From Purchasing Treasury Bonds to FDI: China's New Financial Strategy towards the US*

Song Guoyou †

Sino-US financial relations have become an essential part of Sino-US bilateral relations. At present, the main feature of Sino-US financial relations is China purchasing huge amounts of the US treasury bonds. According to statistics released by the US Treasury Department, to the end of December 2013, China had held US$1.2689 trillion of US treasury bonds, accounting for 23% of total US external debt and 31.3% of debt held by all the foreign creditor governments.[1] On the one hand, this feature is an unavoidable consequence of the rapid development of Sino-US economic relations. On the other, it plays a significant role in stabilizing Sino-US relations. Under new circumstances, however, it is necessary for China to properly adjust its financial relations with the United States from featuring bond purchasing to better complying with common interests of both sides and future economic development trends of both countries.

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* This article is originally written in Chinese.

† Professor, deputy director, Center for American Studies, Fudan University.

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I. Perspectives on China's Purchasing of US Treasury Bonds

China is the largest foreign creditor of the United States. There are currently eight perspectives regarding China's purchasing of a large sum of the US bonds, which can be categorized into four pairs of opposing opinions.

(1) Motivation: Assistance vs. Interdependence

One perspective believes that China's holding of US treasury bonds represents a kind of assistance to the US economic and financial system. The US bonds held by China is of great help to US economic recovery, especially given its economic vulnerability shown since the financial crisis in 2008 and its unprecedentedly increasing fiscal deficit. China's ever-increasing holding of US bonds plays a significantly positive role in US' economic recovery and financing its fund shortage. China held no more than US$477.6 billion of US bonds in the end of 2007, the year before the financial crisis. Only six years later, however, China holds US$1.2689 trillion of US bonds, a growth of US$791.3 billion. Purchasing enormous sums of US bonds has proved to be conducive to alleviating the economic pressure on the United States, which is not only expressed in the direct purchasing of US bonds but also in lowering the issuing interests rates of the bonds by boosting external demand, thereby helping the US Treasury Department to reduce its future payment of interest.

The other perspective argues that China's purchasing of the US bonds is, no doubt, helpful to the US economy. But, this help is mutual rather than being one-way. In other words, it is not China that helps the United States but that China and the United States that help each other. Many American scholars argue that purchasing the US bonds is actually beneficial for China as the US treasury bonds are the most secure and most liquid financial/investment product; and that the US bond market has provided the best option for China's huge reserves of foreign exchange. Other than the US bond market, no other financial market could accommodate China's need of investment with more than a trillion US dollars. In addition, China can get stable and secure interest returns by purchasing the US bonds. Based on the above analysis, China's purchasing of the US bonds is mutually beneficial.

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(2) Objective: Politics vs. Economy

Regarding the policy spillovers of China's purchasing of the US bonds, there are two main perspectives. One is the "diplomacy theory" and the other, the "economy theory". Those who are for the "diplomacy theory" hold that China buys and holds large amounts of US treasury bonds not only for economic interests alone but also out of diplomatic considerations. With the huge sums of the US bonds, China can sway the United States' China policies in a more favorable stance. Even if China does not have such an intention, it will produce such policy spillovers when the US bonds it holds reach a certain amount. For instance, people hold this opinion argue, the Chinese government can exert diplomatic influence over the United States through RMB exchange rate policies and other economic disputes, so as to dissuade the US government from making decisions unfavorable to China. Some even suggest that China's purchasing of the US treasury bonds can be linked up with the United States' Tibet and Taiwan policies. For example, China can threaten to dump the US bonds when the US sells arms to Taiwan. The "diplomacy theory" is mainly proposed by scholars and think tanks. However, the major agencies in charge of China's foreign exchange reserves in huge amounts — the State Administration of Foreign Exchange and the China Investment Corporation — uphold the "economy theory," and they emphasize that China purchases the US bonds are only out of market considerations mainly aiming at stable and long-term investment returns instead of pursuing political or diplomatic concerns.

(3) Effect: Yes vs. No

Another pair of opposing opinions is about whether China's holding of such huge amounts of US treasury bonds can play the desired strategic effects, i.e., whether China can exert influence on the United States' China policy by virtue of the "debt weapon"? Theoretically, such strategic effects are possible. Yet, the results of empirical studies conducted so far indicate China's holding of US treasury bonds cannot really influence the United States' China policy and the making of its China policy.[2] This is mainly because the Chinese and the US economies are deeply interdependent. China will inevitably encounter resistance from the United States

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whenever it attempts to turn the US treasury bonds it holds into a political or diplomatic leverage. Moreover, the magnitude of China's trillion-dollar bond holding implies that China will suffer a great loss itself if it takes any concrete step to substantially reduce its holding of US bonds to influence the US financial system. Even such action can achieve its goal, China will also pay the price for impacting and destabilizing its huge amounts of reserves. As an old saying goes: An eye for an eye, and we all go blinds.[3]

(4) Profits: Low vs. High

As for the profits China can obtain from the US bonds, there are two diametrically opposed perspectives. Those who hold the first argue that the US treasury bonds China holds have not produced a high rate of returns because sharp increases of its holding have largely been seen after the financial crisis of 2008 when the US Federal Reserve adopted the quantitative easing (QE) policy to maintain the interest rate of US treasury bonds below 0.25% for a long time. Therefore, the general rate of return on investment (ROI) in the US bonds held by China will not be high. In addition to the analysis of the US bonds interest returns, some researches also take into account the changes in the exchange rate between the Renminbi (RMB) and the US dollar. Such considerations suggest that, since the RMB has appreciated for more than 30% since 2007, in return, the US bonds held by China calculated in RMB has actually depreciated by 30% — a loss that is greater than the entire interest returns that China acquires from its US bond holdings.

The second opinion is that, are the financial crisis of 2008, there have been virtually no other investment products that can match the US bonds in terms of scale, and stable and secure returns. The yield of the US bonds is not only higher than that of European countries having suffered a sovereign debt crisis but also higher than returns from purchasing oil or other bulky commodities. The opponents consider it is wrong to take the changes of RMB exchange rate against the US dollar into account. Value changes caused by the exchange rate are only value changes in accounts, not actual profits and losses, nor will it directly affect the real purchasing power of foreign exchange reserves. In fact, it is actually just differences in accounts caused by using either the RMB or the US dollar as the

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reporting currency. The real exchange changes will not occur unless the foreign exchange reserves are actually repatriated and converted into RMB. However, so far there is no need for China to redeem its huge sum of foreign exchange reserves.[4]

Through the four pairs of prevailing opinions above, we can now have a relatively panoramic and objective understanding of China's holding of the US treasury bonds and can also reach some preliminary conclusions. First, sharp increases in China's holding of US governments debts is indeed of help to the US economy, and the US government also welcomes and encourages the Chinese government to buy its treasury bonds. But, it is hard to describe such acts as "assistance". Second, China's holding of US government bonds is mainly an investment behavior out of market considerations instead of political or diplomatic ones. Third, except for certain extreme circumstances, the Chinese government has neither the intention nor the capability to influence the United States by virtue of the US government debts it holds. And fourth, regarding the use of its huge sums of foreign exchange reserves, the first and foremost concern of China is the security of investment instead of the returns of investment, which explains the lower yields from the holding of the US bonds.

II. Comprehensive Assessment on China's Holding of the US Bonds

If there is not much controversy over the above four conclusions, the next question will be: whether is it necessary for China to continue to take the purchasing and holding of US treasury bonds as the priority strategic choice in the use of its foreign exchange reserves? That the wording "strategic choice" is used is mainly because that China's foreign exchange reserves have exceeded US$3.8 trillion, of which the US treasury bonds have amounted to 1.3 trillion. Such a huge amount of funds is definitely of great significance to be invested either in China or in any other countries. This is why the United States attaches great importance to the investment orientation of China's foreign exchange reserves and the any purchasing policy adjustment.

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However, this sort of strategic significance seems to have "disappeared" in the real world. First, the Chinese government firmly confirmed it has no intention to use its holding of US treasury bonds as a "strategically financial weapon," stressing that its purchasing of the US bonds is a normal market behavior. If there is any intention, it is a commercial one, i.e., aims at preserving or increasing the value of China's foreign exchange reserves.

Second, there is no sign that shows that the Chinese government uses its holding of US bonds as a strategic leverage to, for instance, significantly changing the amount of the US bonds it holds, as only by significantly changing the amount it holds is it possible to produce a kind of strategic deterrence effect to the United States. However, studies of the records of both increases and reductions in the amount of US bonds China holds reveal that all fluctuations in the amount of the US bonds China holds are closely related to changes in its foreign exchange reserves and America's domestic economic conditions. Furthermore, the scale of these fluctuations, which usually float in a 3% band, is inconsequential considering the mammoth amount of US bonds China holds. As a matter of fact, these kinds of changes can never bring any subsequent disturbance to the US debt market. It is evident that so far China has no incentive to take its holding of US bonds as a strategic weapon.

Third, China has not obtained any strategic returns from its holding of US treasury bonds. If there are any strategic returns, they can be grouped into security, diplomatic and economic dimensions in Sino-US relations. From the security perspective, China has never linked its holding of US bonds with such disputes as the US arms sales to Taiwan, cyberspace security or even the sovereignty issue over the Diaoyu Islands. From the diplomatic perspective, China has not used its holding of US treasury bonds to gain diplomatic advantages from the US. And even from the economic perspective, China has not reaped any so-called strategic returns, such as influencing America's policies in the dispute over the RMB exchange rate. As a matter of fact, the RMB has appreciated by 30% since reform was initiated on the RMB exchange rate formation mechanism, largely reaching a market equilibrium. Even in terms of the economic yield of bond purchasing, China's actual gain is rather

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regular. As the largest external buyer of the US bonds, China must purchase the bonds under the open pricing rules like anyone else; it does not get any extra privileges or returns solely because of the fact that it is the largest buyer.

In generally, any emphasis on the strategic nature of China's holding of US bonds at the present does neither accord with China's real financial strategy towards the US nor accord with the actual financial interaction between China and the United States. Instead, it will only make the United States to take unnecessarily precautionary actions. Therefore, it is necessary to take the strategic nature out of consideration in China's purchasing of the US bonds, sever the connection between the bonds and power as well as the related creditor logic. The financial policies toward the United States should be formulated directly in line with to the principles of market investment. If investment returns are to be considered, holding large amounts of the US governments bonds is never the best choice.

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First of all, the general ROI is low. Besides the above analysis, the ROI can also be analyzed from another perspective. It can be observed that the China Investment Corporation boasted a higher average ROI from its equity and fixed income investment in the past few years as compared with the purchasing of US treasury bonds.[5] Second, although it is more secure to purchase US treasury bonds than other investment products since the US bonds are guaranteed by the credibility of the US government. But viewed from another angle, purchasing

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too large an amount of US treasury bonds brings about another risk since China puts too much financial resources into a debt market with a financial product issued by the US Treasury. Theoretically speaking, such massive purchasing of US bonds endows, to some extent, the US government with a strategic advantage to affect China with such means as controlling the issuance of treasury bonds and the payment of interest. There might even be the possibility that, in some extreme cases, the US government freezes the principal and interest payments for the bonds China holds. In this sense, the pursuit of economic security may cause strategic insecurity.

Now that holding the US bonds can neither bring strategic advantages nor generate ideal investment returns, it becomes imperative to change the way of thinking and seek more reasonable investment channels so as to make the investment both accord to market rules and generate better returns, in addition to playing a constructive role the stable development of Sino-US relations. Therefore, it is but a wise choice to shift from purchasing the US treasury bonds to making direct investment in America.

III. Direct Investment in the US: Advantages and Channels

Compared to purchasing the US bonds, direct investment in the US has the following advantages:

(1) Higher ROI. Current research shows that the ROI of direct investment in the US is much higher than that of purchasing the US bonds. For instance, according to calculation of NBER, from 2003 to 2006, the ROI of FDI in America were 4.8%, 6%, 6.5% and 6.9%, respectively,[6] which are all 3% higher than that of the US bonds in the same period. This difference in ROI has maintained ever since the financial crisis. The fact that the FDI returns are higher than national debt does not only apply to the United States, it is actually an universal economic phenomenon, since it is much easier to buy national debt than to directly invest in a country, and the former involves much lower transaction costs.

(2) Stronger marketization. Direct investment in the US means that Chinese corporations will directly make transactions with the

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US market players. This will involve the Chinese corporations that make estimations about industrial development, analysis of market situations and assess of returns. There is no doubt that, compared to directly purchasing bonds from the US Treasury Department, direct investment in the country will help all sorts of Chinese corporations to become more familiar with the US market and to understand better about international operations.

(3) Greater safety. According to economic principles, national debt is much safer than direct investment, and this is self-evident in most cases. Yet, it is another matter when it comes to the case of United States, where direct investment will be much more secure as long as the amount of investment is sufficiently big and the distribution is sufficiently broad. The reasons for this are: (1) Direct investment is market behavior and is rarely subject to influence of policies adjustment of the US Treasury Department, therefore, much safer from the political perspective; (2) the investment portfolio will be diversified instead of being concentrated on a certain sector or industry, which involves more risks at some time, but it is generally under control; and (3) the higher ROI of investment in America has actually enhanced the security of investment.

(4) Better complying with the trend of China's external financial policy adjustment. China's external financial policy has been shifting from mainly use of foreign exchange reserves to more diversified investment. In terms of investment regions, China's direct investment overseas at the current state mainly focuses on developing countries in Asia and Africa. Plans will be worked out to increase investment in developed countries in the future. As for the sectors in which the investment will go, a shift will also be made from the leasing and mining industries to the high-end manufacturing sector.[7] More FDI in America comply with the two tendencies above.

(5) Less trade frictions with the US. For quite some time, the focal point in Sino-US trade disputes has been the enormous US trade deficit against China. The US claims that China has employed various unfair measures to obtain a huge trade surplus from the United States. In order to reduce this trade deficit, the US has

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taken measures such as putting pressure on the RMB exchange rate, restricting market access of Chinese products, upgrading trade standards and operating against the infringement of intellectual property rights. If China increases direct investment in the United States, exports to the US will decrease, thus the trade imbalance between the two countries will be mitigated, thus reducing the trade pressure from the United States.

(6) Further stabilizing Sino-US relations. The close economic and trade links between China and the United States have been widely regarded as the cornerstone and stabilizer of Sino-US relations. Now, such economic and trade relations are mainly expressed in trade since the bilateral trade volume has exceeded US$500 billion. Such a huge volume of trade has made China and the US closely interdependent and helps the Sino-US relations withstand possible turbulence. If China can increase direct investment in the United States, a new win-win situation in investment will emerge beyond the trade sector, thus encouraging Sino-US interdependence both in trade and investment. This, in return, will strengthen both the market and social bases supporting stable Sino-US relations.

Increasing direct investment in the US is not only beneficial to China but also to the US economy. First, investment in the US can help create more job opportunities. In the face of an unemployment rate as high as over 7%, it is no doubt the economic priority of the US government to expand employment. Second, direct investment in the US can help raise the income of the US people. According to relevant US statistics, the average annual salary of foreign corporations in the United States is US$77000 per person, higher than that of the local companies. Third, foreign companies in the United States can help expand US exports, which in return, will reduce the country's trade deficit. In 2011, foreign enterprises in the US contributed 20.5% of the total exports of the United States, higher than the percentage of foreign companies in the US as well as the percentage of the total assets of foreign companies in the US.[8] And finally, foreign investment can help improve America's industrial structure, enhance the R&D in the United States and overall labor productivity, thus being beneficial to the adjustment of the US economic structure.

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Compared to the purchasing of the US treasury bonds, direct investment in America has some economic disadvantages, the biggest of which their total size will be much smaller than that of national debts. According to US statistics, by the end of 2011 FDI in America had amounted to US$2.27 trillion,[9] with the annual capital inflow being less than US$100 billion. Compared to the US treasuries market which totals more than US$17 trillion, the FDI market in the United States is indeed much smaller. This means that China cannot significantly increase FDI in the US in the short term.

Moreover, it is impossible currently for China to tremendously expand its direct investment in the United States because this is related to capital source selection of America. Technically speaking, there are two choices in relation to the capital source problem if China wishes to increases direct investment in the United States in the future. The first choice is to reduce its current holding of US treasury bonds and use the funds saved from the reduced part of the bonds for investment in the US. Considering the mammoth amount of US bonds held by China, there will be a huge stock of foreign exchange reserves appearing in the short run once China chooses to decrease its holding of US bonds, making it necessary to directly invest this sum of money in the US. The second choice is to maintain the current amount of US bonds it holds and invest directly the surplus part of its foreign exchange reserves in the US. By the end of 2013, China's foreign exchange reserves had amounted to US$3.82 trillion.[10] Apart from the US dollar assets that have already been invested in the US, the euro and the other assets, the foreign exchange reserves that have been used by China's Central Huijin Investment Co. Ltd. and that are needed to pay off the medium and short-term external debts, the amount of foreign exchange reserves left to making direct investment is not much. Another possible approach is to reduce its holding of US bonds in a small scale within a limited period of time, by billions of dollars per month to have the funds invested in the United States when the time is right. Either making use of the foreign exchange reserves surplus or reducing the holding of US treasury bonds in a small scale, the available amount of capital each year is about dozens of

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billions of US dollars, and this amount is well matched with the capacity of the US direct investment market.

Furthermore, from the real political perspective, it is unwise for China to reduce by huge amounts the US bonds it holds in a short run at least. To some extent, the current scale of the US bonds China holds has become a "political symbol" with high diplomatic implications for both sides. It represents the mutual financial need, trust and interdependence between China and America in the form of a financial carrier. Under the circumstances of stable economic and diplomatic relations, an abrupt and massive decrease of China's holding of US treasury bonds will greatly impair the health and stable bilateral relations, triggering unnecessary suspicion against China in the United States, which will be unfavorable to developing a new-type great power relations between China and the US.

IV. Obstacles for Increasing FDI in the US

From either the perspective of China's adjustment of its overseas financial strategy or the perspective of the seeking of a stabilizer for Sino-US economic and trade relations, making direct investment in the US will increasingly become a priority option of China's financial activities in the United States. China's investment in the United States only accounts for 1.5% of the country's total domestic FDI, and this means a great room for further growth.[11] China has already been preparing to increase direct investment in the US. The rapid increase in the last few years has transmitted a clear signal that China is adjusting its financial policies towards America. Through the platform of China-US Strategic and Economic Dialogue (S&ED), China has expressed to the US side the hope to increase direct investment. Now, the largest obstacle impeding direct investment from China is in the US, with the following concerns regarding the expansion of China direct investment.

The first concern is America's national security. The analysis of countries that have made more direct investment in the US reveals that they are all either military or political allies of the United States, such as Britain, the Netherlands, Germany, Japan and France. The United States does not think these countries will

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pose any real challenge to its national security and, therefore, it is more at ease with regard to investments from these countries. As for the investment from its perceived potential rivals, America takes stricter censorship policies.[12] The US government has three safety concerns about FDI from Chinese corporations. The first is that the investment decision and operation of Chinese companies may be manipulated by the Chinese government rather than by the market principles.[13] The second is that the Chinese investment programs may make the US more vulnerable in security or may even damage America's security interests, and make America's defense industry more dependent on Chinese suppliers.[14] The third is that Chinese corporations may obtain important military, technological or economic information through making investment in the United States. Due to all these concerns, most Chinese corporations' applications for direct investment in the US after the 2008 financial crisis have ended in withdrawing the plans. Examples of this include the Huawei acquisition of 3Leaf, 2Wire and a subsidiary company of Motorola in 2012, as well as the investment of Sany's America subsidiary company in a wind farm.

The second concern arises from the US side's attachment to maintain the existing Sino-US financial model. The existing Sino-US financial relations, which are centered on China buying the US government debts, essentially benefits the United States. By buying in massive amounts US treasury bonds, China has effectively helped the US government to ease its fiscal pressure. To a considerable extent, the huge amounts of US treasury bonds held by China have actually become "sunken costs" without the possibility of being redeemed for rather a long time. For rises of inflation rate in the United States, the principal used to buy the

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bonds is actually shrinking in value. What the US government only needs to do is to pay the interests on time. Moreover, as for how the money borrowed by the United States will be used, either as appropriation for national defense or as funds of foreign assistance used by the Department of State, China has no say whatsoever. Yet, it is a different matter for direct investment which is never or hardly subject to the management of the American government; the money shall be used in total compliance with market rules. Hence, from the point of view of the United States, it hopes that China will hold more US treasury bonds rather than increasing its direct investment in the United States.

The third is to safeguard international economic interests of the US. The United States has long been hounded by an international payment deficit, and is a net debtor with foreign assets less than external liabilities. Seen from the constitution of the US net international investment position, the private direct investment position has always been positive, while the net positions of the official investment position and private investment portfolios are almost negative. In general, the US foreign investment is making a net profit. This is only because the US foreign investment largely consists of private direct investments, so America's foreign investment is generally in profits even though it is a net external debtor. From 2007 to 2011, the returns of US foreign direct investments all hit record highs except for that of 2009 which was affected by the global financial crisis, with the ROI being 11.7%, 12.2%, 9.5%, 11.1% and 11.0%, respectively, and an average ROI of 11.11%.[15] That is to say, after the global financial crisis, the average ROI of the US FDI went up rather than went down. The United States holds a conservative attitude towards FDI inflow in order to maintain this kind of advantage based on the private direct investment as well as its high returns.

The fourth is to couple with the high-standard trade negotiation advocated by the United States. The United States is now vigorously promoting major free-trade agreement negotiations such as the Trans-Pacific Partnership Agreement (TPP), one significant issue of which is the high-standard investment agreement. In April 2012, the US government released the new draft of bilateral investment

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protocol, and hoped to negotiate with other TPP negotiators based on the new draft.[16] In the meantime, China and the United States have started the factual negotiations on the Bilateral Investment Treaty (BIT) since 2012. In this sense, the BIT negotiations and the part of the TPP negotiation in relation to investment should be go on together. The US side hopes to frame BIT negotiations with the same TPP criterion, and in return put pressure on China in the BIT negotiations. Before the TPP negotiations are successfully completed, it is hardly possible for the US to reach the BIT agreement with China. The US will never be truly open to China's direct investment without necessary institutional guarantee for the investment.

The fifth is its doubt about China in fulfilling its commitment to reciprocal opening up for investment. Regarding the issue of opening up to direct investment, the US side stands for reciprocal opening up, demanding the principle of mutual benefit to be upheld in foreign investment policy, i.e., the country from which the investment comes to the US must provide the same treatment to investment from the United States. When it comes to Sino-US bilateral investment, it demands that China and the United States give equal opportunities to each other's investment. Yet, considering that China is still a developing country, some of its industries or sectors are still need an appropriate period of protective transition, it is therefore hard for China to be as open as the United States in this regard. What China can promise now is to be open to American enterprises according to a negative list and pro-investment national treatment. Even so, the US still considers that China's negative list is overly extensive and is not clear enough on the standards of pro-investment national treatment before entry.

V. Conclusion

Increasing direct investment in the US not only complies with the trend of Chinese economic growth but also is in America's long-term interests. It will become the engine propelling further development of new common strategic interests in Sino-US relations. But, substantive development in China's direct investment

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in the US calls for both willingness from the Chinese side and cooperation from the US side. The problem now is that the United States, for its various considerations, is not yet prepared to open completely its investment market to China; rather, it is very conservative and remains rather precautious towards investment from China. The US hesitation in responding to China's appeal to increase its direct investment is of no help to the construction of strategic interdependence between the two sides. Fortunately, China and the US have held several rounds of negotiations on a bilateral investment protection agreement, and these negotiations may serve as a touchstone for Sino-US interactions in the financial sector. If this agreement can be reached as soon as possible, it will usher in a new phase in Sino-US economic and trade cooperation and open up broader space for Sino-US financial cooperation, thus making the Chinese and American economies more interdependent and preparing a solid economic foundation for the new-type great power relations between the two countries.

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