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U.S.-China Bilateral Investment Treaty Negotiations

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U.S.-China Bilateral Investment Treaty Negotiations: Context, Focus, and Implications

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Abstract

The growing importance of foreign direct investment (FDI) to U.S.-China relations was highlighted when the U.S.-China Strategic Economic Dialogue (SED) in 2008 mandated the negotiations of a bilateral investment treaty (BIT). Intended to further liberalizing investment policies of either country, the U.S.-China BIT-to-be came at a time of soaring economic tensions between the two economic giants amid global financial crisis.

In contrast to the assertive stance of the United States to base the negotiation on the U.S. model BIT, which is most sophisticated and signifies the highest standard for market access and investment protection, the current Chinese investment regime, which is characterized by an industrial policy orientation and case-by-case approval for prospective FDI, would have to undergo a systematic overhaul. In view of the varying interests of two nations, huge investment potential, clash of the two parties’ positions, the BIT negotiation is destined to be the most difficult one in history, and might turn out to be a long-lasting diplomatic baffle between the two nations.

If the U.S. model BIT is finally adopted with minor revisions, the BIT could have far-reaching implications for China to avoid damage to the reliability of markets and for the United States to avoid the perception of investment protectionism. Moreover, it will serve as an inspiration for, and add the momentum to, institution-building for global investment flow.

KEYWORDS: Bilateral Investment Treaty, Negotiation, China-US Economic Link, Implications

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Process

As part of the high-profiled Strategic Economic Dialogue (SED) on June 18, 2008, the United States and China agreed to negotiate on a bilateral investment treaty (BIT). The decision to launch negotiations follows seventeen months of exploratory talks, which laid the groundwork for BIT negotiations.\(^1\)

The two countries held the U.S.-China Investment Forum alongside the SED (later S&ED).\(^2\) At the first meeting of the Investment Forum that was held on June 16, 2008, both sides discussed bilateral investment and agreed on a framework and work plan. Yet the United States vowed that the timeline for concluding the negotiation will be determined by the quality of the agreement.

In both the SED and the Investment Forum, much progress was made in the exchange of concerns and in the commitment made in certain areas. Although the latest S&ED added some urgency to the BIT negotiation by institutionalizing the Investment Forum and mandating the third meeting of the Forum, as long as the United States gives priority to a high standard BIT over timeline of conclusion, it remains unknown when the BIT will be concluded.

Why a BIT?

One of the world’s most important bilateral relationships is that between China and the United States. An increasingly visible component of that relationship concerns FDI.

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\(^1\) The first Strategic Economic Dialogue between the United States and China was launched in September 2006. The second to the sixth Strategic Economic Dialogues were held in December 2006, May 2007, December 2007, June 2008, and December 2008, respectively. When President Barack Obama and President Hu Jintao first met in April 2009, the Strategic Economic Dialogue was renamed as the Strategic and Economic Dialogue to encompass strategic issues. The first Strategic and Economic Dialogue was held from July 28 to 29, 2009, in Washington, D.C.

\(^2\) In fact, early in 2007 President George W. Bush’s Export Council recommended that the United States and China use the Strategic Economic Dialogue framework to explore whether a BIT would benefit both countries. The State Department, Office of the U.S. Trade Representative (USTR), and Department of the Treasury had held initial conversations with their PRC counterparts throughout 2007.

\(^3\) In addition to discussing BIT, the Investment Forum also serves as a platform for the United States to focus on practical investor concerns, such as the process of investment reviews, potential investment barriers in China, and encouraging job-creating Chinese investment in the United States. The first meeting of the U.S.-China Investment Forum was held on June 16, 2008, not long after the fourth Strategic Economic Dialogue. The second meeting of the Forum was held during the fifth Strategic Economic Dialogue.
As China is a competitive, low-cost export platform as well as a large growing market, U.S. firms have invested almost US$60 billion since China opened its doors to the world in 1978. U.S. foreign direct investment (FDI) in China (stock) was US$28.3 billion in 2007, a 20.9 percent increase from 2006. The FDI plays an important role in many sectors of China’s economy.

Meanwhile, China, the largest recipient of FDI in the world, has become an expanding source of outbound FDI. A growing number of Chinese firms are interested in investing in the United States, and are prepared to allocate considerable resources for that purpose. In comparison, total Chinese FDI in the United States (stock) was US$1.1 billion in 2007, up 12.1 percent from 2006, much less than many other much smaller countries.

Against the backdrop, tensions are increasingly felt and causing a bottleneck in investment. On the Chinese side, Chinese investors have been experiencing what are termed as unfair treatment in the United States, thwarting investment activities.

In 2005, Chinese oil giant China National Offshore Oil Corporation (CNOOC) was forced to abandon an US$18.5 billion offer to buy Unocal Corporation due to stiff political opposition, with some U.S. lawmakers threatening to derail the merger, citing potential threats to national security. CNOOC’s bid was higher than a competing offer from Chevron Corporation, which ultimately acquired Unocal.

Also, the attempted purchase of 3Com Corp. by Chinese company Huawei Technologies and private-equity firm Bain Capital Partners, Huawei’s U.S. partner, was delayed after a federal review identified national-security issues related to the US$2.2 billion deal. Bain Capital eventually called off the deal because of lawmakers’ opposition.

Again, Industrial and Commercial Bank of China's application to establish a U.S. branch was delayed until not long before the fifth SED was held from December 4 to 5, 2008.

On the U.S. side, fettered access to some targeted lucrative Chinese industries often dominated by or reserved for state-owned enterprises (SOEs) has been the concern of U.S. investors or prospective U.S. investors in China. For example, China did not allow US incorporated banks in China to trade bonds in the inter-bank

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market, both for their customers or their own accounts, on the same basis as Chinese-invested banks. The Regulations on Mergers and Acquisitions of Domestic Companies by Foreign Investors in September 2006 have since made it very difficult to facilitate offshore investments into such domestic companies.\(^5\) The United States was also dissatisfied with other longstanding investment barriers, such as caps on foreign ownership of Chinese firms.

With these tensions and hindrance before the bilateral investment relationship, there are no appropriate binding rules to turn to.\(^6\) Moreover, while both the United States and China have been weaving a BIT network (the United States is presently a party to BITs with 45 countries and China has concluded 123 BITs with other countries), there is no BIT between the two countries.\(^7\) European and Asian competitors of many U.S. firms already benefited from these protections through the BITs between their respective country and China. This adds to the urgency on the U.S. side.

Given the unavailability of appropriate investment rules between themselves, both countries opt to conclude a BIT, which is in fact the most practical way to have in place a set of comprehensive investment rules in the near future. In this sense, the BIT serves two purposes: act as guideline to ease the tension and further liberalize investment policies of either country.

The United States attached great importance to the BIT negotiations with China. Traditionally, the Department of State, as well as the Office of U.S. Trade Representative, is involved in the negotiation of a BIT. When it comes to the negotiation of the U.S.-China BIT, the U.S. negotiation team comprises representatives from the U.S. Department of State, Department of the Treasury,

\(^5\) The Coca Cola/Huiyuan M&A case is an example. For an account of the case, see http://online.wsj.com/article/SB123735859467667801.html.

\(^6\) There are currently only two categories of international rules on FDI. At the multinational level there are small rules such as trade-related investment measures (TRIMS) and general rules for service sectors (GATS) within the World Trade Organization (WTO). The second category includes bilateral investment treaty (BIT), the free trade agreement (FTA), and the friendship, commerce, and navigation treaty (FCNT), which are either at the bilateral level or at the regional level. As far as the investment relationship between the United States and China is concerned, the only sporadic investment rules can be found in the aforesaid WTO agreements. However, since investment issues are not included in the Doha Development Round (as a matter of fact, the Doha Round negotiations have remained stagnant), it is not practical to expect the WTO to have in place a multilateral comprehensive investment agreement in the near future.

\(^7\) The country-specific lists of BITs are available at the UNCTAD website: http://www.unctad.org/Templates/Page.asp?intItemID=2344&lang=1.
Department of Commerce, and Office of the U.S. Trade Representative. In contrast, on the Chinese side, the negotiation of the BIT is primarily within the purview of the Ministry of Commerce, the agency responsible for foreign trade and investment.

**Focus of the Negotiations**

The BITs negotiated by the United States aimed to come to an agreement on non-discriminatory treatment; fair and equitable treatment, including the right to due process; compensation in the event of expropriation or nationalization; free transfers of capital; transparent regulation; and submission of disputes to independent international arbitration.

The thrust of the U.S. position is a high standard BIT. A BIT based on the U.S. model text will be able to address most, if not all, of the U.S. concerns. U.S. companies also fear that any deviation from the “high standard” BITs that U.S. negotiators have insisted on negotiating with other countries earlier on would complicate future negotiations with desired BIT candidates such as Russia, Brazil, and India. That is why the U.S. side has insisted on the U.S. model BIT. The United States has made clear its position: “The United States will negotiate on the basis of the U.S. model BIT, which reflects high-standards of investor protection.”

The U.S. model BIT gives national treatment of foreign investors at the “pre-establishment” phase. The United States will press for the "national treatment" provisions requiring China to accord U.S. firms right of entry into any sector including those reserved for Chinese firms. The United States has relatively few restrictions on foreign investment so a successful pact would level the playing field for U.S. investors in China.

Indeed the U.S. model BIT might offer substantial benefits to U.S. businesses, but it is not so for China. Such terms would prohibit the Chinese government from discriminating between Chinese and U.S. investors in reviewing and authorizing investments, granting business licenses, and other governmental actions necessary to “establish” a covered investment.

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8 See U.S. Fact Sheet of the Fourth Cabinet-Level Meeting of the U.S.-China Strategic Economic Dialogue.
China has not included that in previous investment agreements.\textsuperscript{9} Moreover, implementing a pre-establishment national treatment obligation would require the overhaul of much of China’s foreign investment regime. China might not be willing to go so far as to overhaul its foreign investment scheme.\textsuperscript{10} The national treatment issue has been the most difficult area of the talks since the outset.

Another issue that is closely related to and inseparable from the pre-establishment national treatment is that of national security. In China, national security is one of the pillars of the industrial policy for FDI, with which FDI can be left outside of some industries that the government wishes to reserve for SOEs or state-controlled companies, for example. In the United States, national security is not new either.\textsuperscript{11} The Chinese investments in the United States mentioned earlier that were blocked were all based on the exception of national security.

Concerns have also grown about sovereign wealth funds, for example, as well as China’s push to secure resources directly (rather than through long-term contracts combined with smaller equity stakes, the longer-standing approach as pursued by Japanese companies overseas). In 2007 alone, China created a US$200 billion sovereign wealth fund to invest part of its US$2 trillion in foreign exchange reserves. The size of funds available for equity investment raises one policy issue: Would investment decisions be made according to financial criteria, or are they being

\textsuperscript{9} Reportedly, the ASEAN-China investment agreement signed on August 15, 2009, under the auspices of the Free Trade Area does not extend national treatment to the pre-establishment stage. Zhang Kening, counselor with the International Department, Ministry of Commerce, said this in an interview. See \textit{http://www.xinhuanet.com}, August 15, 2009.

\textsuperscript{10} According to a study, China’s outbound FDI has reached significant levels commercially and geoeconomically and begun to challenge international investment norms and affect international relations. See Daniel H. Rosen et al., “China’s Changing Outbound Foreign Direct Investment Profile: Drivers and Policy Implications” (Peterson Institute of International Economics Policy Brief, June 2009).

\textsuperscript{11} Foreign investment in U.S. companies and assets has been controversial since World War I, when national security concerns arose in the United States over FDI, particularly from Germany. The focus shifted to Japan in the 1980s, and Congress passed the Exon-Florio Amendment, which gave the president broad powers to block foreign acquisitions of a U.S. company if that transaction threatened to impair U.S. national security. The latest surge in concern focuses on investment from China. The debate intensified in 2005 with the (subsequently withdrawn) bid by CNOOC to buy U.S. oil firm Unocal. The furor within Congress again reached fever pitch in early 2006 when Dubai Ports World bought the port operations of the UK-based Peninsular and Oriental Steam Navigation Company, which would have given Dubai Ports World control of operations at six U.S. ports. Consequent calls for reforming U.S. laws have led to some proposals that restrict investment without improving security. See Matthew Adler et al., “Policy Liberalization and FDI Growth” (Peterson Institute for International Economics Working Paper, August 2008).
used as instruments to extend state policy? In other words, will investments using the sovereign wealth fund in the United States raise any national security issue?

On the ground that nations retain considerable sovereignty when it comes to deciding on the operational ambit of FDI, a BIT that often entrenches substantive liberalization maintains exceptions for national security or subject investments to national interest tests. U.S. officials have made it clear that any agreement they negotiate with China would contain a provision allowing either government to block any investment that raises national security concerns. That sort of exception could be invoked by the United States, for example, to block or restrict an investment offer by China Investment Company or CNOOC.

National security issue is an area where both parties will agree on the justifiability of provisions on one hand, and attempting to cause changes in the other party while defending its own stance on the other. National security issue will be another hardcore issue of the negotiations.

In addition to the above, the U.S. side is also interested in identifying certain sectors (particularly financial services) and requesting certain concessions (elimination of equity caps, capital requirements, and restrictions on corporate structure, for example). These concessions, if accorded by the Chinese side, will surpass the commitments that China made in connection with its entry to the WTO. In other words, the BIT will impose WTO-plus obligations on China in the identified areas. However, China has refused to consider further disciplines for the financial services sector.

Dispute settlement

Enforcement of the BIT will be another concern of the U.S. side. The United States is not confident of the Chinese administrative and judicial practice, particularly the discretion conferred to officials responsible. It does not feel confident of how effectively the BIT can be enforced. It is interested in having a set of enforcement procedures to effectively monitor China’s compliance with the national treatment obligations. For example, some on the U.S. side suggest that it is necessary to draft the BIT with specific presumptions, evidentiary burdens, or standards to allow inferences of discrimination when the public record is murky.
The United States is particularly pressing for full investor-state arbitration provisions. Under investor-state arbitration provisions in the BIT, the investor can claim directly against the host state for breaching substantive protections (such as expropriations, or transparent “fair and equitable treatment”) for investments that have been made. Investment disputes are accordingly resolved through a much more “judicialized” procedure.

China’s BIT negotiation practice is to allow all issues arising from FDI activities to be arbitrated. The backdrop is that China is now a major FDI-exporter, whose investors are already beginning to bring claims abroad. It should also be noted that in this regard, the national security issue is likely to become even more acute in light of some very recent developments in investment treaty arbitration practice.

Traditionally, the BIT needs to address the issue of free transfer of investments and profits deriving from the host country’s foreign exchange control. Given China’s gigantic reserves, this issue is no longer prominent. However, some on the U.S. side seem interested in imposing a discipline on China concerning the exchange rate. Understandably, China, which has been opposing currency rate pressure, will be unhappy with or at least reluctant with the U.S. request. A further question is on the incorporation of FOREX provisions into the BIT; what are the ramifications of the provisions?

The U.S.-China S&ED mandated the third Investment Forum in the coming months. The BIT negotiation will certainly be the main theme of the forum. However, in view of the clash of the two parties’ positions, the BIT negotiations might turn out to be a long-lasting diplomatic baffle between the United States and China unless either party’s stance is to be compromised.

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15 There is a heresy that contrasts with the rhetoric; the United States is eager to have a BIT while China is quite patient.
Implications of the BIT

The BIT, if concluded based on the U.S. model to address the concerns raised by the United States, will certainly be among the most liberalized bilateral investment pact. Still, it will not be able to address all the issues facing the bilateral economic relation. An important issue is China’s gigantic financial assets in the United States, valued around US$1.5 trillion. China is concerned with the safety of the financial assets that are in principle under the whims of the U.S. financial authorities, particularly at a time of financial crisis.\footnote{When Fannie Mae went into a freefall in 2008, Chinese officials were on the phone with the United States Treasury, demanding an explanation as to how the country’s investment in the mortgage agency’s bonds would be protected. There were no threats made about the future of Chinese investments in the United States, but the message was clear.} Unfortunately, since the BIT does not extend to portfolio investment, it will not safeguard Chinese government from any U.S. act that will threaten the safety of China’s financial assets in the United States.

If the ongoing BIT negotiations adopt the high standards of the U.S. model, China will be committed to further decentralize approval authority and streamline approval procedures for FDI, including increasing the threshold for central government review over time. The BIT will give U.S. companies a stronger foothold in Chinese markets ranging from financial services to heavy industry.

Moreover, as China has agreed to implement the Generally Accepted Principles and Practices governing Sovereign Wealth Funds, the United States has little to worry about China raising political flags throughout the United States.

It is expected that with the BIT the Committee on Foreign Investment in the United States (CFIUS) process will ensure the consistent and fair treatment of all FDI without prejudice to the place of origin. Chinese companies are expected to receive equitable and just treatment in the United States, and be subject to a transparent and open policy framework.

As the United States is supposed to uphold the open and non-discriminatory principles for recipients of sovereign wealth fund investment as identified by the Organization for Economic Cooperation and Development (OECD), the Chinese will feel at ease locating their FDI targets on the condition that they act in a commercially meaningful manner.
Furthermore, a BIT would create a forum to resolve investment disputes between the two countries and between investors and their host country. This could help monitor the enforcement of the BIT obligations of either party, quelling any fears of insecurity.

China’s SOEs remain significant entities in a number of industries, ranging from financial services to heavy industry. With the BIT, more Chinese leading companies will be seen venturing into the large, lucrative U.S. markets.

**Ramifications for the Global Economy**

The willingness to negotiate a BIT shows that the two economic giants are prepared to institutionalize bilateral economic cooperation. The BIT negotiation signifies that the two countries are willing to jointly address the challenges posed by the international financial crisis. The impact of investment liberalization is more far-reaching than that of liberalization trade.

Both China and the United States re-affirmed that, at a time of economic uncertainty, the ongoing BIT negotiations, could contribute to an open global economy. Indeed, the BIT, if the U.S. model is adopted, will rank among the most liberalized bilateral investment pact. It will also show that the two countries are committed to liberalization.

China, Brazil, Russia, and India are termed as BRIC for their soaring economies and for their huge potential. The United States is also contemplating BIT negotiations with the rest of the BRIC countries. The U.S.-China BIT will be seen as a template for BIT negotiations between the United States and other BRIC countries.

The developing countries have been reluctant to accept the U.S. model BITs for fear of diluting their sovereignty over foreign investment. The conclusion of the BIT between the United States and China, a developing country, might be seen as an inspiring example for them to follow.

\[17\] In their own words, the BIT negotiations will “contribute to the implementation of G-20 Summit commitments to an open global economy.” The London G-20 Summit in July 2009 committed both the United States and China, as well as other G-20 members, to further trade and investment liberalization.
One can thus expect a boom in or renaissance of the U.S. model BITs between investment partner countries. The patchwork investment regime in the global infrastructure is likely to be upgraded to a network of BITs.

Although there is little empirical studies on what sort of investment flow a BIT may generate, it is clear that a BIT could open more sectors of the economy, including services, and offer more forms of investments to international investors. The BIT between the two super economies will cast a shadow on the rest of the economies on the possibility of an investment drainage, thus turning the heat on BIT negotiations and competition for investment.