The past decade has seen two main trends in the U.S.-China economic relationship: it has gotten bigger, and it has gotten more contentious. Nowhere is this more apparent than in bilateral investment ties. Even as the frustrations of U.S. companies operating in the Chinese market have mounted in the Xi Jinping era, the stock of Chinese direct investment in the United States has been growing rapidly, stirring up political anxieties in the U.S. Congress. To those familiar with the history of U.S.-Japan economic tensions in the 1980s, these developments raise two concerns. The first is that Congress will repeat the mistakes of the past, damaging an important relationship and missing economic opportunities by overinflating ill-defined fears. The second is that Washington will fail to recognize the unique challenge that China poses and to respond with an appropriate mix of policy tools.

Foreign investment has long been a sensitive topic in Washington. The Committee on Foreign Investment in the United States (CFIUS), the Treasury-chaired interagency body responsible for conducting national security reviews, was created by President Gerald R. Ford in 1975 in response to surging investment from oil-producing countries. In 1988, inflows of Japanese investment led Congress to pass the Exon-Florio provision, which formalized the CFIUS review process and gave the president legal authority to block investments on national security grounds. A number of high-profile acquisition attempts by Chinese and Middle Eastern buyers prompted another major legislative revision in 2007; among other changes, the new Foreign Investment and National Security Act (FINSA) expanded the CFIUS remit to include critical infrastructure.

These legislative reforms have sought to strike a balance between preserving the benefits of an open investment climate and protecting national security. Administrations of both parties have generally maintained this balance in their management of CFIUS. Most recently, the Obama administration issued a public statement on its commitment to openness in June 2011, noting that foreign investments “create well-paid jobs, contribute to economic growth, boost productivity, and support American communities.” At the same time, President Obama twice blocked attempted acquisitions on national security grounds, while other deals were quietly withdrawn after CFIUS expressed serious concerns.

Does China present such a distinct challenge that it requires a new approach?

In many respects, the surge of Chinese investment is similar to the Japanese wave that hit U.S. shores 30 years ago. Many Chinese companies are seeking supply-chain efficiencies by locating production in the United States or trying to skirt potential protectionist walls. Chinese investment may help preserve American jobs and create new ones. And like their Japanese counterparts before them, some Chinese investors will overpay for trophy assets like iconic buildings and golf courses bearing no relation to U.S. national security.

However, China is different from Japan in at least four ways that are relevant here. First, despite nearly four decades of “reform and opening,” the Chinese party-state retains a pervasive role in the economy, and the boundary between public and private control is blurry at best. Second, Beijing is actively seeking to become “the world’s major science and technology power,” a goal reflected in plans such as Made in China 2025 and efforts to acquire strategic technology assets abroad. Third, Beijing has backed up these plans with massive financial firepower and policies—from state-supported intellectual property theft and forced technology transfers to widespread subsidies of Chinese companies and discriminatory antimonopoly enforcement—that distort markets and disadvantage U.S. firms. Finally, China is a strategic competitor of the United States, and its economic policy plans are intimately tied to its military modernization and more assertive security posture.

Reflecting these and other concerns, multiple legislative proposals aiming to tighten the CFIUS screen are circulating in the U.S. Congress. Senators Chuck Grassley (R-IA) and Debbie Stabenow (D-MI) have introduced legislation to increase attention on food security. Senator John Cornyn (R-TX) is reportedly working on a bill focused on making CFIUS more robust as a national security review mechanism. And Senator Chuck Schumer (D-
NY) is reportedly preparing legislation that would require CFIUS to consider economic factors in its review process, a more fundamental reform of the current system.

There is certainly scope for refinement of CFIUS processes. One seemingly reasonable reform is allowing CFIUS to review “greenfield” investments (i.e., those in which a foreign investor builds operations from the ground up rather than acquiring an existing asset). Another is improving transparency around investment transactions to ensure that problematic deals do not slip through the net. The CFIUS process would also benefit from additional resources as the transaction caseload increases. The practitioner community could no doubt come up with other reforms to improve the effectiveness of CFIUS in ways that are practical, inexpensive, and nonintrusive.

However, there is a risk that hasty legislative reforms could undermine a process that is generally working well. Proposals that restrict the flexibility of CFIUS and create new uncertainty are unlikely to make it a more effective guardian of national security. For example, mandating that CFIUS keep a list of countries of concern—something it can already do in practice—would create uncertainty among all foreign investors and encourage more elaborate disguising of problematic transactions. Likewise, the addition of an economic test to CFIUS reviews could dilute the body’s national security focus and encourage other countries to follow suit.

This last point deserves particular emphasis. CFIUS is a national security review mechanism. Its function is to work with U.S. export controls, counterintelligence programs, and other mechanisms to guard against national security threats. These include leakage of sensitive military or dual-use technologies; denial or manipulation of U.S. access to strategic materials; and infiltration, espionage, or other forms of disruption. For the most part, CFIUS is performing its job effectively and has the appropriate flexibility and autonomy to do so. Expanding its mandate beyond clear issues of national security would be a mistake.

At the same time, the factors listed above that make China different—particularly the increasingly hostile environment for U.S. companies in China and Beijing’s stated goal of indigenizing key sectors of the economy—raise the question of whether Chinese inbound investment should be subject to tougher scrutiny outside CFIUS. One suggestion is to apply a separate “net benefit” test to inbound investment. Canada applies such a test through a process distinct from its national security review. Advances in data and economic modeling are allowing more reliable assessments of the likely effects of an individual investment in terms of jobs, growth, or tax revenue. The hard part is determining what is worth measuring and how to weight different variables. An economic test would also open the door to special interest lobbying, leading to protectionism that could undermine U.S. competitiveness and hurt consumers.

Another option is reciprocity. Strict reciprocity, in which a foreign company’s ability to invest in an American shoemaker depends on whether a U.S. investor can buy a shoemaker in the foreign country in question, makes little economic or strategic sense; in effect, it would allow a foreign government to set U.S. investment policy. But there might be benefit in setting conditions of market openness that, if met by an investor’s country of origin, would trigger automatic review—and possible denial—of inbound investments on economic grounds. These review criteria, which could be regularly assessed through a special report authorized under Section 301(c) of the Trade Act of 1974 and might be based on the Commerce Department’s statutory criteria for determining market economy status, could provide leverage to help push for more openness in China or other countries, while preserving executive discretion.

As ideas like these are debated, it is important to bear in mind that an effective U.S. response to the China challenge requires not only good defense but also smart economic statecraft that incentivizes Beijing to open its markets and play by high-standard rules. The Trump administration’s decision to walk away from the Trans-Pacific Partnership (TPP) was decidedly unhelpful in this regard. Other incentives will have to be considered, including enhanced enforcement efforts and the prospect of a high-standard bilateral investment treaty (BIT) that substantially improves market conditions in China.

Competing with China also requires investing in the foundations of U.S. competitiveness, through tax reform, infrastructure spending, and investments designed to maintain America’s innovative edge. The latter requires getting past the traditional American allergy to “industrial policy” and reevaluating the role of the public sector in targeted support for innovation.

Finally, Washington cannot take on the China challenge alone. Coordination with allies—especially partners who possess strong industrial and technological capabilities, such as Germany and Japan—is essential. This will increase U.S. leverage and maximize the incentives for China to adjust its behavior in line with international rules and norms. Coordination of inbound investment policies should be part of these efforts, both to share best practices and ensure awareness of Chinese activities across different jurisdictions.

In sum, CFIUS reform should not take place in isolation and cannot be a substitute for comprehensive and strategic U.S. economic statecraft that maximizes the opportunities and manages the risks of a rising China.

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