter, any other emerging market) and the acquired firm is in the US – there is the additional challenge of meshing different cultures. At the same time, the new unit needs to be incorporated into the international production network of the parent firm. This, in turn, may involve

Table 1.5 Major OFDI deals by Chinese enterprises, 2004–07

Chinese enterprises	Invested project/ acquired asset	Host country	Estimated investment amount (US$ billion)	Date	Comment	Major motivation
Wuhan Iron and Steel and other three steel mill companies	Wheelara joint-venture with BHP billion for mining iron ore	Australia	9.3	2004	Agreement signed	(1) Iron core
CNPC	Petrokazakhstan	Canada/ Kazakhstan	4.18	2005	Acquired	(1) Oil
China Minmetals	CODELCO	Chile	0.55	2005	Agreement signed	(1) Copper
Sinopec	99.49% stake in Udmurtneft OAO	Russia	3.65	2006	Acquired	(1) Oil
CITIC	Kazakh oil assets of Nations Energy Company	Canada/ Kazakhstan	1.91	2006	Acquired	(1) Oil and (4)
China Metallurgical Group	Aynak copper field and related infrastructure project	Afghanistan	2.8	2007	Agreement signed	(1) Copper
Shanghai Baosteel	Joint-venture with Companhia Vale do Rio Doce for a steel slab plant	Brazil	3–4	2007	Letter of intent signed	(1) Steel
Sinopec	Development of Yadavaran onshore oil field	Iran	2	2007	Agreement signed	(1) Oil
Industrial and Commercial Bank of China	20% stake in Standard Bank	South Africa	5.49	2007	Completed	(2) and (4)
Bank of China	669 branches including a recent opening at London	28 countries	40% of its net profits from overseas	By 2007		(2) and (4)

Lenova	IBM (PC hardware division)	USA	1.75	2004	Completed	(3) Computer
Nanjing Auto	MG Rover	UK	N/A	2005	Completed	(3) Automobile
China Mobile	China Resource Peoples Telephone	Hong Kong, China	0.43	2005	Completed	(4)
Bank of China	Singapore Aircraft Leasing Enterprise	Singapore	3.43	2006	Completed	(4)
State Grid Corporation	Consortium led by the Philippines' Monte Ore Grid for grid operation privatization	Philippines	3.95	2007	Bid awarded	(4)
Failed deals						
China Minmetals	Noranda	Canada	5	2004	Aborted	(1) Copper and zinc
CNOOC	Unocal	USA	19.5	2005	Aborted	(1) Oil
Haier	Maytag	USA	1.28	2005	Aborted	(3) Washing Machine
China Mobile	Millicom International Cellular	Luxembourg	5.3	2007	Aborted	(3)

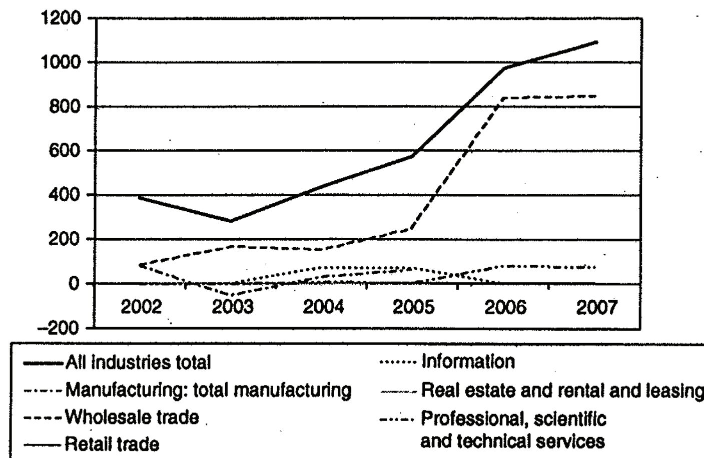
Note: Major motivations include: (1) resource-seeking, (2) market-seeking, (3) strategic-asset-seeking, (4) diversification-seeking and (5) efficiency-seeking.

Source: OECD (2008), p. 95.

Table 1.6 China's foreign direct investment into the US, 2002–07

Year	US$ millions
2002	385
2003	284
2004	435
2005	574
2006	973
2007	1091

Source: US Bureau of Economic Analysis, www. bea.gov.



Note: [a]Foreign direct investment position in the United States on a historical-cost basis.

Source: US Bureau of Economic Analysis data, www.bea.gov.

Figure 1.3 China's FDI in the US by industry, 2002–07[a] (US$ millions)

a restructuring of the acquired assets, including the closing down of existing production lines, the relocation of R&D facilities and lay-offs – all actions that may encounter the resistance of labor unions; local, regional or national authorities; and other stakeholders. In fact, resistance may start earlier, especially if stakeholders – rightly or wrongly – anticipate some of the actions just mentioned (and others, such as increase in concentration and therefore a possible decrease in competition) once an M&A is consummated. Resistance in the host country can be particularly high if the target is in a sector that is considered of great economic or strategic importance or involves a national champion, or if the acquirer is a state-owned enterprise, especially from an emerging market (which would typically be the case for Chinese MNEs, as most of the important ones have some percentage of state ownership).

Given all these difficulties and risks, it is not surprising that many M&As have not lived up to their expectations and that a number have even been unwound. Even long-

established MNEs may not succeed – witness the acquisition of Chrysler by Daimler Benz, a move that, after a few years, was undone. On the other hand, many M&As do succeed. The secret is careful planning, experience and having the skills and patience to navigate the difficulties and risks that are inherent in a cross-border M&A.

Greenfield investments, on the other hand, allow a firm to start from scratch, beginning with the choice of the location; they are unencumbered by various legacy costs and practices that are established in an acquisition target.[9] However, it takes time to establish a greenfield investment and to develop a network of relationships, and it requires more learning in terms of operating in a new environment.

Moreover, greenfield investments are uniformly welcomed by host countries (and typically even benefit from various incentives) as they create new production capacity, while M&As represent only a change in ownership and, moreover, the shifting of control of a domestic entity to a parent firm headquartered abroad. Greenfield investments also mean new jobs, and they may bring new technologies, skills, competition and exports. Exceptional circumstances apart (like a rescue operation of a firm in danger of failing), governments prefer greenfield investments to M&As. This preference holds even though – as Globerman and Shapiro argue – the positive economic effects of greenfield investments and M&As converge over time and, hence, do not support a discrimination between these two forms of market entry.

1.1.2 The Regulatory Environment

These different perceptions of host countries as regards M&As and greenfield investments find their expression in the regulatory framework that governs FDI in the US, with the former investments potentially facing scrutiny, while the latter are uniformly welcome. In fact, the US has one of the most open investment frameworks in the world, reaffirmed in May 2007 in a statement on "Open Economies" by President George W. Bush[10] and the establishment of "Invest in America" within the Department of Commerce.[11] Moreover, virtually all states of the Union fiercely compete for FDI. Many of them have established investment promotion offices abroad. Hence the short answer of "yes" to the question: "is the US ready for FDI from China?"

But, the "rise of the rest"[12] – meaning especially FDI from emerging markets – is creating adjustment problems that are also visible in US–China relations. As US Secretary of the Treasury, Henry M. Paulson, remarked:

> Economic nationalism . . . has been a growing concern in the United States in recent years . . . Foreign investment into the United States, especially by sovereign wealth funds and state-owned enterprises, is also increasingly viewed with suspicion by some US companies, various members of the national security community, and the American public at large, despite regulations by the Committee on Foreign Investment in the United States that provide sufficient protections in sensitive sectors.[13]

In the aftermath of September 11, 2001, in particular, national security concerns have entered the realm of the FDI field, mixed with apprehension about the rise of emerging-market MNEs, especially from countries that are considered to be potentially unfriendly or strategic competitors. The importance of state-owned enterprises in the outward FDI of a number of emerging markets and the growing role of government-controlled

sovereign wealth funds add to this apprehension. Among emerging markets, China receives particular attention, precisely because it is seen as an important strategic competitor and because the bilateral balance-of-payments deficit of the US with China, combined with what is regarded an undervalued Chinese currency, are held responsible for some of the difficulties that the US economy is experiencing.

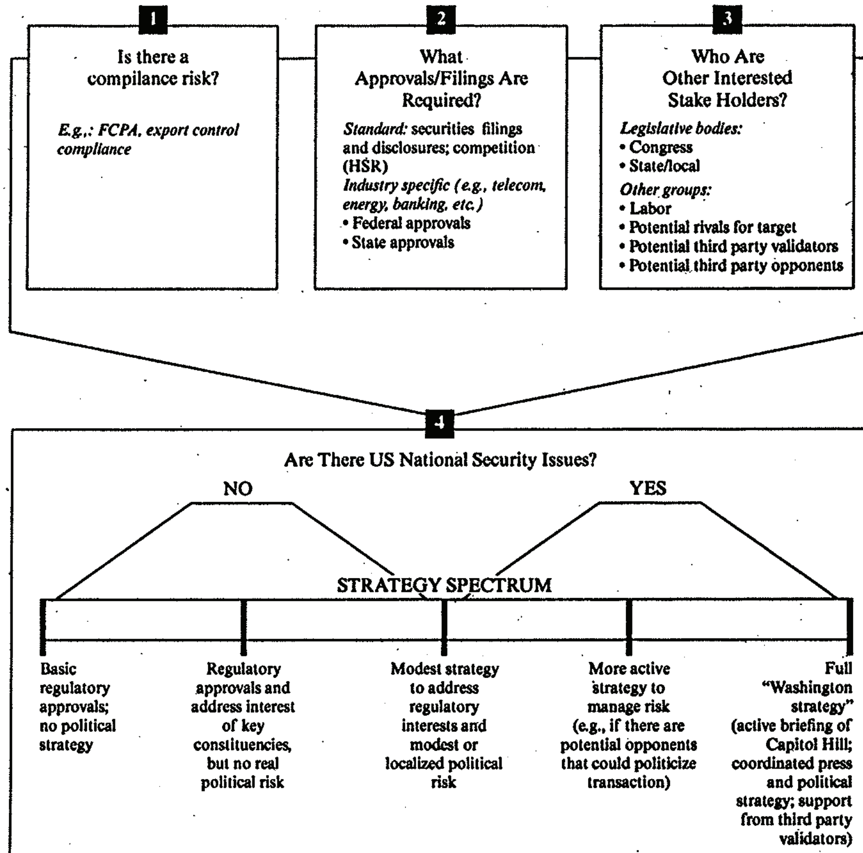
The result has been the strengthening of the established screening mechanism for FDI, namely the Committee on Foreign Investment in the United States (CFIUS). Originally provided with formal authority to review foreign investments with a nexus on US national security interests in the late 1980s, the committee's role in screening certain FDI was further enhanced through the Foreign Investment and National Security Act of 2007 (FINSA) and the subsequent President's Executive Order of January 2008 and the final regulations issued by the Treasury Department (which entered into force on November 21, 2008). The contribution by David N. Fagan, in Chapter 3, describes and analyzes in detail the regulatory and institutional development for FDI in the US and the implications it has for foreign investors in general and Chinese investors in particular.

In brief, the precise legal and institutional framework for any given investment depends largely on the facts and circumstances relating to it, including the nature of the transaction, the location of an investment (which may determine what local laws or institutions can impact prospects for success), the sector of an investment, the size of the investment, and specific facts of a particular transaction such as the legal compliance reputation of the acquirer and US target and the potential broader legal liabilities of the US target. In the case of M&As, furthermore, US anti-trust legislation may well come into play. All this makes the US FDI framework less predictable than it was in the past.

Foreign investors undertaking M&As in the US must pay special attention to the security review conducted by CFIUS. (Greenfield investments are exempted by statute and regulation from review by CFIUS.) In particular, there is a presumption that M&As by state-controlled entities are subject to additional scrutiny in the form of an "investigation," which follows an initial 30-day review, unless certain statutory triggers (related to senior-level sign-off within the CFIUS process and the absence of any remaining national security issues) for terminating the review at 30 days are met. Figure 1.4 presents, succinctly, the principal aspects of this process. As Fagan points out, the critical threshold questions for a CFIUS review are whether there is foreign control over a US business; if there is control, whether a transaction presents any significant national security concerns; and if there are such concerns, whether they can be mitigated through contractual commitments from the parties involved ("mitigation agreements"). Importantly, "national security" is not defined.

The CFIUS process can be crucial for Chinese MNEs, as most of the biggest ones are state-controlled entities. This creates special challenges for Chinese MNEs (as well as for state-controlled entities of other countries) to obtain regulatory approval and manage the potential for a particular transaction becoming an object of political debate as occurred, for example, in the aborted takeover attempt of Unocal by the China National Offshore Oil Corporation (CNOOC) and the acquisition by Dubai Ports World of the Peninsular and Oriental Steam Navigation Company (which operated terminals at six major US ports).

It reflects the changed investment climate in the US that notifications to CFIUS were up considerably in 2007 and 2008 (Figure 1.5). While no deals were blocked, six were

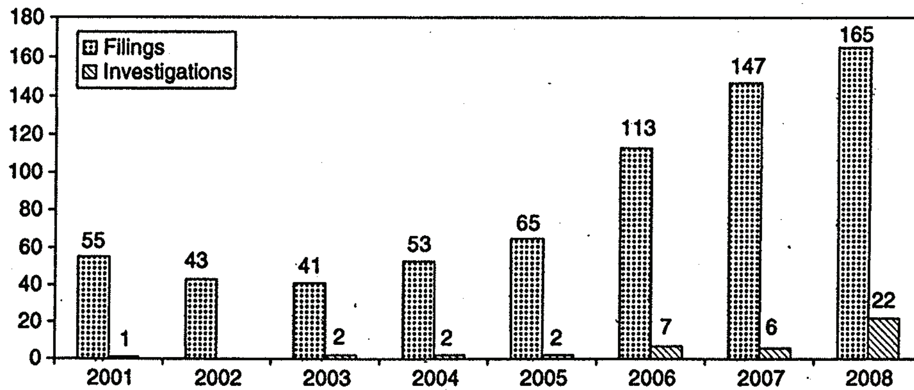


Source: David N. Fagan, Chapter 3 in this volume; copyright Covington & Burling LLP.

Figure 1.4 The US regulatory and strategic due diligence flow chart for cross-border M&As

subject to investigation in 2007, and 22 in 2008. In February 2008, a filing involving a minority Chinese investment in a US telecoms firm was withdrawn in the face of national security concerns. While the data certainly shows a substantial increase in scrutiny, the numbers involved pale, however, in comparison to the total number of cross-border M&As in the US. Still, the growing number of CFIUS notifications and investigations signal that the regulatory framework for FDI in the US is changing.

Developing an appropriate regulatory and political strategy is particularly important for MNEs entering the US through M&As and prospering in that country, as it is not only the various agencies comprising CFIUS that decide on a specific deal but Congress itself, and the entire political establishment can get involved. This is especially true when high-profile transactions are contemplated – and any large M&A by a Chinese firm potentially falls into this category. Navigating the US political landscape for FDI is, indeed, a real



Source: US Treasury Department.

Figure 1.5 CFIUS filings and investigations, 2001–08

challenge for foreign investors (and not only investors from China), as Timothy Frye and Pablo M. Pinto elaborate in Chapter 4.

The dynamics in this landscape are complex. Presidents, responsible for the country as a whole, have generally been supportive of a liberal investment framework, although they also need to take national security concerns into account (see the statement of the President mentioned earlier). Within the Executive branch, the cross-pressures between openness and national security are balanced in CFIUS in the context of specific M&As, as its members represent a wide range of approaches and interests. But for individual members of Congress, the situation is different, because they represent individual districts. As a result, members of Congress need to deliver benefits to their own districts if they want to be re-elected by their constituents, especially if representatives hold marginal seats. Depending on how members of Congress see themselves affected by China in general and the country's FDI in particular, they will seek to shape policies accordingly.

As Frye and Pinto point out, members of Congress interested in China have organized themselves in political groups, most important among them the Congressional China Caucus and the US–China Working Group. The former focuses on the strategic and political concerns associated with China (and is typically critical of China), while the latter focuses on the economic opportunities that result from engaging China (and therefore is typically pro-China) (see Table 1.7). The saliency of these groups can be illustrated in reference to the vote in the House of Representatives in June 2005 on a resolution that called upon the President to "initiate immediately a thorough review of the proposed acquisition, merger or takeover" if Unocal accepted CNOOC's bid. The resolution was passed by a vote of 398 to 15. Tellingly, 8 of the 15 representatives who voted against the resolution were from the US–China Working Group, while not one member of the Congressional China Caucus opposed it. In addition, 6 of the 15 "no" votes came from representatives of districts in the state of Washington, a state that has substantial exports to China.

Moreover, beyond the Executive and Congress, there are many other stakeholders

Table 1.7 US stakeholders' position on economic liberalization toward China

Motivation	General attitude	
	Relatively pro-China	Relatively anti-China
Economic	Financial firms (private equity, M&A players) Business associations (Business Roundtable, Financial Services Forum) Liberal think tanks (IIE; OFFI) Congress: US–China Working Group US states actively seeking foreign investment The public: richer, more educated people who value cosmopolitanism	Labor leaders and unions Conservative think-tanks (American Enterprise Inst.; Heritage Foundation) Labor-affiliated think-tanks Congress: Congressional China Caucus House membership The public: anti-globalization and concerned about trade with China and "US jobs"; human rights advocates
Nationalistic/ strategic	"Panda huggers" in defense community	US military; security community Congress: Congressional China Caucus The public: slight tendency to be wary of China for people concerned about US military superiority

Source: Timothy Frye and Pablo M. Pinto, Chapter 4 in this volume.

that have an interest in the China–US relationship in general and FDI from China in particular. Table 1.7 lists a number of them and their overall orientation and attitude.

What this underlines is that M&As by Chinese firms in the US are not only an economic issue – they are, especially when it comes to larger acquisitions in sensitive sectors – but as much or more a political issue, even if they make economic sense. Hence, to smooth the entry process, it is important to understand Washington's political landscape, know what the interests of key players are, learn to navigate the committee network in Congress, and build alliances from the local level upward.

1.2 OPERATING

Once the mode of entry (M&A versus greenfield investment) has been chosen and regulatory barriers have been navigated, the challenge for foreign investors – and Chinese ones in particular – is to operate successfully in the highly competitive, sophisticated and litigious US market and prosper in it. To do that, foreign investors need to overcome the "liability of foreignness," discussed by Lorraine Eden and Stewart R. Miller in Chapter 5. As one of the leading academics in the FDI field observed many years ago: "Alien status always imposes some penalty on managerial effectiveness."[14] "Liability of foreignness", therefore, is the liability of being a stranger in a strange land. It revolves around a

number of costs that foreign firms – but not domestic ones – incur by operating abroad. These involve, most notably, unfamiliarity costs arising from a lack of knowledge about the host country; the potential (and sometimes subtle) differential treatment of foreign affiliates by host country organizations and institutions; and costs arising out of the need to manage relations between the parent firm and its foreign affiliate, as well as the relations of foreign affiliates and local partners and stakeholders from a distance. These costs can be particularly high if the gap between the regulatory, normative and cognitive situations in the home country (for example, China) and the host country (for example, the US) is high. As Eden and Miller point out, furthermore, the challenge to handle such costs is accentuated in cases in which firms from a country with weaker institutions need to operate in countries with stronger institutions.

Chinese MNEs certainly face the entire range of liability-of-foreignness costs when establishing themselves in the US. On the regulatory side, they need to operate in a country with a highly developed legal system and a strong legal culture. Naturally, the entire set of laws and regulations governing enterprises applies to Chinese foreign affiliates. Some regulatory instruments that are particularly relevant relate to corrupt practices, corporate governance, financial practices, foreign trade, transfer pricing, occupational health, labor safety, civil rights, age discrimination, and employees with disabilities. In addition, a number of industries are subject to sector-specific federal and state regulatory regimes (for example, banking, telecommunications). All this adds up to a complex regulatory framework that is typically enforced at the federal and/or state levels. Foreign affiliates are well advised to observe these laws and regulations scrupulously, lest their operations risk legal difficulties. This is a particular challenge for Chinese firms as they typically have little experience with operating foreign affiliates, including in the US.

At the same time, Chinese firms established in the US (like those of other countries) benefit from various protections against unwarranted action by the authorities, contained in US national and international investment laws. Mark Kantor, in Chapter 6, examines to what extent international investment law provides protection for Chinese investments in the US, even though there is no investment treaty between the US and China. (However, the beginning of negotiations of a bilateral investment treaty was announced in June 2008.) Most important here are the World Trade Organization (WTO) General Agreement on Trade in Services (the GATS, which, in "Mode 3," provides a number of protections to service businesses conducted through a "commercial presence", akin to FDI, in the US) and the WTO Agreement on Trade-Related Investment Measures (the TRIMs agreement) (prohibiting certain performance requirements). The enforcement of both these agreements occurs via the state-to-state dispute settlement mechanism in the WTO Dispute Settlement Understanding. The normal remedy for breach of the GATS or TRIMs agreements is withdrawal of trade benefits, a remedy that is not necessarily valuable to injured investors.

But Chinese investors can obtain the protection of a bilateral investment treaty – and, for that matter, also a double taxation treaty – between the US and a third country by means of "treaty-shopping," that is, by investing in the US via a company they have established in that third country, provided that company has "substantial business activities" in that country. Once they do that, all the protections of that third country's bilateral investment treaty with the US apply. As of 2008, the US had bilateral investment treaties with 47 economies[15] and various types of tax treaties with 65.[16] A similar approach may

be taken with respect to establishing an investment vehicle in a third country that has a free trade agreement with the US (including the North American Free Trade Agreement NAFTA), as long as it has applicable investment provisions.

Such protection involves, among other things, payment of fair market value compensation in the case of expropriation, including indirect expropriation. Applicable international investment agreements (IIAs) also provide protection against US legislative, regulatory or judicial treatment contrary to the international investment law principle of "fair and equitable treatment." Subject to specific exceptions, they guarantee non-discrimination on the basis of nationality ("most-favored-nation treatment" and "national treatment"). They guarantee the free repatriation of dividends, the free distribution of the proceeds of the sale of an investment and the free transfer of other payments. They prohibit restrictions on the nationality of senior managers. Finally, they prohibit certain performance requirement (often beyond those already prohibited by the TRIMs agreement). In contrast to the GATS and TRIMs Agreements, however, applicable IIAs also allow foreign investors to initiate investor–state arbitration proceedings. The normal remedy in investor–state arbitration for the breach of an IIA is the payment of damages to compensate for injury.[17]

However, US IIAs (like the WTO agreements) contain an "essential security" exception under which the US is entitled, notwithstanding other provisions of such treaties, to take measures to protect its essential security interests. Furthermore, recent US treaties expressly state that the exception is "self-judging," that is, the US government alone decides whether or not a given measure is necessary in a particular situation. Still, in spite of this (and other) limitations, the protections offered to foreign investors in the US are among the strongest in the world.

1.3 PROSPERING

How to deal with the liability of foreignness? What, in particular, can Chinese firms – and, for that matter, firms from other countries – do to prosper in the US? The answer to this question has many facets – and it can draw on the experience of firms from Japan that were in a situation similar to that of Chinese firms today when they entered the US in the 1980s. Curtis J. Milhaupt examines this experience in Chapter 7.

During the 1980s, the macroclimate of US–Japanese relations was characterized by trade frictions, exchange rate controversies, concerns about the nature of the Japanese economy ("Japan Inc."), fears about Japan's economic ascendance, and cultural misperceptions. The media and politicians had a field day in Japan-bashing.

In spite of this climate, Japanese FDI in the US rose from less than $1 billion annually during the 1970s, to a peak of nearly $20 billion in 1988–90.[18] It received special attention and faced resistance, exacerbated at times by the relative inexperience of Japanese firms: they (like their Chinese counterparts today) had just embarked on an accelerated internationalization process through FDI and hence had not yet accumulated the experience that comes with operating abroad for decades. During the second half of the 1980s, in particular, when M&As became the principal mode of entry for Japanese firms, a number of high-profile acquisitions (for example, that of the Rockefeller Center) received considerable publicity. One attempted acquisition – Fujitsu's bid for Fairchild Semiconductor

(already foreign owned) – actually contributed to the adoption of the Exon–Florio Amendment, which is the original statute governing the CFIUS national security review process. Moreover, a number of Japanese affiliates in the US faced legal difficulties in the employment area, with one suit reaching the Supreme Court. All in all, Japanese FDI in the US had a rough time.

The parallels in the macroclimate between the US and Japan then and the US and China now are indeed striking.[19] Some of the reactions to Chinese FDI in the US are also strikingly similar, even as far as the reaction by the media and politicians is concerned, and the strengthening of CFIUS through FINSA. Yet, in the case of Japanese FDI in the US, the controversies died down during the 1990s. Today, Japanese firms are firmly implanted in the US; they have become an integral and valuable part of the country's economic and social fabric, and Japan remains an important source of FDI.

What can we learn from the Japanese experience and, broader, how can Chinese foreign affiliates in the US prosper in the US market? Milhaupt, Eden and Miller, but also virtually every other author in this volume, answer this question, each one from his or her perspective and in the context of their specific subjects. The underlying message is clear, though: Chinese firms – like those from other countries before them– need to become insiders, and they need to build up a positive company brand name, to be accepted in the US. Various strategies can be pursued to that effect.

Where Chinese firms have a choice between entering the US market through an M&A or a greenfield investment, the safer route (politically speaking), is the latter. And even in the case of M&As, follow-on greenfield investments can be important to increase the acceptability of a given investment. Greenfield investments, as was pointed out earlier, are universally welcome as they create new production capacities and employment, and they are not subject to a potential CFIUS review. For Chinese firms exporting to the US, perhaps the best way is to establish assembly facilities and eventually move on to full production capacities (reducing the trade deficit in the process). A number of Japanese firms successfully followed this path, especially in the automotive industry.

In the case of M&As, mention has already been made of the need for an appropriate political strategy, if possible avoiding high-profile takeovers, especially hostile ones. Part of such a strategy is to examine carefully who is affected by a planned acquisition and to understand the interests of the principal stakeholders involved. Stakeholder management and learning how to navigate the political process and institutional system in Washington, DC, are very important, either individually or together with other non-US MNEs[20]; discrete lobbying may be an important part of this process. The objective needs to be to reduce, to the greatest extent possible, negative publicity and hence to avoid starting out on the wrong foot. If this cannot be done, an attempted acquisition may not come to fruition or may be vetoed.

Once established, foreign affiliates need to observe local laws and regulations scrupulously – this goes without saying.[21] This requires a thorough understanding of the country's regulatory framework and its functioning. Compliance training and working with local partners who understand US regulations can be important here.

More than that, foreign affiliates need to integrate themselves as tightly as possible in the communities in which they are established. This means, among other things, growing roots by creating backward linkages with local enterprises, giving them a stake in the well-being of the affiliate. It also means recruiting high-level US citizens for management

positions, the board of directors and especially positions in an affiliate that involve an interface with public and private US organizations. Finally, integration involves cultivating the local community which, in turn, has its own links to the state and federal governments. All politics (including in Washington, DC) is, in the end, local. Organizations that foster communications among business people have a role to play as well; the US–China Business Council is important in this regard, and eventually its degree of penetration may be as deep as that of the US–Japan Business Council.

Another important means to advance integration is corporate social responsibility (CSR). It is a concept that has great saliency in the US – firms are expected to pay full heed to it, at the local, state and federal levels. Japanese firms became fully cognizant of the importance of CSR as part of their efforts to become accepted and integrated. Donations to local charities have a role to play here, as has the establishment of foundations in support of education and the endowment of chairs at major universities.[22]

Pursuing these strategies allows foreign affiliates to create a dense network of economic, social and cultural interactions and ties that embed them and their reputation in their communities and, eventually, make them insiders with a good corporate brand name.

Naturally, this requires considerable learning on the part of the managers of foreign affiliates and their parent firms. Building that human capacity is one of the key challenges facing Chinese MNEs. This begins with training when it comes to M&As (and seeking advice where this is needed), learning the ropes of the political system, knowing how to become a good corporate citizen, and demonstrating the contribution that foreign affiliates make to the local and national economy. It also requires that the government of the home country of foreign affiliates (in this case, China) encourages foreign affiliates to become insiders in the host country and acquire a good corporate brand name. And it requires that the media, the public and the political establishment of the host country (in this case, the US) recognize the value of Chinese FDI and respect the principle of non-discrimination in the treatment of such investment; a bilateral investment treaty can help in this respect.

1.4 SUMMARY AND CONCLUSIONS[23]

There are indications worldwide that the climate for FDI is becoming less welcoming just as Chinese enterprises are appearing on the global stage. In particular, a number of developed countries, including the United States, Japan and Germany, are taking a more cautious approach to cross-border M&A, by far the most important mode of entry into foreign markets by MNEs and, increasingly, for Chinese enterprises as well. Particularly since CNOOC withdrew its bid for Unocal in mid-2005, cross-border M&As by Chinese firms have attracted special attention, and there is ample indication they will continue to do so for the foreseeable future.

The reasons for this nervous reaction to Chinese outward FDI are mixed, but they are largely political in nature. Questions are raised about the governance of Chinese firms and the fear that Chinese acquirers, especially when they are state-owned, may enjoy financing advantages. This is less an issue for the shareholders of acquisition targets than for rival firms competing for the same assets. There is also some concern, especially in Europe, about the ability of Chinese firms to manage cross-border M&As successfully

and the implication that any failures would have for host countries, especially in terms of unemployment and the business of suppliers. Most importantly, there is the suspicion that cross-border acquisitions by state-owned firms are not necessarily driven by commercial motives alone, but are rather the result of political or strategic calculations determined (or at least influenced) by the government that controls them. The formal launch in September 2007 of the China Investment Corporation, China's new sovereign wealth fund with $200 billion in foreign exchange reserves at its disposal, has only fuelled speculation about the link between Chinese outward FDI and the country's wider geopolitical goals.

If this were not enough, Chinese enterprises are seeking to enter the global FDI market at a time when economic tensions between China and its major trade partners are at an all-time high. In the US, currency valuation has emerged as a lightning rod, while fast-growing trade imbalances with the US, Europe and, more recently, Japan, have deepened frictions as well. In fact, some observers trace a direct link between China's trade surplus and the rapid growth of Chinese outward FDI, especially its state-financed portion.[24] Other issues unrelated to Chinese FDI have helped sour public perceptions of Chinese business, especially the 2007 product recalls involving Chinese-made goods. To the average American or European, unfamiliar with even the largest Chinese companies, it becomes quite easy to allow negative associations to fill the void, with very predictable consequences in the political arena.

Given the speed at which Chinese firms are expected to go global, and the fact that state-owned enterprises account for a substantial portion of China's FDI, Chinese firms are encountering a rapidly evolving political environment in the US and other developed markets. In July 2007, the US revised the Exon–Florio Amendment, including a presumption that filings relating to acquisitions by state-controlled foreign entities will require investigation by CFIUS. Notification to, and investigation by, CFIUS have risen substantially. In a number of European countries, as well as Australia and Canada, investment reviews are now being strengthened, including through the introduction of a CFIUS-like screening process in Russia and Germany. With Japan recently strengthening its oversight of cross-border M&As and political pressure building in Canada, the Republic of Korea and elsewhere, the global investment environment seems to be tightening just as Chinese enterprises are poised to enter the world FDI market.

What to do in light of the vulnerability of Chinese outward FDI? It is only natural that, with the re-emergence of China as a major economy, its firms will spread their wings and become major players in the world FDI market.[25] The world needs to accept that Chinese MNEs are here to stay, and that outward FDI is another aspect of the country's integration into the world economy. The issue for all stakeholders is how to handle this process smoothly.

At the most basic level, it is essential that the non-discrimination principle – which is central to the international law governing cross-border investment – is applied by the US to Chinese outward FDI as it is applied to the investments of other countries; if a bilateral investment treaty should, indeed, be negotiated, non-discrimination would presumably feature prominently in it.

Chinese companies, too, need to be mindful of managing their international growth in light of the sensitivities that exist – rightly or wrongly – about the transnationalization of Chinese business. This begins with the training of executives not only in matters related

to the management of their firms, but also in those related to the political economy and culture of the US and other major host countries. Stakeholder management is particularly important here vis-à-vis policy-makers, labor, investors, local communities and the public. Furthermore, any acquisition by a state-owned enterprise and/or investments with a potential impact on national security will need particularly careful preparation. The same goes for acquisitions in sectors that are perceived to be off-limits to foreign investors from China. On the public relations side, it needs to be shown that Chinese FDI is fundamentally no different from that of other countries – and hence contributes to the economic growth and development of its host countries. Naturally, this message will be better received if Chinese companies behave as scrupulously good corporate citizens when operating abroad, not only by observing the laws and regulations of their host countries, but by exercising exemplary corporate social responsibility as well.

Whatever the overall impact and perception of Chinese outward FDI, Chinese firms may want to draw on the experience of Japanese firms in the US. When Japanese companies burst onto the world FDI market in the 1980s (partly through high-profile M&As), there was widespread fear that they would come to dominate the world economy; attitudes in the US in particular were defensive. Some of these fears began to dissipate as Japan entered a period of stagnation in the 1990s. Yet, perhaps more importantly, Japanese firms began to change their basic approach to investing in the US. Their understanding of the US market and ability to build key relationships with governments and communities grew. In addition to M&As, Japanese companies began to establish assembly facilities in the US and, later, full production units. As their readiness to address US market entry challenges increased, they found that the receptivity of the US business environment rose as well, in a virtuous cycle. Under the best of circumstances, Chinese firms and other stakeholders in the US–Chinese investment relationship will embark on a similar trajectory in a more compressed time-frame. Chinese firms, together with their counterparts in other emerging markets, can then look forward to a normalization of their investment relationships with the US.

NOTES

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1. "Emerging markets," for the purpose of this chapter, are defined as all members of the Organisation for Economic Co-operation and Development (OECD), including, however, the Republic of Korea and Mexico.
2. UNCTAD (2008).
3. OECD (2008), p. 71. At the same time, the concentration ratio is high (as in the case of other countries), as the top five economies accounted for 86 percent of total outflows and 85 percent of total outward stock, especially in Hong Kong (China) and tax havens (ibid).
4. Cheng and Ma (2007), p. 15. (These figures do not include state-owned enterprises administered by regional governments.) According to the same source, the share of state-owned enterprises in the total number of outward investing entities had dropped from 43 percent in 2003 to 29 percent in 2005.
5. Sauvant (2009).
6. UNCTAD (2008).
7. Since M&As can be financed from sources other than FDI, it is not possible to determine the exact share of FDI accounted for by M&As.

8. UNCTAD (2008).
9. It is notable that Japanese automotive firms, when entering the US market, deliberately established themselves in areas in which there had not been an automotive industry previously.
10. "President Bush's Statement on Open Economies," May 10, 2007, http://www.whitehouse.gov/news/releases/2007/05/20070510-3.html.
11. Invest in America, http://www.ita.doc.gov/investamerica/index.asp.
12. Zakaria (2008).
13. Paulson (2008), p. 72.
14. Caves (1971), p. 6.
15. As of December 2008, the United States had signed a bilateral investment treaty with Albania, Argentina, Armenia, Azerbaijan, Bahrain, Bangladesh, Belarus, Bolivia, Bulgaria, Cameroon, Democratic Republic of the Congo, Republic of the Congo (Brazzaville), Croatia, Czech Republic, Ecuador, Egypt, El Salvador, Estonia, Georgia, Grenada, Haiti, Honduras, Jamaica, Jordan, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Mongolia, Morocco, Mozambique, Nicaragua, Panama, Poland, Romania, Russia, Rwanda, Senegal, Slovakia, Sri Lanka, Trinidad & Tobago, Tunisia, Turkey, Ukraine, Uruguay and Uzbekistan (US State Department, http://www.state.gov/e/eeb/rls/fs/2008/22422.htm).
16. As of December 2008, the United States had signed a tax treaty with Australia, Austria, Bangladesh, Barbados, Belgium, Bulgaria, Canada, People's Republic of China, Commonwealth of Independent States (Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan and Uzbekistan), Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Republic of Korea, Latvia, Lithuania, Luxembourg, Mexico, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Slovak Republic, Slovenia, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Thailand, Trinidad & Tobago, Tunisia, Turkey, Ukraine, United Kingdom and Venezuela. (US Department of the Treasury, http://www.irs.gov/pub/irs-pdf/p901.pdf and http://www.ustreas.gov/offices/tax-policy/treaties.shtml).
17. Virtually all of these protections, though, are also found in the US Constitution and US statutory enactments – and US domestic protections are often even stronger than those contained in US treaties. (The principal difference is that the protections of a US IIA can be enforced before a neutral international arbitral panel, while US constitutional and statutory rights are enforced before US courts and administrative agencies.)
18. Flows declined thereafter, when Japan entered a decade of economic difficulties. They only surpassed the 1990 peak in 2007.
19. There is however, one major difference, namely that China is seen, in the political and military areas, as a strategic competitor in the US.
20. The Organization for International Investment, grouping a number of foreign affiliates, is an example.
21. As we know from the experience of Japanese affiliates in the US, employment practices are a particularly sensitive matter.
22. For example, Curtis J. Milhaupt, the author of Chapter 7 in this volume, holds the Fuyo Professorship at Columbia Law School, established in 1980 by the Fuyo Group (one of the six major *keiretsu* corporate groups then in existence).
23. This section draws on Kwan and Sauvant (2008), pp. 39–46.
24. It should be noted that, while a substantial revaluation of the RMB would reduce the trade surplus, it would further encourage outward FDI from China as it would make US and other foreign assets cheaper in terms of that currency.
25. See Sachs (2008), pp. 15–22.

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