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CFIUS 2.0: An Instrument of American Economic Statecraft Targeting China

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Abstract

On 13 August 2018, the president of the United States signed a bill to strengthen the Committee on Foreign Investment in the United States (CFIUS), an interagency executive body responsible for screening foreign investments made in the United States for national security risks. The move is primarily aimed at preventing Chinese firms from exploiting the US open capital markets to acquire technology. While much commentary exists spelling out the changes made to CFIUS by way of the legislation, their focus is largely on the legal and business ramifications of the policy at the firm level. This analysis assesses what CFIUS strengthening portends for the tech ambitions, examines the Chinese state's response to the move, and observes its relevance to US–China economic decoupling.

Keywords

CFIUS, economic statecraft, innovation, techno-nationalism, interdependence

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Introduction

On 13 August 2018, the president of the United States signed the Foreign Investment Risk Review Modernization Act (FIRRMA) in a bid to strengthen an interagency executive body called the Committee on Foreign Investment in the United States (CFIUS). The agency is responsible for screening investments made in the United States by foreign persons or governments in order to safeguard against risks to national security. It is widely considered that the move is aimed at preventing Chinese firms and the state from exploiting the US open capital markets to facilitate tech transfer.

Indeed, investing in US tech companies emerged as an increasingly popular method of acquiring know-how for Chinese companies during the past decade. Overseas investments and Mergers and Acquisitions, in particular, provide rapid access to technologies and techniques. Investors emerge as decision-making stakeholders in capable firms, benefit from joint Research & Development (R&D) and can facilitate transfers from foreign subsidiaries to home bases (Amann and Virmani, 2015; Wang and Wang, 2011). Strategic asset-seeking investments were thus actively encouraged by the Chinese state under the rubric of its "Going Out" policy. Incentives included simplified and decentralised administrative procedures, special financial services and cheap credit, tax deductions, direct subsidies, and state-driven mechanisms to mitigate exchange rate risk (Sauvant and Chen, 2014). According to data collated by the Rhodium Group, Chinese investments in tech-intensive sectors including aviation, electronics, health, and Information and Communications Technology (ICT) stood at USD 29.3 billion for the 1990–2017 period (Rhodium Group, 2019). This constituted 20.9 per cent of total Chinese investment in the United States. In 2015 itself, the year during which the Made in China 2025 programme was announced, investments in US tech firms skyrocketed to USD 9.9 billion which was more than triple the number of the previous year (Bennett and Bender, 2018).

US policymakers have not taken kindly to such strategic investments and cite two primary reasons for this. In a comprehensive report prepared shortly prior to the passage of FIRRMA, the office of the United States Trade Representative (USTR) unequivocally concluded that Chinese acquisitions "burden US commerce" by transferring technologies to Chinese competitors (United States Trade Representative, 2018: 65). Second, China's systematic, state-led modus operandi to acquire technology has been frequently cited as a grave concern (Atkinson, 2018; White House, 2018; Wübbeke et al., 2016). CFIUS strengthening was, thus, devised.

This analysis assesses how CFIUS strengthening impacts China's economy and tech ambitions alike by drawing on insights from the relevant political economy literature. Much of the commentary on the subject spells out the changes made with a focus on the legal and business ramifications of the policy at the firm level. The use of an International Political Economy (IPE) lens to elucidate the state's perspective is, thus, a useful addition to the discourse on the subject. Drawing on this assessment, the response strategy of the Chinese state is then analysed. Commentary on the strengthening also neglects to elucidate on the precise channels through which CFIUS reform influences the phenomenon of US–China decoupling. The analysis addresses this gap as well while observing the Chinese state's response to CFIUS strengthening.

CFIUS 2.0: How Does FIRRMA Target China?

The Chinese state employs a long list of methods in its pursuit of foreign technology which include forced technology transfer through joint venture requirements and licensing requirements, espionage, academic collaborations with research centres and universities, imports of tech equipment, and tech-seeking outbound investments. FIRRMA is only designed to deal with the last of these. Three main elements of the FIRRMA stipulations are especially instrumental in empowering CFIUS to target investment originating from China.

First, FIRRMA, through its conceptualisation of national security urges CFIUS to meticulously scrutinise investments originating in countries that have "a demonstrated or declared strategic goal of acquiring a type of 'critical' technology and infrastructure that would affect United States technological and industrial leadership in areas related to national security." Although China is not named specifically in this portion of the bill, according to US Congressman Jeb Hensarling, Chinese investors will, de facto, be accorded the most attention (Centre for Strategic and International Studies, 2018). This becomes apparent in the latter parts of the legislation. Section 18(b) of FIRRMA mandates the Secretary of Commerce to submit a report on foreign direct investments (FDI) made by Chinese entities in the United States to Congress and CFIUS every 2 years. The report is to contain detailed descriptive statistics on Chinese investments in the United States, employment details, trends, and comparisons with FDI patterns of other investor countries. Moreover, the extent to which the pattern of investments originating from the People's Republic of China (PRC) is in consonance with a state-driven industrial policy such as the Made in China 2025 plan is to be investigated. State-owned enterprises and state-owned funds, in particular, will therefore face tougher scrutiny. It is worth noting that the PRC is the only country to receive such attention under FIRRMA. In a notable departure from the principles of the Washington consensus, the conceptualisation of national security under the new CFIUS has also expanded to include considerations of economic security and broader competitiveness of US firms (Jackson, 2019). This shift in the philosophy concerning investment regulation is instrumental in the targeting of Chinese investments.

Second, apart from origin-based restrictions, FIRRMA also sets out to target the specific channels whereby technology can be acquired with equity investments. The bill calls for the Committee to be aware of modern techniques of illicit technology acquisition by prompting it to observe transactions that could contribute to cybersecurity vulnerabilities. This stipulation is undeniably inspired by China-related concerns, given that Chinese entities have been linked to 90 per cent of all espionage activities in the United States (Geller, 2018). Moreover, under FIRRMA, joint ventures in critical technology or infrastructure sectors will be covered (Covington, 2018a), remedying what was considered a major loophole in the CFIUS process. These enabled Chinese investors to acquire sensitive information while skirting CFIUS reviews for many years (Cornyn, 2018; Kuo, 2018).

Third, the strategic vision of the US dispensation, on a larger scale, is to prop up a global financial regime intolerant to Chinese acquisition of technology. Section 13(3) of

FIRRMA calls for CFIUS to labour towards the harmonisation of investment regulations among like-minded countries and facilitate greater information sharing among allies and partners of the United States. In fact, subsequent to the bill's passage, trade officials of the United States, European Union (EU), and Japan released a joint statement in early 2019 wherein cooperation on national security reviews was confirmed (United States Trade Representative, 2019).

The aforementioned elements of FIRRMA place Chinese investments squarely within the Committee's crosshairs. Chinese investors have already been impacted even as the Committee pilots its new procedures. As of 2019, data-related concerns have taken the centre stage in terms of compelled divestitures. CFIUS instructed two Chinese companies, the Kunlun Group and iCarbonX, to sell the stakes they held in two online dating and health service companies, respectively (Clark et al., 2019). The newly empowered CFIUS was also reportedly involved in the Federal Communications Commission's (FCC) blocking of China Mobile Ltd's bid to provide telecommunications services in the United States (Kim and Burnett, 2019). Additionally, Huawei, Lenovo, and Bitmain Technologies have downsized operations in anticipation of CFIUS strictures (Hanemann et al., 2019). At an aggregate level, half-yearly averages of Chinese investments in the tech-intensive electronics, health, ICT, and machinery sectors fell from USD 1.03 billion in 2018 to USD 0.3 billion in 2019 (Hanemann et al., 2019). Chinese venture capital funding to Silicon Valley has also taken a hit and accounted for only USD 3 billion out of the total USD 84 billion that the United States attracted in 2018 (Global Times, 2019). Consultancy firms are reporting manifold increases in the number of CFIUS cases they handle and admit that more time and effort goes into closing a deal (Klein, 2019). It is abundantly evident, therefore, that Chinese investors' ability to perform strategic asset-seeking investments in the United States, particularly in frontier industries, has been impeded.

The Impact of CFIUS Strengthening

This section explores how large a setback the strengthening of CFIUS is to the Chinese state. The international political economy literature dealing with the use of economic tools in power politics and the costs associated with exit from economic relationships offers useful cues to tackle the question. In the context of foreign trade, Hirschman's (1945) work popularised the perspective that economic exchange, through the generation of material gains for participants, also bred political dependencies. Importantly, such dependence is said to engender power relationships among states that allow for the stronger to influence the policy of the weaker. In subsequent decades, a host of studies have employed numerous methods to measure dependence in order to understand state behaviour (Barbieri, 1996; Gartzke, 2007; Gasiorowski, 1986). The work of Keohane and Nye (2012) was most instrumental in contextualising dependence in a globalised world and is, thus, relevant to the Chinese state's situation vis-à-vis CFIUS. In *Power and Interdependence*, they state, "policy must be based on an analysis of actual and potential vulnerabilities" where vulnerability arises when changes in an economic

relation generate sizeable long-term costs for the concerned state (Keohane and Nye, 2012). On the other hand, when costs are low or transient, the state is faced merely with a sensitivity that is unlikely to prompt policy adjustment. It is germane, therefore, to examine whether the inability to conduct strategic asset-seeking investments constitutes a vulnerability or a sensitivity for the state.

To be sure, Keohane and Nye (2012) offer little by way of measuring dependence and vulnerability under globalised conditions. Assessing the Chinese state's vulnerability to CFIUS strengthening requires more specific tools. Crescenzi's (2003) framework of "complex linkages" offers these. Utilising the concepts of Keohane and Nye, it conceptualises dependence as the costs associated with the severance of an economic tie. These costs are, in turn, operationalised by identifying two principal elements – asset specificity and market structure. In the context of technology denial and CFIUS, asset specificity signifies the importance the Chinese state affords to technological upgradation and strategic asset-seeking investments. If an asset is domestically of very large importance, even small disruptions in availing them will prove undesirable. Meanwhile, market structure has to do with whether China's tech sector can adequately offset CFIUS strictures by performing strategic investments in high-tech markets apart from the United States. In order for a dependence to exist, the gains from an engagement must not only be domestically important and scarce but also difficult to source from alternative suppliers. So how dependent is the Chinese state on strategic asset-seeking investments made in the United States?

In specificity terms, technological upgradation is of high domestic importance. The extensive specialisation in low-quality manufactures which formed the bedrock of the Chinese economy's export-led growth model is gradually rendered obsolete by climbing wage rates and diminishing investment efficiency. In accordance with the consensus in macroeconomic theory, China's economy must now rely on greater total factor productivity generated through industrial upgrading to maintain growth. Neoclassical growth theories consider such upgrading as exogenous to the economic system and a result of market-enabled price discovery in international factor markets (Lall, 2000). Chinese economic analysts, however, derive policy impetus from the Schumpeterian variety of endogenous growth theory. They emphasise that technological upgradation requires not only efficient markets but also state efforts to remedy the problem of underinvestment, particularly through R&D spending but also by leveraging globalisation (Howitt, 2008; Lin, 2017; Romer, 1990; Zhang, 2017).

Chinese leaders concur that productivity must be generated through innovation and technological upgradation (Xinhua, 2018a, 2019). In 2016, president Xi lamented that a lack of innovation had proven to be an "Achilles' heel for economic development," and subsequently, innovation was enshrined in the 13th Five Year Plan (2016–2020) as the "primary driving force for development" (China Daily, 2016; National Development and Reform Commission, 2016: 20). While the thrust was certainly on domestic R&D and homegrown innovations, companies were nonetheless urged to "integrate with the global innovation network" (Xinhua, 2014). Strategic asset-seeking investments particularly were also encouraged under the Made in China 2025 plan (McBride and Chatzky, 2019).

To be sure, a cut-off from strategic asset-seeking investments in the United States cannot cripple the Chinese innovation system in an aggregate sense. In the short run, not all innovation in the country is coterminous with cutting-edge technological progress (Abrami et al., 2014; Breznitz and Murphree, 2011; Chang, 2003). According to McKinsey (2015), progress in customer-driven and efficiency-driven innovation – archetypes that are less reliant on cutting edge technologies – alone can add anywhere between USD 1 billion and USD 2.2 trillion per year to the Chinese economy by 2025. Nonetheless, an inability to acquire US tech firms deprives the Chinese economy of a potent growth catalyst at the frontiers of technological applications where domestic capabilities are most lacking. Acquisitions similar to Lenovo's 2005 takeover of IBM's personal computer division, for instance, would face far stricter scrutiny under the new CFIUS procedures. Chinese internet firms seeking high-quality data from US firms will also be disadvantaged from CFIUS' new emphasis on data security. Some would argue that a stronger investment regulation regime will simply cause Chinese investors to focus their attention on alternative methods of acquiring technology from US firms. However, since they confer firms with high degrees of control over technology and know-how, strategic asset-seeking investments generate benefits that other channels of technology transfer do not (Knoerich, 2017).

Moreover, political imperatives play a significant role in elevating the specificity of technology acquisition. Leaders of the PRC, ever since its inception, have considered technology to be "intrinsically strategic" and worthy of achieving mastery (Feigenbaum, 2003; Gewirtz, 2019a). Recently leaked documents reveal that former Chinese Premier and General Secretary Zhao Ziyang considered a tech-focus to be useful for his political self-preservation (Gewirtz, 2019b). This sentiment has arguably further gained currency under Xi Jinping. Innovation occupies first place in president Xi's "Five Major Development Concepts" (Li, 2016). In a speech to the Chinese Academy of Sciences, president Xi alluded to the centrality of scientific and technological advancement to the attainment of the China Dream and national rejuvenation (Xinhua, 2018a). Furthermore, as professed by Xi Jinping at the 19th Communist Party Congress, China is to be transformed not merely into a prosperous society, but a modern, technologically advanced one as well (China Daily, 2017). With technological progress inextricably linked with Xi Jinping Thought, his success as a leader is incumbent on the Chinese economy succeeding at incubating innovation (Gewirtz, 2018).

The Chinese state's reliance on quantitative targets in the Made in China 2025 plan and the involvement of a powerful Leading Small Group including officials from the National Development and Reform Commission and the Ministry of Industry and Information Technology also raises the political specificity of technology at lower levels (Wübbeke et al., 2016). Effectively, Chinese officials across the bureaucratic hierarchy would incur political costs if engineering-based and science-based innovations at the frontier were to lag behind stipulated time frames. At stake here are not merely the potential macroeconomic gains from advanced exports and economic growth that are attendant with technological advancement. The Chinese state's effectively high dependence on foreign technology is a function of both the economic and political costs of

deprivation. Viewing technological upgradation as purely an economically motivated endeavour is, therefore, erroneous.

With respect to market structure, it is naturally expected that CFIUS strictures would prompt Chinese investors to focus their attentions on other technologically advanced economies as a "shop of last resort" (Godement and Abigail, 2018). As of 2016, the United States accounted for 31 per cent of high-tech manufacturing (National Science Board, 2018: 33). As such, while US companies reign supreme in certain sectors such as semiconductors, they are hardly monopolists of high tech across the board. However, perceptions are undergoing a palpable churn, especially in the "big three" European economies (UK, Germany, and France) and Australia, and CFIUS strengthening has arguably served as a template for these countries (Anonymous, 2018; Covington, 2018b; Nauges and Roudergues, 2018; The Parliament of the Commonwealth of Australia, 2018: 43). In an important breakthrough, an EU-wide investment screening mechanism modelled along CFIUS lines came into effect in April 2019 (European Commission, 2019). According to the Rhodium Group, this new screening framework would have covered 82 per cent of China's investments in the EU during the year 2018 (Hanemann et al., 2019).

In conclusion, therefore, CFIUS reform unites the technologically advanced West against extractive Chinese investments. In doing so, it deprives the Chinese state of an important avenue to expedite progress in high-tech innovation at the frontiers of production where domestic capabilities are nascent. Moreover, it will incur notable political and economic costs, as techno-nationalistic plans for self-reliance at the frontiers of high-tech are held in abeyance and key deadlines risk being overshot.

The Chinese State's Response and US–China Decoupling

The Chinese state has largely responded strongly to CFIUS strengthening. The State Council condemned the reforms as an "abuse of national security reviews" in a September 2018 white paper (Xinhua, 2018b). This sentiment was also reflected in the draft Foreign Investment Law passed by the Chinese legislature in March 2019. The draft primarily drew attention for its commitment to protect the intellectual property rights of foreign firms operating in China and invite more FDI. However, a response to CFIUS was also baked in. Article 39 of the draft states that the state may take "corresponding measures" against countries where Chinese investments are restricted or discriminated against (People's Republic of China, 2019). The aforementioned draft law has also been supplemented by a revised "Catalogue of Encouraged Industries for Foreign Investment" which places emphasis on easing investment regulations in high-tech manufacturing. This is ostensibly a compensatory measure to maintain tech transfer channels.

Additionally, CFIUS strengthening has played a partial role in prompting Chinese leaders to double-down on self-reliance goals. In this regard, the coincidence of CFIUS strengthening with other aspects of US–China tensions has been instrumental. The passage of FIRRMA coincided with the first volley of US tariffs on imports from China and threats to use the International Emergency Economic Powers Act to level the playing

field. It was also accompanied by legislation strengthening the US export control regime which would later be used to block exports of crucial tech inputs to Chinese companies like Huawei and iFLYTEK among others. In response, president Xi stated in 2018 that "innovation entails mastering key and core technologies through self-reliance as well as independent innovation" (People's Daily, 2018) Later, citing "changes unseen in a 100 years," president Xi stressed the need to strive for self-reliance in the tech domain while addressing the nation (Takahashi, 2019). This will involve doubling-down on the domestic development of technologies which it is currently dependent on the West for, such as semiconductors, aviation technology and advanced manufacturing more broadly. For instance, according to reports, the state is planning large investments in 2019 to upgrade supercomputer infrastructure and regain leadership from the United States (Li, 2019). Moreover, the Chinese state effort will be to support manufacturing capacities at various stages in the supply chains of high-tech commodities, in order to insulate the domestic economy from any extraneous interventions (Xie, 2019). Additionally, Chinese tech companies, operating in various parts of the world, will be encouraged to popularise their technical standards in order to capture global markets and royalties and safeguard themselves from US-led disruptions (Arcesati, 2019).

To be sure, certain diplomatic efforts were made to placate the United States in late 2018 and early 2019. For instance, promises were made to import more from the United States, to clamp down on the smuggling of Chinese fentanyl into the United States and allusions to the Made in China 2025 plan were reduced (China Daily, 2019; Yao, 2019). However, these were made in response to the US tariff measures since China's vulnerabilities in the domain of bilateral trade are arguably higher than in outward investments. The Chinese state's long term objectives of achieving technological self-reliance are the priority, nonetheless. On the sidelines of the National People's Congress in 2019, former finance minister Lou Jiwei even indicated that China is not inclined to make particularly large concessions to the United States and will stay its development course (Bloomberg, 2019).

The Chinese state's response to CFIUS strengthening, even as it remains vulnerable to cut-offs, offers valuable insights into the current state of US–China relations and the prospects of decoupling. The two primary schools of thought in international relations posit diametrically opposed views of a state's impulses under conditions of vulnerability. The liberal school contends that the existence of vulnerabilities drives states to resolve conflicts through bargaining in order to preserve economic ties and prevent high exit costs (Crescenzi, 2003; Keohane and Nye, 2012). Liberal theorists in the IPE subdomain emphasise that powerful business interests are instrumental in the formulation of this state preference (Oatley, 2019). According to realists and economic nationalists, on the other hand, states are concerned with the distributional effects of economic interactions and view vulnerabilities as anathema to their standing in the international system (Jones, 1982; Waltz, 1979). States, thus, are driven to mitigate vulnerabilities wherever plausible. The Chinese state's decision to rely less on bargaining and embrace a CFIUS-enabled exit through a strong pushback, tit-for-tat action and self-reliance push suggests that realism better explains the Chinese state's reaction. Its actions constitute the tacit

acknowledgement that the exigencies of power politics, undesirable as they may be, are now major factors in the bilateral economic relationship.

Realist thinking also significantly explains the passage of FIRRMA in the United States and this subdues the Chinese state's bargaining preferences by creating negative future expectations. According to the realist scholar Waltz (2000), "when states notice the market usurping the authority of their governments, the politically and economically strong states try to recapture it." In the CFIUS context, to the extent that open capital markets facilitate the erosion of the US economy's technological superiority relative to China's, the state aims to subjugate them. In fact, calls for jettisoning conventional wisdom that neatly segregates the economic and political domains in CFIUS's functioning were taking hold even prior to the emergence of Trumpian protectionism in the United States (Blackwill and Harris, 2016). Liberal assumptions, on the other hand, have not shone through. For instance, despite strong lobbying efforts of US tech companies, FIRRMA expanded the Committee's purview to cover joint ventures and the lobby was even rebuked in a speech on the floor of the US Congress (Mohsin and Brody, 2018). Nor would the potential constructivist argument that FIRRMA is a function of the US apprehensions towards China's state-led economic system be admissible, even though it is frequently cited by US officials. First, a brief glance of CFIUS's genesis and evolution illustrates that its mandate has, indeed, tended to mirror the geopolitical and geoeconomic threat perceptions of the United States, with less regard to regime type. CFIUS's formation in 1976 encapsulated the US foreign policy animus towards the OPEC countries for their role in the 1973 oil crisis. The two subsequent iterations of strengthening in 1988 and 2007 were done in response to Japan's tech catch up and the 2001 terror attacks, respectively (Graham and Marchik, 2006: 41). Second, it would fail to explain the timing of CFIUS strengthening as the Chinese state has for long been deeply involved in economic activity globally. As in the case of Japan mentioned above, the fact of China's tech catch up has been the main motivating factor. The setting in of zero-sum thinking in both the United States and China with respect to CFIUS and strategic investments has, thus, sparked off tendencies to exit.

In conclusion, CFIUS strengthening has ostensibly ensured a selective decoupling in the context of strategic asset-seeking investments flowing between China and the United States. It should be noted that relatively innocuous types of strategic investments will continue to be made even as a decoupling takes place in sensitive high-tech sectors. With the Chinese economy expected to continue running large current account surpluses in the short term, Chinese economic agents will continue to look for avenues to generate a return on their foreign exchange and the United States remains a lucrative destination. With the passage of time and the expansion of legal capacity in the United States, investors will also acclimatise to CFIUS's mitigation stipulations. In the short term, therefore, China's investment figures in the United States will likely improve compared with the slump of 2019. Even so, these will not generate the kind of dependence prior investments did, since they will offer Chinese stakeholders little more than financial returns. Alternatively put, they will generate notable sensitivities, but not vulnerabilities. The outcome of CFIUS strengthening will, thus, ultimately be attenuation in structural

economic interdependence between the two great powers. To those that argue for the pacific effects of such interdependence, these developments should duly inspire alarm. In today's political climate, it is becoming increasingly apparent that a liberal economic regime, while it confers bounties upon populations and other nonstate actors, generates costs that are deemed unacceptable by states. In driving home this reality, the passage of FIRRMA might be remembered as a watershed moment for geoeconomic great power competition in the twenty-first century.

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