UNITED STATES - CHINA FOREIGN DIRECT INVESTMENT: OPPORTUNITIES AND CHALLENGES

A Thesis
submitted to the Faculty of the Graduate School of Arts and Sciences of Georgetown University in partial fulfillment of the requirements for the degree of Master of Public Policy in Public Policy

By

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ABSTRACT

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China and the United States are the world's most important foreign direct investment host country and source country. Despite the rapid growth of cross-border direct investment between China and the United States over the past five years, the mutual investment between the two countries has only a small proportion in the two countries' foreign direct investment in the world. There is still a large space for foreign direct investment in the future. China recent investment in the United States shows a positive trend. For China and United States, improving the openness of two-way cross-border investment would great benefit to both countries. The investment provides the necessary funds for economic development and creates jobs in emerging market; enable enterprises to reduce production costs and consumer prices, thereby increasing the global competitiveness. Also, by promoting specialization, achieving better economies of scale and encouraging healthy market competition to achieve global integration, can greatly enhance consumer welfare. More importantly, the two countries to strengthen economic cooperation, is conducive to increasing mutual understanding, and further improve bilateral openness.

However, bilateral investment in China and the United States there are still obstacles, including concerns about strategic investment in the industry, the imbalance in the field of investment concerns, policy imperfect, too restrictive restrictions on the visa, there are some lack of effective communication, exchange And mutual trust, as well as cultural differences and domestic policy interference problems. In order to promote bilateral investment between China and the United States, the two governments should be some strategic thinking and methods to make some fundamental changes and adjustments. The study using empirical analysis suggests China’s government with the strategy adjustment and policies that will encourage US-China foreign direct investment benefit in technological innovation, create jobs, and upgrade infrastructure while building national security vigilance, and laying the foundation for a better partnership with China.
The research and writing of this thesis is dedicated to everyone who helped along the way.

Many thanks,
Ziqi Zhang
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INTRODUCTION AND BACKGROUND

Introduction

China's economic restructuring and economic restructuring of the national economic development strategy to US-China bilateral investment provides a huge space. China's economy will undergo fundamental structural changes: from export-driven, labor and resource-intensive industries to economic development models that rely on innovation, technological progress, domestic consumption and service industries. This will undoubtedly lead to the huge demand for high-tech products and services. The Chinese government will also enact policies that are more conducive to direct investment in order to make better use of direct investment to promote the transformation and upgrading of the domestic economy.

Urbanization is another key economic development strategy for China's next decade and is likely to be an important engine of China's economic growth. China's urbanization rate is currently only about 50%, 20 percent lower than the average level of developed countries. The next decade, the ongoing urbanization process will drive 40 trillion yuan of investment, including infrastructure investment will reach 1 trillion yuan. This will bring many new opportunities to foreign direct investment.

Background

Over the past three decades, US companies have made a lot of direct investment in China. By 2011, US companies had 61,000 direct investment projects in China, set up 20,000 enterprises, branches and joint ventures, employing thousands of Chinese workers. As of 2011, the US investment in China reached 70.1 billion US dollars (See Table 1), China's direct investment in the United States stock of 7.8 times. It also reflects that the United States has an advantage in
capital and technology, while China has a comparative advantage in the labor force, and China's domestic market is huge.

However, in recent years, the US direct investment in China also appeared a more obvious downward trend. According to the Chinese Ministry of Commerce data, the United States in 2010 China's direct investment of 4.1 billion US dollars, in 2011 fell to 3 billion US dollars. The main reason for the decline is that China's economic growth has declined slightly in recent years, and some US entrepreneurs are worried about China's investment climate, and more importantly, some of the industries that are easy to enter are already saturated. Nonetheless, a survey conducted by the US China Business Council (USCBC) shows that 89% of US companies are profitable in China, 66% of businesses in 2011 achieved double-digit growth in business income, 75% Expected 2012 earnings will increase, 66% of the enterprises ready to continue to expand investment next year.

In 2011, US direct investment in China accounted for 9.5% of China's foreign direct investment stock. According to the US Bureau of Economic Analysis (BEA), 1,189 US-owned companies held a total of 3,040 Billion dollars of assets, net income reached 39 billion US dollars, hired 154.1 million Chinese employees. According to the Chinese Ministry of Commerce Research data, in 2010 the United States invested in China, the company paid a total tax of 14.9 billion US dollars, employing 1.862 million Chinese employees. In addition, China has benefited from FDI's "spillover effect" and "discipline effect", mainly in the United States in China set up more than 250 research and development institutions.
Table 1: US Direct Investment to China

<table>
<thead>
<tr>
<th>Year</th>
<th>Asia and Pacific</th>
<th>China</th>
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</thead>
<tbody>
<tr>
<td>1982</td>
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<td>2015</td>
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</table>
LITERATURE REVIEW AND EMPIRICAL CONSIDERATION

At my beginning, I reviewed similar studies by institutions in China and US, and reports by international organization reports, on the period from 2000 to now. In reviewing studies, I concentrated on looking at the factor that influence FDI and especially the rapid growth of FDI reflects the rapid growth of multinational enterprises (MNE), also more than most other international transactions foreign direct investment (FDI) depends on both microeconomic development and macroeconomic limitations.

To organize my ideas, I first reviewed the literature that analyzed of FDI determinants from a partial equilibrium view of the MNE, which includes with internal firm-specific factors that motivate a firm to become an MNE in the first place, and external factors that are likely determinants of the location and magnitude of FDI by MNEs. These external factors range from exchange rates and taxes, to factors that are likely more endogenous FDI activity, such as trade protection and trade flows. I concluded by reviewing recent works that develop the theory and estimation of general equilibrium models of MNE behavior.

FDI Determinants: Partial Equilibrium Analysis

Internal Factors: Firm Characteristics that Affect the FDI Decision

The reason that firm invests on a foreign market instead of exporting or licensing arrangement is intangible assets, such as technologies and managerial skills. It suggested the present study works on the technology effect on FDI, but it is difficult to calculate the level of technology in numbers. So that the present study would not import this data on conducting an empirical analysis.
External Factors Affecting FDI Decisions and Location

Past studies used industry-level (or even country-level) data to explore relationships among external factors, which affect foreign direct investment in macroeconomic level.

Exchange Rate Effects

The present study appreciates to explore the influence of exchange rate on foreign direct investment. The effect of exchange rates on FDI has been examined both with respect to changes in bilateral exchange rates between countries and in the volatility of these exchange rates. Before Froot and Stein (1991), the common wisdom was that (expected) changes in the level of exchange rates would not alter the decision by a firm to invest in a foreign country. Enterprises could lower the cost of assets abroad by appreciation of home country’s currency. Through simple regressions using a small number of annual US aggregate FDI observations, Froot and Stein (1991) provide empirical evidence of increased inward FDI with currency depreciation.

Taxes

The effects of taxes on FDI is one of my study interest. The assumption that higher tax rate discourage the foreign direct investment is considered in some previous studies. De Mooij and Ederveen (2003) provided detailed literature discussion, and find a median tax-elasticity of FDI of across 25 studies. However, in the previous empirical analysis, the result is varying from different sort of taxes. My study would appreciate on total tax rate on revenue that used in general studies.
Trade Protection

The assumption of the relationship between trade protection and foreign direct investment is mentioned in many studies. Firms more likely to substitute affiliate production for exports under higher protection. However, it would not include in present empirical analysis because it is inaccurate to quantify non-tariff forms of protection and import data in empirical analysis.

General Equilibrium Analysis of FDI Decisions and Locations

In studies of using cross-sectional data and time series data are interested in the long run influencing factor. The missing analysis of long-run general-equilibrium factors that affect FDI decisions and locations leaded omitted variable bias in empirical specifications. The gravity model of trade appeared in recent year, provided more accurate empirical analysis in long run factor between two countries. However, the present study would not import the gravity model of trade since the study is focusing on smaller sample size between US and China.
METHODOLOGY

The study examines the effect of Chinese economic growth on US direct investment into China. The study employs robust OLS models. Existing literature has demonstrated a suit of critical factors that can influence the amount of direct investment from the US to China. Direct factors include GDP growth in China, taxes on direct investment, unemployment rates in China, China’s inflation rate (GDP deflator), and international trade levels as the index for market openness level (Nicholas, 1999). To capture these forces, study employ the following regression model:

\[ \text{Log}(\text{FDI}) = \beta_0 + \beta_1 \text{GRW} + \beta_2 (\text{TAX})^2 + \beta_3 \text{UN} + \beta_4 \text{INT} + \beta_5 [\text{Log}(\text{IM})]^2 + \epsilon \]

This specification follows the country-level model tested by Nicholas in an empirical analysis of the location of foreign direct investment (Nicholas, 1999). My dependent variable (FDI) is US Foreign direct investment to China (in millions of US dollars), is logged in regression analysis to avoid distortion from outliers. My key independent variables are the GDP growth rate (GRW) in China (in percentage term), total tax rates (on revenue excluding social contributions and natural resource revenue) in percentage term (TAX) measuring tax costs in China for foreign direct investment, China’s unemployment rate (UN) (in percentage term, China’s), inflation rate (INT) that is GDP deflator, and in percentage term, and China’s real imports (IM) in millions of US dollars (Nicholas, 1999). In addition, in Nicholas’s study, “Log (FDI) is used as the dependent variable to allow easy inference of elasticities” (Nicholas, 1999). Also, as in Nicholas’s study, the replacement of TAX with TAX^2 results in a satisfactory set of test statistics and a higher R-Squared. In Nicholas country-level model, based on the
nonlinear relationship between FDI and IM, the factor \([\text{Log(IM)}]^2\) replacing the factor IM better satisfies the all the model diagnostics. In addition, \(\beta_0\) represents the constant term, and \(\varepsilon\) is the error term in the model.
DATA SOURCE DESCRIPTION AND ANALYSIS

Data Source Description

My study uses data from three publicly available data banks, World Development Indicators (WDI) (March, 2017), Statistics: Direct Investment and MNEs from the Bureau of Economic Analysis (BEA) of U.S. Department of commerce (2017), and the Government Revenue Dataset from International Centre for Tax and Development (ICTD) (June, 2016) (See Table 2).

World Development Indicators\(^1\) is a time-series documentation of various development indicators of countries and regions around the world from 1960 to 2015. The data reported by officially recognized international sources, and compiled by the World Bank Group. My statistics on China’s annual GDP growth rate, inflation rate (GDP deflator), unemployment rate, and the real imports are from WDI.

Information on US direct investment on China was obtained from Statistics: Direct Investment and MNEs\(^2\) from Bureau of Economic Analysis (BEA) of U.S. Department of Commerce (2017). The statistics record the amount of US direct investment on China from 1982 to 2015. The present study uses quarterly BEA data for the period 1990 - 2015.

---

\(^1\) World Development Indicators, retrieved from http://data.worldbank.org/data-catalog/world-development-indicators

\(^2\) Statistics: Direct Investment and MNEs, retrieved from https://www.bea.gov/iTable/index_MNC.cfm
Data on home country (China’s) total tax rate (on revenue excluding social contributions and natural resource revenue) was obtained from the ICTD Government Revenue Dataset 2016: Merged. This dataset combines data from several major international databases, and is maintained the International Centre for Tax and Development.

Table 2: Information of Data Sources

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Indicator Name</th>
<th>Source</th>
<th>Organization</th>
<th>Updated Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>FDI</td>
<td>U.S. Direct Investment Position Abroad on a Historical-Cost Basis (By Country)</td>
<td>Statistics: Direct Investment and MNEs</td>
<td>Bureau of Economic Analysis (BEA) of U.S. Department of Commerce</td>
<td>2017</td>
</tr>
<tr>
<td>GRW</td>
<td>GDP growth (annual %)</td>
<td>World Development Indicators (WDI)</td>
<td>World Bank</td>
<td>March, 2017</td>
</tr>
<tr>
<td>TAX</td>
<td>Total tax rate (on revenue excluding social contributions and natural resource revenue)</td>
<td>Government Revenue Dataset</td>
<td>International Centre for Tax and Development (ICTD)</td>
<td>June, 2016</td>
</tr>
<tr>
<td>UN</td>
<td>Unemployment, total (% of total labor force) (modeled ILO estimate)</td>
<td>World Development Indicators (WDI)</td>
<td>World Bank</td>
<td>March, 2017</td>
</tr>
<tr>
<td>INT</td>
<td>Inflation rate (GDP deflator)</td>
<td>World Development Indicators (WDI)</td>
<td>World Bank</td>
<td>March, 2017</td>
</tr>
<tr>
<td>IM</td>
<td>Import Value Index</td>
<td>World Development Indicators (WDI)</td>
<td>World Bank</td>
<td>March, 2017</td>
</tr>
</tbody>
</table>

Empirical Result And Analysis

Nicholas’s study established the direct influence factors affecting the direct investment between two countries. However, his study did not appreciate the impact on FDI between two specific countries. To estimate the impact of these influence factors on the foreign direct investment between US and China, OLS regression model with US and Chinese quarterly statistics in the period 1993 to 2015. Table 3 presents my regression result.

Table 3: US Direct Investment into China: OLS regression

<table>
<thead>
<tr>
<th>Log(FDI)</th>
<th>Coefficient</th>
<th>Robust Std. Err.</th>
<th>t</th>
<th>p-value</th>
<th>95% confidence interval</th>
</tr>
</thead>
<tbody>
<tr>
<td>GRW</td>
<td>0.1065</td>
<td>0.0211</td>
<td>5.06</td>
<td>0.000</td>
<td>0.0647 – 0.1484</td>
</tr>
<tr>
<td>TAX(^2)</td>
<td>-0.0009</td>
<td>0.0004</td>
<td>-2.56</td>
<td>0.012</td>
<td>-0.0017 – -0.0002</td>
</tr>
<tr>
<td>UN</td>
<td>0.1266</td>
<td>0.1013</td>
<td>4.41</td>
<td>0.000</td>
<td>0.2454 – 0.6479</td>
</tr>
<tr>
<td>INT</td>
<td>0.0316</td>
<td>0.0054</td>
<td>5.8</td>
<td>0.000</td>
<td>0.0207 – 0.0424</td>
</tr>
<tr>
<td>[Log(IM)](^2)</td>
<td>0.0920</td>
<td>0.0087</td>
<td>10.55</td>
<td>0.000</td>
<td>0.0747 – 0.1093</td>
</tr>
<tr>
<td>Constant</td>
<td>6.5524</td>
<td>0.3075</td>
<td>21.31</td>
<td>0.000</td>
<td>5.9415 – 7.1633</td>
</tr>
</tbody>
</table>

Number of obs = 96
Prob > F = 0.0000
R-squared = 0.9577
Root MSE = 0.29892
**GRW, UN, INT**

The coefficient of *GRW* is positive and significant (at the 95% level) since a higher GDP growth rate evidently attracts more foreign capital inflows to country. The coefficient on *INT* is also positive and significant (at the 95% level). Then, the results confirm Culem's (1988) view that low interest rates (host country) encourage MNEs to raise more funds in the host country that reduce the size of the actual inflow of funds recorded in the Balance of Payments. The model also shows that, as Friedman (1992) suggested, high unemployment attracts *FDI* since it is a sign of both labour abundance and a willingness to work for a lower wage.

**TAX**

The relationship between *FDI* and *TAX*\(^2\) is negative and significant (at the 95% level), as the past studies suggested. However, to compare this nonlinear relationship to the others, we need to calculate the elasticity of *FDI* with respect to the corporate tax rate. Table 4 indicates the elasticity of *FDI* respect to the corporate tax rate by the following calculation:

\[
\frac{\partial \log FDI}{\partial TAX} = \frac{\partial \log FDI}{\partial TAX^2} \cdot \frac{\partial TAX^2}{\partial TAX}
\]

\[
= (-0.0009) \times 2 \times (TAX)
\]

\[
= -0.0018 \times (TAX)
\]
Table 4: Summary of the Elasticity of FDI Respect to TAX

<table>
<thead>
<tr>
<th>Variable</th>
<th>Objectives</th>
<th>Mean</th>
<th>Standard Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elasticity</td>
<td>96</td>
<td>-0.0289</td>
<td>0.0091</td>
<td>-0.0511</td>
<td>-0.0168</td>
</tr>
</tbody>
</table>

It is evident that the elasticities of FDI respect to TAX are significant influencing on the US direct investment into China, and the degree of influence is varying from -0.05 to -0.16.

IM

Since the undesirable properties of the highly nonlinear relationship between FDI and IM, the model distinguish the factor of IM by \( (\log(IM))^2 \). Similar to the TAX, it is not effective to interpret the factor directly, and it is more useful if we describe the result by the elasticity with FDI as following:

\[
\frac{\partial \log FDI}{\partial \log IM} = \frac{\partial \log FDI}{\partial (\log(IM))^2} \cdot \frac{\partial (\log(IM))^2}{\partial \log IM}
\]

\[
= \frac{\partial \log FDI}{\partial (\log(IM))^2} \cdot 2 \log(IM)
\]

\[
= 0.0920 \times 2 \log(IM)
\]
Table 5: Summary of the Elasticity of FDI Respect to IM

<table>
<thead>
<tr>
<th>Variable</th>
<th>Objectives</th>
<th>Mean</th>
<th>Standard Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elasticity</td>
<td>96</td>
<td>5.540714</td>
<td>2.131973</td>
<td>0.243997</td>
<td>0.868767</td>
</tr>
</tbody>
</table>

Table 5 indicates the US direct investment into China is influenced by real import by the elasticity ranging from 0.24 to 0.86.
POLICY IMPLICATIONS

Promote Industrial Structure Optimization

China’s government should encourage the United States to flow more to the services industry for industrial structure optimization. In service industry, US enterprises have advantage on technology and management system that played a more important role in strengthen the development of services industry. At present, the US investment in China's service investment is still lower than its investment in the Asia-Pacific region and foreign investment in the proportion of the total investment in services, and many of China's service industry has a monopoly and the degree of openness has a great relationship. Therefore, we should gradually expand the market access of the service industry, eliminate institutional and policy barriers, and promote the flow of US capital into the service industry. To focus on attracting investment in the US logistics industry, and actively contract the US information technology outsourcing business, the appropriate introduction of US investment to participate in commercial banks, insurance companies share-holding system reform.

Tax

China's "going out" strategy can be successful requires foreign investment enterprises and the joint efforts of our government, market-oriented to stimulate the initiative of the enterprise and get stronger international competitiveness. Tax policy is one of the more effective means of market. At present, the tax policy adopted by each country on its foreign direct investment enterprises is neutral and non-neutral.
On one hand, the domestic and foreign investment of resident enterprises is treated equally on the tax burden, and the income obtained from the inside and outside tax laws and regulations to declare tax, not to differentiate the tax burden of its investment decisions; the other hand, the residents of foreign direct investment income derived from deferred tax or tax concessions to encourage enterprises to expand the scale and areas of foreign investment, to enhance its Self - management of the enthusiasm and creativity. In view of the tax burden of China's foreign direct investment enterprises, the specific recommendations are as follows:

**Tax incentives for specific foreign investment industries**

Such as oil, natural gas and important metal mineral resources, overseas scientific and technological cooperation, advanced manufacturing, foreign investment in infrastructure investment and other areas of foreign key areas of foreign investment, foreign investment tax burden should not be higher than the domestic industry Tax burden, therefore, the profits of these industries can be given a certain period of time to extend the preferential tax policy. In addition, because the oil and gas industries need a long time to adapt to the host country's investment environment and the investment cycle is longer, so you can allow such enterprises to adopt a flexible form of corporate organization and investment, and increase the indirect income level.

**Improve the tax credit system, timely introduction of the comprehensive limit credit method**

Compared to China's current sub-national credit limit approach, the comprehensive limit of credit is conducive to taxpayers, to better reflect the government's policy of overseas investment incentives. Consolidated credits can increase the overall amount of credit
between the countries where each investment is made on the credit limit. Formulate the overdue part of the forward carry-over period. The portion that exceeds the credit limit can be offset by a three-year period based on the current allowable payments within the next five years. This will help enterprises to increase the opportunity to offset, reduce the actual effective tax burden.
CONCLUSION

China and the United States have many opportunities and challenges of foreign direct investment. China's 12th and 13th Five-Years Plans, reflect a high expectation of participating in the international economic system and contributing to the international economy. China's direct investment in the United States and US's direct investment in China have grown linearly in recent years, and the Chinese government has encouraged a series of policies to encourage outward and inward trade and investment, from the perspective of international trade and foreign direct investment between China and the United States. The continued growth of China's GDP reflects the greater strength of domestic firms in directly investing in the United States, and greater attraction to attract direct investment from the United States. But at the same time, China still need to strengthen its system for emerging domestic enterprises invest overseas, and to create better conditions for the introduction of foreign capital. Direct foreign investment between China and the United States is complementary. Maintaining a benign investment environment also requires China to continue its sustained and stable economic development, and to conduct a healthy investment environment improved policies and regulations. As a result, there will be more direct foreign investment between China and the United States.
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