

**Redefining Critical Industry:
A Comparative Study of Inward FDI Restrictions in China and the United States**

by

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Master of Arts, SciencesPo (Institut d' études politiques de Paris), 2013

Bachelor of Arts, Zhejiang University, 2011

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Supervisory Committee

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Abstract

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International political economy scholarship largely focuses on the motivations and determinants of FDI flows and their effects on economic wellbeing, stability and peace. An overlooked question, however, is the restrictions of inward FDI. Extant research widely regards national security and economic security as the justifications for FDI restriction. This is an oversight because there is a broad overlap in conceptualizations of national security and economic security.

In this thesis I study the phenomenon of the use of the concept “critical industry” to justify FDI restrictions. I investigate eight cases of restricted FDI transactions occurred in China and the United States between 2005 and 2012, and the relevant institutions and practices of both countries. This study argues that the protection of critical industry is the key driver of inward FDI restrictions and that the security of critical industry is better understood to protect individual industries, defense-sensitive industries, critical infrastructures, and industries pertaining to regime-security.

Table of Contents

Supervisory Committee	ii
Abstract	iii
Table of Contents	iv
List of Tables.....	vii
List of Figures	viii
List of Acronyms and Abbreviations	ix
Acknowledgements	x
Dedication	xi
Chapter 1: Introduction	1
Research Question.....	3
Thesis Statement.....	3
Research Design and Methodology.....	4
Research Structure.....	6
Chapter 2: Literature Review	9
The Political Analysis of FDI.....	9
FDI’s Impact on International Relations	12
FDI from the Global South.....	14
China’s outward FDI	15
Inward FDI Opposition	18
Concluding Remarks	20
Chapter 3: National Security, Economic Security, and Critical Industry.....	22
National Security, an Ambiguous and Controversial Concept.....	22
National Security: Excluded in International Obligations.....	25
Economic Security	26
Concluding Remarks	27
Chapter 4: Critical Industry and Inward FDI Restrictions in the United States	30
Definition of Critical Industry in the United States.....	30
Cases of FDI restrictions in the United States.....	32

Case 1: CNOOC-Unocal	32
Case 2: Northwest-Firstgold.....	34
Case 3: DWP-P&O.....	35
Case 4: Huawei-3Com/3leaf/Sprint.....	37
Case 5: Ralls-Terna	38
Greenfield Restrictions in the United States.....	40
National Security Review of M&A Transactions.....	41
Operation of the CFIUS System.....	44
Chapter 5: Critical Industry and Inward FDI Restrictions in China.....	46
The Absence of Definition of Critical Industry in China	46
Cases of FDI Restrictions in China	46
Case 1: Carlyle-Xugong	47
Case 2: Mittal-Laiwu	48
Case 3: Coca Cola-Huiyuan	49
Concluding Remarks	50
FDI Restriction Institutions in China	50
Phase One: An Indiscriminate Approach	51
Phase Two: From FDI review to M&A review	53
FDI Restriction as Part of National Industrial Policy.....	55
Operation of China’s FDI Review System.....	63
Concluding Remarks	64
Chapter 6: Discussion.....	66
Emphasis of Critical Industry.....	66
Comparison of the Security Review System in China and the United States	68
Transactions Covered	69
Control.....	70
General Path of FDI Restriction.....	72
Who Could Restrict Inward FDI?.....	72
Political System Matters.....	74
Chapter 7: Conclusion.....	77

A Redefinition of Critical Industry.....	77
Research Significance	80
Research Limitations and Avenues for Future Research.....	81
References	85

List of Tables

Table 1: Types of Foreign Investments restricted by the United States	40
Table 2: Inward FDI Encouraged, Restricted, and Prohibited by China	56
Table 3: Types of Foreign Investments prohibited by China	58
Table 4: Types of Foreign Investments Removed from the China's Prohibited List	62

List of Figures

Figure 1: Dimensions of Critical Industry.....	77
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List of Acronyms and Abbreviations

BIT	Bilateral Investment Treaty
PRC	People's Republic of China
CCP	Chinese Communist Party
CFIUS	Committee on Foreign Investments in the United States
EU	European Union
FDI	Foreign Direct Investment
FINSA	Foreign Investment and National Security Act
GDP	Gross Domestic Product
JV	Joint Venture
M&A	Merger and Acquisition
MNC	Multinational Corporation
MOFCOM	Ministry of Commerce
NAFTA	North American Free Trade Agreement
NDRC	National Development and Reform Commission
NOC	National Oil Company
OECD	Organization of Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
SASAC	State-Owned Assets Supervision and Administration Commission
SOE	State-Owned Enterprise
UAE	United Arab Emirates
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

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Dedication

To my friend Pu Zhiqiang and Wu Wei.

Thy burden will become thy gift, and thy sufferings will light up *our* path.

You will never walk alone.

To everyone fighting for freedom, human rights and democracy in China.

黑夜给了我们黑色的眼睛，我们用它寻找光明！

Chapter 1: Introduction

Globalization permeates our daily life. Starbucks in Beijing's Forbidden City, McDonalds in Paris city center, and Toyota sedans on American highways... all of these scenes indicate that this transformation has fundamentally changed our lifestyles. Capitalist globalization is driven by a number of factors, in which foreign direct investment (FDI) acts as a key component and has gained momentum in recent decades¹. In 2013 alone, Global FDI flows rose to \$ 1.45 trillion, and was expected to reach \$1.6 trillion in 2014 (UNCTAD, 2014).

Undeniably, FDI is essentially an economic phenomenon; however, it is also a political issue since it concerns the inflow and outflow of capital from one national economy to another that are both subject to state sovereignty. In other words, this process is unavoidably influenced by political factors and therefore poses specific questions for national governments.

In August 2005, the state-owned China National Offshore Oil Company Ltd. (CNOOC) abandoned its \$18.5 billion offer to take-over the Unocal Corporation, America's ninth largest oil exploration company, owing to "political pressure" from Washington². In 2011, Huawei, China's largest telecommunication equipment maker, withdrew its proposition to acquire assets of the American company 3Leaf after

¹ FDI is commonly understood as an enterprise from a home country invests in a host country whose objective is to establish a lasting interest and gain a management control. It is distinguished from portfolio foreign investment by the element of ownership: in the international standard, FDI must have 10% or more of the voting power (OECD, 2008).

² Ying, W. (2005, August 3). CNOOC drops bid for unocal. *China Daily*. Retrieved from http://www.chinadaily.com.cn/english/doc/2005-08/03/content_465741.htm

meeting opposition from the Committee on Foreign Investments in the United States (CFIUS)³. In 2012, U.S. President Barack Obama blocked a privately owned Chinese company from building wind turbines close to a Navy military site in Oregon due to national security concerns.⁴

Three examples above showcase the political dimension of FDI and the international political economic role of host governments. In brief, FDI restriction policies are conducted in two forms: “hard” prohibition and “soft” opposition. The former refers to the fact that host governments can outright block certain types of FDI; while the latter takes a variety of forms, ranging from but not exclusive to reviews on national security grounds, anti-monopoly investigations, and capping foreign investors shareholding.

FDI-related research tends to base analysis on successful foreign investments. The extant literature has extensively documented the motivations and determinants of FDI, as well as their impacts on host countries. However, a largely overlooked area is that not all types of FDI are welcome by host countries and their politicians. Foreign investment propositions can either encounter immediate opposition and rejection or after careful investigation and review by host governments. My research seeks to better understand this wide range of possible policy outcomes; in particular the rationale, modes, and implications of host governments’ restrictive policies on FDI.

³ Raice, S. & Dowell, A. (2011, February 22). Huawei drops U.S. deal amid opposition. *Wall Street Journal*. Retrieved from <http://www.wsj.com/articles/SB10001424052748703407304576154121951088478>

⁴ Yonglai, R. (2012, September 29). Obama blocks Chinese wind farms in security. *Reuters*. Retrieved from <http://www.reuters.com/article/2012/09/29/us-usa-china-turbines-idUSBRE88R19220120929>

Research Question

This study asks two questions. First, what are the determinants of FDI restrictions? Despite inward FDI's various benefits on economic development and social wellbeing, not every transaction is embraced with open arms by host governments. What explains host governments' restriction of inward FDI?

Second, how could we understand "critical industry" as a justification for FDI restriction? Politicians justify restrictive policies by citing a plethora of terms, such as national security, economic security, national economic security, strategic security, essential interest. However, how does it come to be that certain types of industries become considered "critical"?

Thesis Statement

This study argues that host countries restrict FDI in sectors which they consider "critical". The security of "critical industry" encompasses a variety of things such as defense security, industrial security, critical infrastructure security, and regime security. I argue that "critical industry" should be understood in the way that I proposed to enable host governments to calibrate the acceptable level of FDI and reduce the haphazard political manipulation of this term.

Defense-related industries are the primary concern in terms of FDI restriction, in which host governments are willing to sacrifice economic gains to safeguard military technologies and facilities. Industrial security theoretically covers all industries, but two aspects make it important in FDI restriction. One refers to the protection of

leading technology, which is more pertinent for FDI flows from developing countries to developed ones. The other aspect refers to maintaining the dominant position of a domestic enterprise in a particular industry, which, in essence, is industrial protectionism. As a sub-group within industrial security, critical infrastructure is more limited to those areas concerning public interests, which are often investigated by host governments' security reviews. The Regime security concerns the stability of undemocratic regimes where authoritarian states restrict FDI that might threaten their ruling power.

Research Design and Methodology

This project develops an understanding and new definition of the concept “critical industry” by analyzing how China and the United States define their “critical industries” by means of their *de facto* FDI restrictions.

China and the United States are prime cases for analysis due to their combined clout in the global economy and the fact that they are the largest markets for FDI. China and the United States together make up around 35% of world aggregate gross domestic product (GDP) in 2013 (World Bank, 2014). In addition, both countries also rate as the two top destinations in terms of FDI inflows (UNCTAD, 2014).

This bilateral case study also offers insights into FDI flows between developed and developing countries. In the Sino-American context, FDI flows for decades were a one-way direction: American firms massively invested in China whereas Chinese ones lacked interest and capacity to invest in the American market. However, this

pattern has changed drastically in recent years: in 2013, Chinese FDI flows in the United States reached \$14 billion, four times the amount of American FDI in China in the same year⁵.

Despite the dynamic FDI exchange between China and the United States, there is little to no information on restricted FDI transactions. One reason why is that in both countries, FDI restrictions, in particular those concerning national security, are carried out rather secretively or in the very least opaquely. Governmental bodies responsible for implementing FDI restriction policies, both the United States and China, rarely make relevant documents publically available.

Another reason for the disparity of research is that, only a small number of proposed FDI transactions fall within the realm of host governments' restriction policies. Furthermore, only a minority of the concerned transactions have been reported by the media and discussed in public. Once a FDI proposal faces perceived or real government hesitancy or opposition, many deals are either silently withdrawn or renegotiated. Foreign investors are more inclined to avoid a formal decision by the host government to block a transaction out of political concerns because it might damage the firm's reputation (Larson & Marchick, 2006).

Regardless of the paucity of data, a content analysis of the available reported cases still provides some inferences on the motivations and practice of FDI restrictions. The analysis gives us a better understanding of how industrial sectors come to be defined as "critical" when governments implementing restrictive policies

⁵ Hanemann, T. & Gao, C. (2015, January 15). Chinese FDI in the United States: Q4 and full year 2014 update. *Rhodium*. Retrieved from <http://rhg.com/notes/chinese-fdi-in-the-united-states-q4-and-full-year-2014-update>

to inward FDI.

In the following chapters, I will analyze several opposed FDI transactions which received significant international media attention. With only one exception, the cases concern either Chinese investments meeting opposition in the United States or vice versa. The time scope of such transactions are from 2005 to 2012, a period in which FDI from emerging countries, China in particular, skyrocketed in the United States. The objective of these case studies is to delineate the scope of “critical industry” by looking at what types of FDI is more likely to be restricted and how host governments justify their restrictions. My analysis draws from government press releases, congressional or executive statements, media reports, and academic sources.

I will also look at the political dynamics of each country reflected and institutionalized in laws and legislation used to implement FDI restrictions. My objective is twofold: to identify the similarities and differences between China and the United States and illuminate why FDI in certain industrial sectors is more likely to meet state restrictions.

An important point to make here is that in this paper, the term “restriction” is used to designate governmental policy. FDI transactions which elicited oppositions from citizens and caused public discussion without any governmental investigations are not considered.

Research Structure

This thesis contains the following chapters. The second chapter reviews the

existing literature on FDI in the fields of international political economy (IPE) and comparative politics. There I focus on several topic areas: the first is the motivations and political determinants of FDI, which are well documented in the previous studies. The second area concerns how FDI could *conversely* affect international relations and security, and how it receives far less attention in research on FDI. The third area studies the determinants and impact of FDI from the Global South, including China's outward FDI, it differs from the FDI from the Global North. All the literature reviewed highlights the fact that FDI restriction is an under researched aspect in IPE studies.

The third chapter sets the framework of this study, in which I argue that it is premature to state that governments restrict FDI because of the protection of national and/or economic security. There are two reasons for this; one is that the conceptualization of the agenda of both national security and economic security are broad and overlapping. The other is that on the practical level, national security is an exception in international trade and investment treaties. Governments could arbitrarily define it. In this regard, "critical industry" is better placed as a prism to understand the determinants of FDI restriction.

The fourth and fifth chapters are dedicated to an empirical study of FDI restrictions in the United States and China respectively. Official definitions of "critical industries" in both countries will be presented first. I then present the case studies on FDI transactions which received opposition in both countries. Next, I will trace the historical evolution of the FDI restriction and prohibition policies as well as the

procedures of the current national security system in both countries.

Based on these findings, chapter six compares and contrasts the Chinese and American definitions of critical industry, the history of institutional development of FDI restriction, and their decision-makers. Furthermore, I will highlight the political system as a cause of differential treatment of inward FDI between China and the United States.

In the final chapter, I will postulate my own definition of critical industry and state the limitations of this study and potential avenues for future research.

Chapter 2: Literature Review

Foreign Direct Investment (FDI) has become a major form of capital flow. It is made by multinational corporations (MNC) through either greenfield projects or brownfield transactions. Greenfield projects refer to FDI that establish new production facilities in the host countries, whereas brownfield FDI refers to cross-border mergers and acquisitions (M&As) (UNCTAD, 2011). The entry mode is jointly decided by economic factors such as market size, cost, market competition, and fixed set-up cost with greenfield FDI (Qiu & Wang, 2011; Mattoo, Olarreaga, & Saggi, 2004; Yu & Tang, 1992; Horn & Persson, 2001). Furthermore, host government's FDI policy of equity participation restriction is the key political determination in the MNC's entry mode decision (Norbäck & Persson, 2004).

The Political Analysis of FDI

What are the determinants of FDI? The existing literature has mostly focused on reasons why firms decide to operate in other countries than their home countries.

Dunning (1977) developed the Ownership, Location, and Internationalization (OLI) Paradigm to explain why multinational corporations (MNC) conduct FDI. According to this paradigm, MNCs have ownership, location, and internationalization advantages. Ownership advantage means a MNC has advantages such as marketing, patent, organization, access to capital etc., which are not possessed by others. If location-specific advantages are found in a foreign country, an MNC will internationalize rather than trade with this foreign country. By coordinating

production within a hierarchical structure across different markets, a MNE possesses an internationalization advantage.

The OLI framework serves as an important tool to understand FDI motivations from a MNE's perspective; however, it fails to answer the question *why* some countries are more successful in attracting FDI than others. In other words, what are the country-specific factors that affect FDI inflows. Explanations of the determinants of FDI could be clustered into economic factors and political factors.

Macro-socioeconomic conditions in a host country could explain the cross-national differences in FDI attraction. For instance, market size, levels of economic development, economic growth rate, GDP per capita, natural resources endowment, exchange rate and literacy and education rate are all positively related to a higher rate of inward FDI (Brewer, 1993; Crenshaw, 1991; Grosse, 1998; Mankiw, 1992; Solomon & Ruiz, 2012). In addition, economic institutions such as trade reform, capital control, organized labor and unionization, and government regulation also impact the decisions of prospective investors (Agarwal, Gubitz & Nunnenkamp, 1992; Bajpai & Sachs, 2000; Mckeown, 1999; Root & Ahmed, 1978).

In addition to the aforementioned business and economic considerations, MNEs are also influenced by political factors when choosing the destination of their investment. One of the most controversial question concerns the regime type, in which extant literature is highly divisive. One side argues that democracies are more successful in attracting FDI because their institutions hold credibility advantages in terms of property-rights protection, adherence to rule of law, an effective judicial

system, and low political risk of nationalization and expropriation (Biglaiser & Staats, 2010; Bollen & Jones, 1982; Crenshaw, 1991; Jensen, 2003; Li & Resnick, 2003). In contrary, an alternative point of view argues that FDI prefers authoritarian regimes, whose independency from popular votes could provide better entry deals as well as lower-cost workforce, and repress protests to drive down wages and costs (Harms & Ursprung, 2002; Kebschull, 1969; O'Donnell, 1978; Oneal, 1994; Tuman & Emmert, 2004). A pragmatic perspective in this debate is that regardless of regime type, governments with a good governance (high political capacity, regime stability, and commitment to open market policy frameworks) more successfully in attracting FDI. (Adji, Ahn, Holsey, & Willnett, 1997; Coan & Kugler, 2008; Feng, 2003) However, whether democracy or not, high levels of corruption will deter FDI inflows (Egger & Winner, 2006; Khamfula, 2007).

Domestic politics of the host country is not the only factor which affects foreign investors' decision. International strategic and security factors also have a significant impact on FDI flows. Jones & Kane (2012) and Little & Lablang (2004) show that U.S. military station provides a safer environment for both short-term and long-term American investments. Moreover, the home country's military presence in the host country does not only affect the destination selection of outward FDI, but also boosts the amount to be invested (Biglaiser & DeRouen, 2007). However, terrorism activities in the Global South often reduce foreign investors' confidence and scare foreign capitals away (Kinyanjui, 2014). In a longer time frame, terrorist attacks' negative impacts on regional or global FDI is negligible (Enders & Sandler, 1996).

In brief, attempts mentioned above are made to answer the question *what* determines the flows of outward FDI. Another stream of literature focuses on the question *how* various forms of FDI could conversely affect foreign policies and international security.

FDI's Impact on International Relations

Some research has sought to show that FDI, like international trade, has a stabilizing effect on peace. In their studies of the correlation between conflicts and different types of investment, Gartzke, Li, and Boehmer (2001) and Polachek, Seiglie, and Xiang (2007) conclude that FDI is positively correlated with international conflict reduction and peace promotion. However, no such relationship was found between portfolio investment and international conflict. Moving one step further, Rosecrance and Thompson (2003) argue that two-way (reciprocal) FDI constrains international conflicts more effectively than one-way (nonreciprocal) FDI relationships.

In contrast to peace promotion, FDI could also be employed as a “weapon” of governments of both home and host countries to achieve political goals. Put differently, FDI is also a means of economic statecraft, defined as state’s employment of economic levers to achieve strategic objectives (Baldwin, 1985). Economic sanctions could be put into place through the cancellation of promised FDI or the withdrawing of existing investment projects. However, the use of FDI as an instrument of economic statecraft is a double-edge sword which generates economic costs for both home and host countries. By using data from 171 countries from 1971

to 2000, Lektzian and Biglaiser (2014) find that the higher American FDI in one host country, the more unlikely that the United States is going to impose economic sanctions on it. But once sanctions are put in place, diminishing American FDI does have a positive effect on the success of economic sanctions imposed by the White House. However, the result will be compromised if non-American MNCs offset the loss of American FDI. In addition, Kim (2013) argues that the effect of economic sanctions employing FDI also depends on its entry mode: Cross border M&A projects and Greenfield Projects impose more costs to home countries, while cross-border joint ventures (JVs) impose more costs to FDI host countries.

Further elaborating the content of economic statecraft, Armijo & Katada (2015) coined the term “financial statecraft” to designate the use of domestic or international monetary or financial capabilities by national governments to achieve foreign policy objectives. According to their studies, traditional economic statecraft largely focuses on how wealthy democratic nations, the United States in particular, employ economic sanctions to achieve political and diplomatic goals. However, since the 21st century, emerging powers in Latin America and Asia could use financial statecraft either defensively or offensively to achieve foreign policy ends in a bilateral or multinational context. (Ibid, pp. 42-58) Though Armijo & Katada (2015) does not adequately point out how FDI could be employed as a component of financial statecraft, it captures a new trend in the changing world political economy which is less covered by previous western-centric studies: the increasing economic prowess of emerging countries and the political implications and impacts of their rapid growing

outward foreign investments, particularly in the developed world.

FDI from the Global South

Since the 21st century, a new trend in the global FDI topography points to the rapid rising of developing countries as capital-sender countries. In 2013, FDI from the Global South reached \$ 553 billion, or 39% of the global total, compared with merely 12% in the beginning of the 21st century (UNCTAD, 2014).

A key factor which distinguishes the Global South's outward FDI from the Global North's one is that the former often acts as an integral component of their national development strategies. In other words, the role of the home government is more salient in FDI from developing countries compared with developed countries (Gammeltoft, Pradhan, & Goldstein, 2010; Goldstein & Pusterla, 2010). Most of the existing literature on FDI from emerging countries adopts the previous conceptual framework developed for developed countries, which is inadequate to explain the South to South FDI pattern. To fill in this theoretical gap, Arita (2013) argues that South-South FDI could be partially explained by shared similarity factors across the Global South. To put differently, MNCs from the developing world are more adept at operating in similar political and economic institutions.

Another prominent tendency is that among the total outward FDI from developing countries, a significant portion comes from Brazil, Russia, India, China, and South Africa (BRICS). Their outward FDI has risen 18 times from \$7 billion in 2000 to \$ 126 billion in 2012 (UNCTAD, 2013). In 2002, outward FDI by BRICS was

merely 1% of the world aggregate flows, while ten years later the share was 9% (Ibid, 2013). The BRICS block invests not only in developing countries, but also in OECD countries. Such phenomenon is increasingly salient following the 2008 global financial crisis and the debt crisis in the European Union (EU) since 2009. By conducting a case study of eight MNCs from Brazil, Russia, India, and China (BRIC) operating in Europe and North America, Holtbruegge and Kreppel (2012) argue that gaining access to new overseas market and acquiring technological knowledge and managerial know-how are the primary reasons why MNCs from emerging countries invest in the Global North. Moreover, emerging countries' MNCs in developed countries largely reflect the comparative advantage of their home country (Milelli, Hay, & Shi, 2010). However, FDI from the BRIC is not homogenous: Brazilian and Indian FDIs are primarily driven by economic motivations, while Chinese and Russian firms receive more political and financial support from their governments (Holtbruegge & Kreppel, 2012).

China's outward FDI

To understand China's rapid growing outward FDI, previous research has identified the key determinants and motivations, for instance the quest for natural resources, acquirement of advanced technology and managerial skills, and market expansion (Buckley, 2004; Kolstad & Wiig, 2011; Cheung, Haan, Qian, & Yu, 2009). Another stream of literature focuses on area distributions of China's outward FDI across the world. For instance, in an analysis of the drivers and motives for China's

foreign investments in Africa, Drogendijk and Blomkvist (2013) argue that three major reasons justify China's presence in Africa: market-seeking, natural resource-seeking and strategic asset-seeking, which match other western MNCs' investment patterns in global markets.

Destination selections of China's outward FDI are also influenced by bilateral political relationship with host countries. By using 346 surveys at firm level and looking at China's outward FDI flows to 95 countries between 2003 and 2005, Li and Liang (2012) argue that among developing countries with high political risk for FDI, Chinese investors⁶ prefer to go to countries having closer political ties with China, so that China's overseas assets could be better protected. Duanmu (2014) confirms this argument and points out that the level of home state ownership could reduce SOEs' risk of expropriation in the host country; and in the bilateral context, inter-state relationship could compensate for the lack of credible government commitment. Therefore, Chinese national oil companies (NOCs) chose to invest in countries with high political risks which are usually shunned by western NOCs (Ramasamy, Yeung, & Laforet, 2012).

Compared with the studies on Chinese outward FDI in the developing world, less research has attempted to look at the political impact of China's FDI on developed countries. One exception is a recent study by Meunier (2014a; 2014b; 2014c) on the politics of hosting China's FDI. By using the EU as an example, this research established a comprehensive framework for students of the political impact of China's

⁶ Statistics in 2014 indicates that outward FDI from Chinese SOEs roughly equals the ones from Chinese private enterprises. Shi, Y.. (2015, April 23). Zhongguo qiye haiwai touzi yinglai "dashidai" [Chinese outward FDI is embracing a "Big Epoch"]. *Chinanews*. Retrieved from <http://www.chinanews.com/cj/2015/04-23/7229975.shtml>

outward FDI. Meunier (2014c) outlined some potential areas in which China's foreign investment could have political impact in the EU: Inside the individual EU member states, potential implications of China's FDI could cover a wide range of domestic policy areas, such as labor policies, environmental standards, and human rights protection. In addition, FDI might also be used as a bargain to pursue foreign policy objectives such as the lifting the arms embargo on China, granting China the market economy status, or obstructing the reception of Dalai Lama by European leaders (Ibid, pp.144-149). The second area concerns the cohesiveness of the EU's investment policy making: Chinese investors might selectively and strategically invest in some member states rather than others and play "divide and conquer". (Ibid, pp. 150-164) The third one concerns the EU's investment relationship with third countries; in particular the United States (Ibid, pp.154-157). Considering the ongoing status of the negotiation of the Transatlantic Trade and Investment Partnership between the United States and the EU, Chinese FDI previously denied by Washington, for instance China's telecommunication giant Huawei, might go through the European market and gain access into the American one indirectly.

Though Meunier (2014a; 2014b; 2014c) delineated the wide range of policy areas in which China's FDI could potentially influence member states as well as the EU's decision-making, this comprehensive agenda does not provide any detailed analysis of the actual de-facto political impacts and implications. Probably one reason is that China's outward FDI in the EU, though increased exponentially in the past five to six years, is still small in terms of aggregate inward FDI stock in the EU. By the

end of 2013, though doubled compared with the previous year, FDI inflow from China merely represented 6.7% of the total inflows into the EU.⁷ Thus more data in the coming years could help researches to carry out this ambitious agenda and evaluate the political impact and implication of Chinese FDI in the EU, which is not yet obvious.

Moreover, to study the potential political impact of FDI in a host country, we shall not forget that not all types of FDI are welcomed with open arms by the host governments. That is to say, to fully comprehend the political dimension in FDI, it is insufficient to simply study the impact and implications of those successfully made ones. The political treatment of inward FDI by host governments also deserves a careful study.

Inward FDI Opposition

How could we explain host governments' refusal and opposition of FDI? One stream of literature focuses on the economic concern of host governments' restriction of FDI. Similar to the determinants of FDI attraction, this type of research emphasizes the potential negatives impact of FDI in certain industries on domestic economic growth (Jackman, 1982; Graham & Krugman, 1995; Aitken & Harrison, 1999) and their distributional consequences as the reasons for FDI restriction. (Pinto & Pinto, 2008)

The other stream of existing research, prevalent in the 1970s and 1980s, looks at

⁷ United Conference on Trade and Development. (2015). *Global Investment Trends Monitor*. Retrieved from http://unctad.org/en/PublicationsLibrary/webdiaeia2015d1_en.pdf

inward FDI restriction through the lens of power relations and dependency theory. For them, the central question is whether inward FDI could enhance poor countries' economic development or make them more dependent on rich countries (Cardoso & Faletto, 1979; Kaufman, 1975; Moran, 1978; Smith, 1979; Jackman, 1982).

Another dimension of inward FDI restriction which is insufficiently developed in both streams of literature concerns FDI's impact on host country's national security. The foci of research in this area touch key industrial and defense sectors receiving foreign investments.

By looking at inward FDI with national security implications in the United States during the Cold War era, Ulan (1990), Reich (1990) and Kudrle (1991) conclude that such risks were minimal and could be mitigated by relevant regulations and legislations. Reich (1990) argues that national security has an "early warning" role, which intends to tell foreign investors that the purchase of American assets in some sectors are not welcomed. In addition, provided that a foreign threat of national security is identified, this operation could be immediately aborted by the invocation of the 1917 Trading with Enemy Act, which entails the shutdown of foreign firms' "disloyal operation" (Kudrle, 1991). To put differently, foreign investors tend to voluntarily avoid investing in sensitive industrial sectors which they might encounter restrictions.

However, rapidly intensifying globalization has largely enhanced the economic interdependence worldwide and has reduced the cost and time for international investments. Along with this trend, the national security concern in inward FDI is

more than ever stressed. In particular, since the 21st century, fear of terrorism and the rise of emerging powers stirred up new debates on developed countries' investment policies (Hemphill, 2009). Legal and business scholars argue that foreign governments could use FDI to gain sensitive and military technologies which are not available for them through purely economic channels (Feng, 2009; Jackson, 2010). Moreover, information security could also be endangered because foreign governments could use their enterprises' investment in those sensitive sectors to eavesdrop on government and business in developed countries. (Byrne, 2006; Feng, 2009; Seitzinger, 2013)

Concluding Remarks

To summarize, substantial gap still exists in the studies of FDI. Students in this field have largely focused on the motivations and determinants of FDI; however, strategic aspects of FDI are less researched. Except for several studies on the correlation between FDI and economic sanctions, very few studies have touched on the question *how* FDI could conversely impact international relations and inter-state relationships. Furthermore, most of the existing studies, in particular quantitative ones, employed FDI data from 1960s to 1990s. In this time frame FDI predominantly flowed from developed countries to developing ones. As the growing literature on FDI from emerging countries indicates, the reaction of the Global North countries to foreign investments by firms from the developing world deserves a closer analysis.

Of particular note is that all the above mentioned research is based on the

successfully made FDI, a fundamental question which is insufficiently addressed in the literature is what factors could determine whether FDI attempts will be treated with hostility in the host country. As the examples in the introduction part indicate, proposed FDI from authoritarian and/or emerging countries such as China indeed met opposition in developed countries like the United States because of national security reasons.

In response, a comparative study of FDI restrictions in a particular set of political and economic institutions is highly necessary to fill in the theoretical gap in the studies of FDI.

Chapter 3: National Security, Economic Security, and Critical Industry

The review of literature shows that FDI restriction is an under researched topic in the scholarship of international political economy. Existing attempts mostly approach it from establishing the causal relationship between inward FDI's potential threat to national security and host governments' restriction policies. However, the ever-expanding agenda of the conceptualization of national security and the exclusion of national security in multilateral FDI regulation frameworks make it premature to argue that host governments restrict FDI for the sake of national security protection. Moreover, the inter-dependence of the global economy has strengthened the economic dimension of national security, which blurs the boundary between political and economic impact and implications of inward FDI. In other words, both "national security" and "economic security" are over-generalized and parsimonious to be considered as determinants of FDI restrictions. We need a new prism to investigate host governments' restriction of FDI, political motivated or economic motivated.

National Security, an Ambiguous and Controversial Concept

National security is an ambiguous and controversial term whose modern and academic origin could be traced back to the end of the World War II. Early definitions of national security focus on its military and sovereignty dimension. Later on, the rapid capitalist globalization since the second half of the 20th century substantially enlarges the scope of national security.

At its inception, the term national security is viewed as the survival of a

nation-state. Therefore, a nation has security when it does not have to sacrifice its legitimate interests to avoid war, and is able, if challenged, to maintain them by war (Lippmann, 1943). In other words, military force is both a threat to and a guarantee of national security. On the one hand, foreign military incursion poses a threat to national security; on the other hand, military is also an indispensable means to protect home country's national security. By the same token, the distinctive meaning of national security means freedom from foreign coercion and dictation (Lasswell, 1950).

In addition to the "hard" armed incursion, threats of national security could also come from foreign powers' "soft" interventions in domestic politics. Therefore, national security refers to "continued ability of a country to pursue the development of its internal life without serious interference, or threat of interference, from foreign powers" (Kennan, 1947). To distinguish the visible real threats and the potential ones, Wolfers (1952) divides national security into objective security and subjective security. The former means "the absence of threats to acquired values" and the latter means the "absence of fear that such value will be attacked."

Definitions above indicate the early military and political features of national security: the autonomy of a state in face of foreign intervention, and the potential military channels to guarantee such security. Nevertheless, traditional definitions become increasingly insufficient to reflect the security of states imbedded in this increasingly globalized world. The complex economic, cultural and ideological exchanges in the world since the end of the World War II adds more issues on the

agenda of national security. As Nobile (1988, p.11) argues:

National security refers to an intricate interaction between political, economic, military, ideological, legal, social and other internal and external social factors through which individual states attempt to ensure acceptable provisions to maintain their sovereignty, territorial integrity, the physical survival of its population, political independence and possibilities for a balanced and rapid social development on an equal footing.

In addition to the expanding domestic policy areas which are concerned by national security, in a longer time frame, considering global changes and development, nation-states should also protect their identity, existence and interests within the range of their social capacities at present and in future (Hewedy, 1989).

Moreover, the traditional state-centric approach in the studies of national security is also challenged. National security is deemed as the capacity to control both domestic and foreign conditions that the public opinion of a given community believes necessary to enjoy its own self-determination or autonomy, prosperity and wellbeing (Maier, 1990). In this regard, national security is no longer merely to be decided by political elites. Rather, it is provincialized for local communities and expressed through public opinions. More than that, it confirms that national security is not only analogous to state's existence and military security, but also relates to human development issues such as prosperity and wellbeing.

To sum up, national security has become an "all-inclusive" concept. The capitalist globalization blurs the boundary between nation state and sovereignty and adds new issues to the research agenda of national security ranging from economic prosperity to cultural identities. In addition, contrary to the traditional state-centric perspective putting an emphasis on the military and political dimension of national security, new

researches look at local grassroots actors as their foci of research. More than that, the definition of national security is also expanded both geographically and temporally, which covers activities both in and out of the home country in both the short and long term. Therefore, national security is over generalized to be regarded as an explanation of determinants of FDI restrictions.

National Security: Excluded in International Obligations

The ambiguousness and broadness of the concept of national security are not unique in the academic world, but also reflected in the practical level. Though it is agreed that national security should be protected, there is no international agreement on an explicit definition of national security.

The right to protect essential security interests of the state is vaguely documented in WTO principals, which leaves a huge space for nation states to discretionally define their own “essential security interests”. As Article XXI provides that:

Nothing in this Agreement shall be construed (a) to require any contracting party to furnish any information the disclosure of which it considers contrary to its essential security interests; or (b) to prevent any contracting party from taking any action which it considers necessary for the protection of its essential security interests; or (c) to prevent any contracting party from taking any action in pursuance of its obligations under the United Nations Charter for the maintenance of international peace and security.

Multi-lateral or bilateral trade agreements such as OECD investment instruments, North American Free Trade Agreement (NAFTA), as well as bilateral investment treaties (BITs) also assigns the role of deciding whether the essential security interests are at stake to their member states. Without a multinational governing structure on security-related obligations, some intergovernmental organizations provided a

platform for participatory governments to discuss how governments could reconcile their duty to safeguard security interests when facing FDI with the need to continuously attract foreign capital. For instance, According to the OECD, though essential security concerns are self-judging, three principles must be respected: transparency and predictability, proportionality, and accountability.⁸

In the absence of a unified definition of national security, it is necessary to look at the economic dimension of it, which is directly related to FDI restriction.

Economic Security

Economic security, along with political independence and cultural autonomy, is an indispensable component of national security (Ma, & He, 2006). However, the scope of economic security is highly debatable.

One of the reasons is that when talking about economic security, it could be applied to both individuals and the state. Though income stability (Hacker, 2008), individual well-being (Miron-Shaz, 2009; Graham & Pettinato, 2002), labor market behaviors (Stephens, 2002), and savings aspirations (Carroll, Dynan, & Krane, 2003) all fall into a citizen's viewpoint of economic security, they are clearly less emphasized in the state level. For a sovereign state, economic development and economic interests are the primacy of economic security, which could be influenced by both internal and external factors (Ye, 2008). According to such a state-centric perspective, economic security refers to the security from manipulation by other

⁸ Organization of Economic Cooperation and Development (OECD). (2008) Freedom of investment, national security, and "strategic" industries: Progress Report by the OECD Investment Committee. Retrieved from <http://www.oecd.org/investment/investment-policy/40473798.pdf>

governments that wield economic statecrafts as a means to influence other state and their policies (Kahler, 2004). In this regard, domestically, economic security equals a solid industrial and economic foundation, a stable economic growth rate, and a sustainable economic development model (Li, 2007). In addition, in the global level, economic security could also be understood “offensively”, meaning that a country could have the capacity to either guarantee or enhance its economic competitiveness internationally, or to ward off large scale crisis and prevent its own economy from suffering from loss (Mao, 2008; Sang, 2006).

Similar to national security, the ambiguity and broadness of the definition of economic security makes it difficult to determine the scope of it. Economic security could mean the security of all types of economic activities in all industrial sectors. Therefore, it is premature to argue that host governments tend to refuse FDI having a negative impact on economic security.

Concluding Remarks

To sum up, why do host governments restrict FDI? A quick answer could be they restrict FDI posing a threat to their national security or economic security. However, such an answer is parsimonious and overgeneralized because national security and economic security cover a wide range of aspects, some of which are even overlapping. In addition, the exception of national security in international investment or trade treaties also gives states enough margins to define it. In this way, a further question that we shall continue to ask is: how do host countries define their national security

and economic security in terms of inward FDI regulation? Instead of investigating the relationship between these two types of security, this study chooses a different avenue.

As mentioned before, host governments could combine the use of both economic and political justifications to oppose investments that they do not welcome. In other words, the FDI restriction could be either used politically or economically. In addition, owing to the differences in histories, economic structures, development levels, and industrial policies between different countries, *how* foreign countries could wield economic statecraft and *in which sectors* they could achieve this goal are inherently different.

In spite of the fact that the definition of both national security and economic security largely depends on whether we look at their narrow sense or broad sense, the core issues associated with FDI restrictions concern industrial allocation and sovereign power. To put differently, whatever implication or impact inward FDI might have, it must represent an inflow of capital in a particular industry. Therefore, to comprehend the politics of FDI restriction, it is indispensable to look at which industrial sectors are deemed critical by governments, as well as *how* host government restrict FDI in these sectors.

In the next two chapters, I will leave the “national security” and “economic security” debate of FDI restriction aside, while attempt to find determinants of FDI restrictions by starting with the concept of critical industry. Understanding what industrial sectors are considered critical and how host governments employ de facto

FDI restrictions in these sectors could enhance our knowledge on determinants of FDI restrictions.

Chapter 4: Critical Industry and Inward FDI Restrictions in the United States

As mentioned in the Introduction, only a small number of proposed FDI transactions fall into the scope of host governments' restriction policies. Furthermore, once facing perceived or real government opposition, many proposed deals are either silently withdrawn or renegotiated, making those reported by the media and debated in public an even smaller minority from the minority. For instance, from 1988 to 2011, only 2,266 notices have been filed to CFIUS, representing roughly 10% of all reported inward FDI projects in the United States (Hasnat, 2015). Among these filings, only 161 of them generated investigations conducted by CFIUS and 41 transactions withdrew before the commencement of the investigations. Among those remaining ones, merely 14 transactions received decisions from the President in which only one was rejected. (Ibid, 2015)

Definition of Critical Industry in the United States

Critical Industry is a distinct area within the rubric of essential security interests. As the examples in the Introduction indicate, critical industry has increasingly gained prominence in FDI restrictions. How is critical industry defined? The section below attempts to review the definition of "critical industry" and looks at which sectors are included in it.

In the United States, "Critical industry" was added to the CFIUS process in 2001 with the USA Patriot Act (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism) after the terrorist

attacks in September 2011.⁹ It is thereby defined as:

Systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on security, national economic security, national public health or safety, or any combination of those matters.¹⁰

Such vague definition draws two dimensions of critical industry: physical and virtual; and it specifies the influence areas of such industries in three realms: political, economic, and social. Even though the 2001 Act does not specify which industries could be considered as critical, other Acts could shed some light upon the potential ones, including financial services, water, transportation, energy, telecommunication, financial services¹¹, as well as “cyber and physical infrastructure services critical to maintaining the national defense, continuity of government, economic prosperity, and quality of life in the United States”¹² Moreover, the Department of Homeland Security listed 18 sectors of the economy as falling within the definition of critical infrastructure. They include agriculture and food, defense industrial base, energy, public health and healthcare, national monuments and icons, banking and finance, drinking water and water treatment systems, chemical, commercial facilities, dams, emergency services, commercial nuclear reactors, materials, and waste, information technology, telecommunications, postal and shipping, transportation systems, government facilities, critical manufacturing.¹³

⁹ The United States. The Library of Congress. (2001). *Bill Text 107th Congress (2001-2002) H.R.3162. ENR Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorist Act of 2001*. Retrieved from <http://thomas.loc.gov/cgi-bin/query/z?c107:H.R.3162.ENR:%20>

¹⁰ The Organization for Economic Cooperation and Development (OECD). (2008). *Protection of Critical Infrastructure and the Role of Investment Policies Relating to National Security*, Retrieved from <http://www.oecd.org/investment/investment-policy/40700392.pdf>

¹¹ The United States. The Library of Congress. (2001). *Bill Text 107th Congress (2001-2002) H.R.3162. ENR Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorist Act of 2001*. Retrieved from <http://thomas.loc.gov/cgi-bin/query/z?c107:H.R.3162.ENR:%20>

¹² Ibid.

¹³ The United States. Homeland Security. (n.d.) Retrieved from <http://www.dhs.gov/critical-infrastructure-sectors>

Information above only gives us a general idea of what industrial sectors are considered as critical in the United States. However, the mechanism of FDI restriction and justifications could not be adequately comprehended unless we investigate some case studies.

Cases of FDI restrictions in the United States

In this section, I will present five famous proposed FDI transactions restricted in the United States. Three of them are from China, while only one came from United Arab Emirates (UAE). Those propositions concern industrial sectors of petrol, mining, telecommunication, and transportation.

Case 1: CNOOC-Unocal

The CNOOC-Unocal Case demonstrates the United States' alert in FDI in its energy sector. In 2005, China Offshore Oil Corporation (CNOOC) attempted to take over the California-based energy company Unocal.¹⁴ The bid offered by CNOOC outstripped the one from its American competitor Chevron by \$ 2 billion.¹⁵ However, more than forty Congress members requested CFIUS to review the proposed transaction as a potential threat to the national security of the United States. In the end, CNOOC dropped its bid before CFIUS reached the final decision.¹⁶

In the CNOOC-Unocal case, the Congress Resolution reiterated the strategic

¹⁴ Gold, R., Pottinger, M., Berman, D. (2005, June 23). China's CNOOC lobs in rival bid to acquire Unocal, *The Wall Street Journal*. Retrieved from <http://www.wsj.com/articles/SB111946772267766700>

¹⁵ Ibid.

¹⁶ White, B. (2005, August 3). Chinese drop bid to buy U.S. oil firm. *The Washington Post* <http://www.washingtonpost.com/wp-dyn/content/article/2005/08/02/AR2005080200404.html>

significance of the energy sector in the United States.¹⁷ It worries that the CNOOC-Unocal deal would have effectively injected a foreign power into the American economy and enabled China to control energy supply in the United States and strengthen the power of China.¹⁸

Congressional concern is not limited to the domestic energy market. Since “Unocal’s oil reserves could be found throughout the world, from Gulf of Mexico to the Caspian Region to Southeast Asia, as well as in Africa, Europe, and South America”¹⁹, CNOOC’s transaction was considered as a zero-sum game which reduces the United States’ role in international market. Moreover, the Resolution also mentioned the concern of potential proliferation of sensitive dual-use technologies in the oil industry²⁰: The Congress was concerned that China could use FDI to acquire advanced technologies and spread them to adverse countries like Iran.

Another cause of opposition points to CNOOC’s corporate structure and identity. According to the House Resolution 344, since the Chinese government owns approximately 70% of CNOOC, their intimacy makes it possible that the proposed transaction is financed and heavily subsidized by Chinese state-owned financial institutions, which is unfair for American domestic competitors.²¹ Furthermore, how CNOOC would operate in the United States also raised concerns. One congressman

¹⁷ The United States. U.S. Government Publishing Office. (2005). 151 CONG.REC. H5570 – Announcement by the speaker pro tempore. Retrieved from <http://www.gpo.gov/fdsys/pkg/CREC-2005-06-30/pdf/CREC-2005-06-30-pt1-PgH5570.pdf>

¹⁸ The United States. Congress. (2005). *H. Res.344 (109th): Text of Expressing the sense of the House of Representatives that a Chinese state-owned energy company exercising control of critical United States energy infrastructure and energy production capacity could take action that would threaten to impair the national security of the United States.* Retrieved from <https://www.govtrack.us/congress/bills/109/hres344/text>

¹⁹ Ibid.

²⁰ Ibid.

²¹ The United States. U.S. Government Publishing Office. (2005). 151 CONG.REC. H5570 – Announcement by the speaker pro tempore. Retrieved from <http://www.gpo.gov/fdsys/pkg/CREC-2005-06-30/pdf/CREC-2005-06-30-pt1-PgH5570.pdf>

expressed the view that “one of the parties to a deal is owned and operated by a totalitarian communist government that does not answer to the rules of the government”²².

Last but not least, in the CNOOC-Unocal Case, reciprocity is also a reason of the opposition. The Congress pointed out that since the Chinese government is not likely to accept American investment in China’s national oil companies, the United States should also prevent Chinese capital from tapping into American oil industry based on the principal of reciprocity.²³

Case 2: Northwest-Firstgold

In 2009, China’s Northwest Nonferrous International Investment Co. (Northwest) proposed a \$26 million deal to purchase a 51% interest in a U.S. mining company Firstgold Corp. (Firstgold).²⁴ However, the CFIUS review “raised serious and significant and consequential national security risks” because of the mining locations’ adjacency to the Fallon Naval Air Station.²⁵

Though CFIUS’s decision to protect national security is well understood, how much Firstgold’s location is related to the military site is controversial. As Terry Lynch, CEO of Firstgold comments:

...we disagree 100% with their conclusion. We fail to see the connection between US national security and our principal asset the Relief Canyon mine, which has existed at its present location since the early 1980s. Our property

²² The United States. Congress. (2005). H. Res.344 (109th): Text of Expressing the sense of the House of Representatives that a Chinese state-owned energy company exercising control of critical United States energy infrastructure and energy production capacity could take action that would threaten to impair the national security of the United States. Retrieved from <https://www.govtrack.us/congress/bills/109/hres344/text>

²³ Ibid.

²⁴ Lipton, E. (2009, December 17). Questions on security mar foreign investments. *The New York Times*. Retrieved from http://www.nytimes.com/2009/12/18/business/18invest.html?_r=0

²⁵ Ibid.

is over 50 miles away from the Fallon base and surrounded by several other mining properties.²⁶

In this Case, although the proposed transaction did not catch the attention of the Congress, CFIUS issued a negative recommendation to President Obama to block the deal. The other determinant of restriction concerns the identity and corporate structure of Northwest, a firm owned by the Shaanxi provincial government.²⁷

Case 3: DWP-P&O

In October 2005, Dubai Ports World (DPW), a state-owned port operations firm from the UAE, proposed to acquire the British Company Peninsular & Oriental Steam Navigation Company (P&O) operating in the United States.²⁸ This acquisition would have given DPW operational rights, instead of ownership, of 11 terminals in the United States.²⁹ On 17 January 2006, the customary thirty-day review was completed by the CFIUS and none of its members raised any national security concerns.³⁰ However, from mid- February, the Congress voiced its opposition.³¹ Eventually, DWP decided to sell its control of Ports in the United States to American International Group in the end of 2006.³²

²⁶ Forster, J. (2009, December 17). Firstgold expects CFIUS to recommend rejection of Northwest. *Bloomberg*. Retrieved from <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aGegXyo18Y0U>

²⁷ Forster, J. (2009, July 20). Firstgold Announces restructuring agreement in principle. *Bloomberg*. Retrieved from <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=abuIsCzmBO5g>

²⁸ N.A. (2005, November 29). P&O agrees bid from Dubai Ports. *BBC*. Retrieved from <http://news.bbc.co.uk/2/hi/business/4480542.stm>

²⁹ Ibid.

³⁰ Vaughan, M. (2006, February 23). Administration officials say port takeover underwent rigorous review. *Government Executive*. Retrieved from <http://www.govexec.com/defense/2006/02/administration-officials-say-port-takeover-underwent-rigorous-review/21226/>

³¹ Regulations of the functioning of the CFIUS provide that the Congress could initiate a forty five-day long extended review after the initial one with thirty days.

The United States. Department of the Treasury. Process overview of the CFIUS. Retrieved from <http://www.treasury.gov/resource-center/international/foreign-investment/Pages/cfius-overview.aspx>

³² Dayan, C. (2006, December 11). Dubai Ports to sell U.S. operations to AIG. *Reuters*. Retrieved from <http://www.reuters.com/article/2006/12/11/us-dubai-ports-usa-idUSL1177085920061211>

The DPW-P&O Case demonstrates how fears of state-ownership related issues such as state-sponsored terrorism, espionage, and transportation of dangerous weapons could lead to the ban of an M&A transaction. Their arguments focus on the strategic and security significance of port management in the United States and the UAE's geopolitical stance vis-a-vis the American foreign policy. The nature of ports as security assets is raised by one Congressman, who stated that:

Most importantly, our ports are our most valuable targets for terrorist attack. Despite efforts to improve port security by the Administration, only one in 20 shipping containers entering the United States is physically inspected. A single terrorist incident could shut down our system of container transportation, affecting our entire economy, as well as facilities relied on by the Department of Defense as military load-out ports.³³

The other concern is the relationship between DPW and the UAE government.

House member Curt Weldon argued that the transaction could “transfer a vital national defense asset to a foreign nation in an unstable region.”³⁴ Moreover, the fact that “two of the 9/11 hijackers were UAE nationals and UAE was one of the three governments in the world to recognize the legitimacy of Taliban in Afghanistan”³⁵ could make the American homeland security more vulnerable. Peter King, Chairman of the House of Homeland Security Committee, also questioned DWP's relationship with terrorist groups by asking “how are they going to guard against things like infiltration by Al Qaeda or someone else? How are they going to guard against

³³ Communications Workers of America. (2006, February 20). Lawmakers begin push for new thorough federal review of United Arab Emirates-owned company taking control of major U.S. ports in NY, NJ and East Cost. Retrieved from http://www.cwalocal4250.org/article?id=a_1140415200-628537&t=lpat&p=42

³⁴ Knowlton, B. (2006, February 19). Lawmakers increase criticism of Dubai deal for ports. *The New York Times*. Retrieved from http://www.nytimes.com/2006/02/19/politics/19cnd-port.html?_r=0

³⁵ Communications Workers of America. (2006, February 20). Lawmakers begin push for new thorough federal review of United Arab Emirates-owned company taking control of major U.S. ports in NY, NJ and East Cost. Retrieved from http://www.cwalocal4250.org/article?id=a_1140415200-628537&t=lpat&p=42

corruption?”³⁶

Conflicting business interest could also be considered as one of the reasons which triggered the failure of the DWP-P&O Case. Before the transaction was proposed by DWP, Miami-based Eller & Company had a long standing commercial dispute with P&O over its operation in the port of Miami.³⁷ After failing to persuade CFIUS for a resolution of dispute, it hired Washington lobbyist Joseph Muldoon to inform Congress members of this deal and expressed its unwillingness to become involuntarily a business partner with the government of Dubai.³⁸ Hence, Eller & Company successfully used the Capitol Hill and media to voice its own commercial grievance with the national security justification.

Case 4: Huawei-3Com/3leaf/Sprint

Restrictions based on corporate identity are not limited to SOEs. Huawei, China’s leading private enterprise in telecommunication, also encountered opposition in their attempts to merge American firms.

From 2008 to 2011, Huawei’s proposed M&A deals of 3Com³⁹, 3leaf⁴⁰, and Sprint⁴¹ all met oppositions from CFIUS. For example, Representative McCotter addressed his concern to the CFIUS by saying that:

³⁶ The Associated Press. (2006, February 20). More objections to port takeover by Arab entities. *The New York Times*. Retrieved from <http://www.nytimes.com/2006/02/20/national/20ports.html>

³⁷ Overby, P. (2006, March 9). Lobbyist’s last-minute bid set off ports controversy. *National Public Radio*. Retrieved from <http://www.npr.org/templates/story/story.php?storyId=5252263>

³⁸ King, N., Hitt, G. (2006, February 28). Small Florida firm sowed seed of port dispute. *The Wall Street Journal*. Retrieved from <http://www.wsj.com/articles/SB114105320594384271>

³⁹ Waters R. & Politi J. (2008, March 21). Huawei-3Com deal finally collapses. *Financial Times*. Retrieved from <http://www.ft.com/intl/cms/s/0/c2091814-f6b5-11dc-bda1-000077b07658.html>

⁴⁰ Raice, S. & Dowell, A. (2011, February 22). Huawei drops U.S. deal amid opposition. *The Wall Street Journal*. Retrieved from <http://www.wsj.com/articles/SB10001424052748703407304576154121951088478>

⁴¹ Shields, T. & Strohm, C. 2013, (May 30). Huawei loser in Soft Bank-Sprint deal over alleged spying.

Bloomberg Business. Retrieved from <http://www.bloomberg.com/news/articles/2013-05-29/huawei-loser-in-softbank-sprint-deal-over-alleged-spying>

...the Committee on Foreign Investment in the United States must review and block Bain Capital and Communist China's Huawei Technologies' deal with the 3Com Corporation. If approved, Communist China's Huawei Technologies stake in the 3Com Corporation will gravely compromise our free Republic's national security.⁴²

In all Huawei's three cases, justifications were given based on Huawei's purported link to the Chinese military and the potential risk of economic and cyber espionage, as well as potential corruption to the telecommunication system used by the American defense industry.

Case 5: Ralls-Terna

In 2012, Ralls, a Delaware based firm owned by two Chinese nationals and executives of the Chinese privately-owned firm Sany Group Company, planned to purchase four small plots from a Greek Company Terna Energy SA, and install turbines made by the Sany Group. Located in north central Oregon, these turbines would have been built on and near land used by the U.S. Navy as an aircraft training range.⁴³ Reinforcing the initial veto decision made by CFIUS, President Obama ordered the stop of the project and told Ralls to divest itself of its Oregon assets.⁴⁴ The Order signed by the President stated that the transaction threatens to impair the national security of the United States.⁴⁵ It was the first time since 22 years that an

⁴² McCotter, T. (2007) "Communist China and CFIUS: dropping the shark," *Congressional Record*, Vol. 153, No. 149, pp. 11226-11227

⁴³ Francis, M. (2014, July 15). Chinese investors in Oregon wind farm project are entitled to know better why Obama administration blocked it, court rules. *The Oregonian*. Retrieved from http://www.oregonlive.com/business/index.ssf/2014/07/chinese_investors_in_oregon_wi.html

⁴⁴ Ibid.

⁴⁵ The United States. The White House. Office of the Press Secretary. (2012, September 28). *Order signed by the President regarding the acquisition of four U.S. wind farm project companies by Ralls Corporation*. Retrieved from <https://www.whitehouse.gov/the-press-office/2012/09/28/order-signed-president-regarding-acquisition-four-us-wind-farm-project-c>

American President raised national security concern to block a FDI transaction.⁴⁶

As the examples above show, the industrial sectors in which the foreign investments concern could decide whether they will meet restrictions or not. Energy, transportation and telecommunications are deemed strategically critical in the United States. In addition, though all the investors are multinational companies conducting business in a variety of countries throughout the world, it is the corporate identity which is highlighted in host governments' opposition to proposed transactions. Both state-ownership and home country profile could potentially cause restriction. In terms of Chinese investors, enterprises' relationship with the government as well as the status of Chinese Communist Party (CCP) as the ruling party of China are the important causes of concern in the United States.

Empirical findings from cases above push us to look at foreign investments in which sectors are more likely to meet restrictions and how those restriction measures are put into place. Moreover, since political actors such as CFIUS, the Congress, and the President are involved in the decision-making process of FDI, the evolution of FDI restriction institutions also deserve a closer study. As mentioned in the Introduction, FDI projects could be either greenfield projects or brownfield M&As, does the United States restrict them differently? If so, how? Paragraphs below aim to answer these questions.

⁴⁶ Goldenberg, S. (2012, October 2). Chinese-owned Ralls sues Obama over blocked Oregon windfarm project. *The Guardian*. Retrieved from <http://www.theguardian.com/world/2012/oct/02/ralls-sues-obama-oregon-wind-farm>

Greenfield Restrictions in the United States

In terms of greenfield projects, American federal statutes have established ownership requirements in sectors which have significant security implications. The United States does not have a blanket prohibition on any one type of direct investment.

As Table 1 below indicates, some types of investment trigger a requirement to file information, while others which the Congress believes have an impact on national security have limitation requirements. The latter category includes maritime industry, aircraft industry, banking, resources and power, and businesses which are parties to government contracts.

Table 1: Types of Foreign Investments restricted by the United States

Industry	Detailed sector	Requirement
Aircraft		No more than 25% for foreign investors
Communication	Radio station license controlling interest	
Shipping	Merchant shipping	Documentation
Mining	Valuable Mineral resources	American citizenship or declared intention of citizenship
	Deposits of coal, phosphate, sodium, potassium, oil, oil shale, gilsonite	U.S. citizens, associations, corporations organized under US laws Reciprocity with investor's home country
Energy	Construction, operation, maintenance of facilities of development, transmission, and utilization of power on land and water over which the federal government has control Nuclear facility	U.S. citizens and domestic corporations

Lands	Ownership of Land, grazing on Public Land	American citizenship or declared intention of citizenship
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Source: Foreign Investment in the United States: Major Federal Statutory Restrictions.
Compiled by the author

National Security Review of M&A Transactions

In the United States, review of M&A transactions is governed by another institution, namely CFIUS, which conducts case-to-case reviews on M&A transactions which might have national security implications. The establishment of CFIUS was a result of increasing FDI from oil producing countries in the 1970s. Subsequently, the role and functioning of CFIUS experienced two major changes in late 1980s and early 21st century respectively.

After the World War II, the United States adopted an open door policy to foreign investment, with the exception of prohibitions and restrictions targeting the communist bloc and some pariah states (Kang, 1997). However, this attitude started to change in the 1970s due to the capitals inflows from the Organization of Petroleum Exporting Countries (OPEC) (ibid, 1997). The major concern was that the OPEC members could use their surplus gained by their oil embargo to purchase American companies and strategic assets driven by political rather than economic motivations. Such concern led a series of Congressional hearings and the creation of the CFIUS by an Executive Order of President Ford in 1975 (1975 Executive Order).⁴⁷

The 1975 Executive Order designated the Secretary of the Treasury as the Chairman of the Committee, and states the responsibility of the CFIUS is to “monitor

⁴⁷ The United States. National Archives. (1975). Executive Order 11858 on Foreign Investment in the United States. Retrieved from <http://www.archives.gov/federal-register/codification/executive-order/11858.html>

the impact of foreign investment in the U.S., both direct and portfolio, and coordinate the implementation of United States policy on such investment within the executive branch.”⁴⁸ To be more precise, CFIUS was created for the following four purposes:

to arrange for the preparation of analyses of trends and significant developments in foreign investments in the United States; to provide guidance on arrangements with foreign governments for advance consultations on prospective major foreign investments in the United States; to review investments in the United States, which in the judgement of the Committee, may have major implications for United States national interests; and consider proposals for new legislation or regulations relating to foreign investment as may appear necessary.⁴⁹

Since the 1980s, increasing numbers of Japanese acquisitions of American firms raised concern in the United States. In 1988, the Congress approved the Exon-Florio provision as part of the Omnibus Trade Act, giving the President the authority to block proposed “foreign mergers, acquisitions, or take-overs of persons engaged in interstate commerce in the United States which threatens to impair the national security.”⁵⁰ The adoption of the Exon-Florio provision strengthened the President’s role in investment policy. While on the one hand, it mitigates rising public concerns about economic impacts of certain types of foreign investment, on the other hand, it does not intend to alter generally open foreign direct investment climate of the United States. In addition, CFIUS gained power and transformed from a responsive data-gathering agency to an authority capable to make recommendations on foreign investment transactions (Hasnat, 2015). In the early 1990s, Byrd Amendment⁵¹

⁴⁸ Ibid.

⁴⁹ Ibid.

⁵⁰ The United States. U.S. Government Publishing Office. (1988). 50 U.S.C. 2170- Authority to review certain mergers, acquisitions, and takeovers. Retrieved from <http://www.gpo.gov/fdsys/granule/USCODE-2011-title50/USCODE-2011-title50-app-defensepr-sec2170>

⁵¹ The United States. The Library of Congress. (1992). *Bill Text 102nd Congress (1991-1992) H.R.5006.ENR*. Retrieved from <http://thomas.loc.gov/cgi-bin/query/z?c102:H.R.5006.ENR>:

complemented the Exon-Florio provisions by taking into account the national security implications of foreign-government-owned or controlled firms' acquisition of US companies.

Another critical juncture for CFIUS is the terrorist attack on September 11, 2001. The USA PATRIOT Act of 2001⁵² included economic dimensions into national security review by offering a definition of "critical industry". In this regard, economic activities are included as a distinct component of the national security (Hasnat, 2015).

The Foreign Investment and National Security Act (FINSAs) of 2007⁵³ further reformed the CFIUS process and codified its responsibilities, roles, and structures. It enlarged CFIUS's scope by including critical infrastructure and homeland security comparable to national security. Moreover, it enhanced the required of the Byrd Amendment by stating that any transactions owned or controlled by foreign government, whatever sectors they belong to, are subject to the CFIUS review.⁵⁴ In addition, FINSAs required CFIUS to submit reports to the Congress after each review and hold an annual report for all its reviews in the past year.⁵⁵

In summary, no general screening or blocking authority exists in federal level of the United States. CFIUS only considers the implications of any investment that may affect the national security of the United States.

⁵² The United States. The Library of Congress. (2001). *Bill Text 107th Congress (2001-2002) H.R.3162. ENR Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorist Act of 2001*. Retrieved from <http://thomas.loc.gov/cgi-bin/query/z?c107:H.R.3162.ENR:%20>

⁵³ The United States. The Congress. (2007). H.R. 556 (110th) Foreign Investment and National Security Act of 2007. Retrieved from <https://www.govtrack.us/congress/bills/110/hr556>

⁵⁴ Ibid.

⁵⁵ Ibid.

Operation of the CFIUS System

Under the CFIUS process, proposed M&A transactions are required to submit notifications to CFIUS, and it is CFIUS which has the authority to initiate a security review if it deems it necessary. Once the complete notice is received, the chair of CFIUS will circulate it to all other CFIUS members. Thirty business days are allocated for the CFIUS members to assess whether national security is concerned in the M&A transaction.⁵⁶ If CFIUS finds national security-related issues in the transaction, it will conduct the second review, which takes a maximum of 45 business days.⁵⁷ The precondition of the conduction of second review is that a proposed transaction poses a national security threat, involves a foreign government-controlled transaction, or could potentially result in foreign person's control of critical infrastructure.⁵⁸ Once the CFIUS reaches a decision that national security is endangered and the proposed transaction shall be prohibited, it will advise the President and request his final decision. The President then has the final authority to investigate and block the proposed transactions.

The evolution of the FDI restriction policies in the United States is triggered by increasing FDI from non-western countries: the Middle East in the 1970s, Japan in late 1980s and early 1990s, and emerging markets since the 21st century. The main reason for the United States to strengthen the security review of inward FDI is to prevent the possibility of the loss of strategic assets and leading technology to foreign

⁵⁶ The United States. Department of the Treasury. Process overview of the CFIUS. Retrieved from <http://www.treasury.gov/resource-center/international/foreign-investment/Pages/cfius-overview.aspx>

⁵⁷ Ibid.

⁵⁸ Ibid

enterprises, in particular those with government backgrounds. In other words, the ownership of the investor and its relationship with its home government is the key examination area. Recent policy changes also indicate that future work of CFIUS could be more transparent, as well as more politicized. The transparency lies in the report from CFIUS to the Congress, which could contain the exact reasons of restrictions with more detailed information. However, by giving more power to the Congress, such “transparency” could also enable stakeholders to hire lobbyists to promote their corporate interests through congressmen. In contrast, the political system of China’s party state and China’s opening-up towards the rest of the world since the late 1970s have made China’s FDI restrictions quite different.

Chapter 5: Critical Industry and Inward FDI Restrictions in China

The Absence of Definition of Critical Industry in China

Unlike the United States, China does not have a clearly articulated definition of critical industry. It listed seven industries as vital arteries of national economy and critical to national security. In 2006, the State Assets Supervision and Administration Commission (SASAC), which is responsible for managing a certain number of SOEs, appointing top executives, and approving mergers and sales of stock or assets, reported that military equipment, power generation and grids, oil and petrochemicals, telecommunications, coal, civil aviation, and shipping industries are essential to economic security in which state capital must play a leading role.⁵⁹ Moreover, industrial sectors falling under the 2011 National Security Review system are even larger than the critical industries. They not only include M&A transactions of defense and military industries, enterprises adjacent to key or sensitive military facilities, but also transactions involving agricultural products, energy and resources, infrastructure facilities, transportation services, core technologies, and important equipment manufacturing enterprises.⁶⁰

Cases of FDI Restrictions in China

Compared with the United States, China is even less transparent in terms of FDI

⁵⁹ N.A. (2006, December 18). Woguo queding qida hangye jiangyou guoyou jingji kongzhi. [China names key industries for absolute state control] *Xinhua*. Retrieved from http://news.xinhuanet.com/fortune/2006-12/18/content_5502762.htm

⁶⁰ China. Ministry of Commerce. (2011). *Notice of the General Office of the State Council on the establishment of the security review system for mergers and acquisitions of domestic enterprises by foreign investors*, Paragraph 1 (1). Retrieved from <http://www.mofcom.gov.cn/aarticle/b/c/201108/20110807713530.html>

restriction data. On the one hand, until now no statistics of annual investigated or refused FDI transactions are made available; on the other hand, how exactly one investigation is initiated and how a restriction decision is made are often not made public. Only some high-profile transactions endangered strong opposition from domestic stakeholders have been broadcasted by the media. In the following paragraphs I will present three cases from 2005 to 2009. They concern American investors' propositions in manufacturing, beverage, and steel in China.

Case 1: Carlyle-Xugong

The Carlyle-Xugong Case demonstrates China's vigilance in terms of the protection of key industries, in particular manufacturing, from foreign M&A activities. Xugong Group Construction Machinery (Xugong) develops and manufactures a variety of hydraulic components and basic construction machinery components.⁶¹ In 2005, American private firm Carlyle had agreed to pay \$375 million for an 85% stake, making it the largest ever announced private equity deal in China at the time.⁶² According to the 2003 Provisional Regulations on foreign M&A activities in China, Xugong falls into the category of state-owned enterprises which the government would encourage to bring in foreign investment. However, the examination and approval authorities, National Development and Reform Commission (NDRC) and Ministry of Commerce (MOFCOM), have been very cautious.⁶³ As a result, the

⁶¹ XCMG. (N.D.). Overview of Xugong. Retrieved from <http://www.xcmg.com/aboutus/qiyegaikuang.htm>

⁶² Tucker, S. (2008, July 23). Carlyle learns bitter Chinese lesson. *Financial Times*. Retrieved from <http://www.ft.com/intl/cms/s/0/76342814-58d2-11dd-a093-000077b07658.html>

⁶³ Lu, Y. & Cheng, Z. (2006, April 3). Carlyles' Xuzhou deal remains uncertain. *Caijing*. Retrieved from <http://english.caijing.com.cn/2006-04-03/100043017.html>

proposed stake to be purchased was reduced from 85% to 50%, and eventually 45%. Even though, it still did not obtain approval by MOFCOM. In July 2008, after three years negotiation, the investment eventually was abandoned.

One explanation of China's "cautiousness" in this affair is that Xugong is directly implicated in China's defense industry because it manufactures vehicles for military use (Zhao, 2008). China's Sany Group, a former competitor of Carlyle who attempted to acquire assets of Xugong, also highlighted the strategic security of national industry and selling state-owned assets at a low price. According to Sany's CEO

Xiang Wenbo:

Xugong's business areas concern the basis of our nation's defense and security. A lot of military equipment and technology are interconnected with manufacturing. Enterprises like Sany and Xugong could produce military equipment for the state when required. In other countries, similar types of enterprises also undertake the work of military production. Therefore, Xugong, as well as Sany, are highly implicated in a nation's competitiveness and industrial security.⁶⁴

Case 2: Mittal-Laiwu

Similarly, the Mittal-Laiwu Case also demonstrated the national security in FDI restriction. In 2006, Arcelor Mittal, the world's biggest steel maker, attempted to buy 38% stake in China's Laiwu Steel. However, the offer finally did not receive the required approval after a one-year-and-a-half review.⁶⁵ The reason given was that the

⁶⁴ Sina Finance. (2006, June 19). Sanyi zhonggong zhixingzongcai xiangwenbo zuoke xinlang liao shougou shilu. [Guest Speaker Xiang Wenbo, CEO of Sany Group, talked about M&A Deal]. *Sina*. Retrieved from <http://finance.sina.com.cn/g/20060619/13172662531.shtml>

⁶⁵ Miles, T. & Yan, F. (2007, December 13). ArcelorMittal says China Laiwu deal collapses. *Reuters*. Retrieved from <http://uk.reuters.com/article/2007/12/13/us-arcelormittal-laiwu-idUKSHA15609620071213>

deal concerns foreign control of major domestic steel mills and steel market development.⁶⁶

In addition, this case demonstrates that industrial security concern finally prevailed local economic interests. As Mr. Jiang Kaiwen, Chairman of Laiwu Steel, lamented the abortion of this transaction by commenting that:

ArcelorMittal is well known as one of the most sophisticated producers of steel products. We are disappointed that we will not have the opportunity to directly benefit from this as strategic equity partners, but we hope we may have other opportunities to work closely together in the future.

Case 3: Coca Cola-Huiyuan

In March 2009, China's MOFCOM announced that it had bared Coca-Cola's proposed \$ 2.4 billion acquisition of China Huiyuan Juice Group.⁶⁷ It listed three primary reasons for its decision to block the transaction⁶⁸:

Even though Coca Cola's market share in the juice market is negligible, it could still use its dominant position in carbonated soft drinks market could be used to curb competition in the juice market through tying, bundling or exclusive dealing, thus eliminate or resist competition among other juice manufactures. Therefore, the lawful rights and interests of consumers will be violated.

This transaction could raise the entry barriers to juice market by potential competitors. Coca-Cola could add the popular Huiyuan Juice brand into its existing Minute Maid brand, which will translate into market power in the juice market.

Lastly, the transaction would restrict competition for small and medium-sized juice companies, which is negative for the sound and sustainable development of China's juice industry.

⁶⁶ Ibid.

⁶⁷ China. Ministry of Commerce. (2009, March 6). *Ruling on the anti-monopoly investigation of Coca Cola's M&A of Huiyuan Juice*. Retrieved from <http://www.mofcom.gov.cn/aarticle/ae/ai/200903/20090306108388.html>

⁶⁸ China. Ministry of Commerce. (2009, March 6). *No. 22 Notification of MOFCOM on banning Coca Cola's M&A of Huiyuan Juice*. Retrieved from <http://fldj.mofcom.gov.cn/article/ztxx/200903/20090306108494.shtml>

Concluding Remarks

Case Studies above indicate that similar to the United States, China also restricts FDI in strategic industries, steel and heavy manufacturing as indicated. In addition, as the Coca Cola-Huiyuan Case reveals, China blurs the boundary between political review and economic review by putting the industry security dimension in the Anti-monopoly investigation. Does China treat the economic and political aspects of FDI propositions together? How does China's FDI restriction institution develop? Sections below seek to answer these questions.

FDI Restriction Institutions in China

China prohibited both inward and outward FDI after 1949. However, this situation changed dramatically since the adoption of the opening-up and reform policies in late 1970s. It was a calculated decision to attract foreign capital, advanced technology, as well as managerial know-how to support China's domestic construction and economic development (Gallagher, 2002).

The path of the development of China's FDI restriction institutions is quite different from the American one. Generally speaking two steps could be identified: the first period spans from late 1970s to 2003, in which China adopted a blanket approach to oppose unwanted foreign investments without a clear review procedure. During these years, restrictions mainly target greenfield project. Since 2003, China started to strengthen its effort to review M&A transactions. The climax of this period is the establishment of the national security review system in 2011.

Phase One: An Indiscriminate Approach

China unveiled three basic laws governing inward foreign capitals (*waizi sanfa*) in late 1970s and 1980s, namely the Law on Chinese-Foreign Equity Joint Ventures, the Law on Chinese-Foreign Contractual Joint Ventures, and the Law on Foreign Capital Enterprises. Though having been amended several times after their promulgations, they act as the guiding principles governing inward FDI in China. According to them, FDI in China could be divided into three types: entirely foreign owned enterprises (*waizi qiye*)⁶⁹, Sino-foreign equity joint ventures (*hezi qiye*)⁷⁰, and Sino-foreign contractual joint venture (*hezuo qiye*).⁷¹ In terms of FDI restriction and opposition, the three basic laws on foreign capital only vaguely outlined that foreign investors should not be detrimental to China's public interests and not violate Chinese laws⁷². No concrete definition of "public interests" was provided.

⁶⁹ China. Central People's Government of China. (2005). Law on foreign capital. Retrieved from http://www.gov.cn/banshi/2005-08/31/content_69774.htm

Article 2 stipulates that "enterprises with foreign capital refer to those enterprises established in China by foreign investors, exclusively with their own capital, in accordance with relevant Chinese laws. The term does not include branches set up in China by foreign enterprises and other foreign economic organizations."

⁷⁰ China. Central People's Government of China. (2005). Law on Chinese-Foreign joint equity ventures. Retrieved from http://www.gov.cn/banshi/2005-08/31/content_69775.htm

Article 4 stipulates that "a joint venture shall take the form of a limited liability company. The parties to the venture shall share the profits, risks and losses in proportion to their respective contributions to the registered capital."

⁷¹ China. Industry and Business of Huizhou. (n.d.). *Sheme shi Waishang touzi qiye, Zhongwai hezi qiye, zhongwai hezuo jingying qiyehe waiguoqiye? Tamen gongtong de jiben tezheng he zhuyao qubie shi shenme?* [What are entirely foreign-owned enterprises, Sino-foreign equity-joint ventures, Sino-foreign contractual joint ventures, and foreign enterprise? What are their basic characteristics and differences?] Retrieved from <http://hzgs.gov.cn/fgzx/fgwd/jy022.htm>

The difference between Joint Equity Venture and Joint Contractual Venture lies in their modes of investment, distribution, liquidation, cooperation and risk. In a Joint Equity Venture, both Chinese and foreign investors use the same currency to calculate the amounts of investment. Distribution of profits, responsibility of risks and liquidation are based on their proportions of investments. Within the operation period, using depreciation cost to repay the capital and interest is not allowed. In a joint contractual venture, proportion of investment is not calculated and responsibility of risk and liquidation are not allocated proportionally. Modes of distribution, responsibility, risk, and liquidation are negotiated by the Chinese and foreign investors within the realm of legal prescriptions.

⁷² For example, the Law on Foreign-Capital Enterprise stipulates that "Enterprises with foreign capital shall be established in such a manner as to help the development of China's national economy, and provisions shall be made by the State Council regarding the lines of business which the state forbids enterprises with foreign capital to engage in or on which it places certain restrictions." (Article 3), and "enterprises with foreign capital must abide by Chinese laws and regulations and must not engage in any activities detrimental to China's public interest."

The more precise categories of FDI restrictions are listed in the three administrative regulations formulated by the State Council in early 1990s with a view to facilitating the implementation of the “three fundamental FDI laws”.⁷³ According to these three regulations, foreign funded projects will not be granted approval if they “impair China’s sovereignty and public interests; endanger national security; cause environmental pollution, or run against laws, decrees, or national industrial policies.”⁷⁴

Moving one step forward, the State Council approved “Provisional Regulations on Direction Guide to Foreign Investment” in 1995 and formally made it in 2002 as the Direction Guide (*zhidao waishang touzi fangxiang zanxing guiding*)⁷⁵. This Regulation aimed to “give a guide to foreign investors in placing their investments in China to adapt to China’s national economic and social development planning and to better protect the investors’ rights.”⁷⁶ The Direction Guide specified FDI treatment in China by dividing foreign-funded projects in China into four categories: allowed, encouraged, restricted, and forbidden.⁷⁷ Furthermore, it established the system of Guiding Catalogue of Industries for Foreign Investment (the Guiding Catalogue, *waishang touzhi chanye zhidao mulu*) as the basic guidance for the examination and

(Article 4). Article 3 of Law on Chinese-Foreign Contractual Joint Ventures also stipulates that “A contractual joint venture must abide Chinese laws and regulations and must not injure the public interest of China”

⁷³ The three regulations are: Regulations for the Implementation of the Law on Joint Ventures Using Chinese and Foreign Investment (*zhongwai hezi jingying qiyefa shishi tiaoli*) in 1983; Regulations for the Implementation of the Law on Foreign-funded Enterprises (*waizi qiyefa shishi tiaoli*) in 1990; and Detailed Rules for the Implementation of the Law on Sino-Foreign Contractual Joint Ventures (*zhongwai hezuo jingyingfa shishixize*) in 1995

⁷⁴ Please see Article 5 of Regulations for the Implementation of the Law on Joint Ventures using Chinese and Foreign Investment (1983 version), Article 9 of Detailed Rules for the implementation of the Law on Sino-Foreign Contractual Joint Ventures, and Article 5 of Rules for the Implementation of the Law on Foreign-Capital Enterprises.

⁷⁵ It expired in 2002 when Regulations on Direction Guide of Foreign Investment (2002 Direction Guide, *Zhidao waishang touzi fangxiang guiding*) were promulgated.

⁷⁶ Article 1 of the 2002 Direction Guide

⁷⁷ Article 4 of the 2002 Direction Guide

approval of foreign-funded projects, which listed the industry sectors in which FDI are encouraged, restricted, and forbidden⁷⁸. Since its establishment in 1995, the Guiding Catalogue has been continuously revised seven times (in 1997, 1999, 2002, 2004, 2007, 2011, and 2015 respectively). In each time, new items could be added and old ones could be either removed or moved to other categories.

The Guiding Catalogue also has the authority to impose the form of FDI participation in a particular industry if necessary. One form is limited to joint or contractual venture (*hezi* or *hezuo*), which prohibits full foreign ownership. The second form is *zhongfang konggu*, with the Chinese parties controlling 51% or more of shares. The third type, *zhongfang xiangdui konggu*, refers to the cases in which various Chinese parties relatively controlling the shares of the percentages of the Chinese parties' investments in a foreign investment project shall be higher than the percentage of any one foreign party.

Phase Two: From FDI review to M&A review

The above mentioned laws, legislations, and administrative regulations deal with all three types of foreign funded projects indiscriminately. Since its accession to the World Trade Organization (WTO), China's FDI restriction policies tend to emphasize M&A transactions.

The Interim Provisions for Mergers and Acquisitions of Domestic Enterprises (2003 M&A Provisions, *waiguo touzizhe binggou jingnei qiye zanxing guiding*)⁷⁹ in

⁷⁸ The FDI falling out of the three categories belong to the ones allowed

⁷⁹ The 2003 Provisional Regulations were substituted by Regulations on Mergers and Acquisitions of Domestic enterprises (2006 M&A Rules, *guanyu waiguo touzizhe binggou jingnei qiye de guiding*), which were amended in

2003 stipulated that foreign investors who will gain the actual control through the M&A activities should report to the MOFCOM if such transactions relate to critical industries, have or may have influence on national economic security, or cause the transfer to actual right of the domestic enterprise owing famous trademark or having a long history.⁸⁰

Subsequently, the Anti-Monopoly Law (*fan longduan fa*) revealed China's intention to set up a national security review system of foreign M&A deals.⁸¹ Promulgated in 2007, it stipulated that where a foreign investor participates in the concentration of business operators by merging or acquiring a domestic enterprise or by any other means and the national security is involved, besides the examination on the concentration of business operators according to this Law, the examination on the national security shall also be conducted according to the relevant provisions of the State.⁸² However, no further information is offered regarding the procedure, actors, and content of the national security review. In 2010, the establishment of a National Security Review System was put onto the government's agenda in State Council's "Several Opinions on Further Utilizing Foreign Capital" (2010 Opinions), which requires relevant ministries to "speed up its establishment of an M&A Security Review System as soon as possible".⁸³

The genuine establishment of China's National Security Review Mechanism was

2009.

⁸⁰ Article 12 of the 2006 and 2009 Regulations

⁸¹ Article 31 of the Anti-Monopoly Law

⁸² Ibid.

⁸³ China. State Council. (2010). *Guowuyuan Guanyu Jinyibu Zuohao Liyong Waizi Gongzuo de Ruogan yijian*. [Several Opinions of the State council on Further Improving the Utilization of Foreign Investment]. Retrieved from http://www.gov.cn/zwqk/2010-04/13/content_1579732.htm

adopted one year later. Announced by the State Council, the Notice on the Establishment of the Security Review System for Foreign Mergers and Acquisitions of Domestic Enterprises (the 2011 Notice, *guanyu jianli waiguo touzizhe binggou jingnei qiye anquan jiancha zhidu de tongzhi*) in Feb. 2011 and the subsequent Provisions of the MOFCOM on the Implementation of the Security Review System for M&A of Domestic Enterprises by Foreign Investors (the 2011 MOFCOM Provisions, *shangwubu shishi waiguo touzizhe binggou jingneiqiye anquan shencha zhidu de guiding*) were regarded as the two guiding documents on the National Security Review System.

FDI Restriction as Part of National Industrial Policy

As mentioned before 1995 and 2002 Direction Guide established the types of FDI which China encourage, restrict, and prohibit. As Table 2 shows, from 1995 to 2002, China's attitude towards inward FDI did not change substantially. Investments with high technology, energy-saving, agricultural and sustainable resource development are encouraged by the Chinese government. Moreover, China also tries to use FDI to boost economic development in underdeveloped regions by providing favorable conditions for inward FDI in central and western provinces. After China's accession to the WTO in 2001, the 2002 Regulations revised the restricted category by highlighting its unwillingness to accept FDI involving environmental degradation, obsoleting technologies, and mineral resources exploitation. Furthermore, it reveals China's cautiousness in opening-up some industrial sectors for foreign capital, for

instance industries monopolized by the state.

Table 2: Inward FDI Encouraged, Restricted, and Prohibited by China

		1995 Regulations	2002 Regulations
Encouraged	Unchanged	<p>New agricultural technologies aiding comprehensive agriculture development; energy, transportation and other industrial materials</p> <p>High-tech Projects Saving energy and raw material, raise economic efficiency, or produce new equipment and materials that are demanded by home market but cannot be sufficiently produced at home</p> <p>New technologies using renewable resources or preventing environment pollutions</p> <p>In line with China's industrial policies, and capable to bring into advantages of human power and resources in Central and western China</p> <p>Other situations as provided by laws and administrative regulations</p>	
	Reformulated	<p><u>Meeting international market's need</u>; improving product quality; developing new markets, and <u>boosting exportation</u></p>	<p>Projects meet market need and increase products' international competitiveness</p>
Restricted	Unchanged	<p>Other situations as provided by laws and administrative regulations</p>	
	Reformulated	Technologies already imported or developed domestically; productivity satisfy domestic needs	Technological obsoleting
		prospecting and exploration of rare and valuable mineral resources	Exploitation of specific types of mineral resources to which the State applies protective exploitation
		Industries under overall planning of the state	Industries that the State opens up step by step
		Industries in which the State sets FDI attraction, monopolized industry	
Prohibited	Added		Adverse to resource saving and environment improvement
	Unchanged	<p>Over occupying arable land, harming land resource protection; harming the safety and usage of military</p>	

		facilities ⁸⁴
		Using China's particular method of production Other situations as provided by laws and administrative regulations

Source: Article (5)(6)(7) of Provisional Regulations on Direction Guide to foreign Investment (1995), Article (5)(6)(7) of Provisions on Guiding the Orientation of foreign Investment (2002), compiled by the author, retrieved from <http://www.mofcom.gov.cn/aarticle/b/f/200207/20020700031063.html>
http://www.mofcom.gov.cn/article/zt_swfg/subjectby/200612/20061204133533.shtml

Despite the key areas outlined in the 1995 and 2002 Direction Guides, in the practical level these general and abstract principals are very difficult to judge. In addition, neither of the regulations provided a clear explanation of the realm of “critical industries”, or “social and public interests”. More detailed industry-specific information could be found in the Guiding Catalogue issued by NDRC and MOFCOM.

With over thirty categories and hundreds sub-categories listed, thorough research on specific industries is out of the scope of this research since it requires detailed industry-specific knowledge. Moreover, since such information is revised, reformulated, and regrouped every time, it is meaningless to simply look at the increase and decrease of numbers of categories or sub-categories. Therefore, in the following paragraphs, I will look at the exact changes in the content of the Catalogue from 1995 to 2015. In other words, I attempt to analyze which items are added/re-added on the prohibition list, and which items are removed compared with the previous years.

As Table 3 shows, The Guiding Catalogue provides a more industry specific

⁸⁴ The provision was put individually in Article 7(4) of the 2002 Regulations

perspective regarding FDI treatment. It does not prohibit investment for stated reasons, or define national security, although some industries clearly fall into that category, including weapons and ammunition manufacturing, mining and processing of radioactive materials and rare earth metals, and construction and operation of power networks. Some sectors are prohibited based on a broader definition of national security, including film, television, book publishing, and other media production. Other prohibited sectors appear completely unrelated to national security, including processing special Chinese teas, preparation of traditional Chinese medicines, and production of enamel products and rice paper.

Table 3: Types of Foreign Investments prohibited by China

Category	Year	Items added
Information Dissemination	2002	News Agencies Publication, Issue and import of books, newspapers and periodicals Publication, production, issue and import of audio-video electronic products Compulsory education Institutions ⁸⁵
	2004	Social Survey
	2007	Movie production companies and theater companies Provision of news websites, online audio and video programs, operation of business premises for Internet-access services, and operation of Internet cultural business ⁸⁶
	2011	Domestic express delivery business of mails
	2015	Internet Publishing service Chinese legal affairs consultation (excluding information on China's legal environment)
Economic and	1997	Processing traditional Chinese medicine ⁸⁷
	2002	Fishing in the sea area and inland waters under China's jurisdiction

⁸⁵ The 2007 Catalogue enlarged its scope to include educational institutions in special fields such as military, police, political, and Chinese Communist Party school

⁸⁶ Music is excluded in the 2011 Catalogue

⁸⁷ Including: 1. processing of traditional Chinese medicinal materials listed in the Regulations for Protection of Wild Medicinal Resources and the Catalogue of China's Rare, Precious and Endangered Plants under Protection 2. Application of such processing techniques as steaming, stir-frying, moxibustion, and calcination for making small pieces of ready-for-use traditional Chinese medicines; and production of traditional Chinese patent medicine of secret prescriptions

industrial policy		Exploration, mining and selection of rare earth elements
	2007	Certain types of thermal generators ⁸⁸ Certain types of batteries ⁸⁹ transgenic breeding livestock and poultry, and aquatic fingerlings Development and application of human stem cell and genetic diagnosis and treatment technology Exploration and mining of tungsten, molybdenum, tin, stibonium and fluorite
		Production and development of seeds of transgenic plants Construction and operation of golf courses
	2011	Construction and operation of villas
	2015	Wholesale and retailing of cigarettes and other tobacco-related products Cultural Relics Auction enterprises and Antique Shops
Military Related	2007	Geodetic surveying, marine charting, aerial photography for surveying and mapping purposes, administrative boundary surveying and mapping, topographic map compilations and general map compilations, and compilations of electronic maps for navigation purposes
	2015	Cartographic compilation of administrative, school, and three-dimensional maps. Surveys of geological mapping, geophysics, geochemistry, hydrogeology, environmental geology, geological hazards, and remote sensing geology Production of nuclear fuels

Source: The Catalogue of Industries for Guiding Foreign Investment in 1995, 1997, 2002, 2004, 2007, 2011 and 2015. Compiled by the author

As Table 3 shows, from 1995 to 1997, sectors restricted almost remained unchanged. However, the list of FDI prohibition keeps enlarging since 2002, one year after China's accession to the WTO.

Like other countries, China blocks FDI which might have direct or indirect implications on national defense sector. Examples in the prohibition list include nuclear fuels, cartographic compilation of maps, and geodetic surveying.⁹⁰ They later

⁸⁸ Construction and operation of, outside small grids, power plants using coal-fired and steam condensation thermal generator sets with a single generator capacity of 300,000 kilowatts or less, and thermoelectric power stations using coal-fired, steam condensation and extraction thermal generator sets with a single generator capacity of 100,000 kilowatts or less

⁸⁹ Manufacture of open (i.e., acid mist directly coming out) lead-acid batteries, mercury-contained silver oxide button batteries, mercury-contained alkaline zinc-manganese button batteries, pasted zinc-manganese batteries and nickel-cadmium batteries

⁹⁰ China. National Administration of Surveying, Mapping and Geo-information. (2011). Guojia Cehui Dili Xinxiju

two items echoed China's Surveying and Mapping Law, According to which:

“Foreign organizations or individuals that wish to conduct surveying and mapping in the territorial air, land or waters, as well as other sea areas in China shall be subject to approval by the administrative department for surveying and mapping under the State Council and the competent department for surveying and mapping of the army, and they shall observe the provisions of relevant laws and administrative rules and regulations. In addition, as required by law, foreign investors should join hands with the relevant departments or units of China in the form of Chinese-foreign equity joint venture or Chinese-foreign contractual joint venture and such surveying and mapping may not involve State secrets or endanger State security.”⁹¹

China also uses the prohibition of FDI as a way to adjust its domestic economic interests and industrial policies. For example, China's opposition to technological-obsolete industries such as small electricity-grid and environmental-unfriendly batteries, and exploitation of precious natural resources and aquatic products were in line with its policies on phasing-out FDI in industries with high energy consumption, high environmental pollution, and resource-industries (*liangao yizi*). The prohibition of the construction of villas and golf course⁹² is consistent in consideration of Beijing's efforts to reduce land occupation of peasants' collective land and rights abuses.⁹³ In addition, China prohibits FDI in sectors where its national enterprises having an absolute recipe advantage, such as traditional Chinese medicine.

Another field in which China continuously prohibits foreign investment concerns

Youguan Fuzeren jiu “Waiguo de Zuzhi huo Genren Laihua Cehui Guanli Zanxingbanfa” Dajizhewen. [Q&A session on interim measures for the administration of the surveying and mapping conducted by foreign organizations]. Retrieved from <http://www.sbsm.gov.cn/article/zcfg/zcfgjd/201106/20110600083543.shtml>

⁹¹ China. National Administration of Surveying, Mapping, and Geoinformation. (2002). Surveying and Mapping Law. Retrieved from <http://www.sbsm.gov.cn/article/zcfg/flfg/200709/20070900000463.shtml> Article 7

⁹² China. General Office of the State Council. (2004). Guowuyuan Bangongting Guanyu Zanting Xinjian Gao'erfuqiuchang de Tongzhi. [Provisional notification of the General Office of the State Council on cancellation of new golf course projects]. Retrieved from http://www.gov.cn/gongbao/content/2004/content_63138.htm

⁹³ N.A. (2007, December 19). Waishang Touzi Qiuchang Jinling “Qvxian” Huajie. [A Curve Solution to the Ban on Foreign Investment in Golf courses]. *Golf Review*. Retrieved from <http://sports.sina.com.cn/golf/2007-12-19/10083369033.shtml>

information dissemination. From 1995 to 2015, foreign capitals are not allowed to tap into media organizations. This does not only apply to paper media such as publications of books, newspapers, periodicals, and radio stations, but also includes TV stations and rebroadcasting stations, channels concerning the production and transmission of TV and radio programs, audio and video products, and electronic products. Since 2007, internet based publication and distribution services are also prohibited. More perplexing is education, which neither impacts on defense-related implications nor economic impacts, are also prohibited.

In the meantime, China also removed prohibitions on a number of sectors as a response to its WTO commitment. Table 4 indicates that before its accession to the WTO in 2001, China did not open any prohibited sector for foreign investment. Since the early 21st century, China made a consistent progress in opening up its manufacturing, finance, media and infrastructure sectors for foreign investment. However, such openness is not conducted in a straightforward manner. Rather, most of them were conducted progressively by first being put into the restricted category which requires control of Chinese parties (*zhongfang konggu*). Significant progress could be observed in 2015, when some items are directly removed from the prohibition list and became allowed ones. More importantly, the 2015 Catalogue stated that industry-specific policies will not be issued in terms of FDI approval, which will be substituted by clauses in Investment Treaties. This change indicated that China intends to loosen its protection on of uncompetitive industries and open them up for foreign competition.

Table 4: Types of Foreign Investments Removed from the China's Prohibited List

Sector	Year	Previous prohibited sectors	Remark
Finance	2004	Financial derivatives	Opened up gradually
	2007	Financial Insurance	
		Futures Company	Chinese Parties as controlling share holder
Infrastructure	2002	Construction and management of urban water supply and drainage, gas and heat pipeline	Chinese Parties as controlling share holder
		Management of telecommunication	Opened up gradually
		Production of electricity, gas, and water	Chinese Parties as controlling share holder
Media	2004	Production and Issue of broadcasting and TV programs; Film Production	Chinese Parties as controlling share holder
	2011	Importation of audiovisual products	Restricted to cooperation
	2015	Cinema Line Corporation	Chinese Parties as controlling share holder
		Video-showing Company	
Manufacturing And Biology	2015	Bodiless lacquer	
		Enamel work	
		Products causing macrocephaly , cancer and mutation	
		Persistent Organic pollutant	
		R&D of GMO	
Others	2015	Lead-Acid batteries etc.	
		Sectors regulated by industrial policies or State council's special provisions	Industrial policies regarding FDI entry will no long be published

Source: The Catalogue of Industries for Guiding Foreign Investment in 1995, 1997, 2002, 2004, 2007, 2011 and 2015. Compiled by the author

In summary, China adopts a two-layer FDI restriction system. The first concerns the limited and prohibited areas established in the Catalogue system. The second refers to the anti-monopoly and national security mechanism. In addition to the

protection of national defense related sectors from FDI, China also uses the prohibition of FDI as a way to adjust its domestic economic interests and industrial policies. However, some other sectors closed for foreign investments seem to be tenuously linked to national security.

Operation of China's FDI Review System

In China, the Security Review is conducted by a Joint-Ministerial Review committee (hereafter the "Security Review Committee"), with NDRC and MOFCOM as two principal actors and the participation of other relevant organs. The security review is triggered by MOFCOM, who receives foreign investors' application and calls the Security Review Committee within 5 working days. Organs in the State council, industrial-specific associations, other companies in the industry, and domestic enterprises could also ask the MOFCOM to initiate the security review. The Security Review Committee has 5 days to consult these stakeholders (*liyi xiangguanfang*) and these relevant units have 20 working days for feedback. With the feedback, the Security Committee shall make a decision in 5 days, if a consensus has been reached by all the relevant units, special review is canceled. If relevant units think the M&A propositions have an implication on national security, the Security Review Committee shall initiate the review process with 5 days. The Security review Committee will organize a security evaluation and conduct review based on the evaluation. If a consensus could be reached, the Security Review Committee will issue an opinion. If a huge controversy exists, the Security Review Committee will report to the State

Council for the final decision, which will take up to 60 days. The applicant may withdraw or modify its application anytime. Moreover, a transaction that has already cleared without being subject to national security review can be investigated and unwinding or divestiture can be required in some circumstances.

Concluding Remarks

In brief, Since China's FDI policies were initially only created for greenfield projects, they might not completely reflect China's interests in M&A activities. For instance, China encouraged FDI in high-technology and equipment manufacturing, however, these sectors are the ones which concern national security. How to reconcile the economic interests with security ones is problematic in such an approach. Only since the 21st century, with increasing number of M&A transactions in China has the Chinese government started to pay attention to the security-related issues and built up a review system for such transactions. China is more proactive to use FDI restrictions to achieve its short- and mid- term economic goals. It adopts a rather flexible way to restrict FDI through a catalogue system which could be frequently changed. What to be added and deleted in the catalogue is an executive decision up to the States Council. Therefore, it is a reflection of Chinese administration's efforts in economic management. The security review system of M&A activities acts as the second layer of China's FDI restriction policies, which adds the political dimension of investigation which is not clearly articulated before.

Therefore MOFCOM is the most powerful organ in China's FDI restriction

policies. Its role is significant in three ways: Firstly, though it might be influenced by superior or other ministerial organs, MOFCOM has the capacity and responsibility to update the Catalogue system. Thus MOFCOM has a say in what types of FDI will be restricted. Secondly, as the Coca Cola-Huiyuan Case indicates, MOFCOM is also the chief executor of China's Anti-monopoly investigations, which covers the economic aspect of an inward FDI. Lastly, MOFCOM is also a leading and coordinating player in China's inter-ministerial FDI Security Review System, which covers the political and security aspect of an inward FDI. MOFCOM's mandate largely surpasses the of CFIUS in the United States.

Chapter 6: Discussion

Chapters above indicate that in this highly economically integrated world, national governments still have great latitude to decide discretionally which sectors could be considered “critical”. Thus, foreign investors could face barriers erected by host governments. Such barriers usually take two forms: economic restrictions and political restrictions. In addition, a vague definition of “critical industry” makes it possible for lobby groups and other stakeholders to wage their influence to push the security review of the foreign transactions. To what extent does China’s treatment of inward FDI in its “critical industries” differ from the United States? What factors cause such differences? This section aims to answer these questions.

Emphasis of Critical Industry

Focusing the broader economic and security consequence of proposed foreign investments in the long term, the scope of “critical industry” tends to be very broad and implicit, which is very difficult to be evaluated.

In China and the United States, FDI in some strategic and infrastructure industries such as defense, telecommunication, agriculture, energy, nuclear, hi-technology are likely to meet opposition. However, in China, key industries tend to be those under state-ownership. In the United States, though the authority is alert to” investments potentially have a debilitating impact on security, national security, national public health or safety or combination of those factors”⁹⁴, a crucial factor lies in the

⁹⁴ The Organization for Economic Cooperation and Development (OECD). (2008). *Protection of Critical*

corporate identity of the foreign investor, in particular enterprise' relationship with the home government raises the concern.

In China, Both of the Carlye-Xugong and Mittal-Laiwu Case caused a heated debate on selling state-owned assets at a low price and engendering national security.⁹⁵ The primary reason for opposition is that Xugong's business falls into the category of the 18 industries listed by the NDRC as key industrial sectors in China. As it provides a technological and research and development (R&D) platform for China's national construction industry, once it is controlled by foreign investors, its spare parts and technological development capacity will be lost to foreign enterprises. Such action could have a serious negative implication for China's entire construction industries. (Zhao, & Li, 2006)

Corporate identity of foreign investors is the most salient factor in the FDI review in the United States. Almost all the cases mentioned in the chapters above indicate that the American authority finds the enterprise-home government relationship troublesome and worries that foreign State-Owned Enterprises (SOEs) might not have the political loyalty as the domestic ones have. In particular, since the 21st century, proposed FDI by SOEs from the Global South increasingly became the target of the American FDI security review. SOEs, as well as privately-owned enterprises from China are deemed to be a potential threat to national security in critical industries.

Infrastructure and the Role of Investment Policies Relating to National Security, Retrieved from <http://www.oecd.org/investment/investment-policy/40700392.pdf>

⁹⁵ N.A. (2006, June 13). Sanyi Jituan Jiaoju, Siyi Meiyuan Jiaomai Xugong. [Sanyi offered 400 million bid for Xugong]. *Beijing News*. Retrieved from http://www.cnstock.com/rdzt/syxx/2006-06/13/content_1267045.htm

Comparison of the Security Review System in China and the United States

Chinese national security review model shares its American counterpart's vagueness and ambiguity in the definition of national security and critical industry. In terms of the procedure, as Chapter 4 and 5 have shown, the Chinese one largely resembles the American one. The difference lies in who could initiate the review, the definition of control, and transaction covered.

The first difference lies in who could initiate the security review. In the American model, usually the parties involved in the transaction shall submit voluntary notifications to the CFIUS; or, CFIUS may also initiate security review even if the transaction is completed. In other words, both the transaction parties and CFIUS could initiate the Security Review.

The Chinese model has both of the components, but in addition, other "stakeholders" could also refer a proposed deal to MOFCOM and to initiate security review. These actors include government agencies, industrial associations, other companies in the relevant industries, competitors, and upstream or downstream companies. In the 2011 Notification, there is no mentioning about under which circumstances or in which criteria those interested parties could request the MOFCOM to initiate the security review. In this regard, the American security review system is purely government decision, while the Chinese one incorporates business interest of particular industries in the security review system. To be more precise, one potential risk here is that the national security review mechanism might be used and manipulated by China's vested interests. In this case, purely economic issues are

politicized and escalated into strategic and political issues, and in this way vested interests could resist legitimate foreign competition and save their own economic interests in the domestic markets.

Transactions Covered

M&A Activities eligible under national security review in the U.S. are similar compared with the ones in China. The scope of investor and domestic enterprise are used identically. In both countries, domestic enterprises include both foreign invested enterprises and non-foreign invested enterprises, and financial-related transactions are left-out. However, the difference lies in the benchmark of Foreign Direct Investment.

In the United States, a covered foreign investment transaction is defined as any merger, acquisition, or takeover which results in foreign control of any person engaged in interstate commerce in the United States.⁹⁶ In this regard, a target company does not have to be an American company, and all required is that it conducts business in the United States.

In China, compared with the 2006 M&A Regulations which define a target company as “a domestic enterprise without foreign investment”⁹⁷, the 2011 Notification enlarged its scope by putting both foreign invested enterprise and non-foreign invested enterprise within the scope of the national security review system. In addition, investors located in Hong Kong, Macau and Taiwan are also considered as foreign investors.

⁹⁶ The United States. National Archives. (1975). Executive Order 11858 on Foreign Investment in the United States. Retrieved from <http://www.archives.gov/federal-register/codification/executive-order/11858.html>

⁹⁷ Article 2 of the 2006 M&A Regulations

Purely financial products related M&A transactions fall out of the scope of national security review in both countries. In the United States, M&A transactions which are “solely for the purpose of investment” are not subject to national security review. Such transactions are normally processed directly by banks, trust companies, insurance companies, investment companies, pension funds, mutual funds, finance companies, and Broker Companies.⁹⁸ Identically, the 2011 Notification in China states that M&A transactions of domestic financial institutions will be treated separately.⁹⁹

The difference between China and the United States lies in the numerical benchmark in terms of the definition of FDI. The United States defines FDI as the ownership of control, direct or indirect, by a foreign person of 10% or more of the voting securities of an incorporated U.S. enterprise or an equivalent interest in an unincorporated business enterprise.¹⁰⁰ In China, foreign invested enterprises refer to the enterprises with at least 25% of its equities held by foreign investors.¹⁰¹

Control

American Regulation does not have a numerical bar to decide foreign control. Rather, it focuses on the influence that the ownership allows a foreign investor to affect the decision-making in the acquired firm. As the Regulations of the Treasury

⁹⁸ The United States. Government Publishing Office. (2010). *31 CFR 800.302- Transactions that are not covered transactions*. Retrieved from

<http://www.gpo.gov/fdsys/granule/CFR-2010-title31-vol3/CFR-2010-title31-vol3-sec800-302>

⁹⁹ 5(4) of the 2011 Notification

¹⁰⁰ The United States. Government Publishing Office. (2009). *15 CFR 806.15- Foreign direct investment in the United States*. Retrieved from

<http://www.gpo.gov/fdsys/granule/CFR-2009-title15-vol3/CFR-2009-title15-vol3-sec806-15>

¹⁰¹ Law of People's Republic of China on Foreign Capital Enterprises

Department stipulates:

Control means the power, direct or indirect, whether or not exercised, and whether or not exercised or exercisable through the ownership of a majority or a dominant minority of the total outstanding voting securities of an issuer, or by proxy voting, contractual arrangements or other means, to determine, direct or decide matters affecting an entity; in particular, but without limitation, to determine, direct, take, reach or cause decisions.¹⁰²

Instead, China's definition of control combines a numeric threshold and functional definition. In the 2011 Notification, control means foreign investor(s) obtaining 50% or more of the share capital of a Chinese enterprise.¹⁰³ Moreover, holding voting rights sufficient to exercise a major influence on corporate decisions, even though less than 50%, is also considered as a way to gain actual control of an enterprise.¹⁰⁴ The last type of actual control is ambiguous defined, which refers to taking actual control over decision-making, finance, human resource or technology of domestic enterprise through any other means.¹⁰⁵ The 2011 Notification does not provide any guidance as to the circumstances in which voting or other rights accompanying minority shareholdings will be regarded as giving the minority shareholder control over the invested enterprise.

¹⁰² Nine types of decisions are concerned: 1) the sale, lease, mortgage, pledge or other transfer of any or all of the principal assets of the entity, whether or not in the ordinary course of business; (2) The organization, merger, or dissolution of the entity; (3) The closing, relocation, or substantial alternation of the production operational, or research and development facilities of the entity; (4) Major expenditures or investments, insurances of equity or debt, or dividend payments by this entity, or approval of the operating budget of the entity; (5) The selection of new business lines or ventures that the entity will pursue; (6) The entry into termination or non-fulfillment by the entity of significant contracts; (7) The policies or procedures of the entity governing the treatment of non-public technical, financial, or other proprietary information of entity; (8) The appointment or dismissal of officers or senior managers; (9) The appointment or dismissal of employees with access to sensitive technology or classified U.S. Government information, or, (10) The amendment of the Articles of Incorporation, constituent agreement, or other organizational documents of the entity with respect to the matters described at paragraph (a) (1) through (9) of this section.

¹⁰³ The 2011 Notification

¹⁰⁴ Ibid.

¹⁰⁵ Ibid.

General Path of FDI Restriction

The establishment and further upgrading of the security review system in China and the United States are both due to the increasing inward foreign investments. However, the rationale, realm, and execution mechanism of FDI restriction policies behind such institutional changes is not identical in both countries.

China's FDI restriction policies started by focusing on greenfield projects, Only since its accession to the WTO when it started to promulgate legislations governing review of M&A attempts separately. While the American one is opposite: security review system is primarily designed for M&A deals and greenfield projects were governed by other federal statutes. This is largely due to the fact that FDI in China mainly takes the form of Greenfield projects. According to MOFCOM's statistics, in 2010, China absorbed \$105.74 billion Foreign Direct investment, while only 3% concerns M&A activities.¹⁰⁶ In the contrary, the majority of FDI in the world takes the form of M&A activities: in 2010, global FDI aggregate reaches \$1.12 trillion, in which over 70% concern M&A activities. (UNCTAD, 2011)

Who Could Restrict Inward FDI?

The action of FDI restriction is not a straightforward "sanction" in which the government simply decides and rules. In both countries, cases demonstrate that a review of a proposed transaction could be triggered by economic actors with commercial concerns or populist public opinions. In this way, economic interest are

¹⁰⁶ Hong, J. (2011, February 18). M&A Will Be the Trend for China to Attract FDI. [Binggou Jiang Chengwei Zhongguo Xiyin Waizi Fazhan Qvshi]. *Jiefang Daily*. Retrieved from http://newspaper.jfdaily.com/jfrb/html/2011-02/18/content_513966.htm

interwoven with political and security considerations. However, restriction could be based on economic and security grounds. The organs in charge of such investigations differ between China and the United States.

In the United States, CFIUS reviews the national-security dimension of the proposed transaction. In addition, the Congress could also step in even when a decision is made by CFIUS. In other words, the FDI review system in the United States could be influenced by both the administration and the legislative body. The competition aspect of the inward FDI is governed by another set of institutions.

While in China, MOFCOM is in charge of the execution of FDI restriction policies regarding both economic and national security aspect. In the Coca Cola-Huiyuan Case, MOFCOM's justification confirmed that the decision is made on the consideration of impact on "national economic development" and "industrial security" of other Chinese companies. During the review period, stakeholders were consulted and concerns were raised about the acquisition of a well-known domestic brand by a foreign competitor, which suggest that its decision was influenced beyond the competitive nature of this transaction.¹⁰⁷ As the MOFCOM's justification states, the core of the denial of Coca cola's proposition is that it might cause "a high concentration of market in high concentration juice". It is widely known that unlike water which is essential for human being's life, beverage is highly substitutable. Other alternatives such as yogurt, mineral water, tea, carbohydrate could replace highly

¹⁰⁷ Paragraph Three of the 2011 Notification states that "MOFCOM had contacted thorough analyses and research, consulted the opinions of relevant governmental organizations, industrial associations, juice companies, upstream concentrated juice providers, downstream retailer, and experts in law, economy and agriculture through written work, seminar, conference, field research and appointment."

concentrated juice. Undeniably, the fundamental objective of anti-monopoly is to protect fair competition and to enhance industrial development and protect the consumers' interests. In this case, it is even more controversial to equate a potential monopoly issue with industrial security.

Political System Matters

The difference between the creation and development of the American security review system and its Chinese counterpart could also be explained by their political systems.

To be more precise, In the United States, the creation of the CFIUS is a result of the power play between the executive and the legislative branch. Moreover, rising protectionist public opinion also translated into the Congress's activism in facilitating the establishment of the national security review system. However, neither of these factors is found in China.

In the United States, public opinion fanned by alarmist media broadcast on inward FDI, which drove elected politicians in the Congress to voice their concerns and pressure the White House for policy changes.¹⁰⁸ Driven by the voters' demand, legislative activism (Kang, 1997) facilitated the creation of the CFIUS. According to the American Constitution, the federal government is a government of limited powers, and the power to regulate interstate and foreign commerce falls into one of its power

¹⁰⁸ Such stories could be found in newspaper headlines, popular magazine covers or movie themes. For instance, "A Big Foreign Stake in U.S. Industry," *Fortune*, August 1971, 118; "From Oil to Baseball to Beer, Foreign Firms Invade U.S.," *U.S. News and World Report*, 26 June 1972, 60-63; "The Foreign Invasion," *Time*, 2 April 1973; "Will the Arabs Use the Money Sword?" *Forbes*, 15 December 1973, 31; "The Invasion of Petrodollar," *Saturday Review*, 25 January 1975, 10-13; and "New Invasions by Oil Money: "Take-over" Fears Rise Again" *U.S. News and World Report*, 3 March 1975, 21-23

bases (Seitzinger, 2013). Facing a wave of investment from Middle East and OPEC countries, it was the Congress members from localities where bulk of new investments flood to, rather than concerned interest groups or guardians of national security who strongly lobbied to revise the FDI policy (Miller, 1997). Therefore, the creation of the CFIUS was a compromise between the President and the active Congress in terms of foreign investment regulation. On the one hand, as a new executive and bureaucratic organ provides a potential entry point for the Congress' voice in inward FDI policies; on the other hand, the President still keeps its jurisdiction over such policy areas.

In China's Party State, there is no check and balance between legislative, judicial, and executive powers. Though the laws governing foreign investment were promulgated by the National People's Congress, China's rubber stamp in 1979, it was the 3rd Plenary of the 11th National Congress of the CCP which adopted the opening up and reform policy. Moreover, since the very beginning, FDI restriction and oppositions were established and monitored by MOFCOM under the State Council. Therefore, the policy equilibrium between the legislative and the executive in the United States are not found in China. In China, types of FDI restriction or opposition are solely an executive decision made within the State Council. Thus China's administrative branch could feel relatively free to decide what types of FDI are allowed, encouraged, limited, and prohibited. In this way, China's FDI restriction as showed by the Catalogue System covers a much broader and detailed realm than the American one. The prohibition and limitation lists could reflect China's overall

industrial policy change and transformation by incorporating or removing very specific and technical items through a mobile Catalogue system which is revised every several years. In this regard, China's restriction of FDI is more practical. While the industrial sectors in which the United States have constraints on ownership are relatively stable, and specific requirements are given in federal rather than administrative regulations.

Another potential difference caused by the political system is political use of FDI restriction to protect ruling elites' own legitimacy and security. As the study of the Catalogue content indicates, China is increasingly willing to ban foreign capital regarding information dissemination. In the United States, foreigners are prohibited from controlling interest in a radio station, while foreign investments in newspapers and magazines are not. (Hasnat, 2015) In the contrary, China's prohibition not only includes traditional media, a new trend since 2007 is that internet-related products and services are also included.

Chapter 7: Conclusion

A Redefinition of Critical Industry

What are considered critical industries? As Chart 1 indicates, critical industry has four dimensions: defense security, industrial security, infrastructure security, and regime security. The policy agenda of economic security could cover all the industrial security related aspects, including critical infrastructure and other defense-related sectors. The scope of national security depends on whether a country adopts a minimalist approach or a maximalist approach. For the former, national security could refer to potential threats to all the areas stated in Figure 1. A minimalist definition of national security only concerns the overlapping area of critical infrastructure and defense security or, in other words the sectors in which the national security review system of FDI's ought to scrutinize.

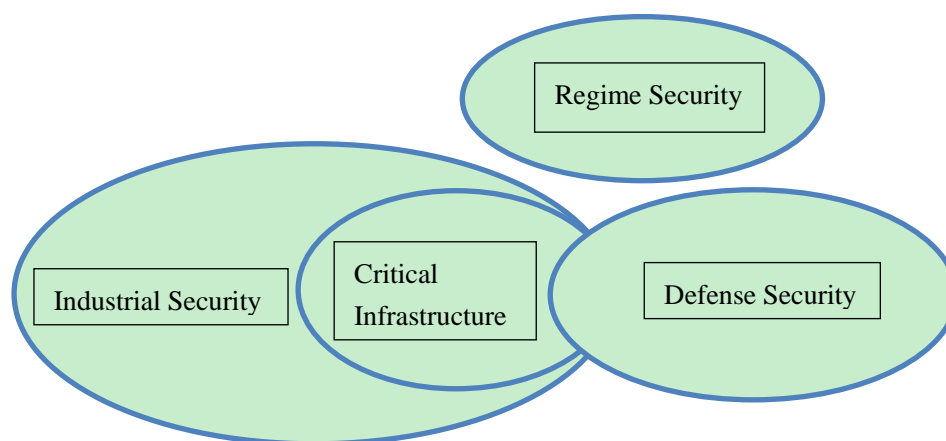


Figure 1: Dimensions of Critical Industry

Defense-related industries are the primary concern in terms of FDI restriction. Not only are the FDI directly involved in defense security likely to be restricted, but also those indirectly implicated. The Rall-Terma Case demonstrates that physical

proximity from the FDI project to the military facility also acts as a concern, and host government is willing to sacrifice economic gains to safeguard its military technologies and facilities.

Industrial security has two aspects. One refers to the protection of leading technology. The CNOOC-Unocal Case demonstrates that host governments are inclined to restrict foreign investments in industrial sectors where their domestic enterprises possess technological and managerial advantages. This aspect is more pertinent in FDI flows from developing countries or technology underdeveloped countries to developed ones.

The other refers to protecting the dominant economic position of domestic enterprise(s) in one particular sector. For example the Coca Cola-Huiyuan Case shows that a leading enterprise merged by a foreign competitor could shake its previous dominant position and “jeopardize” the industry in a direct or indirect manner. In this regard, industrial security could be potentially applied to any sector of a national economy.¹⁰⁹ For instance, China’s National Development and Reform Commission (NDRC) unveiled China’s industrial policy for the dairy products industry¹¹⁰, and the China Leather Industry Association published its own 12th Five-Year Development Plan¹¹¹. Even though those industries are not essential lifelines for the national economy, their industrial policies could be used as political or economic justifications

¹⁰⁹ China. Information Center of the State-owned Assets Supervision and Administration. (2006). *China’s basic industrial security until 2015*. [Dao 2015nian Zhongguo Chanye Jiben Anquan]. Retrieved from <http://www.sasac.gov.cn/n1180/n2335371/n2335404/n2335555/2514353.html>

¹¹⁰ China. National Development and Reform Commission. (2008). *Industrial Policy of Dairy Products* [Ruzhipin Gongye chanye Zhengce]. Retrieved from <http://www.miit.gov.cn/n11293472/n11293832/n11294057/n11302390/11705274.html>

¹¹¹ China Leather Net. (2011, March 18). Zhongguo pige hangye “shi’erwu” fazhan guihua (cao’an) [Draft Plan of China’s Leather Industry]. Retrieved from <http://www.chinaleather.org/uploadfile/news/201103/20110315043014725.pdf>

for governmental restrictions on foreign competition by limiting FDI. To put it differently, the participation of such industry associations in the process of foreign FDI review have the potential to escalate challenge to an enterprise or an industry in normal market conditions of healthy competition to the national security level and thereby employ political means to resolve economic competitive pressures. Such protectionist measures serve domestic industries to counter-weight to trade liberalization.

Compared with industrial security, which theoretically could be applied in any sector, critical infrastructure is limited to areas concerning public interests. The studies of cases and FDI restriction policies in China and the United States show that both countries are cautious to inward foreign investments in sectors such as power generation and distribution, energy, telecommunication, water, and transportation. The notable difference is the Chinese and American economic systems where Chinese critical infrastructure are mostly state-owned.¹¹²

Last but not least, the regime security dimension distinguishes democracies from authoritarian regimes. As an authoritarian regime, China's party state restricts FDI in a wide range of sectors regarding information dissemination, which is viewed as potentially challenging its legitimacy.

Does globalization make the state irrelevant? This study disagrees and demonstrates that globalization does not reduce the state's role especially in terms of FDI regulations. Rather, states are free to determine the boundary of national security

¹¹² N.A. (2006, December 18). Woguo Mingque Qida Hangye Jiangyou Guoyoujingji Kongzhi. [China confirms that seven industries will be controlled by state economy]. *Xinhua*. Retrieved from http://news.xinhuanet.com/fortune/2006-12/18/content_5502762.htm

and select the types of investments they desire. The difference between China and the United States, and authoritarian regimes and democracies at large, lie in *how much* freedom governments have to regulate FDIs, how transparent and discretionary their restriction powers are, and whose and which security is protected. The study shows that the power to regulate FDI in democratic countries such as the United States is less concentrated than authoritarian regimes like in China. Though they seem politicized, American refusal of FDIs mainly reflect their concern that FDI is a Trojan horse influenced for foreign states. In China, such opposition also stems from vested industry interests or the regime itself.

Research Significance

This project makes several contributions to the study of China's foreign investment and more broadly, the IPE literature on the subject.

First, it helps to explain what types of Chinese FDI are more likely to meet opposition in the United States and how the restrictions have been justified. In the meantime, it also presents the sectors in which China erects barriers for foreign investments. Such information could be used for both governments and entrepreneurs in their policy formulation or strategic planning.

Second, IPE studies have largely focused on how foreign investments from developed countries are treated in developing host countries. A relatively new and understudied phenomenon is the FDI from developing countries flowing into developed countries. Furthermore, an overlooked research area is the *political*

reactions of the Global North to FDI from the Global South. In this regard, my research provides some insights by comparatively studying the restrictions of FDI in China and the United States, respectively the largest developing country and the largest developed country. It demonstrates that the importance of research in this arena will only rise since the Global South is increasingly keen to invest in the Global North.

Third, extant literature only looked at the political system as a determinant factor in FDI reception. To my best knowledge, few researches have looked at whether the *home* country's regime affects outward FDI. In this regard, China, a party state regime under the rule of the Chinese Communist Party (CCP), offers a good case study. By comparatively studying the component of "critical industry" in China and the United States, I distill the regime security factor in the FDI restriction, which is different from purely economic and political concerns. In addition, China's economic clout has made it a popular destination of inward FDI and an important capital-exporting country. I contribute to policy research that investigates regime security factor and its political nature.

Research Limitations and Avenues for Future Research

There are limitations of this research due to methodological drawbacks and the availability of some key data.

First, the eight case studies on which I based my analysis are qualitatively selected from the very few publically available from government releases and media

reports. A larger number of FDI transactions that met opposition and were restricted are not accounted for owing to the secrecy of FDI review proceedings in both countries.

Second, the time range of this study only covers eight years from 2005 to 2012, in which China's FDI massively surged in the United States. My intention is to make it possible to compare the FDI treatment in a bilateral context. What is missing is how China restricted American FDI, in particular M&A transactions, from the late 1970s to the early 21st century when FDI unilaterally flowed from the United States into China. Historical research of this period would be valuable to further understand American FDI in China and answer whether increasingly restricted Chinese FDI in the United States has sparked retaliatory measures for American FDI in China.

With this in mind, I suggest pursuing several avenues to research the limitations FDI encounters. Researchers should consider focusing on studying the policy decision-making process in FDI restrictions, which is not fully explored in this study. An important question is how do various stakeholders advance their own interests in the process of an FDI investigation? More research is needed in order to properly study the political dynamics of decision-making processes in China and the United States that determine FDI restrictions.

The second interesting prism through which we could look at FDI restriction is reciprocity. The CNOOC-Unocal Case displays that, one of the justifications offered by Congress is that "since Chinese government is not likely to accept American investment in China's national oil companies, the United States should also prevent

Chinese capital from tapping into American oil industry based on the principal of reciprocity".¹¹³ In this regard, more qualitative research on the topic is expected to illuminate whether the principal of reciprocity, common in international trade, also exists in the bilateral FDI relationships. Research in this area could help us to see whether FDI conflicts could trigger policy retaliations between states and whether such frictions produce broader political backlash in foreign policy or even multi-lateral relationships. Given that China and the United States are two superpowers in the world; their bi-lateral relationship has global implications. It is important to understand the potential causes of frictions or avenues of cooperation. In light of the military dimension of the Sino-American relationship, my research contributes to understanding the economic dimension of this broader relationship which FDI plays a crucial part.

Finally, one research area concerns whether findings based on China and the United States could be generalized to explain FDI restrictions elsewhere. This depends on whether the United States' restriction of FDI is representative of other developed countries' reactions toward FDI from China. In this regard, more research could be conducted on the subject in other countries in the Global North such as Canada, Japan, Australia, and the European Union and identify common determinants restricting Chinese FDI. Drawing more generalizations also depends on whether FDI from China is more likely to meet opposition in the United States as compared to FDI

¹¹³ The United States. Congress. (2005). H. Res.344 (109th): Text of Expressing the sense of the House of Representatives that a Chinese state-owned energy company exercising control of critical United States energy infrastructure and energy production capacity could take action that would threaten to impair the national security of the United States. Retrieved from <https://www.govtrack.us/congress/bills/109/hres344/text>

from other developing countries? In other words, does the United States treat FDI from developing countries or authoritarian regimes differently? Though the DPW-P&O case suggests that the enterprise-home country relationship was not solely used to obstruct Chinese investments, more data and cross-national studies are needed to confirm the finding. In this regard, future research could have two avenues to pursue. One way is to look at FDI in the United States and the developed world from other BRICS countries or Gulf countries. The other way is to look at whether investors from western developed State-owned enterprises (SOEs) such as France, that has a strong state ownership in various industries, received treatment similar to SOEs from China.

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