US Economic National Security: Divesting China from America's Capital Markets

By Darren Spinck

Introduction

There is growing bipartisan agreement amongst US policymakers that Washington's decades-long approach to Sino-American relations is unsustainable, as both the United States and China stake claims to their respective visions of economic, technology, and security leadership in an increasingly bi-polar world. Although the US and China have both pursued economic interdependence since Washington granted Beijing Permanent Normalized Trade Relations (PNTR) in October 2000, recent flashpoints - ranging from growing Taiwan Strait tensions, investigations into Covid-19'origin, reports of Chinese companies supplying Russia's military, and human rights abuses in Xinjiang - make accelerated decoupling a likelihood. China's economy slowed in 2022 due to the Chinese Communist Party's (CCP) mercantilist-communist economic model and its draconian "zero-COVID policy", which exacerbated global supply chain delays and inflationary shocks. China's President Xi Jinping, however, recently blamed US policies for curtailing China's development, accusing Washington of "suppression."

Instead of reforming China's policies to reflect the norms of its trading partners and acknowledging domestic economic policy mismanagement has led to China's burgeoning dept crisis, the CCP instead chose to externalize its blame toward the United States government and initiate more regulatory control over the People's Republic of China's (PRC) financial services sector. China's new foreign minister Qin Gang has even warned of "conflict and confrontation" between China and the United States, which would disrupt sea and air trade routes, upend global supply chains yet again, and likely destroy semiconductor foundries in Taiwan. Unbeknownst to many Americans, a conflict between the two powers would also risk US retirement savings, as pensions and personal retirement accounts are often invested in Chinese companies through mutual or bond funds. Despite Beijing's bombast and the clear risks for Washington maintaining a "business as usual approach" with the PRC, there remains opposition to decoupling the two economies and, remarkably, continued support from Wall Street for China maintaining access to US capital markets.

Sino-US Economic Ties

The US enabled the CCP's decades-long economic rise due to naivete, hoping China's growth would morph the communist regime into a "responsible stakeholder." US Senator Marco Rubio (R-FL) contends the US and its trading partners mistakenly believed the PRC's accession to the World Trade Organization (WTO) would transform China into a democracy. "Capitalism didn't change China," Rubio recently argued, "China changed capitalism." Since the US granted PNTR for China, the PRC's December 2001 WTO entry has not advanced America's economic interests as former US President Bill Clinton promised Americans it would. China's economy has increased over 13.25 times since the US supported the PRC's WTO bid, growing from the world's eighth-largest economy with a $1.16 trillion gross domestic product (GDP), to a $15.4 trillion GDP 20 years later. Meanwhile, America's trade dependency on China and the ensuing deficit cost an estimated 3.7 million US jobs due in large part to China dumping steel, aluminum, and other capital-intensive products which contributed to factory closures in America's metals, machinery, and fabricated metals production sectors.

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Despite calls for the US to re-shore manufacturing after pandemic-era supply chain delays became a national security risk, America's trade with China became increasingly one-sided in 2022, leading to a $382.9 billion trade deficit, an 8.3 percent increase from the previous year. Some Biden cabinet officials such as Gina Raimondo have supported continued US-PRC interdependence, with the US Commerce Secretary recently stating "the US does not seek to decouple from China." The PRC has itself begun to mitigate its own risks related to international trade. The CCP introduced a Dual Circulation economic model in its 2021 14th Five-Year plan, which aims to create "self-developed, controllable" supply chains and lessen the PRC's vulnerabilities from trade dependencies on the United States and Europe. As former US National Security Advisor HR McMaster noted during Congressional testimony, the CCP is seeking decoupling on their own terms.

US and European policymakers have awoken to the risks of the CCP controlling supply chains for emerging and advanced technologies and using these innovations for dual-use purposes. The 2023 Director of National Intelligence (DNI) Annual Threat Assessment noted PRC President Xi Jinping has stated China's intention to use supply chain dependencies to the PRC's advantage by threatening to "cut off" foreign trading partners during a crisis. Unfortunately, the US has not yet prioritized curtailing the PRC's access to capital markets which fuels the CCP's techno-authoritarian industries. The US Senate Select Committee on Intelligence has warned the US Treasury and Commerce Departments that the PRC is working to displace the United States as the world's dominant economic and military power, and has detailed how US technology and investment enhances the Chinese military as well as perpetuates human rights violations in the Xinjiang Uyghur Autonomous Region (XUAR).

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Current restrictions on inbound investment from China and export controls of emerging and advanced technologies are insufficient for ensuring the US does not purposely or unwittingly support financing CCP-controlled entities with clear risks to US national interests and national security. If Washington and other US partners hope to counter the CCP's use of forced labor and help ensure investments from the United States are not used to strengthen the PRC's military capabilities, better coordination is needed between the US Departments of Defense, Commerce, and Treasury on restricting outbound investment to targeted Chinese companies as well.

The Biden White House has not yet heeded the warnings of previous US presidential administration officials, failing to even follow former Clinton Administration Treasury Secretary Larry Summer's advice on the commercial agenda of US financial services entities operating abroad having "almost no nexus with US job creation." If the White House is serious about advancing US foreign policy for America's middle class, not China's, the link between Wall Street and Beijing must be severed. Policymakers in two successive US presidential administrations have attempted to mitigate America's commercial dependency on China and slow the PRC's coercion of the global economy, but an undeniable love affair between Wall Street and the CCP endures. As the *Wall Street Journal* reported, "America's money men have long held a special place in Beijing's corridors of powers."

CCP-Wall Street Interdependence

Massive trade deficits have jolted China's trading partners to face the realities of non-mutually beneficial trade, but Wall Street and the CCP continue to embrace interdependency. Morgan Stanley, which received a $107 billion bailout from the US government during the 2008 financial crisis, was one of China's loudest cheerleaders during the PNTR Congressional debate, with a bank managing director testifying before Congress that an objective of US financial services firms is filling the capital flow requirements needed to fund $1 trillion of infrastructure inside China. The American Society of Civil Engineers, meanwhile, annually grades America's infrastructure and reported in 2021 that US roads, ports, airports, railroads, inland waterways, etc., clearly in need of capital investment, have struggled to improve beyond an assessment of "poor/at risk" since 1998.

Prior to its 2008 US taxpayer-funded bailout, Morgan Stanley had previously sold a nearly 10 percent stake of the financial services company to China Investment Corporation, which chief executive officer (CEO) John Mack called an "important step in increasing the flow of capital between the two countries." During the PNTR discussion, US financial services companies, including New York Life, appeared to view China's opening to the global trading system strictly through a transactional lens and the potential to reach China's 1.45 billion population, with the firm's executive vice president espousing the potential for America's banking sector to manage privately held pensions and annuities in China. When debating the merits of granting PNTR to China, the benefits for the US financial services sector gaining access to China's economy outweighed the potential risks of enabling capital flows to a communist regime.

Remarkably, despite widespread support for China's WTO accession, US financial services companies still waited nearly two decades after the PRC's WTO entry to gain access to China's market without the CCP requiring a joint venture (JV) with a Chinese bank. Former Silicon Valley Bank chief executive officer Ken Wilcox stated Chinese banking regulators mandated foreign banks form a JV so Chinese officials could better learn about the West's banking system and reverse engineer the Chinese banking system based on US bank operating models, while barring American banks unfettered access to the PRC market. As part of the US-China Phase One trade deal negotiated by the Trump Administration, Beijing agreed to end foreign equity caps for US securities firms and American life, health, and pension services as of April 2021. Total US portfolio investment in Chinese companies and government securities (including US retirement savings investments) then surged to $1.2 trillion by the end of 2021, often "without the active consent or knowledge of most Americans" as noted by Steven Schoenfeld, chief investment officer of BlueStar Indexes.

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The China Securities Regulatory Commission (CSRC) approved BlackRock's individual operating license in June 2021 and, during the height of the Covid-19 pandemic when China's lockdowns stalled global supply chains and led to inflationary price hikes for US consumers, BlackRock Global Chief Investment Strategist Wei Li recommended the investment company's investors increase their exposure in the PRC by as much as three times. The CSRC had previously approved Citigroup as the first US financial services firm license for a custody bank, allowing the bank to hold securities in China for mutual and private funds. Citigroup was also the first US bank to receive a bond settlement license in 2017. Despite heightened Washington-Beijing tensions and the Belt and Road Initiative (BRI) posing a national security threat to the United States, US financial services firms continue to provide the CCP with access to US capital markets, with the Principal Financial Group forming a joint venture with China Construction Bank Pension (CCBP) Management in January 2023. CCBP's majority shareholder, China Construction Bank, has been tasked with raising financing for the CCP's global infrastructure initiative. In 2000, Principal

Financial Group CEO Norman Sorenson called China's WTO accession a "win-win," a phrase later borrowed by Xi Jinping from time to time in an attempt to assuage concerns over China's BRI enabling the CCP greater control over international supply chains. Sorenson noted in his Congressional testimony, that China's WTO membership would benefit US financial services companies, Chinese citizens and entities, and the world trading system, omitting how China's access to US capital markets lacked any benefit whatsoever for American citizens.

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In 2017, CEFC China Energy (CEFC) bought a stake in the Cowen Group, a New York investment bank, giving the Chinese conglomerate a "springboard into high finance in the United States." CEFC, with 98 percent of its shares once owned by Shanghai Energy Fund Investment, was later implicated by the US Department of Justice for unlawfully gaining business advantages for BRI projects through bribes paid to officials in Chad and Uganda. The US House of Representatives Committee on Oversight and Accountability is currently investigating possible instances of CEFC approaching members of US President Joe Biden's family to "expand its energy portfolio in the United States."

PRC Forced Labor in Xinjiang

Wall Street remains enamored with the CCP despite documentation of an entrenched system of state-imposed Uyghur forced labor in Xinjiang, China. Former US Secretary of State Mike Pompeo determined the CCP committed crimes against humanity against Xinjiang's Uyghurs, including not only forced labor, but freedom of religion violations and restrictions to freedom of movement as well. An estimated one million Uyghurs are subjected to forced labor, which the International Labor Organization (ILO) defines as work or service extracted from a person under threat of criminal or financial penalty. Indeed, current government policy requires all adults to be in a state-assigned place of work. Reports of Uyghur forced labor include the production of polysilicon, a material used in solar panel production, as well as cotton extraction and other exported agriculture and goods.

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The US government aimed to disrupt China's forced labor supply chain from the XUAR through the 2021 Uyghur Forced labor Prevention Act (UFLPA), which puts in place a rigorous enforcement mandate regarding forced labor of Uyghurs. Delays in solar panel imports reaching the US market, Reuters reports, has been a "setback to the Biden Administration's climate goals." Potentially more problematic for the Biden White House's climate agenda, the production of polysilicon in XUAR depends on coal-powered plants, with coal use accounting for 54 percent of greenhouse gas emissions according to the US Environmental Protection Agency (EPA). The PRC has averaged opening two new coal plants per week in 2022, six times as many as the rest of the world combined, despite China's Vice President Han Zheng once telling US special envoy John Kerry that "on the issue of climate change, China has always been true to its words and resolute in deeds."

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China-based LONGi Green Energy Technology Co. produces solar panels with polysilicon from a company described as "intertwined" with Xinjiang Production and Construction Corps, an entity sanctioned by the US Treasury Department for "serious human rights abuse." According to an investigative report, LONGi, along with Yitu Limited, which the Treasury Department determined uses facial recognition technology to monitor Xinjiang's Uyghur population, have received funding from Hillhouse Capital, a Singapore-based private equity firm. US climate czar John Kerry disclosed over a $1 million investment in Hillhouse Capital, which has also received tens of millions of dollars in investments from US universities including Yale, Princeton, the University of Pennsylvania, and Massachusetts Institute of Technology, all capital which could strengthen those PRC companies which Hillhouse is a shareholder of and which have links to sanctioned Chinese entities accused of human rights violations.

The CCP and ESG

Concerns have been raised that the CCP has used environmental, social, and governance (ESG) ratings to its advantage with US retirement fund managers misallocating US capital to Chinese firms. According to Americans for Tax Reform, this has allowed politicization of American pension savings and provided the PRC with a competitive advantage in the energy sector. S&P, a ratings agency which has been accused of "trading reputation for profit and giving implausibly high marks to securitized mortgages" and named a "key enabler" of the 2008 financial meltdown, is now providing ESG ratings for China's LONGi in its S&P China A 300 Sustainability Screened Index as of February 2023. The rating agency's global market intelligence division first reported the PRC green energy company was "exposed to possible human rights violations through its supply chain" in 2021.

US Oversight

The Holding Foreign Companies Accountable Act (HFCAA) hopes to hold PRC entities and other foreign companies seeking access to US capital markets to the same rigorous audit standards as any US publicly listed company listed on a US stock exchange. Foreign firms failing to allow the US Public Company Accounting Oversight Board (PCAOB) access to audit work papers for three consecutive years would then be delisted from American equity exchanges. Beijing had previously blocked US regulator access to New York Stock Exchange (NYSE) or Nasdaq listed companies based in China and Hong Kong. The Biden Administration struck a deal with Beijing allowing the PCAOB to review auditing records from China's KPMG Huazhen LLP and PriceWaterhouseCoopers in Hong Kong.

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At the time of this writing, US regulators chose eight auditing records from the two accounting firms to review and will not access any audit documents from Chinese domestic accountants. Furthermore, Beijing's negotiated terms bar PCAOB regulators from accessing records that the CCP deems linked to PRC military installations. The Chinese Communist Party "golden shares" in many PRC entities eligible for audit, allowing the CCP veto control over any decision making with as little as a 1 percent investment stake in the company. It is therefore conceivable that the CCP will tighten audit access to US regulators for any sectors it believes necessary for accessing US capital markets, citing national security concerns over military installation information, whether true or not. The initial deal struck by the Biden Administration and Beijing will allow many CCP-controlled Chinese entities continued access to more than $1 trillion in US market capitalization.

Systemic risks of CCP Access to US Capital

The CCP's reach into US capital markets is vast. The recently failed Silicon Valley Bank (SVB) formed a joint venture with Shanghai Pudong Development Bank and, according to a CNBC report, helped relieve regulatory pressure on the China-to-US initial public offering (IPO) pipeline and allowed Chinese SVB account holders to "tap funding from US-based investors with an eye to a public offering the US." SVB, which received a US government bailout, reportedly made uncollateralized loans to unprofitable Chinese firms. SVB's former CEO indicated the Chinese government still controlled decision-making for the SVB venture with China, the first instance that the CCP allowed a foreign bank JV to form a new commercial bank entity in China.

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As tensions between Washington and Beijing rise, the potential for the CCP to use western capital as coercion is an alarming possibility. Mark Mobius, founder of Mobius Capital Markets, raised concerns when he stated China's capital controls prevented him from withdrawing funds from an HSBC account in Shanghai. Mobius warned investors to be "very, very careful," adding the CCP's golden shares in companies allows the government far more control over the economy. Soon after Mobius announced his frustrations with China's capital controls, Vanguard Group closed its Shanghai-based investment management unit and ended its joint-venture with Ant Group.

As US-China Commission commissioner Jacob Helberg wrote "blocking US investments is about investor protection as much as its about national security," making a potential reverse Committee on Foreign Investment in the United States (CFIUS) increasingly needed to scrutinize outbound investment from the US to China. Until such a platform launches, the Biden Administration is expected to issue an executive order barring outbound US investment into China's technology industry, including artificial intelligence and dual-use technologies.

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