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POLICY BRIEF

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Reluctant US vs Ambitious German Direct Investment in China – the Tale of Two Strategies

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- Discrepancies in the regional structure of FDI rely on (1) differences in the sectoral focus: US in services and Germany in manufacturing, (2) differences in the regulatory framework protecting national security in the two home countries: much stronger in the US than in Germany especially against China, and (3) differences in Chinese policy interventions: stronger in services than in manufacturing.
- It can be expected that rising tensions between China and the US will lead to stronger trends of technological self-reliance on both sides, a higher local content of production and more importance of protecting national security.
- US companies with their low presence in China might face less challenges than German companies which are more subject to path dependency given their high presence in China.

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OVERVIEW/ÜBERBLICK

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- It can be expected that rising tensions between China and the US will lead to stronger trends of technological self-reliance on both sides, a higher local content of production and more importance of protecting national security.
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Keywords: Foreign direct investment, US, Germany, East Asia, China,national security

- Die USA als weltgrößter Auslandsinvestor meiden bislang die dynamischste Gastregion Ostasien insbesondere China und setzen stattdessen weiterhin auf Investitionen in Europa. Deutschland geht einen anderen Weg. Ähnlich wie im Handel waren deutsche Unternehmen als Investoren sehr aktiv, insbesondere in China.
- Unterschiede in der Regionalstruktur der amerikanischen und deutschen Auslandsinvestitionen lassen sich erklären durch (1) Unterschiede in der sektoralen Ausrichtung (USA im Dienstleistungs-sektor, Deutschland im Verarbeitenden Gewerbe), (2) Unterschiede im regulatorischen Rahmen zum Schutz der nationalen Sicherheit in den beiden Herkunftsländern (in den USA viel stärker als in Deutschland, insbesondere gegenüber China) und (3) Unterschiede in den politischen Interventionen Chinas (im Dienstleistungssektor stärker als im Verarbeitenden Gewerbe).
- Es kann erwartet werden, dass zunehmende Spannungen zwischen China und den USA dazu führen, dass beide Seiten die technologische Eigenständigkeit fördern, zunehmende heimische Wertschöpfungsanteile anstreben und dem Schutz der nationalen Sicherheit hohe Bedeutung beimessen werden.
- US-amerikanische Unternehmen mit ihrer relativ geringen Präsenz in China könnten sich geringeren Herausforderungen gegenübersehen als deutsche Unternehmen, die aufgrund ihrer starken Präsenz in China eher einer Pfadabhängigkeit ausgesetzt sind.

Schlüsselwörter: Ausländische Direktinvestitionen, USA, Deutschland, Ostasien, China, nationale Sicherheit

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RELUCTANT US VS AMBITIOUS GERMAN DIRECT INVESTMENT IN CHINA – THE TALE OF TWO STRATEGIES CHINA

Rolf J. Langhammer

1 PIVOT TO ASIA: THE US STRATEGY LACKS AN ECONOMIC COMPONENT[1]

In 2011, more than thirty years after China had started to open its market to global competition and ten years after the country acceded to the World Trade Organization (WTO) , the Obama administration introduced its strategy of "pivot to Asia". It departed from the assessment of the administration that with the rise of China to No. 2 and later (and foreseeable) No. 1 world's economic powerhouse and to the dominant player in the Asian region, there was no other region in the world which was so essential for the economic prosperity and political stability of the US as Asia (Lieberthal 2011).

The strategy rested on a number of pillars with bilateral defense and security agreements with Asian countries in the forefront. These agreements included pledges of support and were targeted to deter China from possible expansionary steps to widen the Greater China sphere of influence. Apart from the bilateral free trade agreement with South Korea, the major economic component of the strategy was the regional integration scheme Trans-Pacific-Partnership (TPP) which the Obama administration negotiated without China. It included a number of rules on investment, intellectual property rights, digital trade and sustainability objectives far beyond usual tariff cuts and reflected the US perceptions of a modern rules-based scheme. The Trump administration left the TPP and by early 2022, the Biden administration has shown no engagement to revitalize the successor institution Comprehensive and Progressive Trans-Pacific-Partnership (CPTPP). The Sino-US trade deal phase I of 2020 negotiated by the Trump administration could not substitute for an East Asia-wide strategy. It even drove a wedge into such a strategy, as the deal was limited to erode the imbalances in the bilateral US-China trade relations by accepting negative trade-diverting effects against other East Asian countries. Under the Trump administration, the "pivot to Asia" strategy derailed into a "US-China zero trade balance" target.

As a result, the "pivot to Asia" strategy of the US still lacks a major economic component. This is the more missing as traditional trade policy with the focus on dismantling tariff and non-tariff barriers loses its importance at a time when latest free trade agreements include other targets and tools than just liberalizing trade and lowering trade barriers. More sustainability,

[1] Helpful comments by Katrin Kamin , Wan-Hsin Liu und Klaus Schrader are gratefully acknowledged.

worker rights, environmental protection and provisions to govern digital trade range highly among these new objectives.

Outside trade agreements, trade restrictions are increasingly accompanied by (and eventually substituted for) restrictions against foreign investors. This happens simultaneously in the US, EU and China. These restrictions do not only review inward investment whether or not they endanger national security and national control over sensitive infrastructure technology. To different degrees, they also induce foreign investors to raise their local content when supplying the host country market, to give priority to remote over core locations for their plants and to facilitate the transfer of technology to domestic users.

In competition with China as a systemic rival commanding strong technological competence in digitalized production of goods and services, US companies must see investment in China as a double-edged sword. On the one hand, they are particularly competitive in consumer and business services where the Chinese market offers vast opportunities along rising income and with still constrained competitive strength of local suppliers. Furthermore, expansion of services production meets with the industrial policy of the Chinese government to shift the production structure from manufacturing to services and from outward to inward orientation. Following this target, China in recent years has allowed foreign companies in some service sectors to open affiliates in China as a precondition to supply services to Chinese residents (so-called mode 3 supply of services in the WTO jargon). On the other hand, producing in China means to submit foreign companies more to controls of compliance with governmental targets than through direct exports to China. This would be essentially relevant for control on firm-specific technology know-how. Once domestic suppliers, with many particularly protected stare-owned enterprises among them, would have gained control over such know-how, US companies and other foreign investors could feel the heavy hand of the Chinese government more than before. Moreover, while access for foreigners to service sectors had been opened and regulatory reforms were introduced, “it will not protect companies from the risk of becoming collateral victims of geopolitical games on which they have no control whatsoever” (Duchâtel 2021).

To find out whether US companies have already moved into a direction that a strong presence in China and total East Asia (relative to other host countries) could make them vulnerable to economic coercion or whether investment reluctance in the past leaves their options now open in a much less investment-friendly environment, is the motivation of this paper.

The paper compares the regional and sectoral structure of US FDI in East Asia in general and China in particular since 1980 with the same structure of another important home country of foreign investors, Germany, a leading exporter of manufactures and among the top five countries of overseas investment. It is organized as follows: In chapter 2 the importance of the China and the Ast Asian host region for US and German FDI since the eighties of last century is shown. In chapter 3 one of the major hypotheses for differences in the regional structure is discussed: the strong focus of US regulations on defending national security. Chapter 4 constrasts US strong regulations with very liberal regulations in Germany which are supported by the German FDI focus on investment in manufacturing against the US focus on services and technology software. Chapter 5 offers an outlook and points to higher challenges for German investment compared to US investment should the investment climate in China in the foreseeable future give more rise to stress and tensions.

2 SURPRISE: THE WORLD'S LARGEST HOME COUNTRY OF FOREIGN INVESTMENT SHUNS THE MOST DYNAMIC HOST REGION

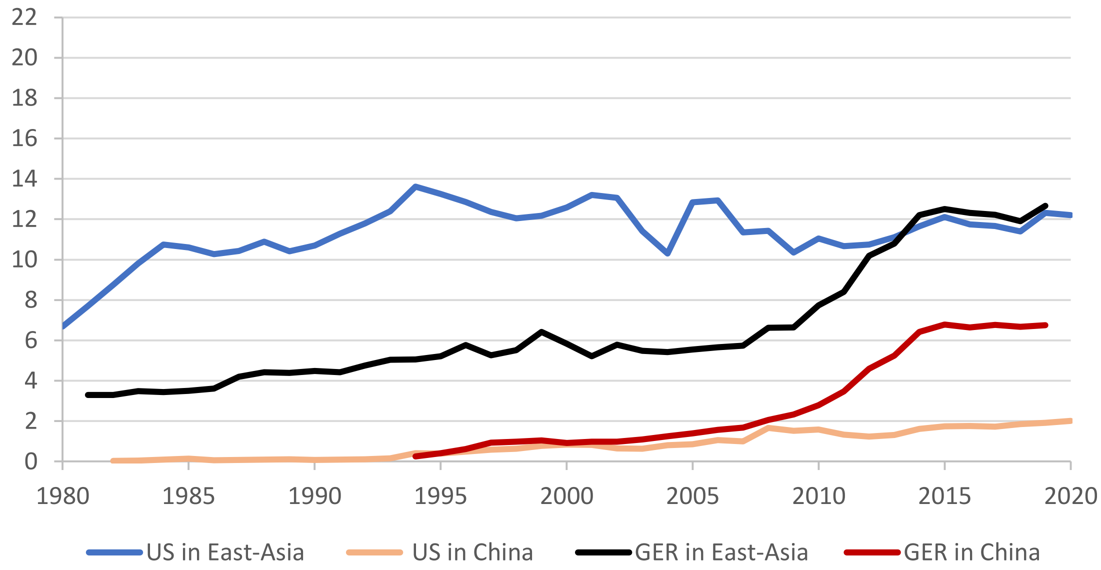
Differences between the US and Germany concerning the presence of their companies in East Asian host countries are amazing. Since 1980 the US has only doubled its total investment in East Asia (China, South Korea, Japan,Taiwan, Hong Kong and the ASEAN economies) from 6 percent to just 12 percent in 2020, with China accounting for just 2 percent. Over the entire period, by far the largest host region for the US remained Europe. Germany, however, raised the share of East Asia as a host from 2 to about 13 percent over the same period. China (with data on German FDI stock only available since mid-eighties of last century), steadily emerged as an important host from zero to almost 7 percent in 2019 thus accounting for more than half of German FDI in East Asia (Figure 1).

Differences between the two home countries get even more distinct, if instead of total investment only investment in manufacturing is looked upon. Here East Asia as a host became more relevant for the US than for total investment while never challenging Europe as the most important host region. In 2020, almost 19 percent of total US FDI in manufacturing was in East Asia (up from 6 percent in 1980), yet with China accounting only for less than a third (6 percent) in 2020 (Figure 2). In contrast, China became an ever more important host for German manufacturers since 2000 comprising about 14 percent of global German FDI manufacturing and more than two thirds of German manufacturing investment in East Asia.

Within the manufacturing sector, the automotive sector emerged for both home countries as the outstanding investment target in China. In 2020, China accounted for almost a quarter of German global investment abroad in the automotive sector while in 2020 the US transport equipment sector had about 16 percent of its world investment located in China. Yet, since the importance of US global FDI in manufacturing is low (in 2020 only 15 percent of total FDI) relative to Germany (in 2019 about 32 percent of total German FDI), even an outlier like US FDI in the Chinese transport sector failed to raise China's share in US total FDI beyond the 2 percent level (BEA, Deutsche Bundesbank).

US investment in China and other East Asia generated trade, mostly (for more than 80 percent) intra-firm trade, between the foreign affiliates and the US parent company on the export as well as on the import side (Table 1). Yet, such trade fell far behind sales for the host country market. Jackson (2017) reports that in 2014 US affiliates in China had 82 percent of their sales in China and only 6 percent of their sales back to the US. Hence, US investment was mainly market driven rather than cost driven.

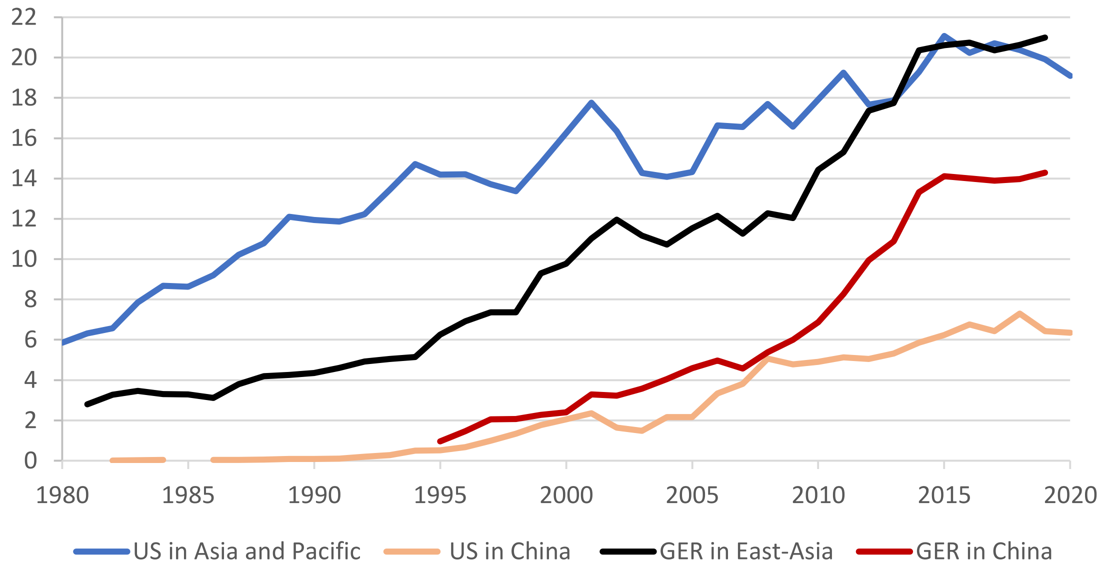
Figure 1:
Share of East Asia and China in US and German foreign direct investment (FDI), 1980–2020,[a] in percent of total US and German FDI



[a]Germany until 2019.

Source: BEA (var. iss.); Deutsche Bundesbank (var. iss.); own calculations and illustration.

Figure 2:
Share of East Asia and China in US and German FDI in manufacturing, 1980–2020,[a] in percent of total US and German FDI in manufacturing



[a]Germany until 2019.

Source: See Figure 1 own calculations and illustration.

Table 1:
US Intra- and Extra-Firm Trade with US Affilates in East Asia and China, 2019, in percent of total

	US Exports to Affiliates		US Imports from Affiliates	
	by US Parents	**by Unaffiliates**	**by US Parents**	**by Unaffiliates**
East Asia	87.7	12.7	82.3	18.8
China	85.1	14.9	87.0	13.0

Source: US Department of Commerce (2020).

How strongly US companies abstained from investing in China becomes evident in the US stronghold sector, investment in services. In 2020, about 82 percent of US investment abroad was in non-manufacturing and non-mining and so-called investment of holding company affiliates (investment by affiliates of US parents rather than by the parent company itself) accounted for 47 percent of total US investment abroad. Such dominant position of holding company affiliates arises in particular in Asian finance centers like Hong Kong (61 percent of total US FDI there) and Singapore (60 percent) but not in China (only 3.5. percent). A similarly low position was in information services which in 2020 accounted for only 1.7 percent of US investment in China.

To sum up, US FDI in mainland China has remained remarkably low in spite of recent selective opening of the Chinese market to foreign investment which included options to avoid compulsory joint ventures with Chinese companies. Opportunities to serve the Chinese market through neighboring hosts, in particular Hong Kong, remained widely untouched as well. In contrast, German investors were much more present in China, in particular in the manufacturing sector. The question arises whether different regulatory conditions together with the different sectoral focus of the two host countries (US in services, Germany in manufacturing) can explain such divergence in the regional pattern of US and German FDI.

3 US REGULATORY BARRIERS TO US INVESTMENT IN CHINA: A RELEVANT EXPLANATION FOR LOW PRESENCE

US regulatory barriers covering FDI are particularly relevant for FDI in the US. The Committee on Foreign Investment in the US (CFIUS) based on the 2018 Foreign Investment Risk Review Modernization Act (FIRRMA) oversees and screens inward FDI on issues of national security (Jackson, Cimono-Isaacs 2018). What matters for outbound US FDI is a variety of export control measures comprising the exports of goods (in particular of dual use) but also security-relevant services, technology and software (Fergusson and Kerr 2020). As services can be supplied by cross-border trade via internet as well as by commercial presence of affiliates which have settled down as investors in the home country, different export control measures in the US can indirectly act against internet trade and FDI abroad especially in countries which are subject to US precautionary measures and even sanctions. Especially in recent years, China has been targeted by these measures (Schwarzenberg and Sutter 2021, Sutter 2021). Therefore, FDI in services in China can be borderline cases for approval or disapproval by US authorities especially when Chinese companies hold equity and implement supervision or when Chinese authorities enforce censorship activities. The rise and failure of Google in China (and recently Hongkong) when the company got censored and responded by retreat from the Chinese market exemplifies the risk that US service companies have faced when trying to reconcile the principles of their own business models with restrictive policies of a host country like China (Sheehan 2018).

Thus, there is a combination of three different barriers which either led to the reluctance of US service companies to invest in China or a deliberately chosen absence.

First, for many years the service market in China was closed or heavily restricted to foreign suppliers especially when the mode of supply was via internet (WTO mode of supply 1) or commercial presence of affiliates (WTO mode 3). The other two modes 2 and 4 (transport, tourism and travel as well as services temporarily supplied by foreign individuals in China) were less vulnerable to forced technology transfer and national security and thus were politically less sensible. The opening of the Chinese market occurred gradually and in particular very selectively in compliance with government policies.

Second, US regulations under the various export control acts expose US service companies to risks that investing in China does not comply with US politics of defending national security. Once US authorities would contest business plans of US companies in China, the costs of litigation in the US plus the costs of loss in reputation among US customers could exceed gains from investment.

Third, Chinese competitors especially in IT services are powerful and enjoy preferences in governmental support. This holds the more if they are state-owned. The risk to lose control over know-how and technology against these competitors is real.

4 THE GERMAN INVESTMENT STRUCTURE IS LESS VULNERABLE TO SECURITY CONCERNS

The legal counterpart to the CFIUS and FIRRMA in Germany is the Foreign Trade and Payments Act FTPA (Aussenwirtschaftsgesetz). Traditionally, it has focused on goods trade rather than on services trade and has concentrated on exports of sensitive (dual-use) products. As the EU commands the control on member states' trade policy, the FTPA is integrated into the common EU trade policy. With respect to investment, the Foreign Trade and Payments Ordinance (Aussenwirtschaftsverordnung) sets conditions for inward investment's compliance with targets of protecting national security but not explicitly for outward investment of German companies. Rules for outward investment follow the underlying principle of the FTPA laid down in Art I,1 that foreign trade and foreign capital transactions are essentially free.

In addition to the liberal German policy towards outward investment, it is the German sectoral supply structure biased to manufacturing which may explain why so far German companies felt safe to defend the control over technology and know-how. More than in services, manufacturing is splitted into global supply chains where parent companies can control the distribution between technologically advanced state-of-the-art stages preferably produced at home or in safe neighboring markets such as the EU internal market. Only stages which use mature technologies combined with cheap labor would be outsourced into less safe markets via FDI. Furthermore, parent companies in manufacturing can command the distribution of trade between intra-firm and extra-firm trade.

Moreover, it has often been argued that so far many German manufacturers especially those producing in "niches" were hidden global champions with a high innovative potential (Rammer and Spielkamp 2015) and thus relatively immune towards the threat of forced technology transfer. Finally, in all countries, national security concerns are more loudly raised when it comes to production of software than to hardware. This would in particular apply to so-called disembodied services which (unlike after-sales services related to manufacturing) are supplied without physical contact. Such services are more a US than a German stronghold.

As a result, the combination of a very liberal political stance towards outward FDI, the sectoral bias towards manufactures, the assumedly strong position of hidden champions and stronger concerns about threats of national security in software than in hardware may explain why German investors so far have much less shied away from producing in China than US investors.

5 OUTLOOK: THE GERMAN BENIGN NEGLECT ATTITUDE TOWARDS INVESTMENT IN CHINA: CARELESS OR PATH DEPENDENT?

China's so-called dual circulation strategy prioritizes the production of domestically located companies for the domestic market over world market orientation. It is both an offer to foreign companies to produce in China for the domestic market and a serious challenge. The challenge arises from three angels: (1) tight regulations for a progressive industrial policy, (2) strengthened SOEs during the pandemic, and (3) the policy of the government to subordinate all companies to two targets: furthering common prosperity and self-reliance in modern technology.

It is at least open to debate whether foreign companies acting as affiliates in China will be able to reconcile their strategies to those of their parent companies in the US and Germany as smoothly as in the past. If not, parent companies could have to cope with rising discrepancies between their strategies and those of the Chinese affiliate operating under the three angles. Furthermore, the risk of getting technologically and financially hollowed out, is real.

Under such prospects, the reluctance of US companies in the past to settle down in China could prove to be a blessing in disguise, at least seen under the objective of the US parent company to take full control on their overseas affiliates. To be forced to produce in China is less of a threat for US companies.

For German companies, the situation is different and resembles the situation in trade. As in trade, in the past China has become a major target market for German investment in manufacturing. Yet, the strong affiliation between export success and investment success will come at a high price should Chinese government strategies lead to a collision with parent company targets. A more optimistic interpretation of this situation points to the freedom of the parent company to decide which parts of its global value chain will remain outside China and also outside Chinese companies' overseas access. Given the larger length of global value chains in manufacturing than in business services, German parent companies could indeed still have many options including the option to slowing down the speed of investment in China and to return to direct exports. It is, however, open to question whether this option complies with Chinese policies of lessening the dependence on foreign sourcing markets..

The less optimistic option is that path dependency with respect to the importance of the Chinese domestic market for the future of the German parent companies has already reached a level beyond the point of easy return and that the dual circulation strategy of the Chinese government will become ever more dominant. Then the result could be a sizable gap between German parent companies' targets and those of their affiliates in China. How large the gap will finally be is open. But there are good reasons to conclude that the gap has risen since the times when the US pivot-to Asia strategy was introduced and that the gap will affect German companies more than their US counterparts.

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IMPRESSUM

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