



# TOWARD A US-CHINA INVESTMENT TREATY

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## INTRODUCTION

The United States and China are the two largest economies in the world. They are among the world's largest trading nations, and they serve as both the destination and the source of the world's largest flows of foreign direct investment (FDI). Both countries participate in a range of regional economic arrangements on trade and investment in the Asia-Pacific region and other parts of the world. Yet when it comes to direct investment in each other's economies, China and the United States are among the world's underperformers. That situation could change with the successful conclusion of the negotiation of a US-China bilateral investment treaty (BIT).

This PIIE Briefing examines prospects for a US-China BIT now that negotiations have revived. Launched in 2008 during the presidencies of George W. Bush and Hu Jintao, the talks faltered after the 2008 election of President Barack Obama, whose economic team had other economic priorities upon taking office at the height of the Great Recession. The Obama administration spent its first years holding internal debates about trade deals that it had inherited.<sup>1</sup> In the same period, they put the US-China BIT talks on hold while the United States revised the terms of what an ideal investment treaty should look like, a document known as the US model BIT. The internal US government review of investment issues was not completed until 2012. US-China BIT negotiations resumed in 2013; the 17th round of negotiations was held in December 2014. The essays in this study focus specifically on recent developments that could inform and possibly set precedents for the investment pact. They also examine issues that pose challenges to a successful negotiation.

Given the large economic footprint of both economies, the size of cross-border investment in each other's markets is surprisingly small. US FDI in China in 2012, valued around \$54 billion, represented only about 1.2 percent of the \$2.2 trillion of total FDI in China.<sup>2</sup> And China accounted for an even smaller share of FDI in the United States.<sup>3</sup> Removing discriminatory investment restrictions via a US-China BIT could yield a significant payoff, not simply as a means of encouraging two-way investment but also as a means of helping resolve investment-related disputes.<sup>4</sup> But getting agreement on such a pact will require reconciling differences regarding the scope and coverage of the prospective pact and addressing the extensive complaints that both have about FDI policies in the other's market.

There is ample precedent for the success of investment treaties. Both the United States and China have used BITs over the years to advance their investment relations. Existing pacts have helped reduce policy bar-

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1. The US-China BIT negotiation is also a challenge for Obama's policy since it counter poses the administration's objective to open Chinese market with their concerns about adverse US job effects related to FDI outflows.

2. Figures are from US Bureau of Economic Analysis.

3. Sources disagree as to the value of investment in each other's markets. In part, the low stock is due to measurement discrepancies but also due to barriers to investment. See [table 2](#) in the essay by Jeffrey J. Schott and Cathleen Cimino.

4. C. Fred Bergsten, Gary Clyde Hufbauer, and Sean Miner, *Bridging the Pacific: Toward Free Trade and Investment Between China and the United States* (Washington: Peterson Institute for International Economics, 2014).

riers limiting FDI and enhance the investment climate between the partner countries. Put simply, BITs are designed to encourage foreign investment and to establish reciprocal rules for the treatment of firms and protection of investments. The number of BITs globally has now reached more than 2,850.<sup>5</sup> The United States has 41 BITs in force, the majority of which are with developing countries. China has 104 BITs in force, of which 78 are with developing countries and 26 are with developed countries, including Canada, Germany, and the United Kingdom.

That said, BITs negotiated by the United States and China differ markedly in terms of the types of investments covered, the rules applied to investment policies, and the enforcement provisions to protect investor rights. For the United States, the 2012 revision of the US model BIT sets out a detailed and broad-ranging template for treaty rights and obligations that US officials expect their partners to undertake and enforce in all bilateral investment pacts.<sup>6</sup> The US model BIT sets a high bar in requiring extensive obligations on investment policies, investor rights and protections that open up meaningful new market access opportunities, and a robust investor-state dispute settlement (ISDS) mechanism.

Only two of the United States' 41 BITs—the US-Rwanda BIT and the US-Uruguay BIT—have entered into force in the past decade. This limited harvest reflects both the challenge that partner countries face in meeting the terms of the US model BIT and the difficulty that US officials face in securing congressional approval of an investment treaty. The US ratification process—requiring a two-thirds vote of the Senate—is prolonged and uncertain. Indeed, many US trading partners prefer to negotiate comprehensive investment chapters in their free trade agreements (FTAs) with the United States, which are similar in content to BITs but differ in the process in which the United States ratifies and implements the pact.

In contrast, Chinese BITs are more numerous but much less ambitious. The large number of Chinese BITs belies their modest content, though over time the substantive provisions of these pacts have been upgraded bit by bit. The most recent iteration is the China-Japan-Korea (CJK) investment pact, which entered into force in May 2014. The recently concluded China-Korea FTA promises to further extend investment rights and obligations at the pre-establishment phase of investment in a second tranche of negotiations, which could commence in a few years. If these talks are successful, the gap between US expectations for a BIT and Chinese investment policies will narrow. Whether bilateral US-China negotiations can then reconcile the differences and resolve outstanding concerns about inward FDI policies in each country is still an open question.

US officials have numerous concerns about Chinese policies that impede investment by US firms. Advantages provided to Chinese state-owned enterprises (SOEs) rank high on the list; so, too, does the application of China's antimonopoly law. Preferences accorded to domestic private firms and SOEs via subsidies and discriminatory regulations and other measures restrict competition in the Chinese market and discourage US investments in China. These practices weigh on both manufacturing firms and service providers. The latter are particularly constrained because many service activities require the firm to be established (i.e., invested) in the market where the service is provided.

Chinese concerns focus primarily on the role of the Committee on Foreign Investment in the United States (CFIUS). The CFIUS reviews prospective FDI that has the potential to impair US national security and has the ability to block foreign acquisitions of US firms if it concludes that specific purchases would do so. Over the past decade, several planned Chinese investments have been cancelled to avoid CFIUS reviews or denied after CFIUS decisions. While no country would cede responsibility for safeguarding national security interests, Chinese negotiators may seek greater transparency in the criteria applied by the CFIUS in its reviews

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5. United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2013: Global Value Chains: Investment and Trade for Development*, 2013, Geneva.

6. For the complete text of the US model BIT, see [www.state.gov/documents/organization/188371.pdf](http://www.state.gov/documents/organization/188371.pdf).

and a commitment that Chinese firms will receive the same treatment as other foreign investors (that is, most-favored nation or MFN treatment).

The essays here examine these issues and offer recommendations on how to resolve outstanding differences. First, Jeffrey Schott and Cathleen Cimino analyze the recent CJK investment pact and compare it with investment provisions that the United States has developed in its model BIT and Korea-US FTA. Sean Miner and Gary Hufbauer then discuss how a US-China BIT would need to address US concerns in China regarding subsidies, other unfair advantages for SOEs, and uneven application of competition policy. J. Bradford Jensen analyzes the potential for increased trade in business services as a result of reducing investment barriers between the United States and China. Gary Hufbauer, Sean Miner, and Theodore Moran analyze CFIUS review procedures in the United States and related issues for the US-China BIT. The Briefing concludes with an overview by C. Fred Bergsten, who assesses the BIT negotiations in the broader context of US-China economic relations.

# THE CHINA-JAPAN-KOREA TRILATERAL INVESTMENT AGREEMENT: IMPLICATIONS FOR US POLICY AND THE US-CHINA BILATERAL INVESTMENT TREATY

JEFFREY J. SCHOTT AND CATHLEEN CIMINO

As a precursor to their free trade agreement (FTA) negotiations, which launched in March 2013, China, Japan, and Korea (CJK) signed a trilateral investment agreement in May 2012.<sup>1</sup> The agreement aims to set the groundwork for greater regulatory transparency, a more predictable policy environment, and a liberalized investment regime in order to facilitate intraregional foreign direct investment (FDI) (*CJK Joint Study Committee 2011*). The pact was subsequently ratified and entered into force in May 2014.

Both Japan and Korea negotiated a basic bilateral investment treaty (BIT) with China more than 20 years ago. But the new trilateral agreement seeks to more closely align the investment standards of the three countries, including provisions on performance requirements, transparency, and intellectual property rights (IPR). These advancements are particularly important for Japan; the 1988 Japan-China BIT lacked such provisions, while the 1992 Korea-China BIT was amended in 2007 to include new obligations in these areas.<sup>2</sup>

In the long gestation period leading up to the release of the CJK investment agreement, scant attention was given to the negotiations, given the shallow investment obligations of other intra-Asian pacts. Most Western observers assumed the agreement would be little more than a political statement of good intent. However, the CJK pact is at least a small leap forward and warrants a closer look because of its content and to assess whether it stands up as a potential alternative template for Asian countries, albeit a less rigorous one than the US model. In addition, the agreement may have important implications for the incremental liberalization that China is ready or willing to accept and thus for the direction of subsequent Chinese negotiations—most notably the Regional Comprehensive Economic Partnership (RCEP) between CJK and the Association of Southeast Asian Nations (ASEAN), Australia, New Zealand, and India and possibly the US-China BIT.

This essay assesses the provisions of the CJK pact drawing comparisons with the highest standards of existing Chinese BITs (or FTA investment chapters) in addition to the US model BIT. The aim is to draw conclusions as to what precedents have been set by both sides that could help facilitate (or deter) the conclusion of a BIT between the United States and China in the medium term.

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JEFFREY J. SCHOTT is senior fellow at the Peterson Institute for International Economics. CATHLEEN CIMINO is research associate at the Peterson Institute for International Economics. They thank Josh Kallmer for his insightful comments on an earlier draft of this essay.

1. Agreement among the Government of Japan, the Government of the Republic of Korea, and the Government of the People's Republic of China for the Promotion, Facilitation and Protection of Investment, May 2012, [www.mofa.go.jp/announce/announce/2012/5/pdfs/0513\\_01\\_01.pdf](http://www.mofa.go.jp/announce/announce/2012/5/pdfs/0513_01_01.pdf).

2. See "Summary of the Japan-China-Korea Trilateral Investment Agreement," Japan's Ministry of Economy, Trade and Industry, May 2012, [www.meti.go.jp/english/press/2012/pdf/0513\\_01a.pdf](http://www.meti.go.jp/english/press/2012/pdf/0513_01a.pdf); and "Significantly Enhanced Protection for Korean Investors Achieved Through Amendment of Korea-China Investment Protection and Promotion Agreement," Korea's Ministry of Foreign Affairs and Trade, October 17, 2007, [www.mofat.go.kr/webmodule/htsboard/template/read/korboardread.jsp?typeID=12&boardid=8588&seqno=305321](http://www.mofat.go.kr/webmodule/htsboard/template/read/korboardread.jsp?typeID=12&boardid=8588&seqno=305321).

The CJK investment pact somewhat narrows the gap between the scope and depth of regional investment rules and the US template as set out in the US model BIT and the investment chapter of the Trans-Pacific Partnership (TPP), but overall it is not as comprehensive. In this regard, we conclude that it is not likely to serve as a concrete building block for the US-China BIT. Still, incremental progress toward liberalized investment norms within Northeast Asia could prove to be a constructive step toward closer CJK economic relations and help advance new investment opportunities for countries seeking to engage China. The hope is that further incremental convergence occurs via the investment chapters of the CJK and China-Korea FTA negotiations contingent on meaningful commitments that build on the provisions of the CJK investment pact.<sup>3</sup> China's track record of incremental progress toward higher standards should make it easier to forge compromises in US-China BIT talks.

## CJK AND US-CHINA INVESTMENT PATTERNS

China has become the largest host country for FDI in the developing world and a major investment destination for Japan and Korea, whose outward FDI stock in China in 2012 was \$93 billion and \$51 billion, respectively (table 1). Nearly three-fourths of Japanese and Korean foreign investment goes to China's manufacturing sector. By contrast, Chinese FDI stock in Japan and Korea remains limited to just \$500 million and \$3 billion, respectively, or 0.3 and 2.1 percent of total Chinese

investment abroad. Similarly, Korean investment in Japan is limited, around \$4 billion in 2012, or 2 percent of total Korean investment abroad. These imbalances gave impetus for concluding an investment agreement that could not only expand opportunities in China but also promote Chinese participation in the underinvested (in relative terms) Korean and Japanese markets.

Compared with the United States, Japan and Korea invest as much if not more in China, but outward FDI stock in China accounted for 9 and 25 percent of total investment abroad, respectively, compared with 1 percent for US investors.<sup>4</sup> Indeed, despite the significant volume of trade between the United States and China, investment in each other's markets remains relatively low by any standard. In 2012, US FDI stock in China was reported as \$54 billion with a majority in manufacturing. In contrast, Chinese FDI stock in the United States was reported as a mere \$7 billion according to the US Bureau of Economic Analysis, though the Chinese Min-

**Table 1 Stock of foreign direct investment (FDI) in China, end of 2012**

Country	Outward FDI stock in China		Inward FDI stock from China	
	Billions of US dollars	Percent of total	Billions of US dollars	Percent of total
Japan	93.0	9.0	0.6	0.3
Korea	50.6	24.9	3.3	2.1
United States	53.7	1.2	6.9	0.3
<i>Addendum:</i>				
Japan (host) and Korea (partner)	25.5	2.5	2.8	1.4
Korea (host) and Japan (partner)	3.7	1.8	41.8	26.8

Source: OECD Statistics, FDI positions by partner country, <http://stats.oecd.org/>; US Bureau of Economic Analysis.

3. Presidents Xi Jinping and Park Geun-hye announced the substantial conclusion of the China-Korea pact in November 2014 and a full text is expected in early 2015. The CJK FTA recently completed its fifth round of talks but is not close to the finish line.

4. Japanese investment in China has declined notably over the past year, attributed to slower growth and rising labor costs in China as well as foreign exchange dynamics, i.e., depreciating yen/appreciating yuan. See "Foreign Direct Investment in China Declines," *Wall Street Journal*, June 17, 2014, [www.wsj.com/articles/foreign-direct-investment-in-china-declines-1402980999](http://www.wsj.com/articles/foreign-direct-investment-in-china-declines-1402980999) (accessed on December 20, 2014); and Jamil Anderlin, "Foreign investment into China slumps," *Financial Times*, September 16, 2014, [www.ft.com/intl/cms/s/0/86808f42-3d7c-11e4-b782-00144feabd0c.html#axzz3MjqRW670](http://www.ft.com/intl/cms/s/0/86808f42-3d7c-11e4-b782-00144feabd0c.html#axzz3MjqRW670) (accessed on December 23, 2014).

**Table 2 Chinese outward foreign direct investment (FDI) stock in the United States, 2008–13** (billions of US dollars)

Year	China Ministry of Commerce	US Bureau of Economic Analysis	Rhodium Group <sup>a</sup>
2008	2.4	1.1	3.6
2009	3.3	1.6	5.3
2010	4.9	3.3	9.9
2011	9.0	3.6	14.8
2012	17.1	6.9	21.9
2013	n.a.	8.1	35.9

n.a. = data not available

a. Sourced from Rhodium Group, China Investment Monitor, <http://rhg.com/interactive/china-investment-monitor>.

Source: Bergsten, Hufbauer, and Miner (2014, table 13.3).

istry of Commerce reported FDI in the United States as \$17 billion, primarily concentrated in energy, manufacturing, and foodstuffs (see table 2). Estimates from private sources, such as Rhodium Group, seek to more accurately estimate investment flows between the two countries, accounting for other important factors like FDI routed through third countries (Bergsten, Hufbauer, and Miner 2014). Rhodium Group estimates that Chinese FDI stock in the United States was as high as \$36 billion by year end 2013 (table 2).

What accounts for the substantial discrepancies? In large measure, official figures do not accurately account for investment routed through third countries offering tax and other advantages; instead such investments are counted as though they come from the intermediate country. In the case of China, direct investment in the United States is sometimes routed through Hong Kong, Luxembourg, and Mauritius. Other possible explanations of the low levels between the two leading economies could include barriers to FDI such as indigenous innovation policies and intellectual

property protection from the perspective of the United States (see USITC 2010).<sup>5</sup>

US businesses cite “foreign investment restrictions” as one of the primary challenges to investing in China (USCBC 2014). China’s Foreign Investment Catalogue includes foreign ownership restrictions in nearly 100 manufacturing and services sectors, including financial services, health insurance, agriculture, and audiovisual services. On the Chinese side, limited market access in certain US sectors like transportation, radio communications, and natural resources has created discretionary barriers, primarily in the form of “political objections” to mergers and acquisitions of US firms or from national security objections raised by the Committee on Foreign Investment in the United States (CFIUS) (Bergsten, Hufbauer, and Miner 2014).

The US-China BIT would seek to redress some of these grievances. The CJK investment agreement attempts to address similar concerns of Japanese and Korean investors and thus may facilitate new opportunities in the Chinese market.

## BILATERAL INVESTMENT TREATIES

The BIT offers an important tool to reduce policy barriers limiting FDI and to enhance the investment climate between two countries. The United States has 41 BITs in force, the majority of which are with developing countries, while China has more than 100, a quarter of which are with developed countries including Canada and Germany.

### US Model BIT

The US model BIT sets out the commitments that the United States expects its partners to undertake and enforce with regard to investment policies and the protection of investor rights.<sup>6</sup> But only two BITs, one with Rwanda and the other with Uruguay, have been ratified in the past decade. This is in part because the terms of

5. USITC (2010, xiii) broadly defines “indigenous innovation” as those policies that “promote the development, commercialization, and purchase of Chinese products and technologies.”

6. For the complete text of the US model BIT, see [www.state.gov/documents/organization/188371.pdf](http://www.state.gov/documents/organization/188371.pdf).



the proposed deals are challenging for US partners and in part because the US ratification process—requiring a two-thirds vote of the Senate—is prolonged and uncertain.<sup>7</sup>

Instead of negotiating treaties, US officials have primarily sought to augment investor protection through FTAs, which unlike BITs require “only” a majority vote in each house of Congress. That strategy has been productive with new US FTA partners like Korea and Colombia but leaves out initiatives with key countries like Brazil, China, and India. BIT negotiations are under way or under construction with China and India, but prospects are daunting given the new US demands added to the revised BIT template in early 2012 (see below). Thus, FTA negotiations in general and the TPP in particular could be an alternative, and perhaps more expeditious, channel for US investment initiatives over the near term. Within FTA investment chapters, US negotiators try to include standards from the model BIT as part of the FTA obligations.

To briefly summarize, according to the Office of the US Trade Representative (USTR), the US BIT is designed to provide US investors with six benefits:<sup>8</sup>

- national treatment (“treated as favorably as the host party treats its own investors and their investments”) and most-favored nation (MFN) treatment (“treated as favorably as investors and investments from any third country”) for investors and “covered investments” for the “full life-cycle of investment,” including establishment or acquisition, management, operation, expansion, and disposition;
- limits on direct and indirect expropriation and procedures for the payment of “prompt, adequate, and effective compensation” when expropriation occurs;
- ability to transfer investment-related funds across borders “without delay and using a market rate of exchange”;
- restriction of the use of performance requirements;
- right to employ senior managerial personnel, regardless of nationality; and
- right to international arbitration for an investment dispute with the host country government, with no requirement to resort to domestic courts.

After extensive review, the Obama administration issued a revised US model BIT in early 2012, which calls for tougher standards.<sup>9</sup> These revisions will undoubtedly complicate ongoing discussions between the United States and China and other emerging markets. The major changes of the latest revision include:

- strong transparency obligations on regulations and other matters affecting investment and commitments to increase stakeholder and public participation;
- expanded labor and environmental standards with commitments not to “waive or derogate” from domestic labor and environmental laws, to “effectively enforce” such laws, and to recognize international commitments under the International Labor Organization and other multilateral agreements; and
- clarified specifications for state-owned enterprises (SOEs) and commitments not to impose technology transfer requirements and to encourage investor participation in the development of standards and regulations.

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7. Indeed, successful negotiation of a US BIT with emerging markets like China and India in particular would require weathering intensive scrutiny from the US Senate, as evident in the recent bipartisan congressional letter to the Obama administration, from July 9, 2013, which lists a number of complaints regarding China’s regulatory process, “opaque and discriminatory” investment restrictions, currency misalignment, “indigenous innovation” policies, cyber-espionage, among other issues. See “Congressional Trade Leaders Flag IPR, Ag Problems Ahead of S&ED,” *Inside US Trade*, July 11, 2013, [www.insidetrade.com](http://www.insidetrade.com) (accessed on April 29, 2014). This list of issues goes beyond the scope of BIT negotiations but could delay the ratification of a US-China BIT (Bergsten, Hufbauer, and Miner 2014).

8. USTR, “Bilateral Investment Treaties,” [www.ustr.gov/trade-agreements/bilateral-investment-treaties](http://www.ustr.gov/trade-agreements/bilateral-investment-treaties) (accessed on April 10, 2014).

9. See USTR, “Fact Sheet on Model Bilateral Investment Treaty,” [www.ustr.gov/about-us/press-office/fact-sheets/2012/april/model-bilateral-investment-treaty](http://www.ustr.gov/about-us/press-office/fact-sheets/2012/april/model-bilateral-investment-treaty); and Johnson (2012).

## Chinese BITs

Chinese BITs contain several standard features, which have evolved over time. [Stephan Schill \(2007\)](#) and other scholars distinguish a “new generation” of Chinese BITs, which began in the late 1990s and early 2000s, breaking from past BIT practice defined by more limited provisions. He argues this shift began with the conclusion of BITs with the Netherlands in 2001 and Germany in 2003, which started to conform, with some exceptions, to the standard guarantees of most treaties, including national treatment and investor-state dispute settlement (ISDS).<sup>10</sup> Importantly, China transitioned to BITs that “offer more effective protection against political risks stemming from undue government interference with the business activity of foreign investors” (Schill 2007, 2). Still, Chinese BITs retain some measure of flexibility for the ability of the state to maintain investment restrictions, through exceptions and “nonconforming” measures.

Using the most recent Chinese BIT with Canada (ratified in 2013) as the current template, standard features of China’s “new generation” BITs include:<sup>11</sup>

- broad definition of investment, including IPR;
- national and MFN treatment, conditioned on extensive exceptions;<sup>12</sup>
- protection against direct and indirect expropriation and compensation “without unreasonable delay” in the event it occurs;
- capital transfer provisions, subject to a balance of payments exception; and
- the right to international arbitration for an investment dispute with the host country.<sup>13</sup>

In an extensive comparative analysis of Chinese BIT provisions, [Kate Hadley \(2013\)](#) concludes that foreign investor rights under Chinese law have improved and become more enforceable primarily through China’s expansion of treaties with developed countries. The upgrading of standards within the CJK investment treaty complements this path (see below). China’s incremental progress toward higher standards also narrows the gap between what China has done and what the United States would like it to do in the US-China BIT talks.

## CJK INVESTMENT PACT AND IMPLICATIONS FOR US-CHINA BIT

The US-China BIT negotiations have progressed in fits and starts over the past six years. The most recent 17th round of negotiations was held in December 2014. From these extensive talks, several sticking points have emerged with respect to Chinese concessions, including:

- pre-establishment rights for US firms,
- greater transparency of investment approval processes,
- market disciplines and subsidies applied to SOEs,
- reform of policies of forced technology transfer and intellectual property protection, and
- ISDS procedures.

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10. That these new practices coincide with China’s accession to the WTO is likely no coincidence. Others have discussed the features of China’s “first generation” and “second generation” BITs extensively, for example, see [Hong \(2009\)](#).

11. For the complete text of the China-Canada BIT, see [www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/fipa-apie/china-text-chine.aspx?lang=eng](http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/fipa-apie/china-text-chine.aspx?lang=eng).

12. For example, the Canada-China BIT does not provide national treatment for the pre-establishment phase of investment, but rather for the “expansion, management, conduct, operation and sale or other disposition of investments” (Article 6). However, MFN treatment does apply to both pre-establishment and post-establishment phases of investment. This is similar to the investment chapter of the China–New Zealand FTA. But in both agreements, MFN treatment is not applicable to dispute settlement procedures from other agreements ([Hadley 2013](#)).

13. For investor-state disputes, BITs generally provide investors the option of international arbitration through an *ad hoc* tribunal under UNCITRAL rules or through the International Center of Settlement of Investment Disputes (ICSID). In China’s “first generation” BITs, investors were required to first submit disputes to a domestic Chinese court; further, only cases of expropriation were allowed to be submitted to arbitration ([Hong 2009](#)). However, China’s post-1990 “second generation” BITs began to include more comprehensive dispute settlement provisions and allow for arbitration for disputes not related to expropriation.

Bilateral talks in other forums like the US-China Strategic and Economic Dialogue (S&ED) have made slow progress in redressing related issues at the source of bilateral frictions, such as indigenous innovation and IPR policies. However, hopes were high for breaking new ground coming out of S&ED talks in July 2013 where the United States lauded several commitments from the Chinese side.<sup>14</sup> China agreed to negotiate market access commitments using a “negative list” approach, rather than its past practice of using a “positive list.” A “negative list” would open foreign investment to all sectors and industries that are not specifically excluded on the list, while “positive list” opens foreign investment only in those sectors that are explicitly listed. Assuming a substantive outcome of the latest round of BIT talks, negotiators plan to turn to negative list negotiations early in 2015.<sup>15</sup> Following the S&ED meeting, China also committed to considering “pre-establishment rights,” which would ensure national treatment at the preliminary phase of an investment project. China has not included either of these provisions in past BITs. These and other commitments, while encouraging, will become more meaningful when translated not only into hard obligations within China’s investment treaties but also into actual policies. China’s unveiling of its pilot free trade zone (FTZ) in Shanghai is widely viewed as an opportunity to test some of these commitments in practice.<sup>16</sup>

China has made gradual commitments to more comprehensive investment obligations within its recent BITs and now has shown signs of continuing this trend within ongoing negotiations with the United States. Indeed, several substantive provisions were agreed to within the CJK trilateral investment agreement. That said, a wide gap still remains with the US standards, and China has not elevated its commitments with Korea and Japan significantly beyond the level in investment arrangements with other developed countries, namely with Canada (BIT signed 2012) and New Zealand (FTA signed 2008). Several specific provisions merit attention and are summarized here.

## Pre-establishment

Unlike the US model BIT, the definition of “investment” in CJK Article 1(5) does not include the “pre-establishment” phase of investment.<sup>17</sup> Pre-establishment rights are intended to mitigate bureaucratic obstacles and discretionary requirements, for example, to “ensure that a potential foreign investor can obtain visas for its personnel to enter the host country, establish a temporary office for “scouting” purposes, receive equal treatment from government agencies on par with domestic or third country investors, and not be subjected to performance requirements as a condition of investment” (Bergsten, Hufbauer, and Miner 2014). This issue has been a major stumbling block in negotiations with the United States, as the US model BIT calls for national and MFN treatment for the entire investment process (subject to a few exceptions). This omission clearly dilutes the value of the pact for Japanese and Korean investors in China. As mentioned, China has not conceded pre-establishment rights in past BITs.<sup>18</sup> Within the China-Canada BIT and the China-New Zealand FTA investment chapter, national treatment is afforded only for the “expansion, management, conduct, operation

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14. For a summary of the S&ED meeting, see “Joint U.S.-China Economic Track Fact Sheet of the Fifth Meeting of the U.S.-China Strategic and Economic Dialogue,” US Department of Treasury, July 12, 2013, [www.treasury.gov/press-center/press-releases/Pages/jl2010.aspx](http://www.treasury.gov/press-center/press-releases/Pages/jl2010.aspx) (accessed on April 10, 2014).

15. “Around the Globe,” *Washington Trade Daily* 23, no. 25, December 23, 2014.

16. High expectations for the FTZ have been tempered by some skepticism. For example, the negative list released by Shanghai authorities is not seen as advancing market access substantially, as one US official explains, because it “largely mirrors China’s existing, very restrictive, foreign investment catalogue, and goes backwards in certain aspects.” See “Official: Shanghai FTZ Has Yet To Yield Major Results, Could Stall Reforms,” *Inside US Trade*, November 14, 2013, [www.insidetrade.com](http://www.insidetrade.com) (accessed on April 29, 2014).

17. In the CJK pact, “investment activities” are defined as the “management, conduct, operation, maintenance, use, enjoyment and sale or other disposition of investments.” Further, an “investor” is defined as one that “makes investments,” by contrast to one that “attempts to makes investments.”

18. Instead, foreign investors must be granted permission to invest in an industry or sector on a case-by-case basis consistent with the guidelines of China’s Foreign Investment Catalogue (Bergsten, Hufbauer, and Miner 2014).

and sale or other disposition of investments.”<sup>19</sup> In the China-Korea FTA—announced as “substantially concluded” in December 2014—services and investment obligations have yet to be released, but both sides committed “to launching negotiations on Pre-Establishment National Treatment and the negative list mode.”<sup>20</sup> But to what extent China will establish a meaningful precedent in the coverage of pre-establishment rights will depend on the scope of related exceptions called “nonconforming measures.”

## **Performance Requirements**

The prohibition of performance requirements in the CJK pact goes only marginally further than obligations already contained in the WTO Agreement on Trade Related Investment Measures (TRIMs), keeping within China’s past BIT practice (see Article 7). The CJK pact covers and defines performance requirements related only to exports and technology transfer; in contrast, the US model BIT includes more explicit and extensive policies, such as indigenous innovation (see Article 6).

## **Intellectual Property Rights**

The US model BIT defines investment to include IPR and mentions adherence to the WTO Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS). Notably, the CJK pact dedicates a specific article to IPR (Article 9). Specifically, the pact commits the CJK partners to protect IP and “establish and maintain transparent intellectual property rights regimes, and will, under the existing consultation mechanism [...] promote cooperation and communications among contracting Parties in the intellectual property field.” However, exceptions will likely limit the effective enforcement of ISDS obligations. Specifically, subparagraph 12(a-b) of Article 15 exempts the obligation quoted above from all arbitration procedures; instead, disputes in these areas can be subject only to “a competent court of the disputing Contracting Party.”

## **Transparency**

The CJK investment pact requires the publication of laws and regulations, and includes some language regarding incorporating “public commentary,” but does not specify the means for collaboration with private interest groups (Article 10). In contrast, the US model BIT contains much more specific language regarding transparency and public comment and provides more opportunity for investor involvement in consultation and collaboration (Articles 10 and 11). Specifically, the articles outline related administrative proceedings and review/appeal procedures and establish commitments that governments and nongovernment organizations will jointly develop standards and technical regulations.

## **Temporary Safeguards Provisions**

Unlike the US model BIT, the CJK investment treaty includes a balance of payments exception, essentially allowing the state discretion for instituting temporary safeguard measures (Article 19). This holds over from standard practice in many developing countries’ BITs but may undercut the pact’s commitments to free transfers as established in Article 13.

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19. MFN treatment, however, does apply both to pre-establishment and post-establishment investments. Since Canada and New Zealand generally extend national treatment to all phases of investment (i.e., includes pre-establishment rights) within its BITs with third parties, the MFN provision essentially assures that like treatment is extended to Chinese investors but not vice versa (Hadley 2013).

20. “Chinese Commerce Ministry Holds Press Briefing on China-ROK FTA Negotiations,” press release, November 20, 2014, <http://english.mofcom.gov.cn/article/newsrelease/press/201411/20141100811629.shtml> (accessed on December 30, 2014).

## Environment and Labor Standards

As mentioned previously, the revised US model BIT includes new obligations to enforce domestic labor and environmental laws. Notably, the CJK pact includes commitments to environmental standards (Article 23). This is a step forward; for example, the China-Canada BIT does not distinguish a separate article in this area but includes a standard general clause recognizing it is “inappropriate to encourage investment by waiving, relaxing, or otherwise derogating from domestic health, safety or environmental measures” (Article 18). However, compared with the US model BIT, the level of obligation in the CJK pact is weaker and the language aspirational, basing the commitment on “should” as opposed to “shall.” Further, no comparable commitment to labor standards exists. Japan and Korea did not press China hard in these areas, so there is a substantial gap between the “hard” obligations that the US Congress required be included in all US trade pacts since the May 2007 accord (see [Destler 2007](#)).<sup>21</sup>

## Investor-State Dispute Settlement

The CJK investment pact follows the standard practice of recent Chinese BITs in providing recourse to international arbitration for ISDS procedures. But ISDS procedures allow the state to require a disputing investor to go through a domestic administrative review procedure (not to exceed four months) before a claim can be submitted to arbitration. Exceptions to ISDS procedures are carved out for claims involving IPR, as well as prudential measures taken that relate to financial services—this is a customary exception. The US perspective is that investment obligations are not generally effective without ISDS procedures—with the exception of the US-Australia FTA, all US investment chapters have included ISDS. The United States would likely be flexible regarding exceptions for specified prudential measures but less so regarding issues like IPR.

## CONCLUSION

The CJK investment agreement falls short of establishing protections as comprehensive as those in the US model BIT. That said, the pact does establish nondiscriminatory national and MFN treatment for post-establishment investment; ensures investments are afforded “fair and equitable treatment and full protection and security”; ensures safeguards against expropriation and the provision of prompt and adequate compensation; and creates a functional investment dispute settlement mechanism. In particular, the inclusion of commitments to prohibit performance requirements, enhance transparency, and provide intellectual property protection, albeit limited, is progress toward a more transparent climate for Japanese and Korean investors in China. Indeed, the CJK agreement could provide new FDI opportunities for Japanese and Korean firms as the investment environment in Northeast Asia becomes more liberalized and investment opportunities shift as China moves up the value-added chain.<sup>22</sup> Whether investors will be able to capitalize on any advantages in the Chinese market may turn importantly on enforcement regarding IPR and technology transfer provisions.

The signing of the investment agreement could also be seen as an achievement for overcoming ongoing political tensions between China, Japan, and Korea. Economic relations between the three countries had largely proceeded without the baggage of political frictions dating back over a century. However, the firewall blocking political feuds from infecting commercial relations has shown signs of breaking down. Following Japan and Korea’s diplomatic quarrels over the disputed Dokdo/Takeshima Islands, Japan hinted it could roll

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21. The political agreement reached between the Democratic leadership and the Bush administration in May 10, 2007, established enhanced provisions covering labor, environment, and intellectual property, among other issues, for US FTAs.

22. With increasing wages and production costs among other structural changes, the offshoring of labor-intensive manufacturing to China has slowed as China has seen a shift of investment toward high-technology areas; see [UNCTAD \(2013\)](#).

back its emergency currency swap arrangement with Korea and stop buying Korean government bonds.<sup>23</sup> In 2010, China issued a rare earth embargo against Japan following the Daiyo/Senkaku Islands fishing trawler collision.<sup>24</sup> These incidents serve as a reminder that in the case of China, Japan, and Korea, the economics component in the emerging trilateral partnership must be even more substantial to overcome political frictions and wariness from historical experience. And as key competitors of each other both economically and politically in the region, the countries must tread now even more carefully in their bilateral relations. The development of these incidents could be a critical factor in the coming months and have stalled the timeline of the CJK FTA talks.

As the first document on trilateral cooperation between the three countries, the investment agreement has been interpreted as the “bridge” for CJK FTA negotiations, with hopes that a trade deal would further elevate investment commitments. But whether the three sides will make meaningful strides toward setting liberalization precedents for the region is yet to be seen. Parallel initiatives in the region, including the China-Korea FTA talks and RCEP talks (and of course, this includes the TPP talks for Japan and possibly Korea) may take precedence in the countries’ respective negotiating priorities. Indeed, this has been the case for the China-Korea talks, which both sides “substantially concluded” at the end of 2014.

In sum, given the scope of liberalization compared with the US model BIT and prospective TPP, our assessment concludes that in practice, the CJK investment pact is not likely to be a foundation for the US-China BIT. That said, incremental liberalization within Northeast Asia is an important contribution to greater economic integration in the region and likewise an important signal of China’s intentions to move forward with a more ambitious investment agenda.

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23. Some have considered these threats by Japan as mere “cheap talk.” See Tomasz Janowski, “Japan hints at economic action in South Korea island feud,” Reuters, August 21, 2012, [www.reuters.com/article/2012/08/21/us-japan-korea-idUSBRE87K06H20120821](http://www.reuters.com/article/2012/08/21/us-japan-korea-idUSBRE87K06H20120821) (accessed on April 10, 2014).

24. See “Of metals and market forces: Is China’s grip on essential minerals loosening?” *Economist*, February 4, 2012, [www.economist.com/node/21546013](http://www.economist.com/node/21546013) (accessed on April 10, 2014).

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# STATE-OWNED ENTERPRISES AND COMPETITION POLICY: THE US PERSPECTIVE

SEAN MINER AND GARY CLYDE HUFBAUER

Efforts to achieve a bilateral investment treaty (BIT) between the United States and China were stalled for years, until a breakthrough at the US-China Strategic and Economic Dialogue in Washington in July 2013. China agreed to two steps long demanded by the United States, reviving the talks. First, China agreed in principle to negotiate a regime allowing US companies to invest in China on the same terms as domestic firms, known as pre-establishment national treatment. Second, China agreed to include in an eventual accord a “negative list” of economic sectors or industries in which foreigners would be prohibited from investing, rather than listing only those industries where foreigners could invest, potentially ending a regime that has led to confusion and arbitrary treatment by Chinese authorities in the view of US businesses.

Since the breakthrough of 2013, both the United States and China have been optimistic that they can strike a deal in the near future. Both sides hope to expand investment from what seems to be an artificially low level, removing barriers to trade, establishing protections for private investors in China, and improving the investment environment in both countries.

A BIT has long been desirable. Direct investment between the two countries is paltry when compared with US and Chinese investments in other parts of the world. US foreign direct investment (FDI) stock in China was \$54 billion in 2012, less than 2 percent of total US FDI,<sup>1</sup> while Chinese FDI in the United States was \$47.5 billion in 2014, less than one-tenth of China’s total outward stock.<sup>2</sup> There is clearly pent up demand for more bilateral investment, which a US-China BIT could facilitate.

Large hurdles are in the way, however. The United States feels that China’s application of its antimonopoly law (AML) favors Chinese private and state-owned firms when assessing large mergers as well as alleged anticompetitive behaviors. Moreover, they feel China’s state-owned enterprises (SOEs) enjoy unfair advantages ranging from cheap land, low-interest loans, subsidized inputs, to favorable regulation. The United States has backed US businesses in their pushing back against imports from Chinese firms it believes are unfairly subsidized, including using countervailing duties on products imported from those firms.

A US-China BIT would have to address all these US concerns: subsidies and other unfair advantages for SOEs, and uneven application of competition policy, which US groups argue tilt the investment playing field toward China. Many experts disagree about whether state-owned and state-supported enterprises are fading in importance in the Chinese economy. But few would argue that they are going away altogether. For a successful BIT, however, China will have to address these US concerns.

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SEAN MINER is China program manager and research associate at the Peterson Institute for International Economics.

GARY CLYDE HUFBAUER has been Reginald Jones Senior Fellow at the Peterson Institute for International Economics since 1992.

1. Data are from US Bureau of Economic Analysis.

2. Data are from Rhodium Group.



The United States would like to see provisions in the treaty that ensure China's SOEs act in accordance with commercial considerations only. These include confining SOE behavior to normal business practices of private firms and certifying that special powers handed to SOEs are covered in the BIT, such as when SOEs control ports, ensuring they provide services equally, including for import licenses and fees charged. Making sure SOEs treat imports the same as domestically produced products and services when making procurement decisions is also a priority, as well as increasing the transparency of SOE actions. The United States would also like assurances that China's antimonopoly regulators will not unfairly target US firms when assessing anti-competitive practices. We describe these issues more in depth later.

## CHINA'S STATE-OWNED ENTERPRISES

The state-owned sector has a long history in China, but the role of SOEs has declined in relative terms since China's turn towards a market-oriented economy during the Deng Xiaoping era. Many types of SOEs coexist in China, including fully state-owned enterprises, collective enterprises, joint enterprises, and shareholding limited corporations. Local or state governments retain at least some control in almost all of these entities. However, China's State-Owned Asset Supervision and Administration Commission (SASAC) of the State Council, formed in 2003, controls over 110 of China's biggest SOEs. These SOEs earned nearly \$4 trillion in 2013, a staggering amount that shows just how much influence only a few firms have in the marketplace. The "local" SOEs, of which there are more than 100,000, control over \$13 trillion in assets.<sup>3</sup>

State ownership was on the wane in China until 2003, when a policy change slowed the decline in the number of SOEs. The dynamics of SOE assets have also changed recently. SOEs were supposed to be concentrated in seven key sectors, as explained by Li Rongrong in 2006<sup>4</sup>: defense, electricity, oil and petrochemicals, telecoms, coal, aviation, and shipping. Other sectors mentioned were equipment manufacturing, automobile manufacturing, electronics, constructions, steel, nonferrous metals, chemicals, surveying, and scientific research. But according to a study by the Paulson Institute, just half of SOE assets are in one of the above listed industries. The other half are in nonstrategic sectors like restaurants, retail, and low-end manufacturing.<sup>5</sup>

How China's AML deals with SOEs is an important matter, as it seems to be lenient with SOE operations. Article 7 of the law requires the state to "protect the lawful business activities" of SOEs in fields where they possess legal monopolies. This language confuses the mandate of the regulators. A report by the US Chamber of Commerce even suggests that Article 7 exempts entities under SASAC from regulation under the AML.<sup>6</sup> Indeed, decisions against SOEs under China's AML have been rare. This fact contributes to the claim that antimonopoly authorities in China scrutinize foreign firms more than their private domestic and state-owned competitors.

## ISSUES FOR THE US-CHINA BIT

How can a US-China BIT satisfactorily cover SOEs and competition policy? US negotiators would like to find a way to ensure that SOEs act with only commercial considerations in mind, both at home and abroad. In 2012 the US State Department published what is called a US model BIT. This document represents the basic US policy position for negotiating investment treaties with all countries and therefore sets the benchmarks for a US-China BIT. Three provisions in the US model BIT address SOE practices:<sup>7</sup>

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3. Andrew Batson, "Fixing China's State Sector," Paulson Policy Memorandum, January 2014.

4. Huanxin, Zhao, "China names key industries for absolute state control," *China Daily*, December 19, 2006, [www.chinadaily.com.cn/china/2006-12/19/content\\_762056.htm](http://www.chinadaily.com.cn/china/2006-12/19/content_762056.htm).

5. Batson, "Fixing China's State Sector."

6. See the US Chamber of Commerce report titled *China's Drive for Indigenous Innovation*.

7. United States Trade Representative, "2012 U.S. Model Bilateral Investment Treaty," [www.ustr.gov/sites/default/files/BIT%20text%20for%20ACIEP%20Meeting.pdf](http://www.ustr.gov/sites/default/files/BIT%20text%20for%20ACIEP%20Meeting.pdf).

*Delegated government authority (Article 2: Scope and coverage):*

- The article clarifies circumstances in which a Party has delegated government authority to an SOE or another entity, to ensure that the actions of SOEs are fully covered by the BIT obligations.
- Government authority that has been “delegated” includes a legislative grant, government order, directive, or other action transferring government authority to the SOE. This happens when SOEs are in charge of important areas of the economy, like ports, and are in charge of issuing import licenses and charging fees.

*Domestic technology requirements (Article 8: Performance requirements):*

- The article contains disciplines to prevent Parties from imposing domestic technology requirements (e.g., require the purchase, use or accord a preference to domestically developed technology) that would advantage a Party’s own investors, investments or technology. This addresses situations when a government mandates firm in certain areas of the economy, like information technology, that they must purchase domestically produced goods, like domestically produced servers rather than imported ones.

*Participation in standard-setting (Article 11: Transparency):*

- Parties are required to allow investors of the other Party to participate in the development of standards and technical regulations on non-discriminatory terms. Some countries designate standards other than internationally recognized standards in order to facilitate growth of domestic industries.
- Non-governmental standard setting bodies are required to follow this guideline.

But more language on investment-related issues is needed. US negotiators want to ensure that regulators and SOEs treat US firms in China fairly and that SOEs doing business in the United States are not acting on behalf of the government. Adding language along the following lines, drawn from *Bridging the Pacific*, would be useful:<sup>8</sup>

“in accordance with commercial considerations” shall mean free from government influence and consistent with the normal business practices of privately-held enterprises in the relevant business or industry.”

In addition, language similar to the Singapore-US FTA Article 12.3(1)(c)(iv), on the abuse of a monopoly position, but extended to oligopolies, is needed.<sup>9</sup> So is a section on national treatment for firms of both countries to ensure that SOEs treat imports of goods and services the same as domestically produced goods and services.

Treaty rules alone will not suffice to relieve the concerns of the US government and firms; effective enforcement mechanisms are also needed. Dispute settlement provisions should enable each country, and its firms, to enforce the BIT rules. The exact nature of these enforcement mechanisms must be negotiated with care.

US officials and firms want to see greater transparency in SOE operations and a level playing field between SOEs and private firms. These goals can be accomplished in many ways.

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8. See C. Fred Bergsten, Gary Hufbauer, and Sean Miner, *Bridging the Pacific: Toward Free Trade and Investment Between China and the United States* (Washington: Peterson Institute for International Economics, 2014).

9. Article 12.3(1)(c)(iv) obligates a monopoly entity to “not use its monopoly position to engage, either directly or indirectly, including through its dealings with its parent, subsidiaries, or other enterprises with common ownership, in anticompetitive practices in a non-monopolized market in its territory that adversely affect covered investments.”

- Impartial regulators and impartial regulation are paramount.
- Governments should submit their SOEs to the jurisdiction of other countries when they engage in commercial activities within the latter’s jurisdiction (in other words, SOEs should not claim “foreign sovereign immunity”).
- Covered SOEs should not be allowed to combine different lines of business more than any private company with which it competes would be allowed under domestic competition law.
- Financial accounts should be published in a timely manner according to International Financial Reporting Standards (IFRS).
- Procurement practices should be nondiscriminatory, in accordance with China’s World Trade Organization (WTO) commitments (Article 46 of the Working Party Report on the Accession of China), and purchases from domestic and foreign suppliers should be disclosed periodically.
- Leading officers and all directors, and their past and present connections to government office, should be disclosed.
- Policy directives or suggestions received from government officials should be disclosed. An exemption for any SOE from any measure, regulation, or law should be published and made available on request to any Party or interested person of such other Party.
- Loan terms from state-owned banks and all transactions with other state-owned companies should be disclosed.
- Tax payments and preferences, and any incentives or subsidies received from the central, state or provincial governments, should be disclosed.<sup>10</sup>
- Parties should agree as to which SOEs will be considered “public bodies” for determining whether payments or concessions they make to other Chinese firms qualify as subsidies under the WTO Agreement on Subsidies and Countervailing Measures (ASCM).
- SOEs should be fully subject to antibribery and anticorruption laws and laws relating to the protection of intellectual property and should act in accordance with international standards.

Whether US negotiators will try to insert such provisions in the BIT is unknown, but some of them are likely to be included in the Trans-Pacific Partnership (TPP).

## SOE INVESTMENTS IN THE UNITED STATES

The perception is that China’s SOEs have not invested much in the United States, or that investments from China’s SOEs are not welcome. Evidence does not support these statements. Of the total of 896 investments from China in the United States, 249 were by Chinese SOEs, about 27 percent of the total. The SOE deals were generally larger than the deals of private Chinese investors, accounting for 42 percent, or over \$18 billion, of total investments from China. Of the 249 SOE investments, 177 were greenfield investments, investments in new facilities and factories rather than purchases of existing companies, worth \$2.5 billion, while the other 72 were acquisitions, accounting for \$15.5 billion.<sup>11</sup> Acquisitions in the energy industry accounted for more than half the value of SOE investments. However SOEs invested across a wide variety of sectors, including aviation, information technology, health and biotech, basic materials, and real estate. The Rhodium Group broadly

10. The Canada-EU FTA (CETA) has draft provisions that limit preferential financing for SOEs. Similar provisions could be an issue in a China-US FTA. In any event, with proper disclosure, competing foreign companies that lose sales will be better positioned to bring trade remedy cases (antidumping and countervailing duties).

11. Data from the Rhodium Group’s China Investment Monitor, <http://rhg.com/interactive/china-investment-monitor> (accessed on December 22, 2014).

defines “government-owned” to include any firm with more than 20 percent government ownership. Even so, plenty of big name-brand Chinese SOEs have successfully invested in the United States.

State-owned China National Offshore Oil Corporation (CNOOC) is a prominent example. Although it failed in its bid for Unocal in 2005 because of political opposition from members of the US Congress, CNOOC now has investments worth over \$3 billion in the United States. CNOOC changed strategy and began investing in minority share positions and entering into joint ventures with US firms. In another case, TPCO America, a subsidiary of state-owned Tianjin Pipe Corporation made a greenfield investment in Texas of more than \$1 billion. TPCO is building a massive plant for processing steel into pipes, creating more than a 1,000 jobs in the process. State-owned AVIC Automobile Industry Holding Company is a majority owner of US-based Nexteer and helped it become a powerful supplier to US auto manufacturers. Dozens of Chinese state-owned firms have invested in the United States, and each has adopted a strategy backed by experience and flexibility.

## **INVESTMENT ISSUES WHEN SOEs DO BUSINESS ABROAD**

The main cause of anxiety from SOEs investing abroad is that their intentions are not transparent. Because of this opaqueness, many US observers expect worst-case scenarios, for example, that SOEs may be acting to fulfill the foreign policy goals of their government. Any host country would object to such behavior, since SOE investments could undermine its national security. Moreover, SOEs could collude in their international business deals, for example, by not bidding against each other when attempting acquisitions abroad. In 2011, China’s Ministry of Commerce (MOFCOM) and SASAC signed a memorandum of collaboration to coordinate when making acquisitions abroad in order to “prevent unhealthy competition.”<sup>12</sup> Observers also speculate that SOEs don’t act fairly in their home business environment, by favoring national firms over foreign firms in their procurement decisions.

SASAC’s market power abroad raises other issues. The European Commission decided to treat all the enterprises managed by SASAC as a single corporate entity, since the Communist Party is the controlling shareholder of all of them. This makes sense because of SASAC’s latent market power: If one entity under SASAC is engaging in business in a foreign country, it seems unlikely that another SASAC entity in the same sector would enter that same market and attempt to compete against its SASAC “cousin.” Moreover, SASAC firms acting together can wield significant market power, for example, by refusing to purchase from certain firms or by purchasing only from each other.

An underlying issue is the transparency of SOE business dealings. The US government wants to ensure that SOEs operating abroad do so with only commercial considerations in mind. It also wants to guard against collusive and unfair practices. These goals are difficult to achieve when SOE operations are shrouded in mystery. However, SOEs are required to notify the Committee on Foreign Investment in the United States (CFIUS) of all mergers and acquisitions involving US assets. This requirement ensures a high level of transparency for SOEs doing business in the United States, but it does not ensure transparency for SOE business practices in the Chinese home market.

## **COMPETITION POLICY**

A competitive business environment helps deliver lower prices to consumers and fosters innovative firms. GATT and WTO rules have helped create a competitive framework for world trade but a well written and executed competition policy goes a long way to building a solid foundation for that framework. Global com-

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12. See “MOFCOM and SASAC Signed Cooperation Memorandum to Regulate State-Owned Enterprises’ Going-Out,” Xinhua News Agency, August 23, 2011, [http://news.xinhuanet.com/politics/2011-08/23/c\\_121900567.htm](http://news.xinhuanet.com/politics/2011-08/23/c_121900567.htm) (accessed on December 17, 2014).

petition laws have been converging over the last decade or so, and indeed China's AML, enacted in 2007, is on par with its Western counterparts. This important step allows investors and multinational firms to feel more at ease when doing business in China; however, implementation of this law has been inconsistent and merits further analysis.

Three institutions are in charge of implementing competition policy in China. The National Development Reform Commission (NDRC) is responsible for price-related anticompetitive behavior. The State Administration for Industry and Commerce (SAIC) is responsible for determining if firms abuse their dominant market position, for example, when a firm uses monopolistic powers to stifle competition. MOFCOM is in charge of regulating mergers and acquisitions.

One of the main concerns of the US business community has been MOFCOM's approach to evaluating mergers by foreign firms compared with mergers by SOEs. Two of the complaints have been that MOFCOM has been very slow to clear mergers and that when most mergers involving foreign companies are cleared, unusual conditions are placed on the transactions (table 1). The *Wall Street Journal* article from April 1, 2014, highlighted these points, commenting that merger advisors recommend, where possible, to bypass or minimize a MOFCOM review.<sup>13</sup> The Chinese review process seemingly goes well beyond the scope of other competition authorities, which generally focus on the national economic interest. For example, the article states that for deals involving energy, technology, and food, MOFCOM consults with other Chinese government ministries to gather and assert conditions that may not be directly linked to antitrust concerns. In the Glencore-Xstrata merger the parties were forced to sign a long-term contract to supply Chinese customers copper at a certain price, an unusual request for a competition agency. Another report suggests that MOFCOM asymmetrically targeted foreign companies for merger reviews compared with Chinese companies.<sup>14</sup>

The NDRC has also made multinational corporations operating in China nervous because of its aggressive pursuit of lowering prices. A string of penalties in 2013 against foreign multinationals, involving fines in the range of hundreds of millions of dollars, as well as TV and newspaper exposés against overpriced foreign products (coffee and automobiles), has prompted some foreign observers to question the motives of the NDRC. Moreover, a report by Reuters in August 2013 stated that, in the previous month, the NDRC held a conference with around 30 companies to convey that if the NDRC initiates an investigation against one of the companies, then the companies should not use external lawyers to fight the regulators. The NDRC division chief Xu Xinyu also put pressure on firms to "confess" if they came under investigation.<sup>15</sup> These tactics are seen as highly suspect and inconsistent with international norms. Agencies like the NDRC should instead focus on uncovering price cartels and not on firms that fairly charge high prices because they sell a higher-quality or a more convenient product.

A US-China BIT could address these competition policy related issues by following investment provisions in the Korea-US Free Trade Agreement (KORUS). Provisions in the FTA guarantee procedural fairness in applying competition statutes, allowing US firms to challenge competition-related charges against them. KORUS allows for an institutional channel for bilateral consultations and cooperation on competition-related matters. Dispute settlement provisions in KORUS permit consultation and resolution of certain competition policy related matters, for example, designated monopolies, state enterprises, differences in pricing, and transparency. If an issue arises and 60 days have passed since consultations have been requested, then a three-person

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13. Tom Fairless, Brent Kendall, and Cynthia Koons, "China Puts the Brakes on Global Mergers," *Wall Street Journal*, April 1, 2014, <http://online.wsj.com/news/articles/SB20001424052702304157204579473500128825052> (accessed on May 6, 2014).

14. Mario Mariniello, *The Dragon Awakes: Is Chinese Competition Policy a Cause for Concern?* Bruegel Policy Contribution, October 22, 2013.

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**Table 1 Mergers involving foreign companies blocked or conditionally approved by MOFCOM's antimonopoly law, 2008–13**

Date	Acquirer	Target	Condition
4/23/2013	Marubeni	Gavilon	Agriculture: MOFCOM requires Marubeni and Gavilon to set up two independent legal entities for exporting and selling soybeans in the Chinese market.
4/16/2013	Glencore	Xstrata	Mining: MOFCOM requires Glencore to divest all its equity in Las Bambas copper mine and provide specific contract offers of copper, zinc, and lead concentrate products to Chinese customers.
12/16/2013	ARM, Giesecke & Devrient, Gemalto		Secured services for connected devices: MOFCOM requires ARM to abide by nondiscrimination rules and release codes and other information for its TEE (trusted execution environments) technology.
8/14/2012	Walmart	Xstrata	Online retailing: MOFCOM requires that the acquisition is limited to direct sales segments of Yihaodian and places restriction on network platform and structure use.
6/15/2012	United Technologies	Goodrich	Aircraft: MOFCOM requires Goodrich to divest its power systems business.
5/19/2012	Google	Motorola Mobility	Telecommunications: MOFCOM requires Google to license Android free of charge and in open source, to treat all original equipment manufacturers in a nondiscriminatory manner, and to continue to comply with obligations on patents and license them in a fair, reasonable, and nondiscriminatory way.
3/2/2012	Western Digital	Viviti (Hitachi GST)	Hard disk drive: MOFCOM requires Western Digital to divest the 3.5 inch HDD business under Viviti and maintain Viviti as an independent competitor.
2/10/2012	Henkel	Tiande Chemical	Chemicals: MOFCOM requires Tiande to supply products to all downstream customers in a "fair, reasonable and nondiscriminatory" manner.
12/12/2011	Seagate	Samsung	Hard disk drive: MOFCOM requires Samsung hard disk drive to remain an independent competitor.
11/10/2011	GE China	CSCLC (Shenhua)	Coal to liquid fuel: MOFCOM prohibits the joint venture from forcing use of its technology through restricting supply of raw coal or raising cost of other technologies.
10/31/2011	Alpha V	Savio	Textile machinery: MOFCOM requires Alpha V to divest its shares in Uster.
6/2/2011	Uralkali	Silvinit	Potash: MOFCOM requires the joint venture to maintain current sales and operations procedures when supplying potassium chloride to customers in China.
8/13/2010	Novartis	Alcon	Pharmaceuticals: MOFCOM requires Novartis to cease sales of Infectoflam in China and terminate contracts with Shanghai Shikang and Haichang.
10/30/2009	Panasonic	Sanyo	Electronics: MOFCOM requires Sanyo to divest all its rechargeable coin-shaped lithium battery operations and nickel-metal hydride battery operations in Japan, and Panasonic to divest its nickel-metal hydride battery operations and to reduce ownership in PEVE, an offshore joint venture.
9/29/2009	Pfizer	Wyeth	Pharmaceuticals: MOFCOM requires Pfizer to divest Respisure and Respisure One brand businesses in China.
9/28/2009	GM	Delphi	Automotive: MOFCOM requires GM not to seek commercial information on Chinese companies from Delphi, both to continue supplying Chinese customers in a nondiscriminatory way and for GM to continue complying with multisourcing and nondiscrimination principles in purchasing.
4/24/2009	Mitsubishi Rayon	Lucite	Chemicals: MOFCOM requires Lucite International (China) Chemical Industry Co., Ltd. to divest upfront 50 percent of its annual methyl methacrylate production.
3/18/2009	Coca-Cola	Huiyuan	Beverages: MOFCOM blocks the proposed acquisition, citing adverse effects on competition in China's beverage sector as the reason.
11/18/2008	Inbev	Anheuser-Busch	Brewing: MOFCOM requires Anheuser-Busch to not increase its existing 27 percent stake in Tsingdao Brewery, Inbev to not increase its existing 28.56 percent stake in Zhujiang Brewery, and the merged company not to hold any stake in China Resource Snow Brewery or Beijing Yanjing Brewery.

Source: China's Ministry of Commerce (MOFCOM), June 26, 2013, <http://fldj.mofcom.gov.cn/article/ztxx>.

panel hears both parties' arguments. After a specified period, the panel issues a decision. If the party at fault does not implement the decision, then monetary benefits may be awarded to the complaining party.

This process could be extended to decisions by the NDRC or MOFCOM relating to a US firm. In exceptional cases, a panel process would call for reconsideration of a decision. Of course, this process would have to extend to decisions by the Justice Department or the Federal Trade Commission, and possibly covering cases arising from private rights of action, which represent the majority of cases in the United States. While all this may seem unlikely, it would represent a progressive stance by both countries and a commitment to market-based competition. National security decisions would not be included in these panel reviews. Competition policy agencies would have to engage in extensive consultations when a complaint is initiated before invoking a panel. If a complaint were solely between an SOE and a private enterprise, then the dispute panel could act as an appellate body with power to remand decisions to the relevant national court. We see this as a last resort, and its presence might ensure transparency in competition policy related decisions.

## CONCLUSION

US officials are keen to ensure that what is promised in the BIT in terms of market access for foreign firms in China, and the behavior of SOEs, is realized in practice.

US officials and businesses want answers to the following questions: Do SOEs escape strict review from MOFCOM in mergers and acquisitions? A clearer understanding of Article 7 of AML is needed. Are foreign firms being unfairly targeted for their pricing practices? Where do SOEs get their financing, at what rates? Are SOEs selling products to domestic firms at the same price as they charge foreign firms? Who really has control of each SOE, who is giving directives, and how is ownership split?

Adam Posen, president of the Peterson Institute for International Economics, stated in a speech at the China Development Forum Economic Summit in March 2014 that SOEs must feel sufficient pressure from competing private firms in order to innovate and adapt to the modern business environment. Antimonopoly authorities must look beyond consumer price protection and focus on the broader role of monopolies and oligopolies. SOEs may be suitable for certain industries, for example, utilities, but they can create unnecessary barriers to investment and competition in finance, media, information technology, and transportation. Posen posited that dominant SOEs in the service sector may limit business opportunities for smaller enterprises and thereby undermine the overall vitality of the economy. Opening the banking sector will allow alternative forms of financing, consistent with the goal announced in the Third Plenum of the 18th Chinese Communist Party Congress of encouraging loans to small businesses. Posen also recommended that corporate governance of SOEs and large Chinese corporations be improved, including reforms to corporate tax law, shareholder rights, auditing, and outside directors. The Third Plenum also opened the door to private ownership of some SOEs.

These steps would go a long way toward establishing good relations between foreign firms and the Chinese government. A robust US-China BIT can improve trust and increase investment.

# ROLE OF A BILATERAL INVESTMENT TREATY IN INCREASING TRADE IN SERVICES BETWEEN CHINA AND THE UNITED STATES

J. BRADFORD JENSEN

Completion of a US-China bilateral investment treaty (BIT) offers an important opportunity for the United States and China to increase their trade in business services. The United States needs to export more to overcome its persistent, large trade deficit with China. China is handicapped by its small, inefficient business service sector and would benefit by importing efficient, leading-edge services in engineering, design, development, testing, marketing, advertising, logistics, and distribution to upgrade the sophistication of its manufactured goods. Both countries would gain from increased trade in business services.

Contrary to popular perception, business services are tradable and the United States has a comparative advantage in them (Jensen 2011). Yet, in spite of its large and globally competitive business service sector, the United States exports less of its business service output than it exports of its manufacturing output. China, for its part, needs to import more services to make its economy more driven by domestic consumer spending rather than exports. But China has relatively high barriers to service trade.

The two countries can address some of these impediments in their negotiation for a US-China BIT. Foreign direct investment (FDI) can spur Chinese imports of services. To understand how a BIT can facilitate Chinese service imports, consider the four modes of trade in services, as defined in the General Agreement on Trade in Services (GATS), negotiated as part of the Uruguay Round establishing the World Trade Organization (WTO) in 1995. Obviously, consumption abroad—for example, when a vacationer travels to a resort in another country and purchases hotel accommodations, meals, and other services there—would be a mode of service “export” unaffected by a BIT. But three other types of trade in services would be affected. For example, cross-border sales of services—i.e., when software is produced in one country and shipped via the internet to another—can be facilitated by a foreign-owned firm in China. In addition, expanded FDI can permit investors to open a branch of a chain of restaurants or retail outlets outside its home country. Reducing curbs on FDI can also expand the temporary movement of natural persons across borders, for example, when a business consultant travels to visit a foreign client.

Policies that restrict the entry of foreign firms into China are an obvious impediment to establishing a commercial presence. But foreign investment restrictions are also likely to impede the other modes of service trade, because having a presence in the foreign market—even if it is only a sales or technical support office—is likely to facilitate all types of trade. If, for example, foreign architectural firms are prevented from establishing an office in China, it might be difficult to export architectural services to China—even though most of the design work would be done in the United States and transmitted electronically to China (mode 1 trade) supported by periodic visits of the senior architects (via mode 4 trade). While services can be traded through

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J. BRADFORD JENSEN, senior fellow at the Peterson Institute for International Economics, is professor of economics and international business at the McDonough School of Business at Georgetown University.



various modes, the ability to establish a physical presence in a large market is important for the export of many service activities (even those that are predominantly digital). Increasing foreign firms' access to China through a US-China BIT is an important precondition to increasing service trade.

As discussed in other essays in this Briefing, FDI in China is governed by a welter of rules tailored for each sector. Some sectors are encouraged, some permitted, some restricted, and some prohibited. The Organization for Economic Cooperation and Development's (OECD) Services Trade Restrictiveness Index notes that many service sectors face FDI restrictions. These restrictions need to be reduced in a US-China BIT for a broad range of sectors. The BIT should adopt a "negative list" approach, listing only the sectors where foreign investment may be restricted. China has agreed to a negative list approach in the BIT. The United States must insist that this list be short.

The lack of data on the service sector, compared with the agriculture and manufacturing sectors, hampers empirical analysis of the sector in China and indeed elsewhere. Also, the links between sectors are not well understood. The evidence does suggest, however, that China and the United States would both benefit from increased service trade. China would gain from better and less expensive intermediate imports from countries with a comparative advantage in these activities, increasing its productivity in the manufacturing and service sectors. The United States would benefit from the opportunity to export to a large and fast-growing market.

## THE SERVICE SECTOR AND ECONOMIC DEVELOPMENT

The service sector is diverse, encompassing activities such as hotels, travel, tourism, education, hair salons, healthcare, finance, computer system design, architecture, engineering, accountancy, and attorneys, to name a few, and accounts for a large share of employment in many countries. The size of the service sector varies considerably in different countries. In the more advanced economies such as the United Kingdom and the United States, the service sector employment share is greater than 70 percent. Singapore and South Korea also have high employment shares. In China and India, countries with lower per capita incomes, the service sector accounts for only about a third of employment ([Jensen 2013](#)).

Economic research has shown that the larger the service sector is, the higher living standards are in that country, but this relationship does not hold for all services ([Eichengreen and Gupta 2009](#)). For example, "traditional services" (retail and wholesale trade, transport and storage, and public administration and defense) actually have a negative relationship with income per capita. But the relationship is positive for traditional and modern services consumed primarily by households (education, healthcare and social services, accommodation and restaurants, and other personal services) and for business services (including financial intermediation, computer services, communication services, and legal and technical services). Many of the services associated with higher levels of development require some type of commercial presence in the country to export services—even though increasing portions of the service are digitized. For example, while much of the value added in telecommunications is software, for a US telecom firm to provide high-end telecommunications services in China requires a physical presence there. Likewise for financial services, computer services, and legal and other scientific and technical services. While some or even much of the work would be done in the United States and "shipped" digitally to China, efficient sales and delivery of these services are often facilitated by the US firm having some kind of office in China.

Business services provide key intermediate inputs to a range of other sectors, including manufacturing. Banking, legal services, marketing, research and development, design, engineering, project management, software, and telecommunications are crucial inputs to other activities throughout the economy and have the capacity to improve the quality, efficiency, and competitiveness of firms. In addition, these services establish key links to the global economy, and as a result, they are key drivers of export growth (even of manufactured goods).

## Business Services are Different

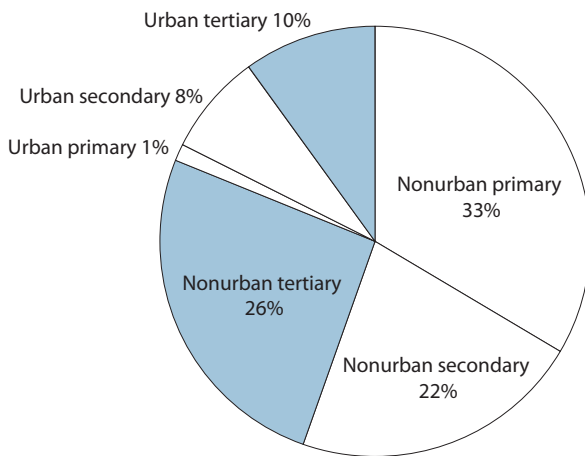
In addition to providing key intermediate inputs in many other sectors, business services are qualitatively different from personal services (NAICS 60s, 70s, and 80s) and from wholesale and retail trade (NAICS 40s). One important dimension on which business services differ from other service types (and even the manufacturing sector) is the share of workers with college and advanced degrees and their average wages.

Jensen (2011) reports the share of workers with a college or advanced degree for a range of US sectors and notes that business services are relatively education intensive. About 40 percent of workers in the business service sector have a college degree compared with 25 percent in the manufacturing sector. The share of workers with an advanced degree in business services is about double the share of manufacturing workers with an advanced degree. The fact that business services have higher educational and skill requirements is an important theme in this essay.

## Business Services in China and the United States

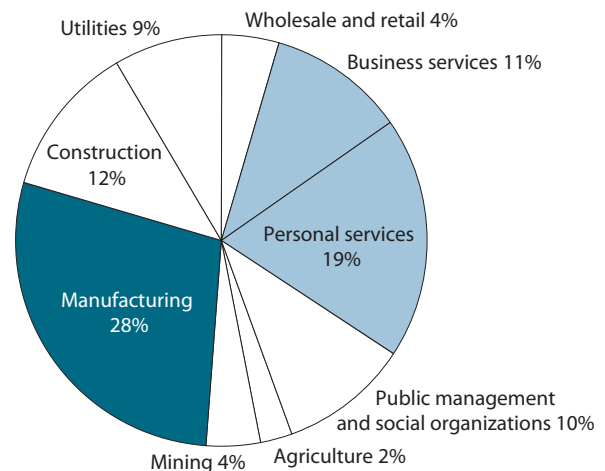
It would be desirable to compare the sizes of the business service sectors in China and the United States. Unfortunately, even this relatively aggregated level of data is not available for China's overall economy. Figure 1 shows the composition of the labor force for all of China with shares of total employment by sector and by urban/nonurban location. The tertiary (service) sector accounts for only about 36 percent of China's labor force. Figure 2 provides a more detailed breakdown of the labor force in urban China. Business services account for only about 11 percent. This share is less than half that in the United States. Assuming that nonurban tertiary services are unlikely to be "business" services, China overall would have an even lower share of employment in business services. Urban China has a different composition than China overall: In the country as a whole, the primary sector accounts for 34 percent of employment; for urban China the primary sector accounts for only 1 percent. The business service sector in China is smaller than that in the United States, where it accounted for roughly 20 percent of the labor force in 2012.

**Figure 1 Employment by sector in China, 2011**



Source: National Bureau of Statistics of China, *China Statistical Yearbook 2011*.

**Figure 2 Employment in urban areas in China, 2011**



## China's Service Sector Has Relatively Low Productivity

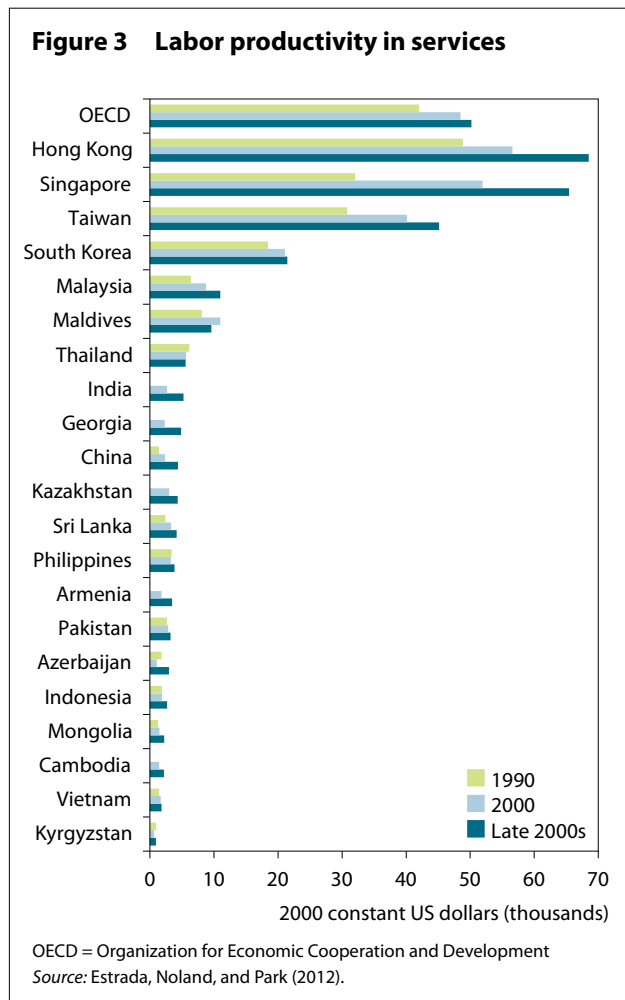


Figure 3, reproduced from [Noland, Park, and Estrada \(2012\)](#), reports labor productivity for a broad range of developing Asian countries and averages for countries in the OECD. They find labor productivity in China (and a number of other emerging Asian countries) in the service sector overall is significantly lower than the OECD average—labor productivity in China is less than one-fifth service sector labor productivity in the OECD. Given the importance of the service sector as an intermediate input to many other sectors, the low levels of productivity are likely to impede China's continued growth and development.

### Sources of an Underdeveloped Business Service Sector

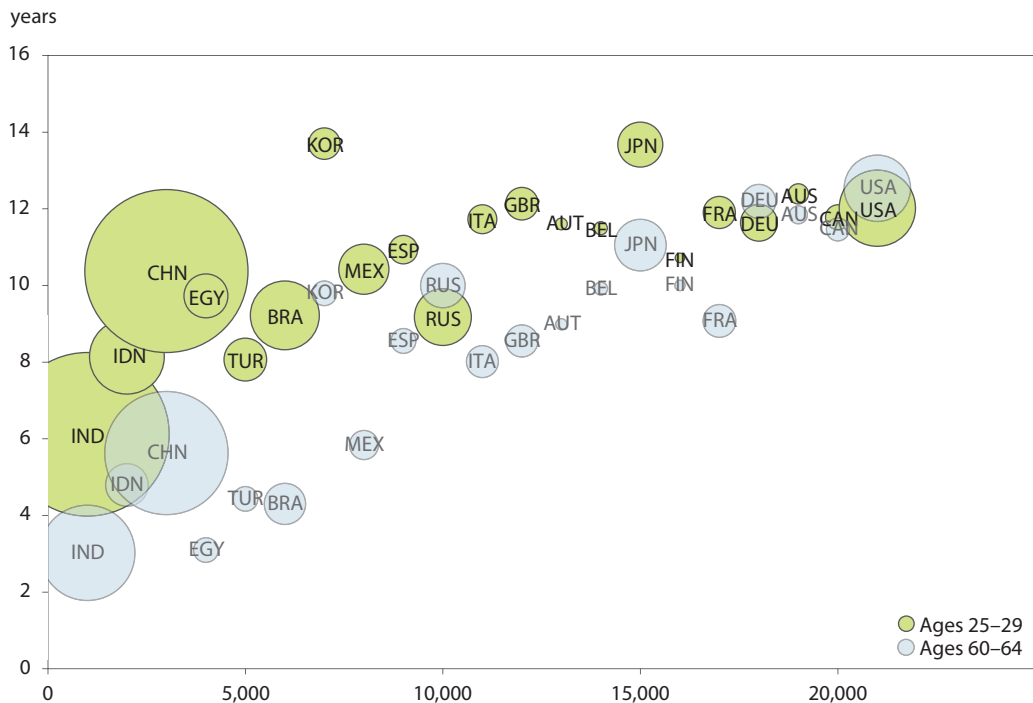
Why is the business service sector in China smaller than the US sector? Why is service sector labor productivity relatively low in China and other developing countries? Business services are skill intensive, and to understand the relative sizes of the business service sector, we need to examine information on educational attainment in the United States and China.

[Figure 4](#) shows the average level of educational attainment for selected countries for 60–64-year-olds (with the size of the bubble representing the size of the labor force) in 2010. The most striking feature is how big an outlier

the United States is in terms of educational attainment for the cohort of people at the peak of their careers. The United States has historically had an abundance of skilled workers. While it is difficult to prove definitively, it seems likely that the skill endowment patterns that have existed for at least the past 40 years have played an important role in shaping the size and productivity of the business service industries across countries. Because business services are skill intensive, countries with skilled workforces are likely to have larger (as a share of the labor force) and more productive industries. The historically relatively low levels of educational attainment in China are undoubtedly a prime contributor to the low level of development of business services.

However, history is not destiny. [Figure 4](#) also shows average educational attainment for the 25–29-year-old cohort for the same group of countries. Most striking is the dramatic increase in average educational attainment across a range of emerging markets. As educational attainment in China converges with that in the United States, the size and productivity of their business services will also likely converge. Thus, in the long run, increases in educational attainment will likely lead to higher productivity in the service sector and improved access to these important intermediate inputs, which will increase productivity throughout the economy.

**Figure 4 Average years of schooling by age cohort in selected countries, 2010**



AUS = Australia, AUT = Austria, BEL = Belgium, CAN = Canada, EGY = Egypt, BRA = Brazil, FIN = Finland, FRA = France, DEU = Germany, IND = India, IDN = Indonesia, ITA = Italy, JPN = Japan, KOR = South Korea, MEX = Mexico, CHN = China, RUS = Russia, ESP = Spain, TUR = Turkey, GBR = United Kingdom, USA = United States  
 Note: Bubble size indicates the size of the workforce.  
 Source: Barro and Lee (2010).

Previous research suggests that healthy and efficient business service industries are an important input into productivity and growth across an economy, so until increases in educational attainment work their way through the economy, growth prospects in China may be hampered by constraints on the availability of business services.

## OPPORTUNITIES TO TRADE BUSINESS SERVICES

What are the prospects for China and the United States to trade in business services? Jensen (2011) develops a new methodology to classify industries (and occupations) as tradable or nontradable and develops estimates of how much US service activity is potentially exposed to import competition and which service activities offer prospects for increased exports. A significant share of total employment is in tradable service industries. For example, more workers are in tradable business service industries alone (14 percent of all workers) than in tradable manufacturing industries (10 percent). True, some large service types (such as education, healthcare, personal services, and public administration) have low shares of employment in tradable industries; however, because the business service industry is much larger than the manufacturing sector, the amount of business service activity that is technically feasible to trade internationally is quite large.

## Characteristics of Workers in Tradable Service Industries

Workers in tradable activities are different from workers in nontradable activities, and the differences are striking (table 1). Workers in tradable service activities are on average more educated than those in nontradable activities. The share of workers with a college degree in tradable services is double that in nontradable services (and double that in manufacturing); the share of tradable service workers with advanced degrees is also double that in the others.

The high level of skill intensity in tradable business services suggests that countries with high levels of skill abundance will have comparative advantage in business service production. This suggests the United States should have comparative advantage in business service production. Indeed, the United States is the largest service exporter and runs a persistent trade surplus in services.

**Table 1 Worker characteristics for selected industries**

Characteristic	Nontradable industry	Tradable industry
<b>Manufacturing (NAICS 30s)</b>		
Number of workers	2,235,432	12,994,490
Average annual earnings	\$44,014	\$49,952
Share with bachelor's degree (percent)	16	24
Share with advanced degree (percent)	3	7
Share in tradable occupations (percent)	26	34
<b>Professional services (NAICS 50s)</b>		
Number of workers	8,038,246	18,430,199
Average annual earnings	\$42,226	\$66,454
Share with bachelor's degree (percent)	29	50
Share with advanced degree (percent)	7	17
Share in tradable occupations (percent)	31	60

NAICS = North American Industrial Classification System

Source: Jensen (2011).

## Comparative Advantage and Gains from Trade

The data presented above show that China has smaller business service industries than the United States and also generally lower labor productivity in services than the OECD. These differences suggest the United States has a comparative advantage over China in tradable business service production.

Yet, in spite of comparative advantage in these activities, a persistent and growing trade surplus in services, and globally competitive service firms, US service sector export performance significantly lags the export engagement of the US manufacturing sector. Gary Hufbauer, Bradford Jensen, and Sherry Stephenson (2012) report that tradable business service exports-to-sales ratios are significantly lower than the exports-to-sales ratio in manufacturing (4 percent versus 20 percent). Jensen (2011) reports that the share of business service establishments that export also significantly lags the share of manufacturing plants that export.

China should be importing more services relative to GDP than developed economies. This does not, however, appear to be the case. Jensen (2011) reports that about two-thirds of US business, professional, and technical service exports go to the developed world. What are the potential sources of the mismatch between China's needs for low-cost, efficient business services and the low levels of service imports?

## IMPEDIMENTS TO TRADE IN SERVICES

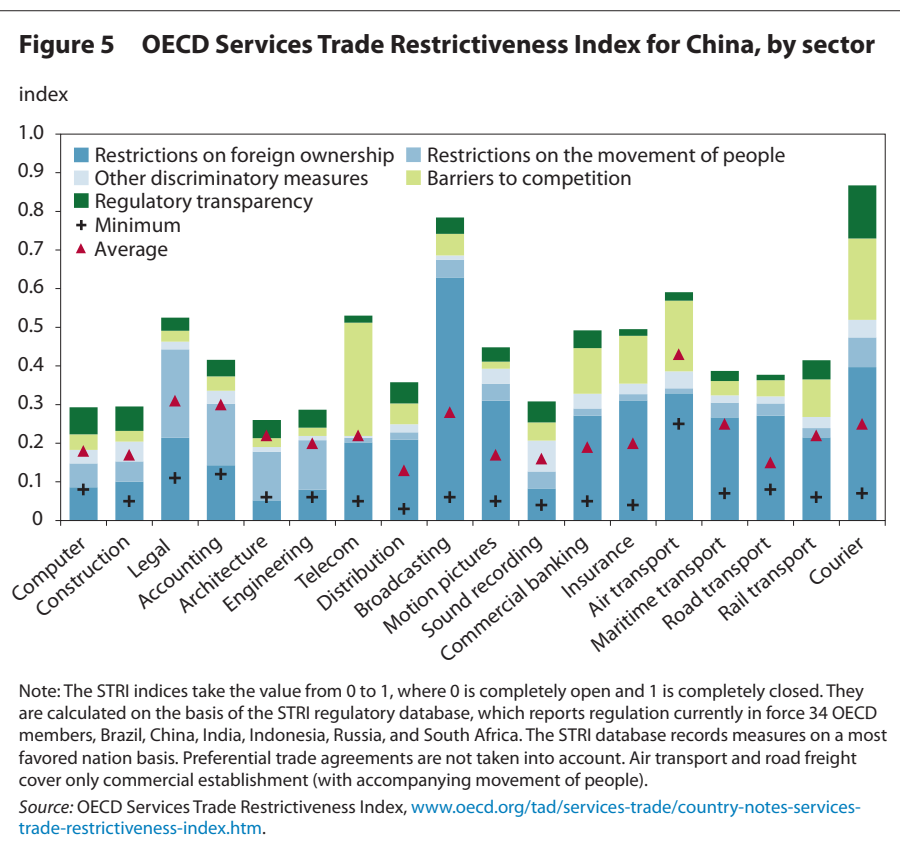
Given the apparent comparative advantage in producing business services in the developed world and the importance of business services as intermediate inputs to many economic activities, it seems that China should be importing more business services from the developed world. One possible reason for the low level of service imports is policy impediments in China to the importation of services.

An exhaustive list of impediments to service trade is beyond the scope of this essay; however, it is possible to provide examples. Charles Findlay and Tony Warren (2000) list the following as some of the most significant restrictions to business service trade:

- requirements on the form of establishment,
- foreign partnership restrictions,
- ownership and investment restrictions,
- nationality requirements,
- residency and local presence requirements,
- licensing and accreditation of foreign professionals,
- limitations on the scope of activities, and
- multidisciplinary practice restrictions.

It is very difficult to quantify the impediments to trade in services. Unlike goods trade, where tariffs are a major impediment and are easily measured, as described above the impediments to trade in services are more varied and difficult to quantify. The OECD recently published a major study that developed the Services Trade Restrictiveness Index for member countries and major non-OECD countries (e.g., Brazil, China, India, and South Africa).

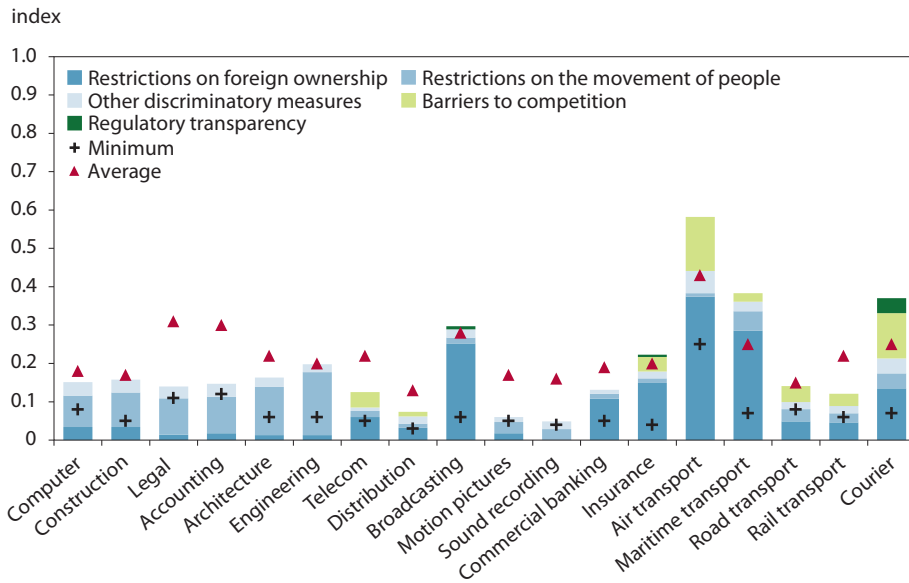
STRI measures by sector for China are reported in figure 5; STRI measures for the United States are reported in figure 6. Two observations regarding the STRI for China are important in this context.



First, China scores well above the average for all sectors (indicating higher than average barriers to service trade). For some sectors, the barriers are significantly higher than the average. In contrast, the US scores are below the average in 13 of 18 sectors. Barriers to the importation of services are high in China.

Second, for China an important contributor to the high barriers to service trade is restrictions on entry of foreign firms. FDI in China is governed by sector; some sectors are encouraged, some permitted, some restricted, and some prohibited. Many service sectors face restrictions on FDI. Service industries that have particularly high barriers

**Figure 6 OECD Services Trade Restrictiveness Index for the United States, by sector**



Note: The STRI indices take the value from 0 to 1, where 0 is completely open and 1 is completely closed. They are calculated on the basis of the STRI regulatory database, which reports regulation currently in force 34 OECD members, Brazil, China, India, Indonesia, Russia, and South Africa. The STRI database records measures on a most favored nation basis. Preferential trade agreements are not taken into account. Air transport and road freight cover only commercial establishment (with accompanying movement of people). The data have been verified and peer reviewed by OECD members.

Source: OECD Services Trade Restrictiveness Index, [www.oecd.org/tad/services-trade/country-notes-services-trade-restrictiveness-index.htm](http://www.oecd.org/tad/services-trade/country-notes-services-trade-restrictiveness-index.htm).

ers to foreign firm entry include commercial banking, insurance, road transport, distribution, courier services, broadcasting, and motion pictures—all industries where the United States has globally competitive firms. Indeed, the OECD scores the barriers to foreign entry in these industries in China higher than the OECD average *overall* barriers to service trade. These types of restrictions would be reduced in a US-China BIT. It is important that market entry impediments be significantly reduced for a broad range of sectors and the “negative” list in the BIT must be short.

Last, though not shown in the figures, the OECD reports that other horizontal regulations including conditions on capital transfers, limitations on cross-border mergers and acquisitions, labor market tests for temporary service providers, and lack of access to public procurement contribute significantly to the indices in all sectors. While some of these restrictions are beyond the scope of a BIT, restrictions on cross-border mergers and acquisitions should be limited for as many sectors as possible in the BIT.

## OPPORTUNITIES FOR GROWTH THROUGH TRADE IN SERVICES

Increased trade would improve the level of service in telecommunications, finance, and other business services in China for both businesses and consumers. To move up the value chain in manufactured goods, China will need access to efficient, leading-edge services in engineering, design, development, testing, marketing, advertising, logistics, and distribution. Given the current relatively small size of the business service sector, it seems

unlikely that China can be self-sufficient in these activities in the near term. Importing these services is an obvious way to provide them.

The United States and China have a significant opportunity to foster growth through increased trade in business services. Many of these activities can be provided at a distance. Sizable gains to trade appear to be available to the United States and China in this area due to differences in current factor endowments. Existing barriers to service trade in China are significant. For example, [C. Fred Bergsten, Gary Hufbauer, and Sean Miner \(2014\)](#) report that a China-US trade and investment agreement (and the accompanying reduction of trade barriers in China) could generate \$218 billion in additional US service exports to China by 2025. These additional exports would help foster growth in the United States and would constitute lower-cost intermediate inputs to China's manufacturing and service industries, enabling faster growth in China too.

The potential for a mutually beneficial relationship between rapidly growing countries like China and business service providers in the United States is large. While services can be traded through various modes, the ability to establish a physical presence in a large market is important for the delivery of many service activities (even those that are predominantly digital). Increasing foreign firms' access to China through a US-China BIT is an important precondition to increasing service trade.



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# COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES AND THE US-CHINA BILATERAL INVESTMENT TREATY: CHALLENGES IN MEETING CHINA'S DEMANDS

GARY CLYDE HUFBAUER, SEAN MINER, AND THEODORE MORAN

Foreign direct investment (FDI) from China to the United States has long been a flashpoint, just as Japanese investments and acquisitions were in the 1980s and investments by Persian Gulf oil-producing countries have been since the 1970s. Investors in these countries understandably question why their investments have raised more concern than similar investments from Europe. Much of the anxiety among Americans is over a perceived loss of autonomy over US business, along with worries about the business practices that might be imported along with the investments. But investments by China have also had a security component, with anxiety focused on the possibility of ownership of sensitive technologies or infrastructure by a country that is far from an ally on foreign policy issues.

The debate over security issues is heavily shaped by the Committee on Foreign Investment in the United States (CFIUS), an interagency group that assumes responsibility when investment in sensitive areas of the economy comes in the form of foreign acquisition of a US company.<sup>1</sup> Established in 1975, CFIUS is led by the Treasury Department. Its purpose is to ensure acquisitions of US firms by foreigners do not harm US national security, and its procedures have been amended and revised many times in response to concerns raised by overseas investors. The record of CFIUS is that it has approved far more investments than it has rejected, although in some cases the investors have retreated before decisions were made because of concerns that CFIUS would rule against them or in some cases because of political protests and criticisms of investments in the US Congress. One result is that CFIUS has become a kind of whipping boy for foreign investors who want its procedures to be more efficient, timely, and transparent.

The United States and China have continually sparred in the area of national security reviews for bilateral investment. The current negotiations on an investment treaty between the two countries cover a wide range of topics. The US-China bilateral investment treaty (BIT) could be an opportunity to clear up issues relating to security reviews, although both sides may end up disappointed. China's grievances stem from some high profile acquisition attempts launched by Chinese firms that were ultimately unsuccessful because they ran into political obstacles from the US Congress or the CFIUS. But the high-profile cases have skewed public perception and now some see CFIUS as an unfair barrier to Chinese investments in the United States.

The Chinese will look to accomplish two things in the BIT. First they would like to ensure greater transparency in order for Chinese firms, including state-owned enterprises (SOEs), to have a clearer understanding of the decisions criteria in a CFIUS review. Second, they would like CFIUS to apply the same criteria to a Chinese

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GARY CLYDE HUFBAUER has been Reginald Jones Senior Fellow at the Peterson Institute for International Economics since 1992. SEAN MINER is China program manager and research associate at the Peterson Institute for International Economics. [THEODORE H. MORAN](#), nonresident senior fellow, has been associated with the Peterson Institute since 1998.

1. This essay draws heavily from [Moran \(2009\)](#) and [Moran and Oldenski \(2013\)](#).

firm trying to acquire a US firm as it would to a British firm doing the same. This is called most favored nation (MFN) treatment.

Chinese commentators point to the perception that even the prospect of going through a review is sometimes enough to prevent an investment. Moreover, additional factors, besides the prospect of a CFIUS review, may discourage potential foreign investors. In certain industries foreign investment is explicitly limited or prohibited by the US Congress, namely natural resources, telecom, TV, and radio. Investment in other sectors may face barriers even though the official US policy is an open door. As mentioned, congressional disapproval can prove too much for a foreign investor. Intense media scrutiny, usually linked to congressional protests, can force a bid withdrawal if it sparks strong negative public sentiment. Most of the Chinese grievances could be alleviated if the BIT could simplify the CFIUS process. The US government is unlikely to take further steps to ease the path through CFIUS, but recently more and more investors, including from China, have successfully navigated a CFIUS review.

## FOREIGN INVESTMENT IN THE UNITED STATES

Several foreign investors have experienced an almost xenophobic attitude toward their proposed investments in the United States. Firms based in Japan, the Middle East, China, and even France have all faced issues springing from fear held by the American public that the foreign investor would acquire a vital US company. CFIUS vets legitimate national security concerns, but public misgivings often extend well beyond the national security realm. Despite these occasional eruptions, the United States remains a popular destination for inward foreign investment. In 2013, the United States received a net inflow of \$160 billion from inward foreign investment. In that year, worldwide flows topped \$1.4 trillion.<sup>2</sup>

The United States wants to maintain its position as a leading destination for foreign investment. Studies show that foreign firms employ over 5 million workers in the United States, and they pay higher wages than most domestic firms. Studies also show that foreign firms in the United States perform at a very high level, fostering a competitive environment, which boosts the performance of domestic firms. Inward FDI also increases domestic spending on research and development (R&D). Inward FDI is concentrated in select but important sectors, such as advanced manufacturing, energy, technology, and finance. The presence of leading edge foreign firms facilitates the diffusion of high technology and innovative management to domestic firms, creating a stronger US economy. This shows up in the positive correlation between inward FDI and domestic productivity.

## CHINA'S INVESTMENT IN THE UNITED STATES

China had inward FDI *flows* of around \$250 billion in 2013, but outward FDI has lagged far behind.<sup>3</sup> China's outward FDI *stock* totals around \$500 billion, while its inward FDI *stock* totals more than \$2 trillion. China's outward FDI *stock* placed in the United States is approximately \$47.5 billion in 2014, less than one-tenth China's total outward stock, and more than half of that arrived in the last two years.<sup>4</sup> Chinese investment in the United States is gathering speed, amounting to \$14 billion in calendar year 2013 and \$12 billion in calendar year 2014.<sup>5</sup>

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2. Data from UN Conference on Trade and Development, *World Investment Report 2013*, Geneva.

3. According to China's State Administration of Foreign Exchange.

4. Rhodium Group, China Investment Monitor, <http://rhg.com/interactive/china-investment-monitor> (accessed on January 27, 2015); and MOFCOM data.

5. Rhodium Group, China Investment Monitor, <http://rhg.com/interactive/china-investment-monitor> (accessed on January 27, 2015).

Chinese companies invest in the United States to take advantage of highly skilled workers, to acquire new production technology, and to reach the US consumer market. It wouldn't make sense for Chinese companies, with cheaper labor at home, to seek low-skilled US workers. Chinese firms spend on considerable R&D in the United States to adapt their products to the American market. Somewhat surprisingly, Chinese-owned firms in the United States tend to export a larger fraction of output than their US counterparts.

US sentiment toward growing Chinese investment is becoming more positive, especially at the state level, where governors vie to attract job-creating firms to their economies. However, convincing Americans that Chinese investment does not pose an economic or security threat can be difficult. As a side advantage, the CFIUS process provides reassurance to the public at least with respect to security concerns.

## THE CFIUS PROCESS

CFIUS was created in the 1970s, as fear spread that Middle Eastern governments, flush with profits from high petroleum prices, would begin to acquire vast tracts of US real estate. This fear was overblown, and massive purchases of US assets did not materialize. Nonetheless CFIUS was created in 1975 to ensure that inward investments would not jeopardize national security. Yet presidential authority to block transactions was not legalized until after 1987, when a Japanese firm attempted to acquire a French-owned technology firm based in the United States. In 1988, the Exon-Florio Amendment was passed giving the president authority to block transactions that might harm US national security. The president subsequently delegated investigatory authority to CFIUS. Only two transactions have been explicitly prohibited by a US president, in 1990 and 2012, and in both cases the acquiring firms were Chinese.<sup>6</sup>

A fresh congressional storm erupted in 2006 over the proposed acquisition of a British firm, Peninsular and Oriental Steam Navigation Company (P&O), which owned ports all over the globe, including in the United States. The acquiring firm was based in the United Arab Emirates (and controlled by the Emir of Dubai) called Dubai Ports World. After CFIUS cleared the transaction, a congressional uproar manifested in the form of a 62-2 vote against the transaction within the House Appropriations Committee. Dubai Ports World went through with the transaction but was forced by political pressure to divest the six US ports, selling them to an American entity.

This episode led to further changes in the CFIUS process, implemented in 2007 by the Foreign Investment and National Security Act (FINSA). The scope of the national security review was expanded and CFIUS now looks, among other issues, at the possibility of “three threats” ([described](#) in more detail later):

1. denial or manipulation of access to supplies,
2. leakage (referring to sales of goods or technology, especially of a military nature), and
3. sabotage or espionage.

Apart from SOEs, foreign investors in the United States are not required to initiate a CFIUS review, but lawyers recommend that they do so. While CFIUS has not distinguished between “mixed ownership” firms—partly state-owned and partly privately owned—and fully state-owned firms, any mixed ownership firms would be well advised to initiate a CFIUS review. If a foreign firm does not file a notice to CFIUS regarding a proposed transaction, then CFIUS can initiate its own investigation, and subsequently order a divestment. The process involves a 30-day review, and the majority of transactions are cleared in this time period. But the committee may initiate an additional 45-day investigation if it needs more time. This second 45-day investigation is man-

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6. In 1990, President George H. W. Bush ordered China National Aero-Technology Import & Export Corporation to divest its interests in Seattle-based MAMCO Manufacturing. In 2012, President Barack Obama ordered Ralls Corporation to divest its interests in four wind farm project companies in Oregon. The reason given was that the wind farm sites were within the vicinity of restricted airspace of a Naval Weapons Systems Training Facility.

datory if the foreign acquiring firm has ties to a foreign government or involves critical infrastructure in the United States. The president has 15 days to evaluate CFIUS findings and allow or prohibit the transaction. The committee's deliberations are secret, and (with few exceptions) it reports summary statistics only on the cases reviewed and investigated.

## CFIUS: IN DEPTH

A closer look at how CFIUS operates and initiates its investigations reveals that notices to CFIUS have increased substantially and so have the percentage of cleared investments. Since 2008, any entity controlled by a foreign government must notify CFIUS of an intended acquisition. This is not the case for private companies, although it is generally a good idea for them to do so. Clearance by a CFIUS review can help shield the foreign firm from congressional or public criticism.

From 2008 through 2012, foreign firms filed 538 notices of transactions with CFIUS. Of these, 6 percent of the firms (32 cases) withdrew from the review process before it was finished, 31 percent (168 cases) went through an investigation, and 7 percent (38 cases) withdrew during the investigation. CFIUS recommended divestiture in just 1 case in those five years, where a presidential decision was made to force Ralls Corporation to sell its American assets. The other 44 percent (238 cases) were cleared during the review process without the need for an investigation. This means CFIUS deemed nearly 87 percent (468 out of 538) of the notices as not a threat to US national security, a very high rate. However, some firms were subject to mitigating measures (8 percent of cases from 2010 through 2012). Mitigating measures ranged from allowing only US citizens to handle certain products and services to termination or sale of specific US business activities.

There are many reasons why firms may withdraw before or during the investigation process. Sometimes the filing parties may not be able to answer all the national security or other related queries within the review or investigation process and decide to withdraw and refile at a later time. Also if the terms of the transaction change, the party may withdraw and refile later, or if the transaction is abandoned for commercial reasons then the party will withdraw the notice. For example, in 2012, 22 cases were withdrawn during the review or investigation process, and 12 of those cases were refiled in 2012 or 2013, with the rest abandoning the transaction either for commercial reasons or because of national security concerns raised by CFIUS.<sup>7</sup>

### High-profile cases

Several high-profile cases have shaped public opinion, in the United States and abroad, on the process foreign investors must endure when investing in the United States. In 1992, a French firm, Thompson (58 percent owned by the French government), tried to acquire an American firm, LTV Corporation, which possessed sensitive missile technology. Thompson had sold weapons to Iraq and Libya, and there was no way to ensure that future sales would not be initiated in zones of US military activity. Thompson subsequently withdrew its bid. In 2002, CNOOC proposed to buy the American-owned Unocal, which had some drilling activity in the Gulf of Mexico. Protestors worried that CNOOC would divert oil sales from the United States to China. While this fear was overblown, CNOOC eventually withdrew its bid. Commentators say that the knowledge gained from this failure helped CNOOC close a deal in 2013 to buy Canada's Nexen, also with significant operations in the Gulf of Mexico. CFIUS did mandate that CNOOC give up operating control of its Gulf activities, although CNOOC still can collect the revenue. In 2010 a Chinese SOE, Anshan Iron & Steel Group, came under political fire for its attempted investment in US-owned Steel Development Company. Anshan withdrew its bid amid congressional pressure.

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7. Statistics from CFIUS *Annual Report to Congress for CY 2012*, [www.treasury.gov/resource-center/international/foreign-investment/Documents/2013%20CFIUS%20Annual%20Report%20PUBLIC.pdf](http://www.treasury.gov/resource-center/international/foreign-investment/Documents/2013%20CFIUS%20Annual%20Report%20PUBLIC.pdf) (accessed on January 14, 2015).

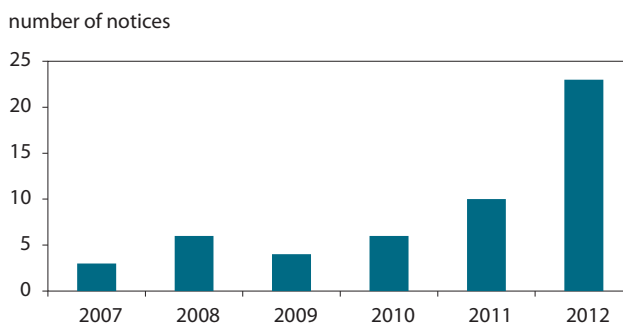
Opposition to foreign acquisitions on supposed national security grounds sometimes originates from the desire of US-based competitors to acquire the target company more cheaply on their own. Chevron, for example, led the attack against CNOOC's proposed acquisition of Unocal, and when the Chinese deal fell through Chevron acquired Unocal itself.

Since the FINSA reform of CFIUS legislation in 2007, US domestic political pressure has been less effective in stopping transactions. During Shuanghui International's purchase of Smithfields in 2013, the largest pork producer in the United States, there was significant congressional opposition to a Chinese firm taking over an important part of US food supply, but congressional pressure was not strong enough to force Shuanghui to withdraw its bid. The bid subsequently passed a CFIUS investigation and the acquisition was completed in July 2013. This may have been partly due to greater Chinese experience at acquiring US firms, and therefore increasing confidence by the Chinese investors that they could withstand public criticism and just focus on national security concerns. Shuanghui started educating public opinion early and hired skillful lawyers and consultants to guide the Chinese parent through the process. Moreover, there was no legitimate security concern in this case, just the fact that an important American company would be sold to a Chinese company. Shuanghui's skill in navigating both the CFIUS process and potential congressional opposition provides a teaching lesson to other Chinese firms that seek to acquire "brand name" US firms.

### CFIUS Case Statistics

Chinese firms have recently been less reticent about investing in the United States. From 2007 to 2009, Chinese firms filed 13 notices with CFIUS, but from 2010 through 2012, they filed 39 notices, accounting for 12 percent of all notices. This includes 23 notices filed in 2012 alone, twice the level in the previous year, the most for any country in 2012 (figure 1). In comparison, UK investors filed 21 percent of total notices during the 2010-12 period, the highest from any country over the three-year period. China filed more notices than French (9 percent) and Canadian (10 percent) firms during that time. Of China's 39 notices filed, 20 were in the manufacturing sector, 12 in mining, utilities, and construction, while the other 7 were in finance, information, and services.

**Figure 1 Notices by Chinese investors of transactions to CFIUS, 2007-12**



Source: US Department of the Treasury.

### Three Threats

China's commerce minister remarked that the CFIUS process needs to be "more open and transparent, because companies never know whether their bid meets the requirements... . We need clearer guidelines on what conditions might violate U.S. Security, to reduce risk for companies that want to invest."<sup>8</sup>

Seeking clearer guidelines, one of us (Moran 2009) has spelled out circumstances in which both CFIUS and foreign investors can determine whether a genuine security threat exists. These are not official CFIUS guidelines but constitute a common sense approach to evaluating foreign investment. The first "threat" iden-

8. Lucy Hornby, "China Commerce Minister seeks clearer U.S. investment guide," Reuters, March 8, 2013, [www.reuters.com/article/2013/03/08/us-china-parliament-trade-idUSBRE92705K20130308](http://www.reuters.com/article/2013/03/08/us-china-parliament-trade-idUSBRE92705K20130308) (accessed on January 20, 2015).

tifies *critical supply*, when a foreign firm acquires a company in a concentrated industry, thereby limiting the purchasing options for firms in the US economy. The threat of denial or manipulation of supplies is credible only if the asset to be acquired is critical to the functioning of the US economy and alternative sources of supply are not readily available.

The next “threat” is that of *technology leakage*, where the firm being acquired has a narrowly available technology, ability, or management expertise, and the sale of that firm may significantly enhance a foreign country’s capability, thereby reducing US national security. The threat of leakage of technology via foreign acquisition is worrisome only if such technology is not widely available from other sources. It should be noted that this approach identifies not only whether the proposed acquisition takes place in a sector deemed to be “critical” but also whether market concentration in that sector is sufficiently concentrated that supplies could be manipulated by the acquirer or technology obtained by the acquirer would make a strategic difference.

The third “threat” involves *infiltration, surveillance, or sabotage* and identifies acquisitions like telecom or ports that may give foreign governments a platform to spy on or sabotage the US economy. A rigorous investigation of whether these three threats are plausible means that the circumstances in which a CFIUS disapproval of the foreign acquisition is justified will be relatively rare. Even if one of these situations occurs, mitigating measures can be imposed on the acquiring firm, such as allowing only US citizens to run certain departments or insisting the firm give up control of or divest certain operations.

## CONCLUSION

Missing from CFIUS’s evaluation—a feature that characterizes investment review in many other countries—is that it does not take into account economic interests when deciding whether to recommend disapproval to the president. The United States would like the BIT to make sure that China’s investment review does not take economic interests into account for US investments into China. One of the core tenets of the US government is to facilitate an environment of free enterprise, where markets determine prices and firms compete freely against one another. A US-China BIT is not likely to make the process any easier, but any government is going to reserve that right to block potentially threatening investments. Chinese firms should feel confident that, if they do not pose a national security threat, their transactions will not be blocked by CFIUS. To be sure, Chinese firms face other potential pitfalls. As with Japanese investors in the 1980s and 1990s, some members of the American public are wary of Chinese takeovers. Therefore Chinese investors must have a strategy to deal with public opinion. Getting an early feel for how the transaction will be perceived is critical, and Chinese firms should not expect that they can fly under the radar of US media attention. Early opinion surveys may save time and money down the line.

As Chinese firms make further US acquisitions, the experience gained should help pave the way for future transactions. A US-China BIT is unlikely to change the CFIUS process because of the difficult political climate, but it could foster greater disclosure of unclassified evidence, arguments, and allegations considered in CFIUS deliberations. This possibility was foreshadowed by the decision of the Court of Appeals for the Federal Circuit that parties to transactions under CFIUS review should be offered the opportunity to review, respond to, and rebut any unclassified evidence or reasoning upon which a presidential order depriving them of property is based. For increased transparency, Chinese firms that hire an experienced lawyer could come to find out any objections by the committee. A BIT could partly satisfy China by requiring CFIUS to provide a written mitigation proposal to the acquiring Chinese firm within a certain number of days after they supply all the information requested by CFIUS. As for granting MFN status, neither Congress nor CFIUS actually treats all foreign countries the same due to geostrategic considerations, so national security reviews will be unlikely to operate under the same norms as commercial policies, and a BIT will not change this.

Chinese investment in the United States has risen quickly in the last few years, and will continue to grow, and investors will gain more experience on how to navigate the CFIUS process. The US government is unlikely to change how CFIUS reviews foreign investment. There may be some room for increased transparency, such as releasing unclassified documents in cases of denial of investment. But the United States may compensate in other areas, for example, adding affirmative language in the BIT that Chinese firms will be permitted to invest in federally funded infrastructure projects, including those administered by the states. Also, a “ratchet” provision could be added to prevent US states from passing further legislation restricting Chinese investment, thus reassuring China that US states can’t try to block Chinese investments by implementing new laws. So China may not get the changes they want to CFIUS, but they might be satisfied by other actions taken by the United States.

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# A BILATERAL INVESTMENT TREATY AND ECONOMIC RELATIONS BETWEEN CHINA AND THE UNITED STATES

C. FRED BERGSTEN

A bilateral investment treaty (BIT) between China and the United States would be of considerable substantive importance. The two countries are now the world's largest home and host countries to annual flows of foreign direct investment (FDI) to and from all locations. But bilateral flows of FDI between them are surprisingly small, in both directions, and both have extensive complaints about the FDI policies of the other. The essays in this PIIE Briefing discuss the most important of these issues and how a BIT could help address them.

This essay seeks to place the current BIT negotiations in the broader context of the international economic positions and policies of the two countries. It suggests that their approaches to these negotiations, and the eventual outcome of the talks, will have a significance ranging well beyond the direct impact of the agreement on the two-way flow of FDI itself. The BIT process and results will carry important implications for the broader international economic policies, and indeed the domestic politics and economic policies, of both countries. Conversely, the outcome of the BIT talks will be importantly affected by the very active trade and investment negotiations that both countries are conducting with a variety of other partners in several different contexts.

## THE CONTEXT

The current US-China BIT talks are taking place during an extremely active period of international economic negotiations by both countries. Both are or probably will soon be engaged together in at least three sets of plurilateral initiatives, at or around the World Trade Organization (WTO): the extension and update of the Information Technology Agreement (ITA II), the Trade in Services Agreement (TISA), and the new effort to reduce barriers to trade in environmental goods, the Environmental Goods Agreement (EGA). In addition, both countries remain involved in various components of the lingering Doha Round and especially the implementation of the Bali Agreement of late 2013 on trade facilitation. On the other hand, China has repeatedly failed to make an offer to join the Government Procurement Agreement (GPA) that is acceptable to its current members, led by the United States, despite China's keen interest in obtaining access to the very large public projects that are likely to be forthcoming in the United States and a number of other countries. It is not yet clear whether China and the United States will be able to agree on substantial results from some or all of these efforts, but, at least for the foreseeable future, both seem to be constructively engaged in them.

On the bilateral and regional fronts, both countries are also extremely active. China recently completed at least the first stages of free trade agreements (FTAs) with Korea and Australia and proposed an FTA with the European Union. It has made commitments to pursue a trilateral pact with Japan and Korea (CJK) and

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C. FRED BERGSTEN, senior fellow and director emeritus, is the founding director of the Peterson Institute for International Economics.

a Regional Comprehensive Economic Partnership (RCEP) with the “ASEAN plus six” (Australia, China itself, India, Japan, Korea, and New Zealand).

For its part, the United States is prioritizing two megaregional negotiations: the Trans-Pacific Partnership (TPP), which now includes 11 other Asia-Pacific countries (including Japan), and the Trans-Atlantic Trade and Investment Partnership (TTIP) with the European Union. After strongly opposing the TPP until a year or so ago, China has more recently expressed considerable interest in that agreement. Some in China have also indicated interest in the idea of a bilateral free trade and investment agreement with the United States (Bergsten, Hufbauer, and Miner 2014).

Perhaps most importantly, China as chair of the Asia Pacific Economic Cooperation (APEC) forum during 2014 proposed the launch of a “feasibility study” of a Free Trade Area of the Asia Pacific (FTAAP), which could include all APEC member economies. APEC leaders agreed in Beijing in November to a “collective strategic study” of that idea, which will be reported to them in late 2016. Hence the groundwork is being laid for a possible comprehensive pact that would accomplish the original Bogor Goals of APEC, from 1993–94, to achieve “free and open trade and investment in the region.” Such an arrangement could provide an umbrella over the other regional and bilateral compacts in the region.

All these ongoing initiatives will both influence the outcome of the US-China BIT talks and be influenced by them. Each of the current negotiations addresses investment issues either directly, as do both the TPP and TTIP, or indirectly like the TISA (because the prospects for expanding trade in some services hinges importantly on the investment opportunities for services firms). Whatever is agreed on investment in those wider arrangements will inevitably affect the bilateral talks. More broadly, the success or failure of some or all those initiatives will alter the prospects for successful conclusion, and degree of ambition, of the BIT by affecting both the overall climate for achieving new trade liberalization and the status of US-China relations within that context. In particular, the investment chapter of the TPP will go far to set a standard for investment policies and relations in the region, especially in light of China’s recent interest in possibly joining TPP at a later stage.

## POLICY IMPLICATIONS

A particular case in point is the trilateral investment pact signed by China, Japan, and Korea in 2012 and implemented in May 2014,<sup>1</sup> which can be viewed as a precursor to the FTA being discussed by the three countries. Its rules and disciplines are considerably more ambitious than previous BITs agreed by China, if still well short of those sought by the United States. It nevertheless gives Japanese and Korean investors an advantage over US investors in the Chinese market.

In addition, the China-Japan-Korea investment pact and the new China-Korea FTA will establish precedents for regional investment rules. This “model East Asian BIT” will compete against the US model BIT and the proposed investment chapter of the TPP, which in turn is based on the investment chapter of the Korea-United States FTA (KORUS). The new US model BIT, which is much more ambitious than either its own predecessors in earlier US BITs or the new “model East Asian BIT,” has not yet been accepted by any other country (and its predecessor 2004 model has been accepted by only two very small countries, Rwanda and Uruguay).

The Chinese and US models therefore offer alternative foundations for the US-China BIT now being pursued. They also represent a microcosm of the competing FTA models being negotiated throughout the region, sometimes with the same countries, by China (less ambitious) and the United States (more ambitious). The converse is also true: Success of the more ambitious US model in the “FTA contest,” e.g., TPP versus RCEP, might signal success for the more ambitious US model in the BIT talks with China.

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1. See [essay](#) by Jeffrey Schott and Cathleen Cimino in this Briefing.

The multiple components of the current trade negotiating context, as just described, also carry two even broader implications for the BIT effort. These implications relate primarily to domestic politics for the United States and to international economic policy for China.

The US administration is aggressively pursuing all the negotiations cited earlier, at both the megaregional and plurilateral levels. However, its ability to win congressional support for any or all of those efforts is uncertain. The administration sought approval of Trade Promotion Authority (TPA) in early 2014 but was rebuffed, notably by leaders of its own Democratic Party in Congress, and did not make much of an effort to reverse that outcome. (The somewhat similar failure throughout 2014 of the administration's efforts to win congressional support for the International Monetary Fund [IMF] reform package that President Barack Obama agreed to at the G-20 summit in Seoul in 2010, while on a substantively different issue, also falls within the domain of foreign economic policy and hence is another disquieting sign.)

No votes have been taken, and no specific agreements submitted recently for congressional ratification, so no definitive conclusions can be reached. Moreover, the administration has indicated in early 2015 that it will be making a major new effort to win political support for its trade initiatives. However, the administration's inability to win Hill approval for its negotiating program, at least for now, may have dampened the enthusiasm of some of its negotiating partners in both TPP and TTIP. There has always been a close linkage between the international and domestic dimensions of US trade negotiations, dating back to the Kennedy Round in the General Agreement on Tariffs and Trade (GATT) in the 1960s when Congress rejected important parts of the package that the administration of the day had worked out with the European Common Market (as it was then called). But today's uncertainties are particularly acute in light of the ongoing backlash against globalization in the United States and polls that reveal substantial public doubt about new trade agreements, the widely perceived (if partially inaccurate) weaknesses of the economy and the job market, and large (if substantially reduced) trade and current account deficits.

A unique feature of a BIT in US domestic politics could amplify these uncertainties. If the BIT is concluded as a treaty, as is typically the case, it would require congressional ratification via a two-thirds vote of the Senate (as opposed to the simple majority, albeit of both House and Senate, that must approve an FTA). Such a majority is difficult to achieve in the Senate on any issue at this point in time. Even if the US-China negotiations are successful, the BIT ultimately faces an important hurdle within the US political process; hence there has been talk of converting the BIT into a "bilateral investment agreement," which would be treated like an FTA in Congress, on the grounds that the House would have keen interests in some of the deal's more far-ranging components, but such an effort is unlikely to survive the Rules Committees and is thus unlikely to succeed.

How Congress responds to the other international economic initiatives now being pursued by the US administration, as enumerated earlier, will thus have exceedingly important implications for the BIT because the response will indicate whether Congress is inclined to support such agreements. Congress passed KORUS and its investment component after a prolonged delay but with strong support from the president and the business community, which provides a favorable recent precedent. That vote occurred in 2011, however, and the political landscape has changed considerably since that time (as suggested by the much more recent failures of TPA and IMF funding). Passage of TPP, which is likely to be the first of the present US initiatives to be completed, would be the most favorable possible signal while a failure of that pact would cast a pall over all other US initiatives in the international economic space. (I deliberately use the term "failure" to encompass congressional unwillingness to take up an agreement, as was the case with KORUS and parallel FTAs with Colombia and Panama for almost four years, as well as outright rejection; it is hard to imagine that Congress would devastate US foreign policy via the latter step but it is clearly prepared to contemplate the former.)

The restoration of Republican control of the Senate in 2015 should help the prospects for ratification of a BIT because Republicans are more pro-trade, pro-FDI, and generally more pro-business (the biggest sup-

porters of the BIT) than Democrats. They may also be a bit less sympathetic to China than the Democrats. On balance, however, this shift in the Senate is likely to be supportive of the proposed BIT. Since the Democrats could regain control of the Senate in the 2016 election, when many more Republican incumbents will be on the ballot, proponents of the BIT should make a major effort to reach agreement quickly enough to place the issue before the current Senate.

For China, the implications of the current negotiating agenda relate primarily to its domestic reform agenda and, through it, to its international economic policies. As noted above, China has recently begun emitting more positive trade policy signals. It appears to be actively participating in the ITA, EGA, and RCEP. On the other hand, it is still standing back from GPA and CJK (the latter maybe mainly for political reasons). China's policy on these issues will obviously turn on its determination of which approach best serves its national interests, which in this case largely means how they relate to the economic reform agenda of President Xi Jinping.

The most extensive trade liberalization negotiated in modern China's history, its entry into the WTO in the late 1990s and early 2000s, was motivated importantly by the desire of the top leadership of the day to use that liberalization and China's international commitment to it to promote and lock in their internal reforms. Hence the willingness of China to engage in TISA, the green initiative, FTAs with Korea and Australia, and the BIT itself is widely taken as an indicator of the current government's interest in a somewhat similar path of market-oriented rebalancing. The reforms themselves would in turn make the liberalization more feasible and might even spur China to participate in it.

Conversely, Chinese rejection of these international opportunities would raise questions about the seriousness of the reform process. It would thus dampen prospects for the BIT (or any other major US-China trade initiative).

## A PRECURSOR TO MORE?

Another encouraging sign in both China and the United States has been a new willingness to at least discuss the possibility of negotiating a comprehensive bilateral FTA or to achieve the same outcome through China's new-found interest in the TPP and/or a comprehensive FTAAP. There was little interest in the idea, and indeed strong doubts about its feasibility, when it first surfaced in 2009. However, conditions have changed dramatically since that time in terms of the economic recovery of both countries from the Great Recession and the adoption of the very active trade agendas described above. Some elements of the US business community and some close policy observers in China have recently endorsed the concept or at least serious consideration of it.

This could have several important implications for the BIT. Most ambitiously, any agreement between the two countries to pursue their own FTA (including via TPP or a new FTAAP) would presumably encompass investment and thus provide major impetus for a BIT (perhaps as a precursor to even more expansive agreement on investment in the FTA itself). The BIT might even be viewed as a first important step toward an FTA, especially if the two countries choose to pursue such an agreement incrementally via stand-alone pacts on specific topics rather than comprehensively all at once through a single undertaking ([Bergsten, Hufbauer, and Miner 2014](#)).

## CONCLUSION

The current BIT negotiation thus takes place at a unique time in the evolution of the international trade architecture. Many major negotiations are under way with the configuration of Asia-Pacific, and perhaps global, trade relationships at stake. The outcome of all this activity will importantly affect the overall relationship between China and the United States. At the same time, China has launched (or at least intensified) an exten-

sive reform program that will have important, perhaps decisive, effects on its international economic policies. The United States is pursuing the two largest regional compacts in history but domestic political support for those initiatives is shaky.

Hence the outcome of the BIT itself is likely to have an important impact on a large number of much broader issues. The outcome of at least some of those issues is likely to have a similarly large, perhaps even larger, impact on the BIT. For example, conclusion of an investment chapter in a TPP would inevitably carry significant implications for the BIT (or the investment chapter in any broader US-China bilateral negotiation). It is clear that the BIT must be seen in this broader context, along with its own substantive merits, in deciding how China and the United States should proceed with it.

## REFERENCE

Bergsten, C. Fred, Gary Clyde Hufbauer, and Sean Miner. 2014. *Bridging the Pacific: Towards Free Trade and Investment between China and the United States*. Washington: Peterson Institute for International Economics.

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1750 Massachusetts Avenue, NW  
Washington, DC 20036-1903  
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