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**U.S.-China Economic and Security Review Commission**

“The Extent of the Government’s Control of China’s Economy, and its Impact on the  
United States”

*Panel on China’s Foreign Direct Investments Abroad*

Good afternoon and thank you for inviting me to share views with the Commission on the extent of the Chinese government’s control over its economy. I come to you as a member of the Peterson Institute for International Economics staff since 1993 including my time as an active Visiting Fellow, and as the principal of a private sector advisory practice helping US policymakers and business-decisionmakers understand the workings of the Chinese marketplace.

I will offer brief comments in response to the formal questions provided in advance of today’s hearings, and provide a few observations about China’s energy sector in particular as it relates to this topic in the course of answering those questions, since this is the subject of extensive work I have recently undertaken.

1. The Commission’s **first question** concerns the motives and objectives of new agency authorities are setting up in Beijing to help manage the nation’s foreign exchange reserves. The agency, referred to in English as the State or China Foreign Exchange Investment Corporation (CFEIC), is not yet fully operational, but is expected to be charged to administer up to \$200 billion in for-ex when up and running.

I have asked a number of well placed Chinese contacts and foreign contacts close to the thinking around this agency about its likely behavior. My current impression is that the guiding principle of CFEIC will be neither of those posited in your question -- maximizing returns or furthering industrial policy goals -- but rather value preservation. The investment managers at CFEIC, as those at SAFE, PBOC and Huijin before them, are not incentivized to maximize returns on these assets. They are incentivized not to loose money (as is the case with most government asset managers). With its timidly conservative investment strategy last year the PBOC made well over \$30 billion, according to Stephen Green of Standard Chartered Bank. Higher return means higher risk, and without a payoff for taking risk, there is little reason to do so.

However being overweight on US Treasury bonds is a risk itself. Returns are low, risks to the dollar are rising, and the political tensions generated between the US and China as a result of heavy T-bill holdings are unhealthy. Therefore the conservative thing for

official for-ex managers to do in China is diversify from Treasuries to some extent, though not necessarily from US dollars. Profit maximizing is out of the question, but value preservation begs for better diversification.

As for the industrial policy motive, the purpose of CFEIC could be industrial policy only to the extent that China has one. Notwithstanding their soaring rhetoric, the Five Year Plan documents are about as good an indication of national economic priorities as the campaign platforms put forth during elections in the United States. There is a great deal of debates about the outward investment behavior of China's state firms today. Many are flush with cash. In many industries government prefers to see investments made at home rather than abroad. Supports for outward investment are being made on an ad hoc basis rather than systematically. I expect CFEIC to make investments alongside SOEs abroad when it sees a secure opportunity to lock in a return, but not to do so when the risk-return calculus does not support it. There are other policy entities available for supporting outward FDI are a non-commercial basis when needed, just as there are in the United States. China Ex-Im Bank is one of them.

In the case of China's national oil companies in particular, the government support offered to CNOOC in the context of Unocal was exceptional. The transaction would represent more than half the total market capitalization of CNOOC. In the case of CNPC and Sinopec investments around the world, the transactions are well within these firms' ability to finance. Meanwhile, due to a combination of moderate interest rates and low dividend payment terms, the hurdle rate of return these firms require is lower than IOC competitors. Therefore, they generally do not need direct subsidies to justify overseas forays. Host countries, meanwhile, often negotiate concessionary lending or grants to finance infrastructure around these energy deals that they could well manage themselves if they had to. That financing is not going to be provided through CFEIC however, except in rare cases where it represents an attractive investment.

In sum, there will be a mixture of motives for the CFEIC, but the commanding principle is likely to be value preservation. While political pressures can deflect the core missions of Chinese agencies, the disposition of China's state natural resource firms – the foremost outward investors at present – is not likely to incline them to subsidized support through the CFEIC channel. Where they do need for-ex financing for their overseas activities, they may work through CFEIC on a largely market-basis.

2. The **second question** poised by the Commission is the motive of Chinese state enterprises in acquiring stakes in US firms, and whether there will be increased such interest in the future.

Certainly I expect there to be a dramatic increase in offers from Chinese firms to purchase stakes in US firms in the future. In large part this is for the same reason there has been and will be a dramatic increase in US purchases of stakes in Chinese firms, including in strategic Chinese industries such as finance and mining machinery: our economies are becoming more integrated and in the process there are only two options for establishing a business platform from which to sell to a new market: build it or buy it.

In the case of China there is a special urgency to buy it. Outside manufacturing, China has poor skills, talent and experience. Operating margins in manufacturing are at risk, relative to margins in distribution, retail, and higher-end services such as financial and design. In order to become more competitive in other markets, instead of just exporting cheap manufactures, China's firms absolutely must expand their businesses downstream from the factory. And yet, they have little experience operating in a heavily regulated, customer-oriented marketplace such as the US. To build retail operations from scratch will require decades; acquisition is the logical and quicker alternative. Typically, the business capabilities global Chinese companies attempt to acquire in this regard will be mundane.

In other industries what is finite is not skills and experience, but proven reserves of resources. China's national energy companies have little enthusiasm to go to Sudan, Iran and other states of concern in order to find exploitable energy and commodities if they can find alternatives in the rest of the world. Therefore, to the extent the US welcomes such investments, there will continue to be Chinese interest in investing in US resources for the foreseeable future. However, there is now a deep distrust of US intention toward investments in natural resources in the United States, and fear of embarrassment again as occurred with Unocal, and this will likely depress the number of investment overtures in this sector.

The signature Chinese overtures to invest in US businesses to date demonstrate a commercial motive. CNOOC's bid for Unocal made sense given their oil and gas portfolio; Lenovo's purchase of IBM PC reflected the logic of acquisition rather than organic build-out described above. I interpret the planned PBOC investment in Blackstone Group's IPO unveiled this week to be another case of business logic. China will make these investments when they represent something Chinese firms could not do well themselves, cannot do quickly enough without making an acquisition, and cannot do without.

In the case of oil markets, in recent research my colleague and I have demonstrated that while state oil company CNPC is actively shipping oil out of Sudan, that oil can wind up in Japan, South Korea or China depending on market conditions. This is at odds with the view that CNPC follows the industrial policy playbook. And in fact the energy sector is a good example: the energy policy bureaucracy is so miniscule that it is clear the NOCs are in charge of outcomes, not the industrial policy planners, such as they are.

3. **Thirdly**, the Commission asks whether a heightened effort by Chinese companies to invest in the United States would be a legitimate reason for concern about the risks of technology transfer. I do not think so.

The vast majority of Chinese offers to purchase firms in the United States will not raise security concerns. Where they do, processes are in place. Export controls apply to all US-domiciled firms regardless of ownership, and CFIUS works. Innovation, meanwhile, does not stand still, and as long as the US is a net-seller of innovation we will continue to be at least one step ahead. In fact, our innovative capacity reflects capital market

efficiency, intellectual property rights protection and a host of other institutional superiorities that will continue to advantage us in this regard for many decades (or until such time as China becomes even more like us, in other words). To maintain its innovative lead, the United States must focus on innovating rather than refusing to realize the value of our innovation whether by product sale or asset sale when the time is right.

It is obvious that if we apply a double standard to China, China will also apply a double standard to us, whether formally or informally. Our advantage is maximized by playing by the market rules we designed rather than shifting to closed economy rules we have fought tooth and nail against for almost a century.

Again, the principle impulse in Chinese outward FDI in the United States will be more rapid attainment of downstream business capabilities than would be possible through an organic growth strategy in a mature regulatory environment.

4. On the Commission's **fourth** set of questions, concerning the composition of US dollar denominated assets in the Chinese foreign exchange portfolio, my co-panelist has done in-depth econometric estimates and I will not try to improve upon those. However, I can offer my view on the question of dependency for the US arising from a large stock of US dollar securities in China.

In short, I believe the extent of vulnerability arising from Chinese holdings is greatly exaggerated. For four reasons. First, while China's holdings are large, the market for US treasuries and other dollar assets is much larger, and after an initial impact markets would likely absorb the dollar liquidity in short order. Second, the immediate costs to China from selling down its dollar position would be relatively high, high enough to deter a casual attempt to use this tool. Third, the longer-term consequences for China would be enormous, as the move would validate the hawkish view in the US and forever change the benign attitude of the United States toward Chinese dollar holdings. And fourth, over time I expect Chinese actors to purchase back the US dollars they have sold to the Chinese government in order to make purchases of dollar-priced goods and services and, especially, dollar denominated financial instruments as a long term portfolio investment.

For instance, as China's capital account normalizes to permit households and enterprise savers to diversify their long-term portfolio holdings to better reflect rational investment strategy (rather than 100% allocation in Chinese securities), a non home-bias portfolio level of perhaps 20% would seem fairly conservative. At present that would amount to \$750 billion. If in turn 40% of this were placed in dollar-denominated securities, then \$300 billion of China's for-ex would be required for this purpose alone. With assets saved in the banking system rising by about \$900 billion per year, this translates into an additional \$70 billion annually possibly ear-marked for US dollar assets. And this is just based on cash savings in the banking system being moved into an international equity portfolio, it does not include diversification of existing share holdings. And it does not include strategic investments overseas or commercial investments overseas.

In light of this analysis I am not overly worried about the level of Chinese foreign exchange holdings in the future.