TOP of MIND

INTERVIEW WITH DANIEL ROSEN

Daniel Rosen is a founding partner of Rhodium Group and leads the firm's work on China, India, and Asia. From 2000-2001, Rosen was Senior Adviser for International Economic Policy at the White House National Economic Council and National Security Council. He is a board member of the National Committee on US-China Relations. Below, he argues that today's focus on US-China trade is just one aspect of a broader debate about Chinese investment and US security.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.

Marina Grushin: The US-China investment relationship seems to be caught in the crosshairs of the Trump Administration's Section 301 case. Can you give us some background on the scale of Chinese foreign direct investment (FDI) in the US and vice versa?

Daniel Rosen: There is a significant two-way flow of investment between China and the US. We estimate that US investment in China, which began back in the 1980s but really took off in the 1990s, has amounted to about $250-260bn of deal activity. That's original deal value; marking it to market and inflating it forward would imply closer to $400-500bn worth of US assets on the ground in China.

China's outbound investment is a much more recent story. It began in the mid-2000s, mostly with investments in energy and raw materials in other developing countries. With the exception of a few deals, Chinese investment in the US didn't really get going until after 2009-2010. Today, its total stock—again, based on original value—is around $140-150bn. That covers energy, extractives, consumer brands, real estate, and R&D—you name it. China has been involved in everything from greenfield investments in Silicon Valley to M&A transactions in an effort to build up Chinese brands.

Marina Grushin: What drove the rise in Chinese investment in the US? Was there more of a push or a pull factor?

Daniel Rosen: There's been both. The push factor relates to China's development. In the mid-2000s, Chinese firms naturally deployed their marginal CAPEX domestically. With gangbuster growth in almost every sector at home, there was little reason to look for opportunities abroad, especially when those opportunities meant clearing significant hurdles. Suffice it to say that operating in California is substantially more onerous than in Guangzhou. But over time, as relatively lax capital conditions in China led companies to over-deploy capital at home, diversification began to look much more interesting. There was also a political driver, as all entrepreneurs in China feel some risk around the preservation of their wealth and the capitalization of their business. All of this became even more acute as China's GDP growth slowed.

So that was the push. But there was also a pull. Chinese companies have enormous market shares in many sectors in the advanced economies. Take low-end textiles as an example—socks, underwear, etc. Around 60-75% of this apparel in the US comes from China. That's a legacy of China having unbeatable production costs. However, China's labor costs have increased; in basic textiles, they're now considerably higher than in Mexico, and in some other industries like shoe manufacturing, they're even comparable to US costs. Chinese suppliers to US brands can no longer count on their cost production advantage. If they want to keep their market share, they need to be deployed on the ground, closer to their consumers, and able to dip into other sources of profit along the value chain. All of these different forces created a powerful logic for Chinese firms to be more present in the US.

Marina Grushin: Chinese FDI into the US declined last year. Are we already seeing the impact of a more hawkish US policy stance towards Chinese investment?

Daniel Rosen: Some people blame this downturn on US policy, and specifically on tighter screening under the Committee on Foreign Investment in the United States (CFIUS), which reviews transactions for national security concerns. But in my view, CFIUS was only a secondary factor. The more important issue was China's own policies. Beijing has had serious concerns about capital outflows and about the amount of leverage being used to deploy capital overseas. So last year, it lifted the drawbridge on outbound investment back up.

This year, it seems that China is aiming to open the doors again. But there have also been powerful signals that China may be taking a less market-oriented path. This is visible in state planning and guidance through programs like Made in China 2025. The Chinese Communist Party has also been insisting on taking a leading role in business decisions, not just at state-owned firms but even in the boardrooms of foreign companies

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invested in China. I see that as a new trend relative to the last 40 years. And it's confirming some of the more hawkish expectations of China that have long been latent in the West, as well as the views of some members of the US Administration. That's resulting in a rethink of China's involvement in our economy, via CFIUS and other means. Going forward, the US and other advanced economies are going to be much less permissive in approving Chinese investments, especially in higher-technology sectors.

Marina Grushin: What do you make of the Section 301 investigation? How much merit does this case have?

Daniel Rosen: At the heart of the 301 case is unfair treatment of intellectual property—the idea that the playing field for FDI has not been level. In particular, Chinese pressure on US firms to transfer their technology in order to secure their place in China has amounted to a huge and unjust transfer of wealth. That's the narrative, and it does have merit. Subsidized and purloined intellectual property is embedded in many Chinese products being put to market around the world.

That said, the reality is more complicated. The truth is that Western companies sometimes offered up the technology that China has absorbed from them. They made their older technology available, thinking—often incorrectly—that China would quickly want to move on to a new generation of technologies, which these Western partners were not going to hand over. And when China stepped up its ability to move toward the next generation without involving Western players in the way that they had hoped, companies and their governments were defeatist about dealing with it and essentially looked to a better, more liberal future—one which is now in doubt.

We often hear that these companies were naïve; that they didn't understand that the Chinese never intended to play by market-economy rules. But in fact they had compelling reasons to engage. China has been more open to foreign participation than almost any other large developing country in history. Consider the fact that virtually every major automobile player in China today is working in partnership with a foreign company, and compare that to Japan or South Korea. Not only did China have a 1.4bn-person market that you couldn't ignore; it was offering up more than other East Asian countries. So the argument that Western players were duped doesn't hold up.

Marina Grushin: How do you see this case playing out? What are the likely targets, and how might China retaliate?

Daniel Rosen: Though the broad strokes of the 301 outcome have been announced, the specific product details have not. China will wait until then to clarify its retaliation list. Narrowly, Washington ought to be targeting the items that have benefited most from unacceptable Chinese intellectual property practices. Consumer electronics and telecom gear are two examples. But much of China's consumer electronics activity involves US companies producing in China and exporting to the US. And on the telecom side, many of the major Chinese players already have limited access to the US market. Looking ahead, Chinese automotive capabilities are one area where the Administration is preemptively closing the door, not least in China's investment in new energy vehicles.

So far China has offered a taste of its ability to tailor retaliation to products made by Trump voters. Targeting US agricultural products could selectively impose substantial pain on red-state farmers, even if China cannot fully substitute its US supply. But in my opinion, having a massive trade surplus means you can't win a trade war. You're benefiting from your access to global markets more than your competitor. So while the Chinese will insist that they are retaliating dollar-for-dollar, we'll have to watch closely to determine whether they are actually trying to de-escalate. Initial indications are—in our judgment—that this is the Chinese goal.

Marina Grushin: What about the possibility of China punishing US companies operating inside the country?

Daniel Rosen: US companies might find that kind of threat more credible if they weren't already being restricted to a fairly thin set of opportunities in China. A lot of US industry would say they're already being punished. And China doesn't have nearly all the cards in its hand when it comes to putting pressure on foreign firms. In finance, for example, I think China needs global institutional investors as much as those institutional investors need China. And several foreign firms have already started to reduce their CAPEX in China because of concerns about the country's growth outlook and debt load. China has many macro risks that have left foreign firms standing on the sidelines. It's just not a great time for Beijing to be threatening them with additional disadvantages, given that those firms bring China substantial benefit and validation.

Marina Grushin: You mentioned CFIUS screening already being tighter. What other changes to CFIUS are in train, and what types of investments would they affect?

Daniel Rosen: There are a number of proposed modifications to the CFIUS regime. Previously, CFIUS would not generally look at an equity stake of less than 10% in a US concern. It would not look at any greenfield investments or any licensing agreements between a Chinese company and a US company. The Foreign Investment Risk Review Modernization Act (FIRRMA) has proposed adding all of these to CFIUS's docket. The legislation is not specific to China but its authors have been explicit that China is the target given new and rising concerns about Chinese activity. For example, there are now worries that China's greenfield operations in the US could absorb enough talent to impact the staffing capacity of domestic firms. Some Chinese firms in Silicon Valley have made it known that they're willing to radically raise the salaries of key talent. That kind of activity has received substantial attention from security analysts in Washington, DC, who are concerned about our source of high-technology innovation and next-generation businesses.

The proposed rules would cover all Chinese greenfield investment in the US, as well as a very large volume of smaller-scale, early-stage Chinese venture capital investment. Of course, they would also create a more hawkish mood around the risks for Chinese companies trying to do a deal in the US.

Marina Grushin: Does all of this add up to a broader recalibration of US-China business relations?

Daniel Rosen: I think so. It's interesting that everybody right now is using the term "trade wars." It's not really just about trade. It's about investment and about security. This debate is taking place not only in the US but in other major economies all around the world. Western policymakers are thinking about how to evaluate the presence of China in their economies, but all policymakers are reassessing their ability to manage foreign influence and strategic threats. Our technologies have evolved so quickly and become so pervasive; personal data can be accessed and weaponized. We have to ask whether our policy constructs are equipped to deal with this reality.

What isn't yet clear is how we will address these vulnerabilities without doing unnecessary damage to our economic opportunities. We have to remember that national security doesn't come just from shutting down risk; it also comes from opening ourselves up, which drives us to be more innovative and efficient. Washington fears that vested business interests will try to block mobilization for higher national security, and wants to shock the system to get past that resistance, even if some things might break in the process. This approach is understandable but untested, and it is going to be a difficult couple of years before we understand the true costs and benefits.

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