CHINESE DIRECT INVESTMENT IN CALIFORNIA

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EXECUTIVE SUMMARY

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SPECIAL REPORT

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Foreword

As we proceed into the second decade of the twenty-first century, the web of global relationships that connects the major nations of the world is undergoing a series of high-speed, tectonic changes. One of the most significant of these changes is the way in which flows of foreign direct investment (FDI) now move around the world.

During the last century, most flows of global investment capital moved back and forth between the so-called developed nations of the Western world. With the largest, most open, and most dynamic economy, the United States has long been such an alluring destination for FDI that Americans hardly even needed to think about soliciting it.

But toward the end of the last century, Western countries also began to step up investments in "emerging markets"—that is, in the economies of countries once referred to, somewhat dismissively, as the "third world" or the "developing world."

Now, however, as we head into the second decade of the twenty-first century, the United States and the global economy find themselves on the precipice of yet another great and unanticipated change in global capital flows: funds moving from the developing to the developed world. In other words, increasing amounts of FDI are beginning to flow abroad from nations such as China and India. China has vastly ramped up its outward FDI in recent years, and in 2010, it even made the top 10 list of global investors.

In 2011, the United States was still the largest global recipient of FDI, with almost $230 billion in inflows. But the source of those flows is increasingly coming from countries such as China. While still relatively small—China invested only around $5 billion in the United States in 2010 and 2011—the aggregate amount of FDI flowing out of China nonetheless represents an average annual growth rate of 130% since 2007.

Indeed, our recent report, *An American Open Door? Maximizing the Benefits of Chinese Foreign Direct Investment* (published in 2011 by the Asia Society Center on U.S.–China Relations and the Kissinger Institute on China at the Woodrow Wilson International Center for Scholars) estimated that by 2020, some $1 trillion to $2 trillion of new investment capital will have flowed out of China. In other words, the river of investment that once ran almost exclusively from West to East is now beginning to flow in the other direction as well, from East to West.

This new reality raises a host of critical questions for the United States:

- Is this the “next big thing” in global capital flows? Where will all of this new FDI end up?
- How will the changing FDI landscape affect American interests?
- Is the United States prepared to maximize its share of this important new source of FDI stock?
- What are the current obstructions preventing the United States from doing so, and how can those obstructions be overcome?
- What new strategies should both the federal government and U.S. states and cities adopt to capitalize on this new trend?

The most notable conclusion that emerged from *An American Open Door?* was that American policy makers, businesspeople, and members of the public were grievously uniformed about this looming new reality. Three other realities seem inescapable:

- The historic change in flows of FDI from China will affect America in a profound way.
- It is emphatically in the U.S. national interest to gain a larger share of these new investment flows.
- It is dangerous to assume that because of the historic openness of the U.S. economy and the desirability of the U.S. investment climate that Chinese capital will automatically find its way here without any new efforts to woo or facilitate it.

So, how does California fit into this changing global picture?

As a follow-up to our last report, which looked generally at FDI flows from China to the United States, we thought that it would make sense to look at the question through the lens of a specific geographic region. Because California is not only the largest and arguably most iconic state in the United States, but also a dynamic and varied economy with a historical relationship with China, we thought that it was an obvious and logical choice. Again we chose to work with Daniel H. Rosen and Thilo Hanemann of Rhodium Group to help us illuminate the actual state of past flows of direct investment into California and to suggest what future flows can be anticipated. The report also recommends how the state might interface more effectively with Chinese state-owned and private investors to encourage further investment.

Toward that end, the Asia Society is pleased to offer this study. We do so in the hope that this effort will be of some utility to the state of California as it goes about the process of encouraging more Chinese investment.

We are also pleased to be working with California Governor Jerry Brown and other state officials in the belief that the state’s economy can be invigorated by increased FDI from China and that, if we are successful, something of a model for other states can be created as well.

Finally, it is worth noting that although efforts to encourage mutually constructive kinds of Chinese investment in California will most certainly help forge closer relations between the state and China, we are also hopeful that in some modest way, they also will help cement better relations between the United States and China. For, as fraught as this bilateral relationship can be, because so many global problems cannot be remedied without joint Sino–U.S. action, it has become an inescapably important one.

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Executive Summary

The era of significant growth in outward foreign direct investment (OFDI) from China to advanced market economies has begun. Just as Chinese exports exploded in the last decade—from $250 billion in 2000 to nearly $2 trillion by 2011—China's OFDI is poised to skyrocket in the years ahead. We expect China's cumulative outward FDI to grow to between $1 trillion and $2 trillion by 2020. Given the evolving set of motives for Chinese investors, the United States and other developed economies can expect to receive a substantial share of these flows.

California, with its long history with China, the most sizable Chinese American population in the country, and more inward investment deals from China than any other state, is in a position to lead the nation in attracting Chinese investment in the decade to come. The Golden State has the potential to attract between $10 billion and $60 billion of Chinese direct investment by 2020. Those flows would bolster employment, feed the tax base, generate exports, and bring positive spillovers of know-how and relationships.

However, these benefits are not foreordained. Competitors for these dollars are ramping up efforts to attract Chinese firms, and they could well out-compete California if the state fails to resolve its fiscal and political problems, provide attractive terms to Chinese firms, and demonstrate its readiness to stand up for Chinese investors and address OFDI impediments at the national level. To build the case for a robust response to these opportunities and looming risks, this report analyzes Chinese investment in California in depth, mining a unique database for insights about California's comparative advantages, the Chinese firms most suited to its economy, and the forces motivating this inflection in cross-border investment patterns. We explain where China is as an outbound investor relative to its past, its future, and other countries and assess California's position as a destination for Chinese OFDI flows compared to its sister states.

The report argues that maximizing California's success as a host for Chinese investors must start with better coordination among interested stakeholders, including government, business, and civil society. Just as it was state-level action, not federal horse-trading, that determined who benefited most from nearly $300 billion in Japanese FDI in America since the early 1980s, the contest to host China's firms will play out in the 50 state capitals. No single politician, government agency, or chamber of commerce can deliver success; attractiveness is truly a function of coordination across all of these actors, and many more.

In fact, the race has already begun, and because the United States is no longer the world's champion of consumption growth, the competition does not stop at the nation's borders—it extends to Canada, South America, Europe, and every other country that is eager for the benefits of FDI. Building on this call to action, the study suggests four initial steps in a long-term strategy to establish California as the top choice in America for Chinese OFDI dollars:

1. Understand California's value and China's needs. Amid tough competition for Chinese capital, a thorough understanding of Chinese motives and what California has to offer is the cornerstone of a strategy to promote Chinese investment. Chinese firms are considering a U.S. presence for various reasons, and California sets itself apart with distinct value propositions. Our analysis of more than 500 U.S. deals highlights several strengths of California that should be emphasized: It has the largest state market in the country, which offers Chinese firms a gateway to the rest of the U.S. marketplace; it is the national leader in many of the high-technology industries that Chinese firms wish to invest in; it is a global leader in higher-value-added service sector activity, one of the weaknesses of Chinese firms; it has an experienced, creative, and multicultural pool of workers, which can help Chinese firms enrich their homogenous and inexperienced staff; and it has an international reputation for its quality of life, which is attractive to both Chinese firms and individuals. Understanding these strengths is vital to developing a relationship with Chinese investors.

2. Target the right Chinese firms. China is a nation of almost 5 million businesses, but not all of these potential investors will be interested in California or serve the state's long-term objectives. The numbers presented in this study provide a starting point for segmenting and prioritizing prospects. First, our data set highlights that California is the place to go for China's *private* firms. The bastions of Chinese entrepreneurialism, such as Shanghai, Zhejiang, and Guangdong, should therefore be a geographic focus of outreach activities. Chinese investors are clearly favoring certain sectors in California—for example, information technology, renewable energy, hospitality, and electronic equipment. In each of these sectors, state investment officials should be capitalizing on past successes to make the case to the next generation of Chinese outbound investors: nothing motivates like the knowledge that your competitor is already doing something. In addition to such an approach based on past patterns, China's large investors, including sovereign wealth funds and industrial conglomerates, are an important potential source of capital. State leaders should systematically open lines of communication to these investment giants regardless of sector, reaching out to China's 100 largest firms and institutional investors.

3. Overhaul the institutional setup for investment promotion. California (and the United States as a whole) needs institutional change in its investment promotion efforts. The traditional hands-off approach is outdated, as officials from the President to local mayors have acknowledged. The United States is no longer unrivaled as a destination for FDI, and a new generation of Chinese investors looking abroad needs local partners and facilitators. Chinese investors are less familiar with Western culture and business practices, they are rooted in a different regulatory environment, and they have relatively little experience operating abroad. Active investment promotion can also help overcome negative preconceptions of the U.S. investment environment stemming from a handful of past deals gone sour. As a first step, we recommend creating a state-level agency with a mandate to lead and coordinate local efforts to promote Chinese investment. The establishment of physical *presence* in China would be another element of such an overhaul, probably starting with Beijing, Shanghai and Guangzhou. The integration of relevant stakeholders is another key component, for example, through an advisory board of Chinese and other foreign firms already present in California, or regular conferences to improve the business environment for foreign firms.

4. Take a proactive stance on national anxieties. Growth in China's U.S. direct investment has rekindled old arguments about foreign firms and the national interest. Narrowly defined security screenings for foreign investments are imperative, and Chinese investment raises legitimate concerns because of a range of general and special considerations. However, security concerns can be misapplied in situations that present no real threat because of simple overreaction or—more worrying—as a back-door route to stifle competition. California, with the largest numbers of deals and a more high-tech economy than most American states, will suffer disproportionately if inflows are rejected arbitrarily. Rather than wait to see whether Washington strikes the right balance between caution and commerce, California should step forward and contribute to the solution. With firms in computing, telecommunications, energy, agriculture, and other sectors at the forefront of the security debate, and a disproportionate number of the deals that have been politicized over the past decade, California has ample experience from which to derive a model for avoiding politicization. In the signature case of OFDI politicization to date, China National Offshore Oil Corporation's bid for Unocal, California politicians in fact played the opposite role, actively rousing national anxiety. Taking a positive stance on the issue today would go a long way toward improving the state's reputation and would be in California's long-term interest.

The findings and recommendations presented in this report are intended to contribute to a better understanding of growing Chinese investment in California and help inform the policy debate on how to maximize the state's benefits from this new trend. While the recent growth is impressive, many chapters in the story of Chinese overseas investment have yet to be written. Securing the proper policy response is crucial, given the potential for future flows from China and from a range of other emerging economies that will follow the "south-north" trail that Chinese firms blaze.