An Outbound Investment Screening Regime for the United States?

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A Report by the US-China Investment Project

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RHODIUM GROUP

NATIONAL COMMITTEE ON U.S.-CHINA RELATIONS

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More background on the US-China Investment Project and interactive visuals are available at:
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The US-China investment project is a multi-year research initiative to provide greater transparency on investment flows between China and the United States.

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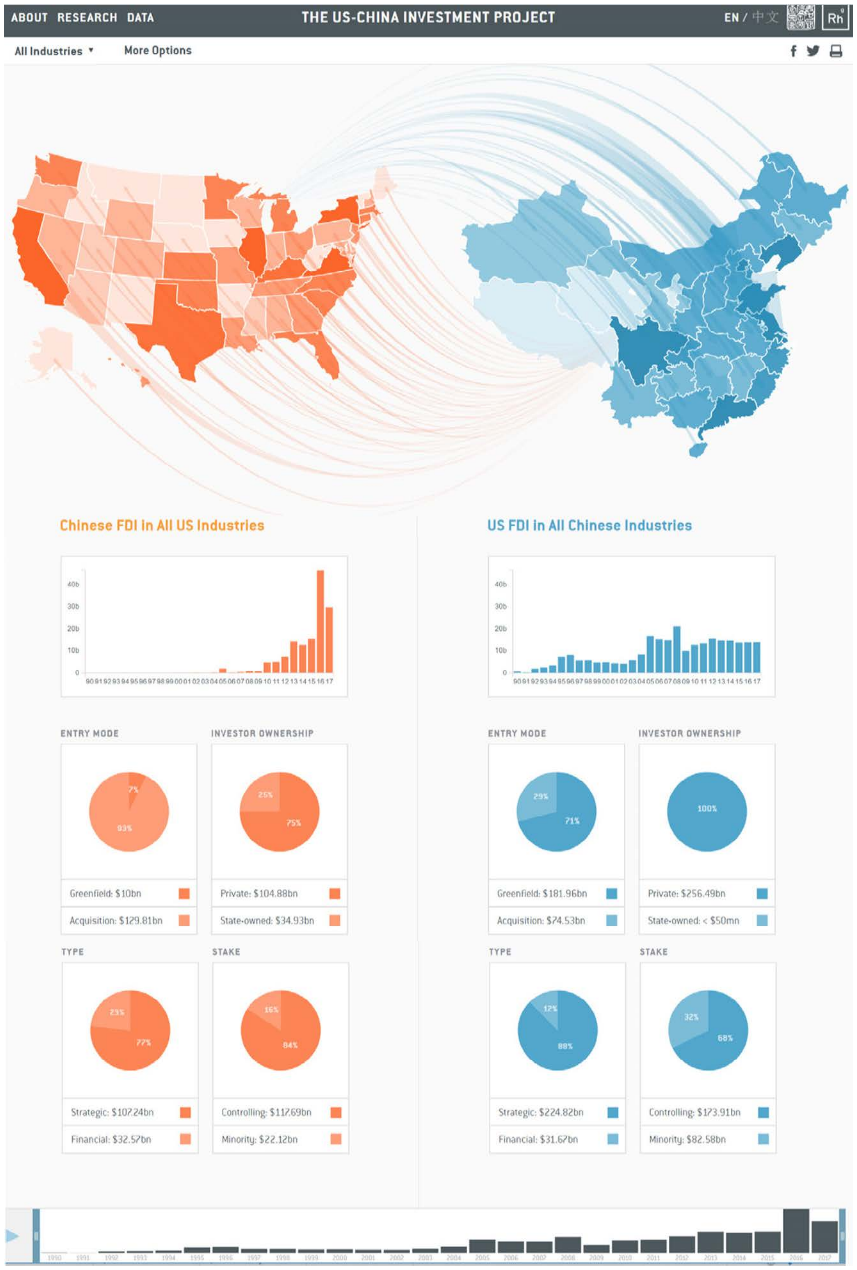

An interactive web application is available at:
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EXECUTIVE SUMMARY

The intensifying competition between the United States and China is forcing changes in the way the global economy is governed. After a significant overhaul of inbound foreign investment screening rules globally, legislative proposals are being considered in Washington that would create a regime to review US outbound investment to China and other countries of concern. This report provides background on the genesis of this legislation and discusses its implications.

- **At a time of intensifying competition between the US and China, lawmakers in Washington are taking a closer look at US investment in China and the risks that such investment could pose to national security:** While US foreign direct investment (FDI) into China has elicited criticism in past decades, growing geopolitical tensions and the COVID-19 pandemic have amplified concerns. Critics argue that such investments, when not properly controlled, can lead to the transfer of potentially sensitive technologies, the outsourcing of critical production, and a loss of visibility into supply chains.

- **A bipartisan group of US lawmakers believe that existing tools are insufficient to address these concerns:** Members of Congress and some parts of the executive branch now argue that the United States needs to go beyond existing policy tools—such as export controls, sanctions, industrial policies and supply chain security rules—to restrict the flow of technology and production capacity to China.

- **Proposed legislation would establish a mechanism to screen US outbound investment to China and other countries of concern**: While the ultimate design of such a regime has yet to be decided, the leading proposal – the National Critical Capabilities Defense Act (NCCDA) – would establish an interagency committee led by the Office of the US Trade Representative. This committee, according to the language in the current NCCDA proposal, would be able to review transactions by US businesses in 'countries of concern' and where 'national critical capabilities' are at stake.

- **If enacted, the proposed regime could have serious implications for the US-China investment relationship:** While the final language of the bill and details around implementation are still pending, our analysis suggests that up to 43% of US FDI to China over the past two decades would have been covered under the broad categories set out in the NCCDA. In addition to slowing new investment, a new regime could also pressure US businesses to reassess existing operations in China because of potential effects on revenue, profits, and market share. The proposed mechanism could accelerate the already visible shift in US-China investment relations away from "active" channels (long-term direct investment) toward more "passive" channels (securities investment and the sourcing of non-sensitive inputs).

- **An outbound investment screening regime would represent a break from US foreign economic policy tradition:** If the legislation is enacted, the US would be one of only a handful of advanced economies with industry specific outbound investment restrictions distinct from traditional sanctions regimes. If not designed in a targeted, predictable manner, this change could negatively impact not only the global competitiveness of US companies in affected industries but also the attractiveness of the United States as an investment location for firms that operate globally.

- **A new US regime could trigger more restrictive investment policies in other nations**: A decision by the US to introduce an outbound FDI screening mechanism might encourage some US allies to consider similar steps. This could help coordination but in a worst-case scenario could also lead to another wave of investment policy reform that creates additional regulatory barriers for cross-border investment flows globally. There is also a possibility that other countries could view US outbound investment restrictions as going too far and refuse to follow suit. US allies could react negatively if the US operations of their companies are suddenly subject to such restrictions. This could complicate, rather than enhance, multilateral coordination in responding to China and put US companies at a competitive disadvantage.

INTRODUCTION

In 2018 President Trump signed the Foreign Investment Risk Review Modernization Act (FIRRMA) which expanded the jurisdiction of the Committee on Foreign Investment in the United States (CFIUS), increased its staffing, and made several other adjustments to the existing investment screening regime. These changes were made mostly due to national security concerns related to foreign direct investment (FDI) from China in the United States. While not the primary driver, FIRRMA has contributed to a sharp slowdown in Chinese investment in the US since 2017, particularly acquisitions of advanced technology companies. In tandem with the new legislation, the US also stepped up its outreach to allies on issues related to investment screening. In recent years, we have seen countries like the United Kingdom, Germany, and Japan overhaul their FDI vetting rules, while the EU has introduced a pan-European coordination mechanism.

Early versions of FIRRMA included provisions that would have expanded CFIUS's jurisdiction to cover outbound investment activities, such as US joint ventures in China. These provisions were ultimately dropped due to lobbying from US businesses and replaced with an expanded export control process for "emerging and foundational" technologies. The America LEADS Act of 2020, a major Democratic-led bill on China that preceded the United States Innovation and Competition Act (USICA), included provisions to create a "Committee on Production Integrity in the United States," under which authorities would have been given new powers to review certain outbound investments.

The COVID-19 pandemic and growing geopolitical rivalry between the US and China have led lawmakers to consider once again the idea of introducing an outbound investment screening mechanism. On May 26, 2021, Senators Casey and Cornyn introduced the National Critical Capabilities Defense Act, a bill to establish an interagency committee to screen outbound transactions that have the potential to shift or relocate critical capabilities to countries that are considered US rivals or adversaries. While China is not specifically singled out, it is a primary target of the mechanism. The bill defines "countries of concern" as foreign adversaries and those with non-market economies.

Though the bill faces opposition from industry groups, there appears to be increased support in Congress and in the White House for tools that would curb technology transfers to China and increase visibility into, and control over, US critical supply chains. National Security Advisor Jake Sullivan, in a speech last summer, suggested the White House may be open to the idea of restricting outbound investment. While many uncertainties remain, outbound investment controls could well be one of the most important policy topics for US-China economic relations in 2022.

This report provides background on the latest legislative efforts in Washington and discusses what a US screening regime for outbound investment could mean for US-China economic relations and the global economy more broadly. The first section describes how the growth of US investment in China has elicited concerns among US policymakers. Section 2 summarizes the policy response in Washington and the details of the National Critical Capabilities Defense Act. Section 3 assesses the potential impact of the legislation on US-China investment flows. Section 4 discusses what implications this break from US foreign economic policy tradition would have for the US and global economy.

1. US INVESTMENT IN CHINA: TRENDS AND CONCERNS

Foreign investment has played a crucial role in China's economic modernization since 1978. Openness to FDI allowed China to increase its manufacturing capabilities, upgrade its technology, learn new management techniques, and benefit greatly from globalization.

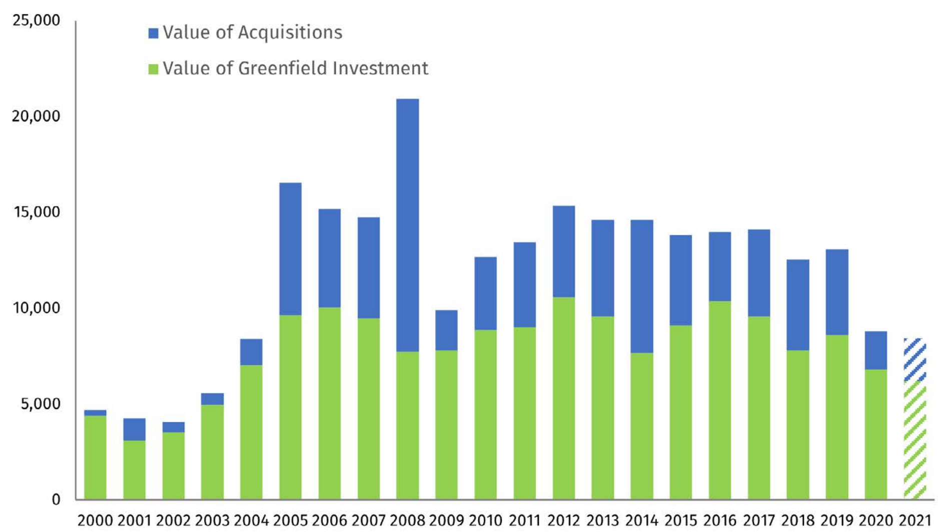
This receptiveness to FDI was a signature element of China's reform and opening policy. US multinationals, for their part, played an active role in the buildout of China's capabilities, integrating the country into the global trading system while seeking to take advantage of China's enormous and growing consumer market. This initial phase of FDI laid the foundation for the modern US-China relationship. US investor presence also meant that much of China's development was built on US standards, with US technologies, conferring both commercial advantages and national security benefits on American interests.

From 2010 to 2020, US investors put nearly $150 billion into China (Figure 1). Annual investment flows peaked in 2012 at $15.4 billion. Some of the largest investments have included Tesla's factory in Shanghai, Disney and Universal Studios theme parks, and Walmart stores.

The leading industries in China receiving US investment in this period were Information and Communications Technology (ICT) ($25b), Automotive ($18b), and Basic Materials ($14b). Annual investment stayed relatively stable from 2010 to 2019 but geopolitical tensions and the COVID-19 pandemic have weighed on new flows in recent years. In 2020, US direct investment in China was at its lowest level since 2004 and our preliminary estimates for 2021 ($8.5b) indicate no major recovery.

Figure 1: Value of US FDI Transactions in China, 2000-2021

USD million



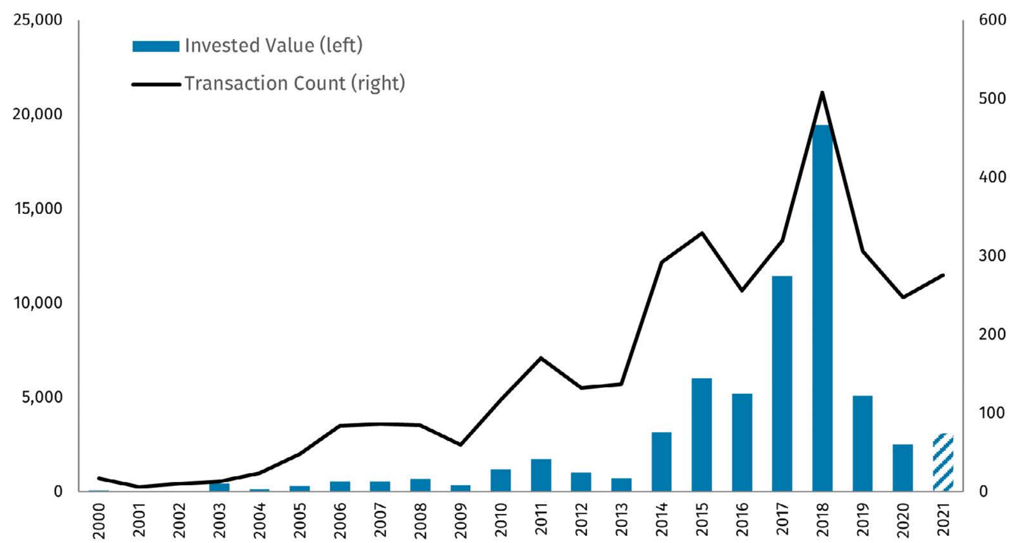
Source: Rhodium Group. 2021 figures preliminary.

US investors have also been major sources of financing for Chinese technology startups. Since 2010, US investors have put nearly $60 billion of venture capital (VC) into China (Figure 2). Venture capital usually results in smaller equity stakes but can still involve significant ownership influence. This investment began to pick up in 2014 and then grew to $20 billion in 2018 before falling back to $3 billion in 2020.

Like FDI, our preliminary VC numbers show no major bounce back for 2021. Over the period of 2010 to 2021, the top sectors for US VC investment in China were Financial and Business Services ($7b) Health, Pharmaceuticals and Biotechnology ($6.4b), and ICT ($5.9b).

Figure 2: Annual US Venture Capital Investment in China, 2010 to 2021

USD million



Source: Rhodium Group. 2021 figures preliminary. Data includes all funding rounds with at least one participating -US-controlled venture fund (usually determined by general partner nationality) or other entity; value reflects the estimated proportional shares of each funding round attributable to US investors.

From its early days, US FDI in China has triggered intense debate in Washington. Supporters pointed to the benefits that foreign investment and free trade brought by reducing prices for US consumers. Critics focused on the outsourcing of US jobs and manufacturing capacity in pursuit of lower labor costs and risks arising from the transfer of US technology. Over the past decade – and especially since 2016 – rising geopolitical tensions between the US and China have amplified these concerns and US foreign direct investment in China has taken a more prominent role in the national security debate.

One long-standing concern in Washington is that US investment in China facilitates the transfer or buildup of technology and knowhow that could strengthen China's civil and military capabilities to the detriment of the United States. These concerns extend back to the 1980s-1990s when what was then known as the Bureau of Export Administration (now the Bureau of Industry and Security), as well as the Office of Technology assessment of the US Congress, identified significant areas of concern for US businesses seeking to establish joint ventures or other business operations in China, including intellectual property misappropriation, extensive technology transfer requirements, and in-country localization.

While a big portion of US FDI to China in the past decade was geared towards serving the Chinese consumer, American investors have become an important part of China's innovation system. The industry in China with the most US FDI since 2010 was the ICT sector with nearly $25 billion, including many investments in semiconductors and other technologies at the center of US-China competition. Chinese startups, critical for approaching the cutting edge of technology, have received more than $50 billion of VC investment from US investors since 2010. In 2019 U.S. multinationals invested nearly $4.2 billion of R&D expenditures in China (BEA). What amplifies these concerns is the existence of civil-military fusion programs and the absence of the rule of law, which make it virtually impossible for Chinese firms to keep homegrown technology away from the military.

Another major concern today is supply chain security—the ability to ensure access to critical goods and services in the face of disruptions arising from conflict, economic coercion, or natural disasters. Since the 1980s, permissive US trade and FDI policies have enabled China to consolidate its comparative advantage in labor-intensive manufacturing and draw in global production capacity in many industries. Subsidies, industrial policies and other measures have allowed Beijing to tip the scales, taking a significant share of global supply chains even in areas in which it does not have a comparative advantage.

China has used this supply chain leverage both as a carrot and a stick in its relations with other countries. China's disputes with Australia, South Korea, Japan and others have included threats of boycotts or blocked access to key minerals and components. At the outset of the pandemic, China's control of the PPE supply chain left countries at the mercy of Chinese suppliers. Analysts have even identified areas where the US military is reliant on inputs from China.

2. THE POLICY RESPONSE: A NEW OUTBOUND INVESTMENT REVIEW REGIME?

Critics argue that current tools have not gone far enough in restricting US investment in sensitive technologies in China and in securing US supply chains, and that therefore new tools are needed.

While FIRRMA increased scrutiny of Chinese investment in the United States, some US lawmakers have criticized the Department of Commerce for not being more aggressive in implementing a companion law that granted regulators new powers to identify and restrict the flow of "emerging and foundational" technologies to countries like China. Export controls are based on a time-consuming multilateral process that can render decisions to control a specific product or technology outdated by the time those decisions are formally approved and published. In recent years, US administrations have expanded list-based sanctions on Chinese companies—for example, by using the Department of Commerce's Entity List and the Non-SDN Chinese Military-Industrial Complex Companies List (NS-CMIC List)—but some critics have argued that such restrictions target only a selection of overtly troubling Chinese companies and fall short of preventing technology transfer to China's broader military-industrial ecosystem

Supply chain security also remains a concern. The Biden administration is seeking to strengthen domestic content requirements on certain goods procured by the government, but government procurement only accounts for a small share of the market in many sectors, even those such as semiconductors that are critical to the functioning of the US economy. Some proponents of tariffs on Chinese goods promised to bring manufacturing in certain sectors back to the United States, but business surveys suggest that the impact on supply chain reshoring has been minimal. There have also been efforts to protect domestic supply chains in specific sectors, such as the Executive Order on Securing the Information and Communications Technology and Services Supply Chain (ICTS rule) and the CHIPS for America Act, but these by their nature do not encompass the full range of supply chains that may trigger national security concerns. The perceived lack of visibility into critical supply chains led the Biden administration to issue an Executive Order on America's Supply Chains in February 2021, ordering reviews of supply chain vulnerabilities in certain sectors.

Growing Momentum in Congress

In response to these concerns, some lawmakers are pushing for an entirely new regime. In recent years, members of Congress have put forward a number of proposals to create a mechanism to review outbound investment. One such bill, the National Critical Capabilities Defense Act (NCCDA) is currently under consideration in Congress, with proponents hoping to attach it to the US Innovation and Competition Act, which is due to be debated in early 2022.

The NCCDA would establish an interagency committee with powers to review and potentially block a wide range of investments overseas, namely:

> *"…any transaction by a United States business that shifts or relocates to a country of concern, or transfers to an entity of concern, the design, development, production, manufacture, fabrication, supply, servicing, testing, management, operation, investment, ownership, or any other essential elements involving one or more national critical capabilities […] or could result in an unacceptable risk to a national critical capability."*

The bill defines national critical capabilities as the production, services, and supply chains in four sectors: medical supplies and PPE, disaster recovery, military and intelligence, and critical infrastructure – an umbrella term that itself encompasses sixteen subsectors ranging from agriculture to nuclear power. The bill also requires the committee to review eleven industries to identify other critical capabilities (Table 1).

Table 1: National Critical Capabilities under the NCCDA

Production, services, and supply chains critical to:
1. Medical supplies, medicines, and personal protective equipment
2. Articles critical to infrastructure construction after a natural or manmade disaster
3. Articles essential to the operation, manufacture, supply, service, or maintenance of critical infrastructure
4. Articles that are components of systems critical to the operation of weapons systems, intelligence collection systems, or items critical to the conduct of military or intelligence operations

Industries to be Reviewed to Identify Additional National Critical Capabilities:
1. Energy
2. Medical
3. Communications, including electronic and communications components
4. Defense
5. Transportation
6. Aerospace, including space launch
7. Robotics
8. Artificial intelligence
9. Semiconductors
10. Shipbuilding
11. Water, including water purification

Source: National Critical Capabilities Defense Act

Under the bill, US businesses planning to "shift or relocate" a critical capability to a foreign adversary or nonmarket economy country would be required to notify a new Committee on National Critical Capabilities led by the Office of the US Trade Representative. The bill does not spell out which countries would be considered foreign adversaries or defined as having non-market economies, but existing Department of Commerce (DOC) lists may serve as a starting point (Table 2).

Table 2: Countries Identified as Foreign Adversaries and/or Non-Market Economies under Current Regulations

Foreign adversaries	Non-market economy countries	
China	Armenia	Moldova
Russia	Azerbaijan	Tajikistan
Iran	Belarus	Turkmenistan
North Korea	China	Uzbekistan
Cuba	Georgia	Vietnam
Venezuela	Kyrgyzstan	

Note: "Foreign adversaries" defined by the Department of Commerce for the purposes of the ICTS rule and "non-market economy countries" defined for purposes of anti-dumping and countervailing duty laws.

If the committee determined that the transaction posed an unacceptable risk to national security, it could recommend that the president take mitigating action, including blocking the transaction. Additionally, the committee would be required to initiate reviews at the request of the leading members of one of a dozen congressional committees. The committee would also have the power to self-initiate a review in cases where a notification was not submitted. Only transactions pending or proposed (from the date of enactment) could be reviewed; past transactions would not be reviewable. The committee may also make recommendations to Congress to establish or expand federal programs to support domestic manufacturing in national critical capabilities in response to a case.

The bill also includes provisions covering transactions with "entities of concern"—businesses whose ultimate owners are domiciled in a country of concern or that are "controlled by, owned by, or subject to the influence of a foreign person that has a substantial nexus with a country of concern." This suggests that even transactions within the United States or to countries that would not normally ring alarm bells might be subject to reviews if people or companies from countries of concern are involved.

3. POTENTIAL IMPACT ON US-CHINA INVESTMENT

Producing detailed estimates of the impact of a US outbound screening mechanism is impossible without details on the legislative outcome and regulatory implementation. However, we can consider the most advanced legislative proposal – the National Critical Capabilities Defense Act – and use our historical data to produce rough estimates for how much US investment to China could potentially be affected. We also use historical data to discuss the possible impact of such legislation on existing US assets in China.

Impact on New Investment

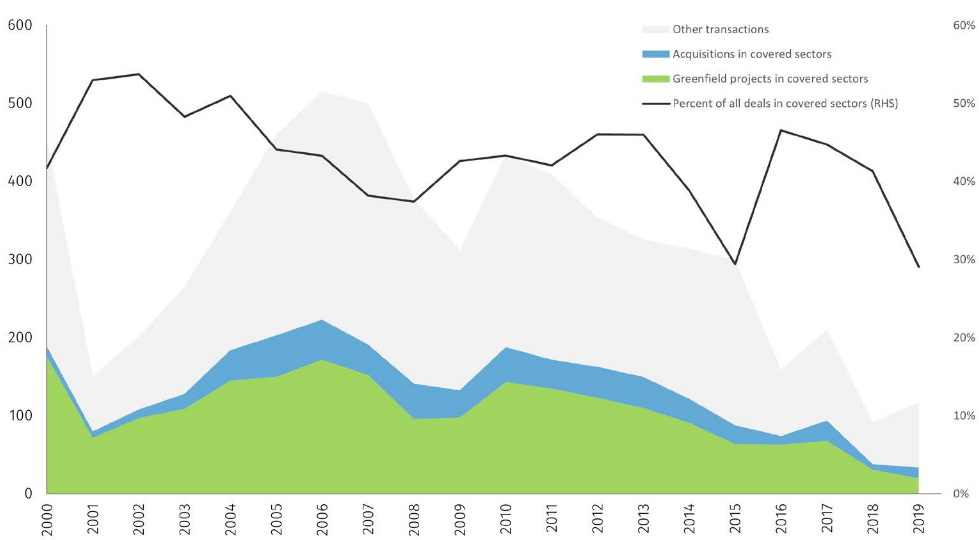
The US-China Investment Project database of historical US direct investment transactions in China allows us to produce some estimates of the scope of potentially covered transactions in the future. We reviewed a sample of 6,309 major greenfield investments and acquisitions from 2000 to 2019 to determine how many transactions occurred in sectors relevant to a national critical capability as defined under the bill. We coded these potentially covered transactions by matching Rhodium Group industry categories with each of the categories listed as critical capabilities in the bill: medical supplies and PPE, disaster recovery, military and intelligence, and critical infrastructure.

The bill defines critical infrastructure as "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on national security, national economic security, national public health or safety, or any combination of those matters." The Department of Homeland Security's Cybersecurity and Infrastructure Security Agency (CISA) uses this same definition to categorize 16 sectors as critical infrastructure, so we used their classification to code investments in this category.

Using this approach, we found that 43% of US FDI transactions into China from 2000 to 2019 took place in industries identified in the bill as relevant to national critical capabilities (Figure 3). In terms of transaction value, US investment in potentially covered industries totaled an estimated $110 billion. In value terms this amounts to 45% of the $243 billion in FDI recorded over the entire period.

Figure 3: US FDI Transactions in China in Potentially Covered Industries, 2000-2019

Number of transactions (left); percent of annual transactions (right)



Source: Rhodium Group. We identified industries defined by the National Critical Capabilities Defense Act (H.R. 6329) as related to national critical capabilities, and then tallied the number of greenfield projects and acquisitions in these industries by US firms in China from 2000 to 2019.

This is a historical snapshot on US investment in China that might have been affected by such legislation, not an estimate of what future deals might be reviewed under the bill if it becomes law. However, it does underscore how broadly the bill defines "critical" industries and gives an indication of the volume of transactions that would need to be reported for China alone. It underscores the need to narrow down definitions and clarify processes to increase predictability and avoid politicization of individual transactions, especially if – as under this bill – members of Congress can initiate investigations.

Clear definitions are especially important for "critical infrastructure," which accounted for most of the investments in potentially covered sectors in this analysis. The sectors with the greatest number of investments were automotive equipment and components, chemicals, and industrial machinery and equipment (Figure 4). Many of these investments likely present no threat to the resilience of US supply chains, but the vagueness of what constitutes a national critical capability under this bill means that a wide range of benign investments could come under scrutiny.

Figure 4: Sectoral Breakdown of US FDI in China in Potentially Covered Industries (2000-2019)

Number of transactions

Source: Rhodium Group.

Impact on Existing Operations

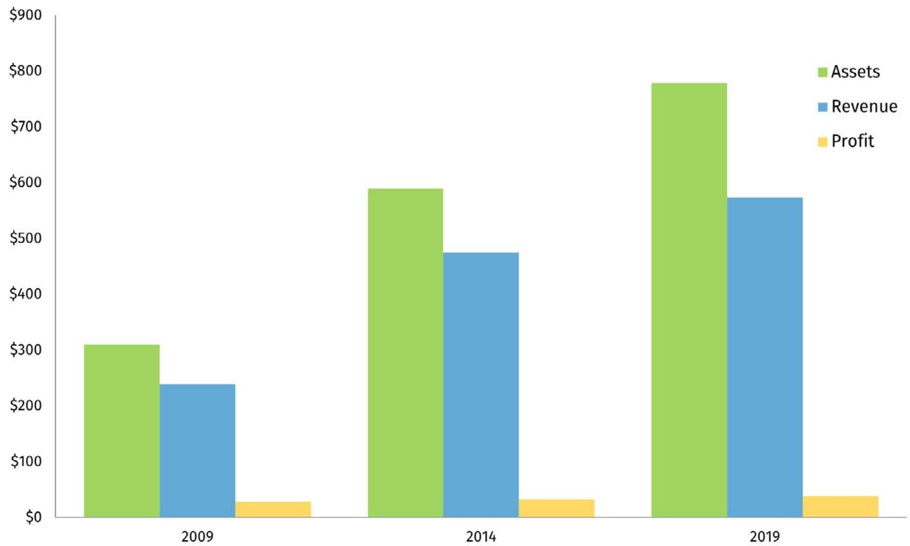
Beyond its impact on new investment, one must also consider what effect such legislation might have on existing US operations in China. Although the screening mechanism is not going to be applied retroactively, greater scrutiny could put additional pressure on existing US operations and even force firms to reduce or divest current operations.

Four decades of investing has endowed the US with an enormous asset footprint in China. The US-China Investment Project dataset catalogues nearly $300 billion worth of FDI transactions at historical value since 1990. Taking an asset perspective (which includes a broader set of assets including bank deposits and locally financed equipment), US multinationals have accumulated $779 billion by 2019 according to data from the US

Bureau of Economic Analysis. According to the BEA, these operations produced $573 billion in revenue and $38 billion in profits for US multinationals in 2019 (Figure 5). For some US firms, China has become a very significant share of their global business, through revenue exposure, growth reliance, asset exposure or value chain reliance.

Figure 5: Assets, Revenue and Profit of US Companies in China, 2009, 2014, and 2019

USD billion



Source: BEA. Rhodium Group.

A possible US outbound investment screening regime puts this asset base in China at risk in several ways.

First, new investment is often needed to sustain existing operations. Many US FDI projects are done in stages, expanding over time. It is unclear how a new outbound screening regime would treat follow-on investments or the expansion of existing facilities. For example, an investment to retrofit an existing US-owned auto factory in China to produce electric vehicles could potentially be construed as shifting a "national critical capability" in a key technology to a country of concern (vehicle manufacturing is included in the Department of Homeland Security's list of critical infrastructure sectors). Without approval, these assets might have to be retired or sold off.

Second, US firms will likely face greater legal/compliance costs and thus have a competitive disadvantage compared to local and other foreign firms. If similar outbound screening mechanisms are not adopted by the European Union and other developed economies, US firms will face comparatively greater regulatory burdens. The regulatory burden and associated costs will ultimately depend on the design of the regime and the requirements and process for submitting mandatory filings. One particular challenge would be possible violations of China's new data security laws. If the expansion of an existing facility was subject to a formal review by the US government, the company would presumably have to submit confidential data to US authorities on the relevant operation in China, which in turn could be prohibited under Chinese law.

Finally, it is possible that Beijing could retaliate against US firms if a new outbound investment regime is enacted. Beijing recently put in place an anti-sanctions law which imposes restrictions on individuals and entities involved in carrying out foreign sanctions. How this outbound investment screening mechanism would fit within that framework is unclear. China has other ways of responding, for example by labeling US firms as unreliable suppliers or using informal tools to raise market access barriers for US businesses operating in China.

All these factors could put pressure on US multinationals and lead to lower revenue and profit, as we discussed in a 2021 publication. Companies that are highly exposed to the Chinese market and operate in sectors potentially covered by the National Critical Capabilities Defense Act would be particularly affected.

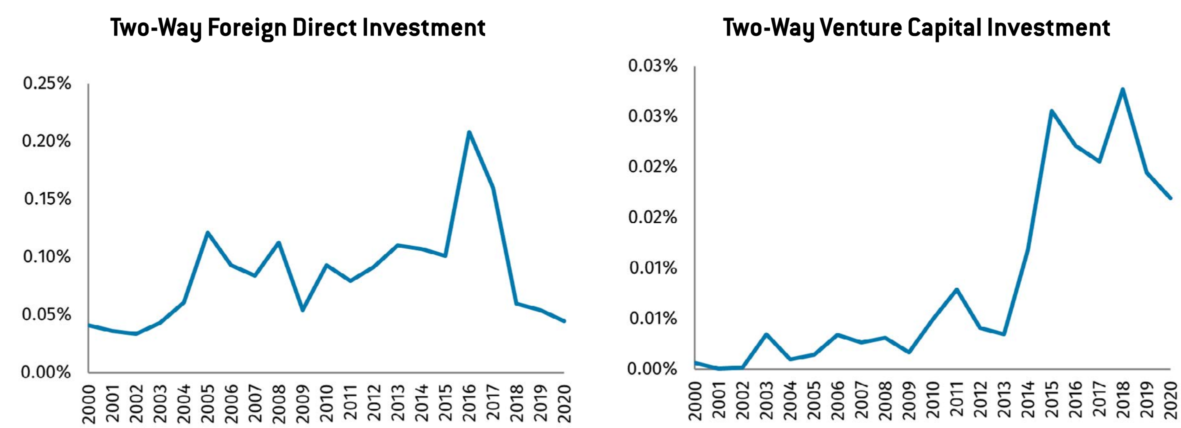
Toward a More Passive US-China Investment Relationship?

In most conceivable scenarios, an outbound investment screening regime will make it more difficult for US-domiciled companies to pursue opportunities in China. Foreign investors are already dealing with a host of issues in the Chinese market including slowing Chinese growth, persistent market access barriers, new regulations by Beijing, and pandemic-related restrictions. Additional policy restrictions from Washington will aggravate these pressures and could cement lower levels of US FDI in China, especially if the scope remains as broad as in the current legislative text.

This would further accelerate an already visible shift in US-China investment relations from "active" to "passive" investment. Active channels – including FDI and VC – have peaked and are on a downward trajectory, especially when measured against GDP (Figure 6). This decline started in 2015/2016 and has accelerated during the global pandemic. On the other hand, passive investment channels – ownership of equities and bonds – have been rising rapidly over the past years and may gain further traction if no new policies to restrict them are enacted.

Figure 6: US-China Two-Way Investment Flows 2000-2021

% share of combined GDP



Source: Rhodium Group.

4. BROADER IMPLICATIONS

Aside from its impact on US-China relations, an outbound investment screening regime like the one proposed by the National Critical Capabilities Defense Act could also have broader implications for US foreign economic policy and global investment policy.

A New Era of US Foreign Policy

Since World War II, the US has been a champion of a free, open global investment environment, with only narrow exceptions for national security. The open investment principles and public security exception principles are commonly accepted by fellow members of the OECD and codified in the OECD Codes of Liberalization of Capital Movements. Individual governments have interpreted the need for national or public security exceptions differently. In the US, those national security exceptions have been applied mainly on the inbound side, through CFIUS. Restrictions on outbound capital flows have been limited to country-, activity- or entity-specific sanctions. US export controls can also limit FDI flows in specific technologies that are blacklisted if the investments involve the transfer of technologies to either establish or expand operations in a foreign jurisdiction. However, in modern times, the US has not been in the business of reviewing outbound investment, whether in specific industries or toward specific countries.

The new regime proposed under the National Critical Capabilities Defense Act would represent a significant break from US foreign economy policy tradition. If implemented, the US would be one of only a handful of OECD economies that have such formal restrictions or review requirements in place, on top of sanctions and export control regimes. Of the ten largest OECD economies, only the Republic of Korea (ROK) and Japan have such restrictions in place. South Korean legislation established the Industrial Technology Protection Committee, which has the ability to block outbound investment by firms that hold "national core technology" developed by government subsidies for R&D. Japan requires government notification for foreign investment in a small number of industries for security reasons (Table 3).

Implications for the US Economy

Openness and a lack of red tape for global investors has helped make the US the dominant country in global cross border capital flows. At the end of 2020, according to the OECD, the US had the world's largest stock of both inward and outward FDI, with $10.8 trillion and $8.2 trillion, respectively.

A US outbound screening regime would not only affect the assets and competitiveness of US companies in the Chinese market but could also impact the US operations of foreign companies. Many globally operating MNCs have operations in the US, either for specific purposes like R&D or as a hub to serve the Americas. According to the National Critical Capabilities Defense Act, foreign-owned subsidiaries in the US would be subject to outbound investment controls as well (foreign companies thinking about shifting production activities involving national critical capabilities to countries of concern would need to report the transaction to the committee, and could face mitigating action).

At a minimum, this increases the cost of doing business for US-domiciled companies, complicating cross-border operations relative to other countries. Under certain circumstances we could see both American and foreign companies shifting IP-intensive operations or assets out of US jurisdiction to avoid being covered under the new regime.

Table 3: Outbound Investment Controls in Major Economies

Country	Macroprudential Controls	Industry-Specific Restrictions	Country-Specific Restrictions	Entity-Specific Restrictions
Australia			Australia maintains a sanctions regime that targets individual countries.	
Canada			Canada maintains a sanctions regime through the Special Economic Measures Act that targets specific countries.	The Justice for Victims of Corrupt Foreign Officials Act targets individuals and entities.
China	Households are prohibited from investing overseas unless they invest through an institution that has a quota under the Qualified Domestic Institutional Investor (QDII) scheme. Outbound investment by companies requires filings and sometimes approval from regulators. There is also informal window guidance to banks on FX conversion for outbound investment.	China's outbound investment regulations discourage investment in specific industries such as weapons manufacturing, new media, and cross-border water-resources. A mandatory approval system is in place for investments in sensitive industries such as real estate, hotels, cinemas, and entertainment (these investments are often labelled as "irrational").	China's outbound investment regulations require prior approval for outbound investments in sensitive regions and countries such as Taiwan and countries without formal diplomatic relations.	China has sanctions in place for individuals and associated entities.
European Union			The EU maintains a sanctions regime that targets individual countries.	The EU maintains a sanctions regime that targets companies, groups, organizations, and individuals.
France			France implements the EU sanctions regime.	France implements the EU sanctions regime. France can adopt autonomous sanctions towards physical and legal persons.
Germany			Germany implements the EU sanctions regime.	Germany implements the EU sanctions regime.
Italy			Italy implements the EU sanctions regime.	Italy implements the EU sanctions regime.
Japan		Outbound investment by residents in fisheries or firms involved in the manufacture of weapons, narcotics, and leather goods requires prior notification.		
South Korea	Residents can invest abroad through designated foreign exchange banks; investment by financial institutions requires notification to and acceptance by regulators.	South Korea's "Act on Prevention of Divulgence and Protection of Industrial Technology" established the Industrial Technology Protection Committee, which has the ability to block outbound investment by firms that hold "national core technology" developed by government subsidies for R&D.		
United States		The NCCDA would impose restrictions related to investment in certain industries deemed a part of national critical capabilities.	The U.S. maintains a sanctions regime that targets specific countries and restricts investment at a national level. The NCCDA would impose restrictions related to investment in certain countries of concern.	The U.S. also bars investment into particular entities through Executive Orders. The Bureau of Industry and Security of the Department of Commerce also maintains an entity list that requires firms to obtain licenses before doing business with a listed entity.
United Kingdom			The United Kingdom maintains a sanctions regime which targets individual countries.	The United Kingdom maintains a sanctions regime which targets specific individuals. Financial sanctions restrict investment in firms related to specific individuals and entities.

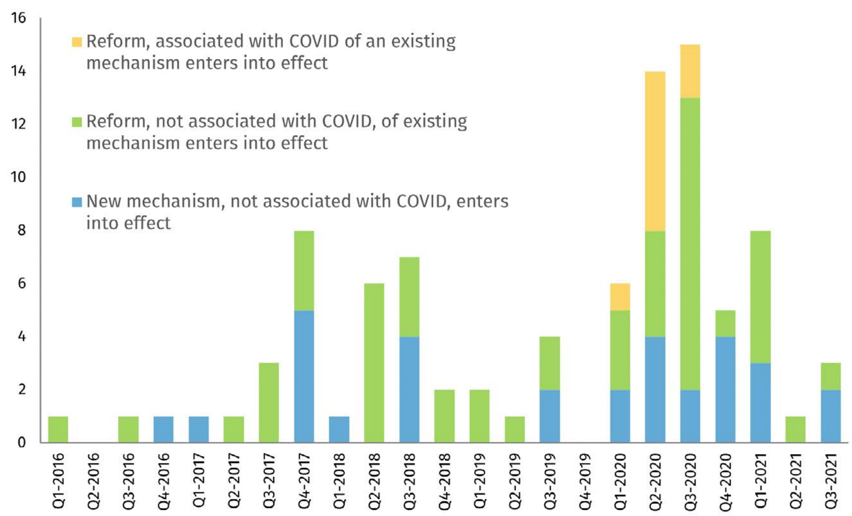
Source: Rhodium Group.

Global Ripple Effects: Convergence or Greater Divide?

Another important aspect to consider is the US leadership role in reshaping global rules in response to national security challenges originating from China. While some early movers, including Australia and Canada, have had a pioneering role, the US has been perhaps the most influential actor in the debate over inbound FDI screening regimes within the OECD. This leadership has contributed to a wave of inbound FDI policy reforms over the past decade, which is only now trending down (Figure 7). A push by the US for an outbound FDI screening regime could prompt other governments to consider similar steps, especially allied "like-minded" nations. The legislation could also help the US and allied nations to better understand supply chain risks and vulnerabilities by bringing additional visibility into how businesses make decisions around offshoring to and sourcing from China.

Figure 7: New or Reformed Investment Screening Policies to Safeguard Essential Security Interests among G20 Members, Q1-2009 to Q3-2021

# of policies and reforms



Source: OECD/UNCTAD

On the positive side, this could increase the potential for productive coordination between the US and allied nations in specific areas. One example of joint action on this front is US-EU cooperation on outbound investment screening in the civil aviation industry. In June 2021, the US and EU issued a joint cooperative framework saying that they would "coordinate and explore common approaches and enhanced cooperation regarding screening of new outward investments in joint ventures and production facilities in non-market economies".

It would be negative, however, if US legislation sparked a wave of investment policy reform that created additional regulatory barriers for cross-border investment flows globally and potentially opened the door to politicization and protectionist interventions. Given their prominent position in global investment, US companies could be heavily impacted by such a development.

There is also a likelihood that some allied nations would choose not to follow the US down a path of stricter outbound investment controls. Some could also react unfavorably to the imposition of new restrictions on the US operations of their companies. This could create additional tensions between the US and major allies at a time when Washington is trying to foster closer international coordination in responding to challenges posed by China.

CONCLUSIONS

In recent years, the United States and other market economies have begun to rethink their free and open approach to trade and investment, in part due to concerns about China's state-driven economic model and its implications for global competition. Washington has begun vetting acquisitions by Chinese companies more closely, used sanctions and export controls to restrict the transfer of sensitive technologies to China, and reassessed its approach to supply chain security. The COVID-19 pandemic brought both supply and demand shocks that intensified these supply chain concerns. At the start of 2022, with diplomatic tensions between the US and China showing no signs of abating, a consensus appears to be emerging in Washington that additional tools are needed to safeguard national security. Congress is considering legislation to create a regime that would review investments that US-based businesses make in China and other countries of concern.

It is far from certain whether these legislative proposals will become law. Even if enacted, elements of the initiative could be watered down as the legislative process unfolds. The ultimate impact on businesses would hinge to a large extent on the rules governing the implementation of such a law. What seems certain, however, is that an outbound investment screening regime, if it materializes, would have major implications for the economic relationship between the US and China. Based on our analysis, as much as 43% of US FDI transactions in China over the past two decades would have been covered by the broad categories set out in the National Critical Capabilities Defense Act, the main outbound screening proposal being considered by Congress. If the bill becomes law without major changes, it will almost certainly accelerate a shift in US-China investment ties away from "active" FDI towards more "passive" holdings of equity and bond securities.

A new US outbound investment screening regime could have broader implications as well. If not designed in a targeted and predictable manner, such a regime could have negative consequences for the global competitiveness of US companies in several critical sectors and for the attractiveness of the US as a global investment destination. It could also stoke tensions with US allies, who may decide not to follow America's lead and react unfavorably to new investment restrictions imposed on the US operations of their companies. These tensions could undermine the push for a collective response to the challenges posed by China.

It is not always possible to take all possible contingencies into consideration before making policy decisions, particularly at a time when the geopolitical landscape is shifting rapidly. However, given the stakes, it will be important for policymakers and business leaders to carefully weigh the benefits and costs of introducing an outbound investment screening regime. A clearly defined and targeted approach could complement other tools in the US arsenal, alleviating concerns about technology transfers and supply chain risks related to China. However, the risks of a broad and loosely defined screening approach like the one proposed in current versions of the NCCDA are high, both for American companies and the US economy.

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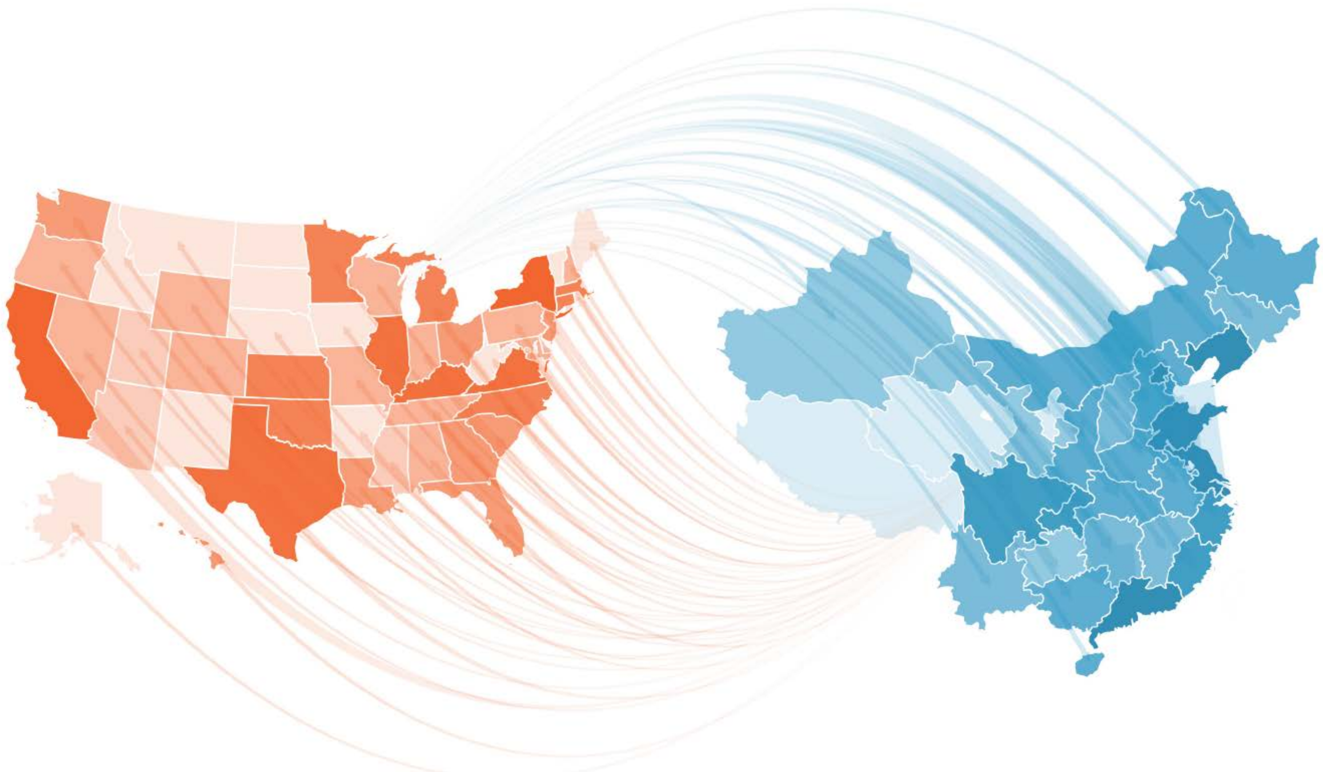

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