**Hearing Entitled "Examining the Flow of U.S. Money into China's Military Might"**
**House Foreign Affairs Committee**
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**Testimony of Peter E. Harrell**

Chairman McCaul, Ranking Member Meeks, Honorable Members of the Committee—

Thank you for the opportunity to testify today and it is a pleasure for me to be here with my distinguished co-panelists.

In recent years members of this Committee have drawn significant, welcome attention to the subject of today's hearing, the regulation of U.S. investment in China. With China's rise as America's foremost geopolitical competitor and with hundreds of billions of dollars of U.S. investment having flowed into China over the past several decades, American policymakers need an effective legal regime to regulate U.S. investment in China to ensure that such investment is consistent with, rather than contrary to, America's national security interests.

I welcome and strongly support President Biden's decision in August 2023 to sign E.O. 14105, which directs the Treasury Department to begin establishing a regime to require the notification of, and in some cases to limit, certain investments in China, pursuant to the International Emergency Economic Powers Act (IEEPA). But it remains important for Congress to legislate in this area to ensure an enduring statutory foundation for the regulation of U.S. investments in China and to ensure appropriate congressional input into and oversight of an outbound investment screening program. I welcome H.R. 6349, the "Preventing Adversaries from Developing Critical Capabilities Act," which Chairman McCaul and Ranking Member Meeks, alongside other Members of Congress, introduced last November as an important framework for Congress to consider.

My opening remarks today will focus on the *why* and the *how* of regulating U.S. investment in China, and I look forward to your questions.

*Why regulate American investment in China:*

Public data indicates that the value of annual flows of U.S. investment to China have fallen since the late 2010s. The Rhodium Group, for example, estimates that annual flows of U.S. direct investment in China (FDI), both greenfield investment and acquisitions, fell to approximately $8 billion in 2022, down nearly 50% from peaks a decade earlier. Venture capital investment has fallen by an even more significant percentage.[1] But the stock of existing investment, including FDI, venture capital, and portfolio investment remains large: U.S. multinational companies likely have existing assets in China valued in the hundreds of billions of dollars, and Chinese companies listed in the U.S. had a market capitalization of just over $1 trillion at the beginning

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[1] Reva Goujon, Charlie Vest, and Thilo Hanemann, "Big Strides in a Small Yard: The New US Outbound Investment Screening Regime," *Rhodium Group*, Aug. 11, 2023, https://rhg.com/research/big-strides-in-a-small-yard-the-new-us-outbound-investment-screening-regime/.

of last year, according to the U.S.-China Economic and Security Review Commission.[2] Moreover, the importance of an investment to U.S. national security interests is not determined solely by its value: a comparatively small investment that enabled a Chinese semiconductor firm to develop a new leading edge design could have substantial implications for U.S. national security, whereas a large investment in Chinese consumer retail shops would have a minimal impact on our national security.

In recent years Congress and the U.S. Executive Branch have begun to take important steps to address certain risks associated with U.S. investment in China. For example, U.S investors, like retirees and everyday investors, face the risk of losses associated with China's opaque investment environment. This spurred Congress in late 2020 to pass the Holding Foreign Companies Accountable Act (HFCAA), which requires Chinese companies listed in the U.S. to comply with basic U.S. audit transparency requirements.

Let me give another example. U.S. national security faces a risk when Americans invest in specific Chinese companies that are tied to the Chinese military, or in Chinese companies that engage in activities contrary to U.S. national security interests. That's why in November 2020, when my fellow panelist Matt Pottinger was serving as Deputy National Security Advisor, President Trump signed E.O. 13959, which prohibited U.S. persons from investing in the publicly traded securities of companies that the U.S. government has identified as being linked to the Chinese military. President Biden strengthened this program, the "China Military Companies Sanctions List," or "CMIC List" in June of 2021 by expanding it to also prohibit U.S. persons from investing in specific Chinese companies the U.S. government has identified as being linked to the Chinese surveillance state. Furthermore, U.S. persons are prohibited from investing in—or doing any other business with—companies that the U.S. puts on its so-called "SDN sanctions" lists, such as companies that the U.S has determined should be sanctioned for engaging in serious human rights abuses in China.

Last year, President Biden signed E.O. 14105 to regulate certain investments in key high-tech sectors in China because those investments can pose another type of risk: that U.S. investors will help China open an edge in key technologies that have both civilian and military applications. U.S. export controls, particularly after Congress strengthened them in 2018 with the Export Control Reform Act (ECRA), provide a strong tool to prevent U.S. companies from sending specific technologies to China. But export controls focus on the flow of technology, and thus are poorly designed to prevent a U.S. person from investing in a Chinese company. Prior to E.O. 14105, this created the perverse situation where the U.S. government prohibited U.S. companies from, for example, sending high-end semiconductor tools and the designs for high-end chips China. However, the U.S. did not prohibit U.S. companies, whether venture capitalists or operating companies, from investing in Chinese companies that were trying to build their own semiconductor tools and which are working to design their own leading-edge chips. This is the gap that E.O. 14105 is working to close, and Congress should enact legislation to bolster it.

[2] U.S.-China Economic And Security Review Commission, "Chinese Companies Listed on Major U.S. Stock Exchanges," Jan. 9, 2023, https://www.uscc.gov/sites/default/files/2023-01/Chinese_Companies_Listed_on_US_Stock_Exchanges_01_2023.pdf.

Moreover, E.O. 14105, like H.R. 6349, will help bring greater transparency to U.S. investment in China's high-tech sector, which is important for effective policymaking. The reality is that the U.S. government currently has limited insight into the nature of U.S. investments in China: for obvious and important reasons the U.S. cannot use intelligence collection tools to monitor U.S. companies to identify what they are considering investing in China. Instead, government officials must rely primarily on public and commercial databases and on private research to understand investment flows. Given the complexity and scale of both the U.S. and the Chinese economies and both countries' high-tech sectors, this leaves large gaps in the government's knowledge. Tools that require U.S investors to report certain types of higher-risk investments will increase the data available to policymakers and ultimately make for stronger policy outcomes.

*How to regulate American investment in China:*

When it comes to the *how* of regulating U.S. investment in China, there is an important debate here in Congress about whether to regulate U.S. investment in specific Chinese sectors or whether to focus on prohibiting investment in specific Chinese companies, for example, by putting more Chinese companies on U.S. sanctions lists.

I want to make a strong recommendation for the sectoral approach, which is the approach taken by both E.O. 14105 and by H.R. 6349. As I discussed several minutes ago the U.S. already has the authority, pursuant to the CMIC List, to restrict U.S. investment in the publicly traded securities of companies linked to China's military. But relying solely on this approach fails to capture important investments in early and mid-stage companies as well as direct investments by U.S. companies in strategic technology sectors in China.

Allow me to offer two examples to illustrate the gap. The first example is SenseTime, a Chinese surveillance technology firm whose surveillance technology China has deployed in its Xinjiang province. SenseTime was founded in 2014 and U.S. investors started investing in the firm by at least 2017, according to publicly available data. But in 2017, when those investments were being made, SenseTime remained a mid-size company worth a few billion dollars that almost no American government officials had heard of and which was still in the comparatively early stages of developing its technology. As a result, it would have been practically impossible for SenseTime to be on a relevant U.S. government list at that time, and, indeed, SenseTime was not on any U.S. government restriction lists in 2017. Later, as the company continued to grow, U.S. policymakers began to understand the risks the company posed, adding SenseTime to the Entity List export controls restriction in 2019 and to the CMIC List in 2021. But sectoral regulations on U.S. AI investment in China, like those contained in E.O. 14105 and H.R. 6349, would have required U.S. investors to disclose their investments to the U.S. government—which would have brought SenseTime to the U.S. government's attention much earlier and likely resulted in such investments being prohibited several years before they actually were.

Let me give another example, a hypothetical. Suppose that a U.S. company chooses to set up a high-tech AI research lab in China. There are many reasons why a U.S. company might choose to do so, for example, to have access to China's significant domestic engineering talent and to keep an eye on technology developments within China. Yet the U.S.-owned high-tech research lab would undoubtedly provide value to China over time—it would bring together top Chinese talent, provide funding for research, offer professional exposure, and foster innovation. After improving their skills, Chinese employees of the lab could well go on to work for competitors or found their own companies, just as engineers at U.S.-based corporate research labs do. The U.S. government has a clear interest in understanding what this type of high-end research lab is doing, and ensuring that it is not engaging in activities that could, over time, strengthen China's relative capabilities. Yet because this hypothetical lab is owned and run by a U.S. company in China, it would never by covered by an outbound investment regime that simply prohibited investment in designated Chinese companies.

I do not want to suggest that U.S. companies should be prohibited from doing any high-tech research in China. There is strong engineering talent in China and I want U.S. companies, where consistent with national security, to be able to benefit from that. Indeed, that is one reason I welcome recent work the State Department and DHS to expand visas for top AI and other technical scientists and researchers to come to the U.S. to innovate here. But in our era of geopolitical competition, the government has a legitimate interest in understanding investments in key technologies and sectors in China and, where appropriate, regulating those investments.

*Keeping regulations narrow*:

In considering legislation to further restrict U.S. investment in key sectors and technologies in China, I urge Congress to pass a narrow and tailored approach.

Regulating U.S. investment in China is very different than just banning investment in a small economy like Iran or North Korea, which we have done with our sanctions. The scale of the economic relationship is vastly bigger, making the economic stakes for U.S. companies and the United States much larger. The U.S. has an interest in ensuring that it does not prohibit investments that pose no national security risk to the U.S., but which have the potential to benefit U.S. companies and ordinary Chinese consumers. The goal should not be to cut off all investment ties, but rather to address discrete national security risks. The implementation challenges of regulating U.S. investment in China are also harder, creating a need for to build appropriate government staff and expertise to analyze and regulate investment. A narrowly tailored approach that focuses on critical technology sectors is a valuable start. Over time, I would recommend also at least requiring disclosures of investments that could increase China's leverage over critical U.S. supply chains, and potentially regulating them—but those are the sorts of expansions that can be added after the program is initially established and up and running.

*Other actions:*

Beyond enacting legislation that would codify and expand on the type of investment regime the Biden Administration is developing pursuant to E.O. 14105, there at least two other steps that I recommend Congress and the Executive Branch consider to effectively regulate the U.S.-China investment relationship.

First, basic data about U.S. investment in China remains far too opaque. The Biden Administration's outbound investment regime, and legislation such as H.R. 6349, if passed, should begin to bring transparency to U.S. investments in the covered sectors. But a substantial share of U.S. investment in China will not be covered by such a regime. Congress could direct the Treasury Department and Commerce Department to expand the type and frequency of data the agencies currently compile and publish about the U.S. investment position in China to better inform both policymakers and the public about investment stocks and trends, as Derek Scissors at the American Enterprise Institute has recommended.

Second, I have spoken about the value of the existing China Military Industrial Complex Sanctions Program to limit investment in specific companies that support the Chinese military. However, the Biden Administration could strengthen this program by more actively reviewing companies for inclusion on the list. Moreover, while this program currently prohibits U.S. investment in the publicly traded securities of covered Chinese companies, it does not prohibit private investments, such as bank loans, in the same companies. The Biden Administration could expand the scope of the prohibitions to cover all new investments in the covered companies.

*Concluding remarks:*

In closing, let me step back and offer a broader comment on the U.S.-China economic relationship. The U.S. and China are the world's two largest economies. While U.S. trade dependencies on China are declining, economic ties between the two countries will likely remain substantial in the years ahead, with hundreds of billions of dollars of economic activity at stake in the relationship. The U.S and China are also major geopolitical competitors, and the economic and technological domains are central to that competition.

Against this backdrop, there are no simple answers for what the U.S.-China economic relationship should look like. We need to manage the economic relationship to derisk strategic dependencies and to maintain our economic and technological edge. We need to manage the economic relationship to promote our national security interests. But we also need to manage the economic relationship to promote strategic stability, and to support U.S. economic interests while remaining true to our values. There are times when geopolitical tensions will be higher, and the U.S. will need to respond by tightening controls on economic and technological ties. Hopefully, there will also be times when tensions will be lower, and we can enable more economic activity.

Managing the economic and technological relationship will be as much an art as a science. But across the ups and downs, American policymakers need a flexible regulatory toolkit to manage the economic and technological relationship to ensure that it promotes America's national security interest. Tools to manage investment flows to ensure that American investment in China is consistent, with rather than contrary to, U.S. national security interests are a key component of that overall toolkit. I welcome the Committee's interest in developing effective policy tools to regulate American investment in China and look forward to taking your questions.