

Written Testimony before the U.S.-China Economic and Security Review Commission

*Hearing on “Key Economic Strategies for Leveling the U.S.-China Playing Field: Trade, Investment, and Technology”*

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## **Funding Your Opponent’s Technology Is Not Competing**

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American policy is rightly aimed at outcompeting China. Yet there are no restrictions at all on American money helping China win. There is not even the basic information necessary to decide what funding restrictions, if any, are needed for the US to prevail.

To illustrate, taxpayer subsidies for semiconductor production here are undermined by US direct investment in semiconductor production in China and portfolio investment in state-backed Chinese chip companies. When the Department of Commerce (reasonably) asks for more CHIPS funding in 2025, the Department of the Treasury will likely tell Congress there are no data on American funds supporting competing Chinese production. Sorry, good luck with your vote. The same is true for any activity the US may be averse to, from critical minerals processing to surveillance drones – American money helping China is barely monitored, much less restricted.

This failure does not only apply to advanced technology but that's where it's most stark. Export controls limit China's access to technology through sales and other transfers. The Committee on Foreign Investment in the United States (CFIUS) limits China's ability to buy technology here. These existing limits are justified by the many possible economic, military, and even human rights costs to technology transfer to China. Yet American funds can freely support development of the same technologies in the PRC. The treatment of outbound investment to date is not only self-defeating in a supposed competition, it's nonsensical in combination with other policies.

There are additional harmful Chinese activities that American funding can support. The US needs much better monitoring of what money is doing, as well as action to stop flows damaging to national interests. Even in purely financial terms, Chinese securities markets performance, Xi Jinping's policy performance, and the PRC's opacity suggest restricting funds is less risky for most investors than taking no steps. Outbound investment is overdue for rational policies, especially ones that stop offering up our capital as a substitute when our knowhow is restricted.<sup>1</sup>

### **The Available Numbers**

Good policy is an accident without good information and, on outbound investment, the US falls far short of good information. Moreover, given the limited available information, many decision-makers end up focused on the wrong thing. In the case of American investment in China, the wrong thing to focus on is direct investment, which is creating a new asset or taking a notable stake in an existing asset.

This is not to say direct investment should be ignored, but it does not appear to be dynamic. At the end of 2022 (data are next updated in July), the cumulative total for American direct investment in the mainland was \$126 billion. Including Honk Kong pushes that to \$215 billion. Nearly \$700 billion supposedly direct investment in the Caribbean islands may mask a higher true figure for the PRC.<sup>2</sup> The single biggest increase for the US in mainland China or Hong Kong was \$24 billion, but it occurred in 2008. The 2022 increase for the mainland was a little over \$10

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<sup>1</sup> For more, see Derek Scissors, "What To Do About American Investment in China," American Enterprise Institute, May 2023, <https://www.aei.org/wp-content/uploads/2023/05/What-to-Do-About-American-Investment-in-China.pdf?x85095>.

<sup>2</sup> US Department of Commerce, Bureau of Economic Analysis, "US Direct Investment Abroad," July 20, 2023, <https://www.bea.gov/international/di1usdbal>.

billion while direct investment in Hong Kong declined. The much larger stock of investment in Caribbean islands also declined in 2022, potentially swamping the rise for mainland China.

Beyond the obscuring role of the offshore financial centers, the public by-sector breakdowns for direct investment are too general and may mask relevant developments. Through 2022, spending on the mainland was topped by wholesale trade at near \$19 billion, followed by computers and electronic products at just over \$17 billion. For Hong Kong, non-bank holding companies were dominant, at over half the total. The leading categories for the offshores are also non-banking holding companies, followed by finance. Those funds in fact support activity in other industries.

Portfolio investment is the acquisition of securities with little ownership. It is certainly less valuable dollar for dollar than direct investment, for example in the potential conveyance of technology. However, the numbers involved for American portfolio investment in China have been larger since 2017, in terms of both levels and changes. This cannot be seen in Treasury's monthly investment data. Those show the Cayman Islands as the top recipient at \$2.56 trillion at the end of 2022. The actual number is very near zero - the Caymans and other offshore financial conduits are only holding areas for funds headed elsewhere.

Once annually for the past few years, the Federal Reserve has determined where portfolio funds labeled as headed to the offshores actually go.<sup>3</sup> The Fed has shown that, at the end of 2022, the single largest final destination of money supposedly headed to the offshore financial conduits is actually the US. The money comes back, round-tripped most likely for tax reasons.

The second-largest destination for the capital assigned to the Caymans and the like is China. The true stock of direct and indirect American portfolio investment in China and Hong Kong was \$910 billion in 2022, falling from \$1.17 trillion in 2021. This followed a leap from \$516 billion in 2016 to \$1.4 trillion in 2020. In 2016, referring to trade, candidate Trump criticized the loss of American money to the PRC. Money does leave the US in China trade, with goods and services coming back. When funds leave the US as investment in the PRC, what comes back (or not) is profits for investors. Which is the worse exchange for the US?

The "trade war" where China and America were said to be at each other's economic throats in fact saw the two further integrating, possibly at the expense of American national interests. Combining the trade deficit and gross US portfolio spending, the top year on record for money leaving the US is 2017.<sup>4</sup> The next two are 2019 and 2020. In 2020, while COVID spread from China to kill hundreds of thousands of Americans, US capital either saw huge paper profits from PRC investments, poured hundreds of billions of new dollars into the PRC, or mixed the two.

The current amount of American portfolio investment in China appears considerably larger than direct, and portfolio changes utterly dwarf changes in direct investment since 2016. But most portfolio investment is in common stock, suggesting equities markets may be more important than injections or withdrawal of funds. Alibaba's stock, for example, peaked in 2020 but lost

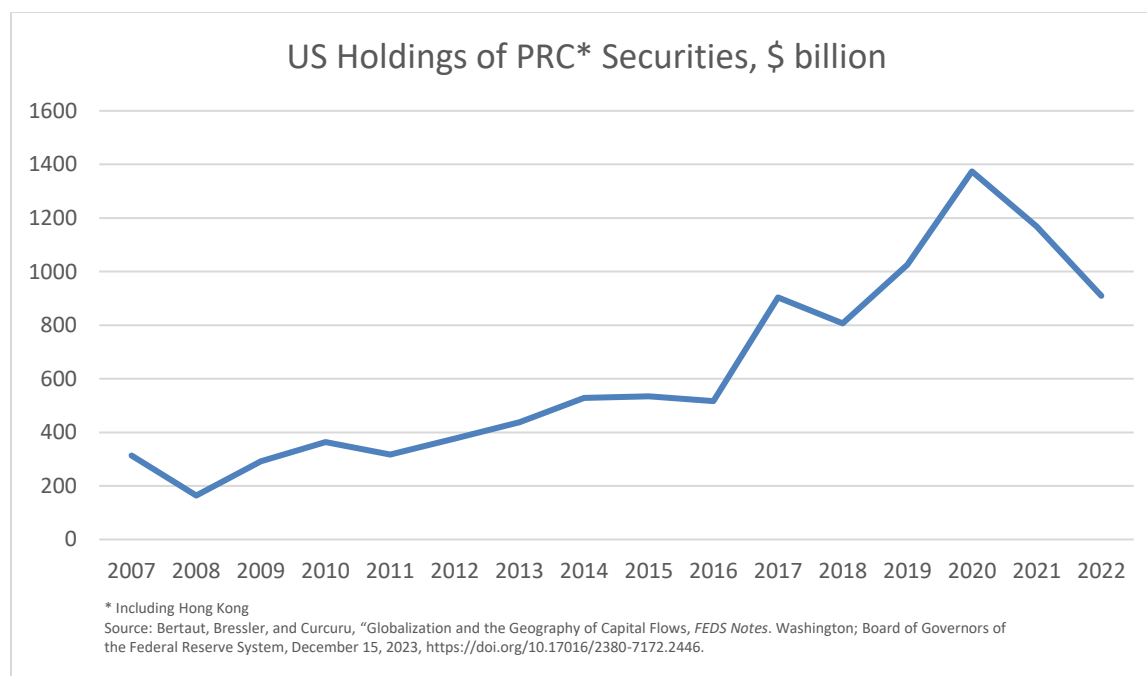
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<sup>3</sup> Bertaut, Bressler, and Curcuru, "Globalization and the Geography of Capital Flows, *FEDS Notes*. Washington; Board of Governors of the Federal Reserve System, December 15, 2023, <https://doi.org/10.17016/2380-7172.2446>.

<sup>4</sup> US Department of Commerce, Bureau of Economic Analysis, "International Trade in Goods and Services," May 2, 2024, <https://www.bea.gov/data/intl-trade-investment/international-trade-goods-and-services>.

\$570 billion in capitalization after attacks by Chinese regulators.<sup>5</sup> While the single largest American stake lost only \$5 billion in this drop, total (notional) losses to American investors were likely in the many tens of billions of dollars. Tencent and other private Chinese firms saw less dramatic versions of the same event, meaning tens of billions more in notional losses.

This reduced the value of American holdings in the PRC. The Alibaba case and others suggest trading gains and losses may have driven the large moves in US portfolio position.<sup>6</sup> Against that, however, is the trend in the benchmark Shanghai composite stock index. From end-2016 to end-2020, the Shanghai index climbed barely 10 percent while American portfolio investment holdings in China soared 166 percent.<sup>7</sup> In 2021-2, Shanghai shares slipped 11 percent, while American holdings dropped 34 percent. Broad market fluctuations do not explain the rise and fall of US investment, point to large amounts of money first being sent then being withdrawn.



<sup>5</sup> Yahoo Finance "Alibaba Group Holding Limited (BABA) Stock Historical Prices and Data," May 1 2024, <https://finance.yahoo.com/quote/BABA/history/?frequency=1mo&period1=1557271514&period2=1715124296> and Xinhua, "China's top market regulator imposes penalty on Alibaba Group over monopoly conduct," April 10, 2021, [http://www.xinhuanet.com/english/2021-04/10/c\\_139871057.htm](http://www.xinhuanet.com/english/2021-04/10/c_139871057.htm).

<sup>6</sup> Another sentiment measure is found in market capitalization of Chinese companies in the US plummeting from November 2021 to September 2022, US-China Economic and Security Review Commission, "Chinese Companies Listed on Major U.S. Stock Exchanges," January 8, 2024, [https://www.uscc.gov/sites/default/files/2024-01/Chinese Companies Listed on US Stock Exchanges 01 2024.pdf](https://www.uscc.gov/sites/default/files/2024-01/Chinese%20Companies%20Listed%20on%20US%20Stock%20Exchanges%2001%202024.pdf).

<sup>7</sup> Yahoo Finance "SSE Composite Index (000001.SS) Stock Historical Prices and Data," May 1 2024, <https://finance.yahoo.com/quote/000001.SS/history/?frequency=1mo&filter=history&period1=867807000&period2=1715125286>.

## Existing Policy?

It's oddly become controversial to say outbound investment should be monitored and restricted by a mechanism similar to CFIUS. An outbound version would be smaller and simpler than CFIUS, with no responsibility for blocking acquisition of sensitive data or land. Acquisitions will be rare, so confidentiality will be easier. Otherwise, CFIUS has sound motivating principles concerning technology and has been largely successful, not anything to shy away from.

With regard to authority over any new body, Treasury's stance is somewhat inconsistent. The August 2023 Advance Notice of Proposed Rulemaking<sup>8</sup> for the outbound executive order (EO) pretends purchases of public securities are beyond the pale or at least require more input, as if it was not extensively discussed for several years already. But if portfolio investment is mistakenly excluded, the main justification for Treasury jurisdiction is Treasury runs CFIUS and this should be like a reverse CFIUS. It's Commerce which provides direct investment data, and better data are necessary for policy making. A third option is Defense is given principal authority, clarifying that American objectives here are not economic. Treasury's standard view that the issue is too financially complex for other agencies is belied by its steadfast opposition to complex action.

Whatever's done is much better accomplished via durable legislation from Congress than an EO that succeeding administrations may void or decline to enforce. Neither the Trump nor Biden administrations is responsible for Congress' failure to provide such legislation, most painfully in 2020 as American portfolio investment stock in China soared while Covid spread. Congress having voluntarily set itself to the side, the Biden administration's record on outbound investment is far superior to the Trump administration's, but this is almost entirely by default.

Fast-rising exposure to Chinese securities during the Trump administration was foolish, as well as likely damaging to American security. Its unwinding cannot be due to Biden administration action because, as of May 2024 and despite constant chatter, there has not been any action. When they finally appear, the implementation regulations for the Biden EO may be better than nothing, barely. Secretary Yellen's deeds and words show desire to cooperate with China, not compete. Perhaps it's not surprising the Advance Notice asks for the most basic information,

“Where possible, please provide empirical data about trends in U.S. investment into country of concern entities engaged {in sectors of concern}”

The Trump administration should have asked for that information starting in 2017 or 2018. This administration, rightly, raised the issue of outbound investment publicly at a senior level in July 2021.<sup>9</sup> Three years later, Biden's Treasury wants policy jurisdiction where it apparently did not

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<sup>8</sup> US Department of the Treasury, Office of Investment Security, Provisions Pertaining to U.S. Investments in Certain National Security Technologies and Products in Countries of Concern,” *Federal Register* 88 (August 14, 2023, <https://www.federalregister.gov/documents/2023/08/14/2023-17164/provisions-pertaining-to-us-investments-in-certain-national-security-technologies-and-products-in>).

<sup>9</sup> White House, National Security Council, “Remarks by National Security Advisor Jake Sullivan at the National Security Commission on Artificial Intelligence Global Emerging Technology Summit,” July 13, 2021, <https://www.whitehouse.gov/nsc/briefing-room/2021/07/13/remarks-by-national-security-advisor-jake-sullivan-at-the-national-security-commission-on-artificial-intelligence-global-emerging-technology-summit/>.

bother to ask for indispensable data and hoped voluntary commentators can provide it. The most recent formal publication indicates the EO will likely accomplish almost nothing, assuming it is ever implemented. There is still no sense at all of how much American investment may be covered in terms of disclosure, restriction, or any ban. And given delays to date, implementation in 2025 is now most likely, after the election and of course optional for whoever wins.

### **Needed: Transparency, Plus**

Treasury prefers capital to flow freely to the PRC and wants to set aside as inviolate the largest flow, which is acquisition of stocks and bonds. It does not want to document where that money might be going - no sector breakdowns are published. From 2017-2020, did the soaring amounts of American capital go to low-risk or high-risk activities? Surveillance or shoes? Were they withdrawn from the same activities in 2021-2 or did the risk profile of American portfolio investment in China change more recently? The meaning and impact of the Alibaba capitalization drop, among many other things, would be revealed by data on sector allocation.

Crucially, the level and trend of American financial support for Chinese work in synthetic biology, advanced computing, and other advanced or possibly dangerous technologies could also be revealed. Even the excessively broad categories presently used for direct investment would be an improvement. The US has never attempted to monitor what American portfolio capital supports in China. Good policy requires this knowledge, and those opposing transparency are deliberately undermining market principles and function, not defending them as they often argue.

Portfolio investment is more mobile than direct and money apparently invested in one sector can easily slide elsewhere. Some counterparties may be illegitimate, which is the responsibility of American investor if they are protecting their clients. But large-scale funds movements within China are detectable. And it is unreasonable to claim American financials raise and deploy huge sums with little knowledge of or accountability from their initial counterparties. Inauthentic counterparties will be revealed over time and barred as recipients. Greater transparency in the extent of American support of high-risk activities in the PRC should be understood as vital to the national interest. If private actors find search costs onerous, they should avoid risky investment.

While more transparency is a necessary and long overdue first step; it cannot be the only one. Proper disclosure by firms and Treasury may show that investment in high-risk sectors is low, which would be reassuring. But that's far from a long-term guarantee, given the previous surge in outbound flows. There are certainly activities in China, from enhancing military capabilities to attempts to change behavior of "troublesome" individuals, that the US should not invest a dollar in. Implementation of outright bans should start cautiously, not for the sake of placating Beijing or American corporate and financial interests but because it's a new US government action that will lead to unexpected outcomes, certainly in the form of attempted workarounds.

The first policy choice is what Chinese activities must not be supported. Congress has struggled with durable definitions of what's critical, and waiting to establish an extensive list is a mistake. One possibility is starting with a consensus list of four or five critical industries, while explicitly leaving the door open to adding (and subtracting) other activities in 2-3 years. There are also other, obvious options based on existing restrictions. If a technology is subject to export controls

or to CFIUS review involving Chinese entities, it's self-defeating to allow American money to help speed development of the same technologies by the PRC. At least some should be off limits. Again the starting list of these can be short, but implementation is already years overdue.

Once scope is decided, restrictions should not be applied entity by entity. The specific entity involved does not serve as the foundation of export controls or inbound investment, for good reason. The problem is not single bad actors, the problem is the goals of the Party routed through the Chinese state. Private Chinese firms cannot choose to be safe partners, to comply with US regulations or to decline transactions with PRC enterprises engaged in targeted activities. The state will shift assets away from sanctioned entities to others even if, on a large scale, this will become fairly clear. (For these reasons, use of the Entity List is also not sensible for China.)

Targeting technologies or sectors instead of firms ties to genuine enforcement. Intellectual property is an extremely destructive example of US laws being flouted with no consequence. Export controls are circumvented, and so on. For outbound investment, multiple instances of misrepresentation by a Chinese entity should be treated as criminal, with the Specially Designated Nationals list the obvious response. Unlawful behavior by American investors should see a public warning which, if ignored, should be treated as criminal. Political incentives are high for talk, but not for any costly enforcement. But without painful enforcement provisions, the US should just stop pretending outbound investment, among other things, is a serious issue.

### **Trivial and True Costs**

If there is no enforcement, the costs and benefits of restricting outbound investment will both be essentially zero. Truly curbing American financial support for high-risk Chinese activities would have *potentially* enormous benefits in the form of saving very large industries or even reducing American war casualties. These swamp any conceivable regulatory cost to the US government.

While benefits are potential, though, costs to enforced restrictions would be definite. There are unavoidable costs to private and public sector monitoring and public enforcement. Public costs are justified by the risks. Private self-policing costs will be small if investment restrictions are clear and eventually small even if they are not, as learning occurs. The most feared cost is lower returns but, for portfolio capital, that fear is manifestly unjustified. The Shanghai composite index was higher in January 2010 than it was in April 2024. The S&P 500 over that period rose from 1,100 to 5,000. Diversification into Chinese securities has long invited painful errors.

Even if individual investors do at some point lose returns due to restrictions, the amount would be insignificant for the national interest. For American portfolio investment in the PRC, the enormous increase 2017-2020 was obviously seeking higher than expected returns. Say half of it had been barred -- highly unlikely under any proposed outbound regime -- had not then been invested in the US and thus earned far more, and thus somehow lost 300 basis points of yield. The bizarrely unlikely scenario still means not much more than \$3 billion annually in lost returns. This is what parts of the financial community want to elevate over the national interest.

Restricting the far smaller volume of direct investment volumes would initially have negligible costs, which may explain why Treasury refuses to discuss the EO's dollar impact. But smaller

amounts of annual direct investment could later reverberate through the very larger quantity of sales by American affiliates in the PRC.<sup>10</sup> A small investment drop due to restrictions today could mean cumulative annual sales losses that eventually become substantial.

But this presumes Beijing does not, in keeping with longstanding goals of technological upgrade,<sup>11</sup> successfully displace the same US technology affiliates most likely to face US capital restrictions. It will certainly happen in semiconductors. New American investment in semiconductors in China could fall to zero by 2027 as domestic output reaches oversupply levels typical of the industries Beijing has tagged as strategic. Soon enough, American firms will only continue to be welcomed by either transferring advanced technology to the PRC or producing solely for export back to the US. These are the long-term opportunities they presently cling to.

Opponents of outbound investment restrictions may worry most about stocks. Authentic restrictions could well blast share prices of exposed US technology or financial firms. The slump would not last more than a year, but a great many decisions seem to be made eying short-term stock movements. Finally, it's absurd to believe the US should invest for the sake of information on PRC innovation. Private companies do not invest with this national goal in mind, nor would they share information with American policy-makers unless compelled, which would then trigger a response from Beijing. If knowledge of Chinese innovation is so valuable, the US should just hand over our innovations. This would yield excellent insight on what's next in China.

## **Recommendations**

- 1) Congress should require Treasury to publish annual sector breakdowns of nationality-based portfolio investment in China. These sectors should be more specific than those provided by Commerce for direct investment. Congress should require Treasury to publish quarterly updates, without sector breakdowns, of nationality-based portfolio investment in China.
- 2) Congress should require Commerce should publish more detailed sector breakdowns of direct investment in China. Congress should require Commerce to investigate the possibility of nationality-based results for direct investment, where offshore financials would not be said to receive hundreds of billions of dollars and true destinations for the capital would be known.
- 3) Congress should put into law a short list of genuinely critical sectors, as few as three and at most six. These should be reviewed every 2-4 years. All American investment in these sectors that may assist China should be banned, regardless of locations of American or Chinese entities.
- 4) If a critical sector list cannot be mandated, Congress should apply the same comprehensive investment ban to all activities for which export licenses have been denied in the preceding five years and for which CFIUS has barred foreign investment in the past ten years.

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<sup>10</sup> US Department of Commerce, Bureau of Economic Analysis, "Activities of U.S. Affiliates of Foreign Multinational Enterprises," August 18, 2023, <https://www.bea.gov/data/intl-trade-investment/activities-us-affiliates-foreign-mnes>.

<sup>11</sup> From Consulate General of the People's Republic of China in New York, "China marks PLA's 80<sup>th</sup> birthday with grand rally," August 1, 2007, [http://newyork.china-consulate.gov.cn/eng/xw/200708/t20070801\\_4686371.htm](http://newyork.china-consulate.gov.cn/eng/xw/200708/t20070801_4686371.htm) to Wang Mingyan, "President Xi underlines need for innovation in military upgrading," March 12, 2017, [https://news.cgtn.com/news/3d41544e336b6a4d/share\\_p.html](https://news.cgtn.com/news/3d41544e336b6a4d/share_p.html).



5) Deliberate attempts to circumvent any ban should be treated as criminal activity by individuals and entities involved, regardless of nationality. Repeated unintentional failures to observe a ban should be punished by fines matching the value of the largest violating transaction.

6) A licensing process for outbound investment can substitute for outright bans if and only if Congress makes the Department of Defense the primary licensing and enforcing authority. (Licensing and enforcement by Treasury or Commerce would again prove unsatisfactory.)

7) As generally recognized, less complex regulation such as simple bans require fewer resources in implementation. Whatever outbound investment mechanism Congress chooses should see suitable increases in funding and personnel to ensure the legislative step is not an empty one.

The portfolio investment rush to China from 2017 to 2020 and constant sales pitches now make clear Wall Street needs little encouragement to pour money (back) in. Policy inaction from 2017 to mid-2024 makes clear Treasury will do little to discourage any future investment surge. US support of Chinese technology development and other potentially harmful economic activity is not compatible with competition. If America is to truly compete with China, Congress must act.