China and the United States at 40 – The Way Forward

China and the Bay Area enjoy an extraordinary history. The first Chinese immigrants came to the United States through the Golden gate and ever since then this region has hosted the country’s largest and most successful Chinese community. That community has provided a foundation on which we have both continued to build, and since then the Bay Area has pioneered the expansion of US-Chinese ties across a number of fronts, including the establishment by San Francisco of the first sister city relationship of a U.S. city with a Chinese counterpart. So China is part of our DNA, and we in this region may have a greater stake in the future of US-China relations than anywhere in the United States.

This year the United States and China marked the 40th anniversary of the establishment of diplomatic relations. Since then the relationship has evolved in the direction of economic integration, anchored by reforms in China that introduced large elements of market capitalism to the economy. Segments of the economy were opened to foreign investment. China’s admission to the WTO was a critical turning point, opening global markets to Chinese goods and setting the stage for a massive flow of foreign investment into manufacturing.
At the same time, large numbers of students were sent to leading universities in the United States and other Western countries, particularly at the graduate level in fields such as computer science and engineering. Many came to Stanford and Berkeley. Most recently, as China’s companies grew and capital reserves expanded, China became a global exporter of capital – acquiring companies and investing actively in real estate and technology. The three leading destinations in the United States were New York, Los Angeles and the San Francisco Bay Area. Today the region hosts a wide range of companies, accelerators and investment funds from China.

Supported by these developments abroad and sustained government strategies, China emerged over this period as the world’s second largest economy, and until this year the United States’ largest trading partner.

But despite this growing web of connections, the US-China relationship is today at a crossroads where the further deepening of economic ties cannot be assumed, and could potentially be reversed. The reasons lie in politics as much as economics, as past assumptions regarding China’s political and economic direction are challenged, and policy issues that have long existed in the relationship have risen to the surface in ways that bring the priorities of both governments into increasingly open
conflict. The power lies in both governments to address those issues and set a new foundation. Whether or not that occurs, businesses on both sides need to manage their way through an increasingly complex environment. The choices that are made now will set the direction for how US-China economic relations will evolve in the next 40 years.

**Where are We Today?**

While much of the first 40 years of the relationship has been characterized by growth and optimism, the relationship today is entering new and largely uncharted territory. While the issues being debated aren’t new, they have grown in intensity and are increasingly interconnected - making their resolution even more challenging. The question for businesses, universities and other entities with Chinese partnerships will be how to navigate this new landscape.

So why has this change occurred now, and what has brought us here? Several factors are at work.

One is more aggressive and nationalistic political leadership in both countries. In the United States, since coming to office in 2017 President Trump has aggressively pursued trade deficit reduction with a range of
global partners. China isn’t unique as a target, as the administration has also targeted U.S. allies such as Mexico, Canada, Europe and South Korea. But China is different because of its size, the scale of the U.S. trade deficit, and leading role that China’s government plays in shaping its economy.

In China, President Xi has centralized political power, reasserted the central role of the Communist Party in the economy and society, and is actively pursuing external policies designed to greatly increase China’s global influence. At the same time, China’s announced goal of dominating many key technologies has become more explicit. These economic considerations have converged in the U.S. with national security concerns, primarily related to technology. So on the Chinese side we’ve seen several converging trends that, given the scale and direction of its economy, have become impossible to ignore.

When US-China relations began to gather momentum forty years ago, there was a belief in the US and the West that while systemic differences would remain, China’s economy would become progressively more market oriented and that over time the two systems would largely converge. With that assumption being called into question today, the US has become less willing than in the past to
overlook market access barriers, technology transfer requirements, or other policies affecting U.S. companies.

So let’s look at the three big issues: trade, investment, and technology (an issues linked to trade, national security, and also to students).

**Trade**

Successive tariffs have been imposed on Chinese imports in the last 18 months that subject $250 billion in goods to tariffs of from 10-25%, with an additional $300 billion likely to be under tariffs by late this year – subjecting essential all imports from China to new tariff measures.

**Investment**

In August 2018 Congress passed the Foreign Investment Risk Review Modernization Act (FIRRMA). FIRRMA gave expanded authority to the Committee on Foreign Investment in the U.S. (CFIUS) – an inter-agency body that reviews inbound foreign investment for national security concerns. In the past CFIUS reviewed only transactions that were very large or involved the acquisition of majority ownership in a company. With its new authority CFIUS can now review and block transactions including joint ventures and the acquisition of minority stakes in companies, including small ones, that would potentially provide the acquirer with access to that company’s technology. Investment in 27 strategic industries must now be reported to CFIUS if it would provide
access to non-public information or allow the nomination of a board member or participation in substantial decisions in the company. The coverage of CFIUS extends to all countries, but the real focus is China. 50% of transactions filed with CIFIUS are Chinese, but 100% of the investments blocked by CFIUS have involved Chinese investors.

**Students and Scientific Exchanges**

Chinese students and research personnel in sensitive fields are now subject to increased scrutiny on national security grounds. In June 2018 the State Department announced that it would start to limit visa validity for Chinese national students, especially graduate students and others involved in high technology (STEM) fields, and would increase the number of cases subject to interagency clearances. Chinese graduate students involved in technology fields such as robotics, aviation and high-tech manufacturing are now limited to one-year renewable visas (reduced from five), and Chinese nationals applying for a US visa must obtain special permission if they work in research or management at institutions that could threaten the US. The effects of these changes are showing up in the form of longer periods for “administrative processing” that can sometimes make the proposed visit or exchange infeasible.
At the same time, federal security agencies are engaging with the federal government’s research funding agencies and with academic institutions to raise these national-level security concerns, identify research that should be protected, and strengthen reviews of programs involving incoming Chinese students. In the Bay Area and elsewhere this is making universities more cautious about admitting Chinese students who may be engaged in sensitive research, or admitting them to sensitive facilities.

This particularly matters in California and the Bay Area because our universities engage so many foreign students. China is currently the largest source of foreign students in the US, with approximately 350,000 enrolled in American colleges and universities, and almost half at the postgraduate level. Chinese students are a large presence in all of the Bay Area’s leading research universities.

**Impacts**

*Trade:* There is evidence that the economies of both countries are being affected, with slower growth and greater uncertainty about the future of both trade and investment. US manufacturers who produce products that incorporate Chinese parts and components are seeing higher costs, most of which will be passed on to consumers. Agriculture has been particularly affected, and the administration is spending
nearly $20 billion to partially compensate farmers who have been affected. Altogether, the Federal Reserve Bank of New York estimates that US tariffs already in place are costing $830 per US household, which will rise to $1030 when the new tariffs are imposed. Others studies estimate that about .5% has been shaved off of U.S. GDP.

Reflecting these actions by both sides, China has recently dropped from being America’s number one trading partner to number two, replaced now by Mexico. In the first half of this year, US imports from China fell 12% and US exports to China fell 19%. This is a remarkable reversal after nearly 30 years of sustained growth.

*Investment:* We are also seeing the impact of the US-China conflict on bilateral investment flows, particularly to the U.S., as inbound Chinese investment fell to $5.4 billion in 2018, from $46.5 billion in 2016. In California the number has dropped from $16.4 billion in 2016 to $299 million last year. Part of this is due to the central government’s desire to control the large outbound flow of foreign exchange and to limit investments by Chinese companies that it considered risky. This has particularly affected investment in real estate and acquisitions by large Chinese companies in a rage of sectors, and is largely non-political. But particularly in the last 12 months, uncertainty around the new scrutiny
being given to Chinese investment by CFIUS has been a factor – and will be more a factor in the future.

_Students:_ Chinese students are continuing to come to the US, but the perception of the US as a friendly environment is falling. Many students and visiting scholars are now subject to long waiting times in China as their applications are reviewed, with more than in the past denied entry. Universities and other research organizations here are scrambling to adjust to the new situation. Some Confucius Institutes, including the one at San Francisco State, have been forced to close.

**The Way Forward**

_Trade:_ Until there is a negotiated solution to the US-China trade dispute, businesses can expect higher tariffs, and their costs, to be a continuing fact of life. While not leaving altogether, U.S. companies are shifting some manufacturing outside China, to avoid the line of fire between the two governments. Global supply chains will be affected, and countries like Vietnam and Mexico pick up the investment that is diverted.

_Investment:_ Despite the new hurdles raised by CFIUS, the door is not closed, and investors are finding ways to go forward even under the new rules. US national security concerns are not categorically
incompatible with Chinese acquisitions, and more than half of US-China deals are still being approved, especially where they’re thoughtfully and carefully presented. This, of course, still entails time, risk and more effort on the investor’s part, and in some cases that will discourage investors from even trying. But where investors are willing to carefully prepare their case, and where the concerns that CFIUS was created to address aren’t triggered, the door remains open.

It should also be noted that CFIUS is continuing to clear even large deals where there are agreements to “segregate sensitive data and agree to protections against leakage” or other forms of “third party mitigation” that create distance between the foreign investor and sensitive technologies. Finally, CFIUS does not apply to joint ventures outside the U.S., and the expansion of its jurisdiction does not extend beyond national security to include broader economic issues.

Students: Recognizing that there are legitimate national security concerns that need to be addressed, great care needs to be taken when reviewing applications and not paint all Chinese students with a broad brush. There is a history of anti-Chinese discrimination in the United States – such as the Chinese Exclusion Act of 1882 - that we don’t want
to revisit. Universities will need to take increased responsibility for the selection of screening of inbound students, recognizing legitimate federal concerns but also ensuring to the maximum extent possible that the door stays open to students from China in all fields. If Chinese students and other immigrants don’t feel welcome or believe they won’t have the opportunity to stay in the US, either their skills will remain in China, or countries like the UK, Australia or Canada will benefit.

Notwithstanding this new scrutiny, first-time enrollment at US institutions of higher institution has remained high over the past two years, increasing 2% for undergraduate students and 4% for undergraduates from 2017-2018. This suggests that for now – and despite worsening perceptions of the US and warnings to students from China’s government – for most students the US remains an attractive destination, and that they are continuing to be accommodated by their host institutions.

**Growing Together**

After forty years of growth and deepening exchanges, US-China cooperation is at risk of going in reverse. Because of the depth of connection between the Bay Area and China, our region will be particularly affected. It is within the power of both governments to
stabilize and bring new balance to the relationship. The US can, if it chooses, look for opportunities to collaborate and to minimize strategic conflict. China’s government can return to the path of market reform, and further open its economy to investment while addressing more convincingly US concerns over technology transfer and IP protection. This is all possible if leaders in both countries are willing.

There is an important role here to be played here by cities, regions and sub-national organizations, which is where the day-to-day exchanges happen and business takes place. Overwhelmingly these places want to see the relationship grow. We in the US, California and the Bay Area, our partners in China, and the world will benefit if China and the US – the world’s two largest economies grow together and not apart. It is imperative that we continue to work together to make that happen.