What to Do About American Investment in China

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Key Points

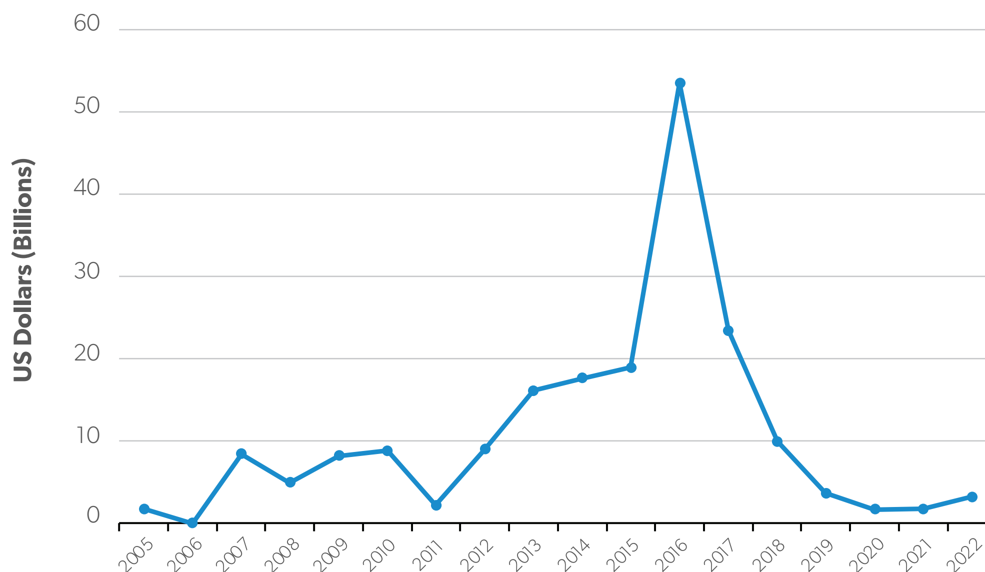
- In terms of money moving between the US and the People's Republic of China (PRC), all the large flows since 2016 have been American investment in Chinese stocks and bonds, the stock of which was $1.18 trillion at the end of 2021.
- The US government has loudly considered policy changes pertaining to outbound investment but has done almost nothing. Worse, the US does not provide basic information about the true levels of outbound investment. This must change for good policy to be possible.
- There are compelling principles that should guide policy changes. One is that, if existing American law restricts Chinese investment in the US to prevent loss of technology, new American law should restrict US investment in the PRC developing that same technology.

Many intelligent, well-meaning people claim the US is in a serious competition with China. They are wrong. No country in serious competition with another sends it almost $800 billion over four years. This is what the US did between 2017 and 2020. In 2021, the value of American investment in China dropped, but not because the US did anything. Rather, it dropped because the Chinese government attacked its own private sector.[1] As for 2022, American investment in China could have risen sharply and the US government would not yet know, much less have limited spending in any way. If that's competition, it's unpleasant to think what cooperation looks like.

Most trade actions, such as tariffs, to confront the People's Republic of China (PRC) for its behavior are not nearly as important financially as this investment flow.[2] Beyond the raw amount of money involved, the US essentially does not monitor what is being funded, remaining largely ignorant of the extent of American support of potentially harmful Chinese military and civilian technology. That makes investment oversight also more important than tariffs for our security and values.

It's true that, to protect the welfare of ordinary people, curbing supply-chain dependence on Chinese active pharmaceutical ingredients and a few other key products should be the top economic priority. But a genuine competition with the PRC is impossible without limiting US financial support of General Secretary Xi Jinping's regime. An executive order (EO) that will not be implemented until late 2023 and could be defunct in early 2025 is not enough. Congress must act. There are multiple options for outbound investment monitoring and review. The most important of these limit American help for China's development of advanced technology.

Figure 1. Chinese (Non-Bond) Investments in the United States



Source: American Enterprise Institute and Heritage Foundation, China Global Investment Tracker, January 2023, https://www.aei.org/china-global-investment-tracker.

Money Flow Has Changed

In the good old days, the financial concern with respect to the PRC was its bond holdings. At the time of writing, the latest comprehensive data are through June 2022. They show China owning $1.87 trillion in American bonds and stocks, including nearly $400 billion through Hong Kong. This was about a $150 billion drop from June 2021 and the lowest amount since June 2009.[3]

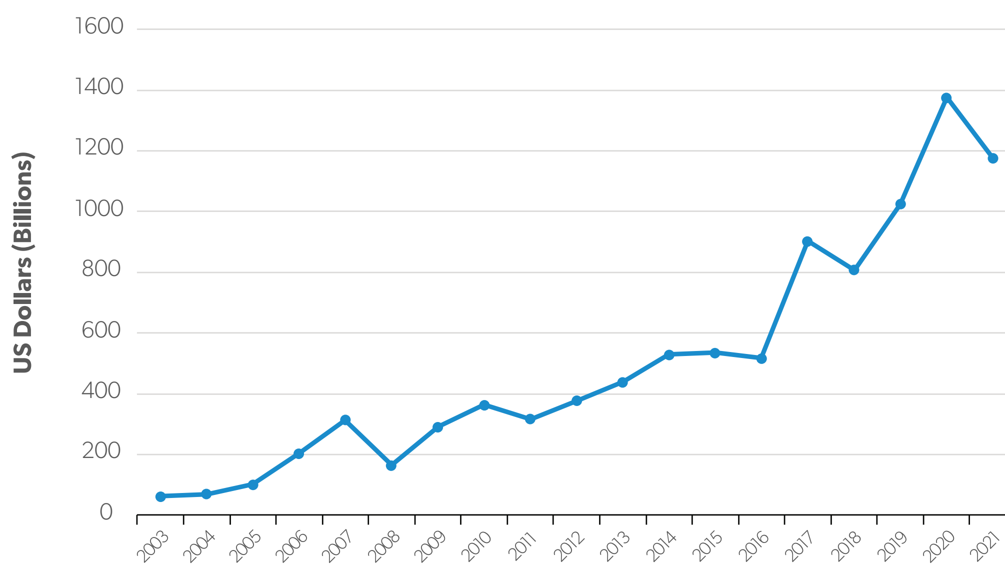
The combined mainland and Hong Kong share of just the American debt held by foreigners was below 12 percent in mid-2022, less than Japan's. (Total American debt is unfortunately much higher, so China's share of that is far lower.) Monthly data suggest a further drop in the PRC's holding of American bonds, at least, since then. Its share of foreign ownership of American stocks is tiny. There are indirect purchases through Belgium and the like, but China is not our banker.

Direct investment (at least 10 percent ownership) by the PRC in the US sees different estimates but is always much smaller than spending on securities. It's also been minor since 2017. The Department of Commerce puts the direct investment position of the mainland and Hong Kong combined at $53 billion at the end of 2021, barely higher than $51 billion in 2017.[4] China Global Investment Tracker follows PRC money through Hong Kong and offshore centers such as the British Virgin Islands to find $193 billion at the end of 2022 (Figure 1). The 2017 figure was $173 billion, however, which fits both the Department of Commerce's direct investment trend and the bond side.

There has been very little new Chinese investment in the US the past few years. Heading the other way, US direct investment in the PRC, including Hong Kong, stood at $205 billion in 2021, from $201 billion in 2020. It was $184 billion in 2017. Again, the past few years have not seen much spending of this kind.[5]

Since the end of 2016, the action has been in American purchases of Chinese securities. This, unfortunately, cannot be found in monthly data published by the Department of the Treasury. The once-a-month figures show the Cayman Islands as the top recipient of US investment in securities, at over $2.5 trillion, even though the Caymans do not have a securities market. These figures are nonsensical, hiding what American financials are actually doing. Once a year, Treasury bothers with the truth, releasing nationality-corrected data that give the correct numbers for the PRC and others and properly show the Caymans as irrelevant.

Figure 2. US Residents' Portfolio Holdings of Chinese Securities (Including Hong Kong)



Source: US Department of Treasury, "Securities (C): Annual Cross-U.S. Border Portfolio Holdings," https://home.treasury.gov/data/treasury-international-capital-tic-system-home-page/tic-forms-instructions/securities-c-annual-cross-us-border-portfolio-holdings.

Using the right numbers (Figure 2), American securities investment in China and Hong Kong soared $385 billion in 2017, passing $900 billion total.[6] A period of ebb and flow ensued until 2021, the latest year available, when $1.18 trillion in US funds were held in Chinese securities. This constituted an 18 percent drop from 2020, but that is hardly reassuring. There was no 2021 US government action limiting funds going to the PRC; it's not even clear American investors retrenched on their own. Alibaba and Tencent had the largest capitalizations among Chinese stocks in 2020. Tencent's share price fell 18 percent in 2021; Alibaba's fell 47 percent.[7] Americans may have put more money into Chinese securities, just to have the value of their holdings fall.

The $1.18 trillion appears important to the PRC. The State Administration of Foreign Exchange's official balance of payments is hard to interpret, with "other" being too important a category. For portfolio (securities) investment and excluding money bouncing back and forth from Hong Kong, the US appears to be by far China's most important partner on the capital side.[8]

Will Xi, who is increasingly concerned with the PRC's dependence on the world,[9] continue to accept this? He might. Despite talk of deleveraging, Chinese credit as a share of gross domestic product (GDP) rose nearly 100 points, to 296 percent, in Xi's first 10 years as general secretary. This is 60 points higher than the global average and, as of 2022, headed in the wrong direction.[10] China needs money. It also needs money properly allocated. The state-dominated financial system responds to political directives, central and local, and is largely responsible for the debt surge. An American investment dollar is worth more to China than one of its own.

What's the Money Doing?

If $1.18 trillion worth of American help for China is a bit disturbing, lack of information about what the funds support is worse. With Treasury pretending the Caymans are a real market and providing a basic data correction way late, it's hardly a surprise there's no breakdown of what PRC industries the US funds. The Department of Commerce is able to do this to some extent for direct investment and, with a delay, for operations of American firms in China. Somehow.

While not at all ideal, the Department of Commerce's data can be used to estimate the industry data Treasury does not provide. Patterns will certainly

differ for direct and portfolio investment, but direct investment is a reasonable proxy for what firms look for. The direct investment sector categories are not that helpful, unfortunately. For American spending in the PRC, the lead recipient is "nonbank holding companies," almost entirely in Hong Kong, which combine activities there is no further information about. Similar to Chinese data, the next-largest category is "other" (Table 1). The top useful category is wholesale trade (purchasing and distribution), followed by nonbank finance, chemicals, and electronics.

Table 1. 2021 Portfolio Investment Estimates, Using Direct Investment (US Dollars, Billions)

Sector	Estimated Amount Received
Nonbank Holding Companies	260
Other Nonmanufacturing	240
Wholesale Trade	170
Nonbank Finance	110
Chemicals	110
Electronics, Featuring Computers	100
Other Manufacturing	100
Transport Equipment	80
Total*	**1,180**

Note: * Numbers do not add to the total due to rounding and are rough estimates.
Source: Author's calculations using US Department of Commerce, Bureau of Economic Analysis, "Foreign Direct Investment in the U.S.: Balance of Payments and Direct Investment Position Data," July 21, 2022, https://www.bea.gov/international/di1fdibal; and US Department of the Treasury, "Securities C: Annual Cross-Border Portfolio Holdings," https://home.treasury.gov/data/treasury-international-capital-tic-system-home-page/tic-forms-instructions/securities-c-annual-cross-us-border-portfolio-holdings.

Another crude estimation method is to use activity by US firms in the PRC.[11] The idea is that higher profits represent an appealing industry that would draw securities investment. This method suffers from the Department of Commerce suppressing some data because they would identify a particular firm but has the advantage of not burying investment in holding companies (Table 2). There's also a twist: It's an obvious practice for Chinese enterprises to try to take sales and profits from multinationals. In this case, they would be taking American investment to help them drive out American companies operating in the PRC.

Table 2. 2021 Portfolio Investment Estimates, Using Net Income (US Dollars, Billions)

Sector	Estimated Amount Received
Wholesale Trade	210
Chemicals	180
Electronics, Led by Semiconductors	160
Finance	150
Other Manufacturing	100
Transport Equipment, Mostly Cars and Parts	100
Machinery	90
Retail Trade	80
Total*	**1,180**

Note: * Numbers do not add to the total because some net income data are suppressed.
Source: Author's calculations using US Department of Commerce, Bureau of Economic Analysis, International Data: Direct Investment and MNE, https://apps.bea.gov/iTable/?ReqID=2&step=1; and US Department of the Treasury, "Securities C: Annual Cross-Border Portfolio Holdings," https://home.treasury.gov/data/treasury-international-capital-tic-system-home-page/tic-forms-instructions/securities-c-annual-cross-us-border-portfolio-holdings.

These approaches may not generate reliable results. But something beats nothing, and Treasury has nothing. To the extent the results are accurate, the US supports the PRC's efforts to dominate the chemical supply chain, causing our dependence in pharmaceuticals. America may be financing the Chinese semiconductor industry. This makes sense because the industry is heavily subsidized and attractive to investors. It makes less sense given that the US is also subsidizing semiconductors. The US is probably aiding recent explosive growth in Chinese auto exports.[12]

As the first step to check all this, Congress should require Treasury to improve data collection and availability. Treasury has failed on transparency through multiple administrations. If the numbers cannot be made public, they must be made available to policymakers, including the legislative branch. Good outbound investment policy requires knowing risks and how they change over time. The minimum increases in transparency are:

- For portfolio investment, the Department of the Treasury provides breakdowns by sectors.
- For direct investment, the Department of Commerce provides a nationality correction, so that capital routed through offshore centers and other areas is not counted as truly invested there.

It would also improve policy if:

- For portfolio investment, the Department of the Treasury provides quarterly instead of annual updates of nationality-corrected data, to show the impact of events such as an outbound EO or other policy changes.
- For portfolio investment, the Department of the Treasury provides a breakdown of holdings by purchases in initial rights offerings and secondary market trading.
- For both direct and portfolio investment, the two cabinet departments provide figures on the amount invested in firms facing US sanctions.
- For both direct and portfolio investment, the two departments provide breakdowns by the US state of the investing entity, since state interest in investigating investment in China has jumped recently.[13]

Current Policy Failures

At the time of writing, the Biden administration's somewhat mythical EO on outbound investment still has not appeared, 21 months after National Security Adviser Jake Sullivan first raised the matter. It could have taken 21 days. The administration cannot still be struggling with the substance of the EO; it can only be struggling with optics. It may be that the Biden administration believes it does not have to take the matter seriously, because the Trump administration's record of soaring American investment in China was so discrediting.

For that reason and others, the EO may be nearly worthless. It could be so narrow in scope as to block only a tiny amount of current investment.[14] The administration might claim it as only a first step, but when a first step takes this long, saying more may be coming has little credibility. At this point, implementing regulations for the EO will not appear until autumn 2023, and the EO may be in effect for just a year. China could continue to offer powerful incentives to invest in technology. Financial institutions can wait the EO out, lobbying to have it expire even if President Joe Biden is reelected (lobbying which may be more effective after reelection no longer matters).

Other administration actions are also unimpressive. Chinese firms have failed to meet US disclosure requirements for the entirety of the time they've been listed, yet one audit at the end of 2022 saved them from the first disciplinary action.[15] They will again fail to meet US disclosure requirements, because Chinese law protecting state secrets is both extremely broad and far more dangerous to the listed firms than are American regulations.[16] The rule of law has been and continues to be bent, chiefly for the sake of trading income going to New York rather than Hong Kong. This is hardly encouraging for enforcing outbound investment restrictions.

One step further removed are the lists of military-linked companies started by the Trump administration. No disinvestment has been required;[17] only new investment is barred. Much worse, the lists started out far too short and remain so, in light of China's requirement that civilian entities cooperate with the military.[18] Money can still go exactly where the PRC wants it to go, merely using a slightly different set of recipients.

For its part, Congress's record on outbound investment is threadbare. This is odd. Congress previously strengthened inbound investment review on an overwhelming bipartisan basis,[19] in large part to prevent technology loss. Members are currently interested in limiting technology loss through exports, suspicious that the executive has not been doing enough.[20] Yet technology development within China can be supported by American money, without limit. Legislators show intense interest in blocking Chinese acquisition of American land. The spending on land is tiny compared to US investment in the PRC, but the level of congressional attention is higher.

There is one notable exception. In 2021–22, Congress attempted to address outbound investment through the National Critical Capabilities Defense Act (NCCDA).[21] It ultimately passed the House but not the Senate, where it had been introduced. NCCDA was far better than nothing, which is what Congress has produced to date. But it was excessively broad, addressing both supply chains and outbound investment and not specifying levels of technology to be covered. This scope was used as an excuse by opponents, most of whom want to do nothing at all.[22] Their excuses can be exposed while halting US aid for advanced Chinese technology.

A Policy Solution

An EO, any administration's EO, is never a solution. It's always a Band-Aid, even if absolutely necessary for a short time. The solution is enduring legislation. The first component of that is mandating much greater transparency, along the lines set out above. The reaction to making capital flows more transparent will clarify who supports genuinely open markets. Opposing transparency means you're not protecting any long-standing American principles. With regard to transparency and all policy steps, routing money to China through offshore financial centers must be treated the same as investing directly. Private equity must be treated equivalent to other forms of investment. The same applies to investing in any other countries of concern Congress identifies, such as Russia or Iran.

Beyond disclosure requirements, the core of outbound investment review is what transactions should be covered. A simple idea is to reverse the scope of the Committee on Foreign Investment in the United States (CFIUS): Covered transactions are those covered by CFIUS. But this must obviously be changed, since CFIUS protection of military facilities and citizen privacy inbound does not apply in outbound investment. The technology aspect does apply. If a transaction in the US would be mitigated or blocked due to potential technology loss to China, American money should not be allowed to help China develop that same technology. Insanity is a good description for blocking off technology here while funding the same technology there.

CFIUS reform passed in 2018. If the technology guidance laid out at that time needs to be reviewed, the review can certainly be part of outbound investment legislation. While in theory technology guidance could instead be drawn from export controls, in practice the Bureau of Industry and Security simply ignored the mandate to control foundational technology.[23] It would further risk legislative authority to rely on export controls as administered by an executive agency that has defied congressional intent.

NCCDA itself would have broadened CFIUS's coverage, which was risky since the US has no experience regulating outbound investment. If Congress wants instead to start with narrower restrictions on outbound investment than are applied to inbound, it can create a new coverage list. There are existing options emphasizing technology. In 2021, the Office of the Director of National Intelligence highlighted, as priorities for American strategic superiority, artificial intelligence and autonomous systems, the bioeconomy, quantum computing, and semiconductors.[24] "Bioeconomy" should be made more specific, but this is otherwise a sound choice. A 2022 White House list of critical technologies is too long and overuses the word "advanced."[25]

An important aspect of covered transactions concerns the fungibility of money. While the sectors covered should be narrow, the companies involved should not be. It's not reasonable to claim that a firm pursuing covered technology, say quantum computing, can be supported by American money because it is also involved in uncovered activities. Funds will not just stay in the "good part" of the firm. Any foreign entity involved with a covered technology should be off-limits.

The third indispensable component of legislation is enforcement. Early in the Biden administration's consideration of outbound investment, Treasury floated a proposal that would have done effectively nothing—and therefore hardly needed enforcement.[26] Added to Treasury not providing needed information, this is disturbing. Given the regulator's reluctance, congressional enforcement provisions should be strict.

All American investors in the PRC or in offshore-registered PRC entities should be required to report amounts, their sector designations for the investment, names of Chinese counterparties, and public information provided on counterparty business and investment profiles plus that of its affiliates. This includes US private equity. If a Chinese counterparty or its affiliates participate in the sectors or technologies Congress chooses to protect, investing in them should be punished financially according to the amount spent. A pattern of such investment should be seen as criminal. It would be better to have a narrower scope of application and stricter enforcement; Chinese incentives will easily outmatch the kind of weak oversight Treasury seems to prefer.

The Main Opposition Is Flawed

American investment in the PRC is unregulated, what's being supported is hidden, and in recent years it has

been much larger than flows in the other direction. In contrast, Chinese investment in the US is screened, and we can see where the money goes. By the time Congress (by huge margins) strengthened inbound investment review, Chinese investment in the US was already dropping like a stone, due to Beijing's own concerns.[27] That investment drop did not visibly damage the American economy at all. Yet the financial sector and its allies insist that outbound investment review could badly damage the US. This is a mistake, or worse.

Some arguments in favor of unregulated outbound investment are discredited by opposition to transparency. Others are historically inaccurate. The period of open US investment overseas begins only with the end of the gold standard in 1971, as dollar liquidity was managed more tightly before then. Of course, the Soviet bloc was still excluded in the 1970s and 1980s, as was any hostile country. Globally open investment is three decades old and emerged because it temporarily seemed the US had no dangerous rivals. That is no longer the case. There is no long-standing American principle here, unless it's that making money trumps everything else.

How much money is being made, or, more to the point, how much might outbound investment review cost? The $1.18 trillion in Chinese stocks and bonds through 2021 was chasing above-average returns. Most investment occurred in 2017–20, indicating this was the best time to invest in the PRC, when outbound review would have caused the most loss. The weighted average S&P 500 return for the period is about 15 percent.[28] Setting the China return at 25 percent as an illustration, losing that entirely and reverting to S&P-level returns would have cost an average of less than $22 billion annually. (In 2021, blocking investment in the PRC would have saved Americans money.)

Direct investment does not have a recent increase to focus on, which presumably means the cost of a change now would be low. Cumulative direct investment is also much smaller in size, though it should have higher returns given greater control for the investor. At most, it would add about $1.5 billion to potential annual losses during 2017–20.

Annual losses to US investors from a China ban would thus have been roughly $23 billion in this illustration, which is a bit over a tenth of 1 percent of annual American GDP during this period. Using a more appropriate figure, it's less than 1/5,000th—not a typo—of household net worth in a year.[29] This would be the peak loss for portfolio investment to date, which quantitatively outweighs any earlier peak loss for the smaller amount of direct investment.

But wait, there's less. Not even the most hawkish proposal is a ban on American investment in the PRC. The unfortunate guesswork about industry allocation forced by Treasury suggests even the most sweeping definition of "critical" would encompass only half of investment volume, cutting 2017–20 losses to under $12 billion annually. It's likely that some investment in vague categories such as "other manufacturing" is not sensitive, which would push the number lower again. If Congress starts from the ground up with a narrow set of technology restrictions, the (backward-estimated) annual loss would be far lower than the baseline, in the neighborhood of $4 billion.

American GDP passed $25 trillion in 2022; wealth was more than five times larger than that. Anyone who genuinely cares about the national interest cannot put this level of cost from restricting investment in China ahead of the military, economic, and security risks of aiding Xi's cult of personality. If much-needed disclosure shows little sensitive investment, then potential losses from restricting that are trivially small. If dangerous investment does turn out to be more sizable, restrictions will pay for themselves many times over in protecting American prosperity, security, and values.

About the Author

Derek Scissors is a senior fellow at the American Enterprise Institute, where he focuses on the Chinese and Indian economies and on US economic relations with Asia. He is concurrently chief economist for the China Beige Book.

Notes

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