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Chinese Overseas Direct Investment – What Kind of Opportunity?

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Summary

- China has never before been an external investor. In the Qing Dynasty, 150 years ago, its accumulation of silver bullion in return for goods led to tragic conflict with the West.

- China's overseas investments, and the reactions to them, have raised questions over the division between the state and non-state sector in China, the corporate governance of Chinese companies, and over the real condition of the Chinese economy.

- For economies like the UK's, the imminent flow of Chinese investment offers an opportunity and a challenge. It brings encounter, and potential conflict, with Chinese corporate behaviour, with the Chinese state controlling the funds, and with Chinese aspirations and their real intent in the 21st century as they extend their sphere of influence.

Introduction

After years of Maoist economic enclosure and Soviet-style command economy structures the last three decades have seen China's Reform programme, in which the government has implemented sometimes radical policies to encourage Foreign Direct Investment (FDI) in China. They were inspired by the performance of Japan and the four Asian tiger economies, Hong Kong, Taiwan, Singapore and South Korea, to create high rates of economic development on the back of exports. The statistics for this phase of China's development are well known – and impressive. Average annual GDP growth of 10% helping China to become the world's fourth largest economy in 2006, leap-frogging the UK and France, and now breathing down the necks of the Germans and Japanese. China is now set to be the world's largest trading entity in terms of inward and outward flows of goods and capital by 2010, if not before. It has become the world's third largest exporter of manufactured goods, after Germany and the US, though this slips to 6th place if invisible services are included. In the process of becoming, in effect, the world's factory, it has amassed a stock of over USD700 billion, increasing in the last three years, according to Chinese official statistics, by USD60 billion per year.[1] It has been the largest recipient of FDI year-on-year for the last decade.

Almost 60% of this FDI has been directed into manufacturing. 40% of it has come either from Hong Kong (which, as a Special Administrative Region (SAR) is considered separate from Mainland China's territory economically) the Cayman islands and the British Virgin Islands (BVI). As a manufacturer, China supplies Wal-Mart in the US with USD18 billion of goods per year, and Tesco's in the UK with USD4 billion. The centrality of its importance as a global manufacturer has been highlighted by the recent quality problems with Chinese goods to overseas markets, and the fact that, for the volumes of goods involved, overseas buyers have few choices about where else to source their products.[2]

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[1] Source - `*Chinese Annual Statistical Yearbook*' , Beijing, 2007.

[2] See Kerry Brown, `China is an Opportunity, nor a Threat,' Daily Telegraph, August 16th 2007, at: http://www.telegraph.co.uk/opinion/main.jhtml?xml=/opinion/2007/08/16/do1604.xml

China's FDI story since 1979, when its first Joint Venture Law was passed, has been at the same time both a victory and a defeat. It has been a victory in as much as it has led to economic success. In early 2006 it overtook Japan as the holder of the world's largest stock of Foreign Currency reserves. It has led to the lifting of 2-300 million Chinese out of poverty, and created, in the coastal regions of China, some of the most modern cities in the world with a thriving middle class.

But it has also been a defeat. China's manufacturing has taken a terrible toll on its environment. It has made the country one of the most energy and resource hungry countries in the world. Its economic model means it runs politically damaging deficits with the US, and the EU, its largest trading partners. It has pushed China towards a position where it hangs on to two contradictory positions – a one Party state, with a `market socialist' system which has become one of the most economically open in the world for outside investors. In the 1980s, Chen Yun, politician and economist, described China's aims as creating a situation where the economy (the bird, as he prosaically described it) was in a cage (the cage being the political leadership of the Communist Party). In 2007, the cage has expanded massively, and the bird is free to roam almost anywhere.[3]

There is also a question mark over how much FDI has really helped China in its ultimate aspiration of creating strong, internationally viable Chinese multi-national companies. 88% of Chinese hi-tech exports in 2005 were made by Foreign Invested Enterprises (FIEs), leading to little knowledge and technology transfer.[4] `Made in China', it has often been pointed out, means made by a foreign company, for export – usually South Korean, Hong Kong, or Taiwanese. The Chinese government is rightly concerned over this reliance, especially as one of the original motivations for encouraging FDI, acknowledged even by Deng himself, was to bring intellectual property and capabilities into China. In the 1990s, the then Premier, Zhu Rongji, talked of creating a `knowledge economy.' As of 2007, that has not happened. China is still predominantly a source of cheap labour, even though it is producing

[3] See Elizabeth Economy, *`The River Runs Black',* Cornell University Press, 2004, for a very good account of China's environmental problems.

[4] Barry Naughton, *`The Chinese Economy'*, MIT Press, 2007, p 396.

increasingly complex goods, and encouraging its companies to invest more into research and development (R&D). [5]

China's Unprecedented New Position

As a result of its economic model China now has USD1.3 trillion foreign reserves, increasing by USD50 billion a month. This has placed China at a crossroads. Having never before been an outward investor of any significance, its massive amounts of foreign reserves now mean that its state and non-state companies can begin to operate internationally as never before.

In the late 1990s, China had a tiny stock of overseas investment, mostly in mining projects, and in oil and petrol, some in Latin America, Australia, and Canada. Much of its investment was routed through Hong Kong. It amounted to no more than a few hundred million USD. In the 1990s, particularly after 1992, the central government talked of a `Go Global' campaign, selecting 100 Chinese state companies which it would assist in becoming global players over the course of the next two Five Year Plans. Scholars like Professor Peter Nolan, from Cambridge University, wrote of the intrinsic weaknesses of Chinese companies compared to their foreign competitors, in terms of scale, R&D capacity, branding power, and international exposure.[6] The fragmentation of the Chinese economy, where its 31 provinces, autonomous regions, and cities under the central government often had markedly different trade policies, meant that there was little economy of scale for companies. Provinces and companies competed as much against each other as against other countries. Yasheng Huang, a US-based economist originally from China noted that for a Chinese businessman in a Southern province, it was often easier for them to set up factories abroad than in a Northern Chinese province.[7]

Paradoxically, the Chinese government's attempt to help its 100 companies was initially unsuccessful but led, indirectly, to success. Deng Xiaoping, in the

[5] A very good analysis of China's FDI is contained in Yasheng Huang, *`Selling China: Foreign Direct Investment During the Reform Period'* , Cambridge University Press, 2003.

[6] See in particular, *`China and the Global Economy',* Palgrace Macmillan, 2001.

[7] Op cit, *`Selling China'*

early 1980s, commented that one of the greatest successes of the original reform process, the creation of hundreds of thousands of semi-privatised Town and Village Enterprises, was in fact both unforeseen and unintended. One could argue that the Go Global campaign, in its original form, was looking for champions in the wrong place. It was not the state-owned enterprises that would become international players but the non-state sector, judged by Yasheng Huang to be `lowest of all' on the political pecking order. Yet according to the 2005 OECD report on the Chinese economy, they were responsible for over half of China's GDP growth.[8]

In the 1990s, the Chinese government set a clear policy framework for overseas investment. Any investments above a small amount needed central government approval and needed to be in resource acquisition and energy. Over the ensuing years, that policy framework evolved. Gradually, Chinese provinces were delegated the same autonomy as they had been in attracting FDI. China looked long and hard at the state investment funds run by, among others, the Singapore government, whose Temasek group had been successful, building up a stock of USD100 billion of overseas investments. In 2006 it set up the State Investment Fund, under a former Vice Minister of Finance Lou Jiwei, with a formal stock of USD200 billion of China's central reserves.[9] This fund will start to make its first formal investments in early 2008.

The creation of such a fund has an air of inevitability about it. At the moment, China has purchased USD400 billion in US treasury bonds. They offer reliable returns, but many in the US have been struck by the irony of the world's richest, largest economy needing its debt to be financed by a Communist country who it often regards, as a competitor and a threat. Recent rumours that the Chinese government were thinking of withdrawing their stock of bonds led to shadowy murmurs of trade war, and this being the tip of an ugly iceberg of political and commercial conflict as the US moves into an election year. But the Chinese are still left with a problem – a massive stock

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[8] The OECD report can be accessed via http://www.oecd.org/document/45/0,3343,en_2649_201185_35344877_1_1_1_1,00.html, accessed 13th December 2007.

[9] For an overview of China's outward investment structures, see Pamlin, Dennis and Long Baijin, *`China's Outward Investment Flows,'* World Wildlife Fund, April 2007, available at www.panda.com/invest.

of foreign reserves, 70% held in US dollars, raising tiny amounts of interest and vulnerable to exchange rate fluctuations.

Beginning of the Spending Spree – A Few Cautionary Tales

In the last decade, Chinese enterprises have made more forays into the international arena. Not the 100 Global champions the government originally chose, but companies who looked to be following commercial rather than political imperatives. Some worked. Some didn't. On some the verdict is still out. But they give a sense of where China is heading in this new stage of its development.

The attempt by China National Overseas Oil Corporation (CNOOC) to purchase the US energy company Unocal in 2004 raised massive press interest in the US. CNOOC's bid of over USD18 billion for Unocal met with political resistance in the US. Congressmen condemned it as an attempt to take over a US strategic industry by a Chinese government owned company. Attempts by CNOOC's executives to placate critics by saying that whatever CNOOC's structure in China, it would perform according to international rules in its activities outside China got nowhere. CNOOC withdrew its offer in the autumn of 2005, citing political obstacles. The depth of opposition it had come across obviously took the Chinese government back. Money, and lots of money at that, was not enough. To be an investor, at least in these sectors in the US, one has to be seen as a friend.

Even the much cited takeover of IBM's personal computer division and the Think Pad brand by the Chinese non-state IT company Lenovo in 2004 drew some concerns. The deal was only allowed to proceed on the understanding that Lenovo (previously known as Legend) only be able to process computers carrying non-classified material for one of its largest customers, the US State Department. Lenovo spent over USD1.5 billion on this deal – and it is held up as a success. It gave the company access to international markets, to foreign expertise, to a foreign brand – all of the things Chinese executives said they were really seeking in foreign acquisitions when surveyed. But matching the corporate cultures of Lenovo and IBM, proved challenging.

One of the great heroes of Chinese entrepreneurship is Zhang Ruimin, of the electrical appliance company Haier. However, he found that taking his company global was harder than building up a successful manufacturing company within China. His attempt to purchase the US washing machine manufacturer, Maytag, fell after a counter-bid, despite the fact that Haier already had a factory in the US. Even a deal that succeeded in going through, the purchase of the French TV manufacturer Thomsons, by TCL of China in 2005 has gone through a painful teething process, with reasonable profits in Asia and the US wiped out by massive losses in Europe.

As of 2006, China's best known attempts to make acquisitions abroad, presented a very mixed record. Beyond resources and energy, it was clear China wanted expertise and intellectual property, association with brands that could help them enter foreign markets and sales networks. It was clear that this was a strategy for immediate market access. China wanted to buy existing assets in the West. But it was also clear that the Chinese, however much of a hurry they were in, needed a lot of help, and were on a steep learning curve. D'long, the Xinjiang based company in North West China, originally successful in property, attempted to copy Warren Buffet's strategy of buying up undervalued brands in the US and Europe. However visionary its methods, it went down as a *cause celebre* – spreading its risks wide and far, and tumbling into debt and liquidation in 2002.

Where China's ODI is Now, and Where it is Heading

The bottom line statistics, at least in September 2007, are simple. China has about USD60 billion committed abroad as investment, almost a quarter of it in Hong Kong. Most of this investment was committed in the last three years, with overseas investment of USD12 billion in 2006. China has less than USD1 billion in the US, and only USD100 million in the UK. Of the global stocks of ODI, China accounts for less that 1 per cent.[10]

In Africa, China has become a major donor of aid, and investor in infrastructure and energy projects. But its impact, and its experience in Africa and Latin America show the dangers that its companies face in their

[10] Figures from UK Trade and Investment, *`China Statistical Yearbook 2006'* and US China Business Council.

accelerated entry into international markets, as seen in Chinese mining company Shouguang's investment in a Chilean mine. Over USD125 million was promised in the early 1990s when Shouguang signed the agreement, but there was almost no financial input over the next decade, resulting in acrimonious labour disputes in the early 2000s, angry condemnation by local and national governments, and heavy-handed reaction by the Chinese owners, who simply imported Chinese workers to run the plant, exacerbating tension.[11] In terms of corporate governance, and assessment of environmental impact, Chinese companies, both state and non-state, come from a wholly different environment. China lacked a basic company law for its indigenous enterprises until the early 1990s. It has constructed, literally from scratch, a non-state sector over the last three decades. But this has grown up in a highly idiosyncratic environment, with a highly politicised legal framework.

As foreign governments and companies look at these enterprises emerging from China, they see the shadow of the Chinese state. Whatever the CNOOC executives said, opponents of the deal with Unocal (from across the political spectrum) said that in the end CNOOC was an arm of the state. And that state was the world's largest, last remaining communist dictatorship. It belonged to an entity that had failed to spell out, in an open and transparent manner, the divisions between it and the executive functions of government, in which all major decisions were made in the end by power holders in the Party. It was, in essence, still profoundly Leninist.

Former Singaporean official, and now academic Dr Friedrich Wu, has talked of the clear regenerative benefits Chinese companies can bring as they have in Poland and other Eastern European industrial areas. He has described this as a potential `win-win' scenario.[12] However this is not the case for Germany, one of the most successful in Europe at attracting Chinese ODI, with over 1000 Chinese investments, 500 in Hamburg. Most of these investments have been small – employing no more than a few people and over half folded in their first year. The abiding image is of the Chinese using 200 COSCO

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[11] See full account of this in Kurlatzick, Joshua: `*Charm Offensive: How China's Soft Power is Transforming the World,'* Yale University Press, New Haven and London, 2007, pp 168-169.

[12] Wu, Friedrich: `*The Globalisation of Corporate China'*, National Bureau of Asia Research Analysis, Vol 16, Nov 3, Dec 2005.

container ships to cart the steel plant they had bought back, piece by piece to the final screw, to southern China.[13]

There is only one certainty in all of this. In the era of the global economy, in which, especially since its entry in WTO in 2000, China has been inextricably plugged in. China has no other option than to go global, and encourage all enterprises, state and non-state, to `go out.' It is unavoidable. The era of China as a major overseas investor is already here. The question is not how to stop it, if that was ever an option, but to work out what to do with it. What the Chinese government means when it talks of the `win-win' from its investments abroad might mean very different things to the recipient economies.

Britain – A Tale of Underperformance

Britain one of the world's most open and liberal economies home to a key global capital market and the largest destination of FDI (including mergers and acquisitions) should be first in-line for this emerging wave of Chinese ODI. In global surveys, the UK, USA and Australia consistently rank as places Chinese enterprises most want to make investments in. But Chinese investment in the UK actually fell between 2004 and 2005, whilst increasing in other European countries. There are 200-250 Chinese companies investing in the UK including Air China, Bank of China, COSCO, Huawei and Fujian Hi Tech Park companies. Almost 100 of these are in London. But, when the China Development Bank share in Barclays is excluded, this investment barely reaches £100 million.

The highest profile Chinese investment in the UK, so far, has been the takeover by Nanjing Automobile Company of MG Rover in 2005. It was a deal preceded by a huge amount of political negotiating, originally approached by the Shanghai Automobile Company who dropped out after refusing to take over the pension liabilities of the British company. Following this, top-level discussions ensued between the then British premier Tony Blair and Chinese premier Wen Jiabao for over three years, until finally the investment by Nanjing Automobile Company was made. As with the Thomsons takeover by TCL, it has been a mixed result. Technical kit and expertise has been taken

[13] This is dealt with by Brown and von Rada, `*The Rise of the Dradon, Chinese Inward and Outward Investment in the Reform Period'*, Chandos, 2008.

back to China, and the MG Rover factory in Longbridge employs barely 100 people, producing components for a proposed new range of cars that were criticised as looking very much like old models. The Chinese minority stake in perhaps the UK's last remaining vehicle manufacturing plant, Manganese Bronze, maker of the London Black taxi cabs, has so far been more successful.

Huawei, a Shenzhen-based telecoms company, has created a richer relationship in the UK and may well offer a glimpse of what the future could be like. With over 350 people based in the UK, they have won a major part of a contract to supply BT with telecoms equipment, and are well placed to take further parts in this long term project. Huawei is 20% owned by the Chinese government, but 70% of its business is overseas, with over 2,500 employees in Europe. It commits 10% of revenues to R&D. Unlike the US, the UK's hospitality to investment in the telecoms sector indicates how the UK is a an easier environment for Chinese investors. The UK and China enjoy a less politically-charged relationship than China and the US. The question is whether the UK wants to present this as a clear advantage, and in an era of heightened security whether the UK will place limits on this open investment climate.

Quick Learners

China's experience with Unocal left a bitter taste to many in China. Many equated Chinese investment with an exploitation of natural resources.[14] But two events in 2007 prove that the Chinese are proving quick learners – the Chinese investment in US hedge fund Blackstone, and the purchase of a stake in Barclays by the China Development Bank. The second in particular is of significance in the UK receiving political clearance from the Chancellor of the Exchequer, Alistair Darling. It was part of a possibly larger deal, if, and when, Barclays proceeded in their bid to take over the Dutch bank ABN AMRO. The investment went against the prevailing current of British banks, among them Royal Bank of Scotland and HSBC, taking stakes in Chinese banks.

[14] This is a complaint particularly made by Bobo Lo in his study of relations between Russia and China, in `*Axis of Convenience',* Chatham House and Blackwell, 2007, Chapter Four.

Even more significantly, Blackstone had been China Development Bank's adviser on the deal. As one commentator said, this was proof that China was really thinking about where it was going in terms of ODI. [15]

'You Should be Worried – We Are'

The Barclays deal raised little concern. The message seemed to be that even in a strategic sector like banking, China is welcome. What would the reaction be if the stake in Barclays edged from under 10% to closer to 20%? And if a Chinese investor in a major industry in the UK went bust, would the UK accept that the Chinese government could be powerless to bailout a `non-state enterprise, investing under its own steam abroad.'

The perception of Chinese companies, just as with China as a country, is both positive and negative. While the West might be deeply impressed by China's emerging economic clout, it is also unsettled by it. Popular Western criticism has focussed on unethical investments and practices overseas, particularly Sudan. Hypocritical it might be, but the bottom line is that Chinese companies abroad have an image problem.

The Chinese government and Chinese companies have undertaken major soft diplomacy campaigns over the last few years. But they need to build up a better track record of operating according to Western standards of accountability, transparency and corporate governance. Unfair it might be, but their relatively recent arrival means that they are up against a challenge to become better understood, and trusted. And somehow they have to counter the presumption that all enterprises serve the agenda of the Chinese state.

The USD200 billion set aside so far for the State Investment Fund should also be seen in proportion. It is far less than Abu Dhabi's fund of approximately USD700 billion, and Temasek's fund of some USD400 billion. Relative to the funds managed by UBS (USD2.2 trillion), or the world's top ten investment banks and fund managers (USD14 trillion) it is small.[16] There are other things that China could do with its reserves – set up a welfare system or fund public investment. Or simply continue to save it, although the longer this goes on the

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[15] Eli Tamir from the London Business School, quoted in [15] Guardian, May 22nd 2007.

[16] I am grateful to Professor Peter Nolan for these insights.

more of a problem it becomes. What China chooses to do with this investment fund is of political importance. It will indicate Chinese behaviour in a new, untested area – an area that with global repercussions.

The UK's Choice

The UK clearly presents an attractive offer to Chinese enterprises. The stock exchange in particular has proved successful for Chinese business, especially the Alternative Investment Market (AIM), with over 50 Chinese companies listing in the last few years. The Barclays deal offers a great advert for the UK's attractions as a place to invest. The message is simple: Britain is more open than other economies.

Before the UK prepares for a deluge of Chinese money, either in M&As (the bulk of China's investment involvement in the West so far), straight buyouts, or strategic investments, it is worth keeping a few clear messages in mind:

- The UK, both at corporate and government level, needs to be very clear about what the Chinese strategic investment aim is. Is it long term? If so, it must be interpreted and understood as clearly as possible. Short term aims are also problematic, particularly in terms of stability. In both cases, engagement is needed in order to increase influence and secure a win-win outcome.

- Chinese political and economic behaviour from the period of Deng onwards has been dominated by pragmatic decision-making. The Chinese strategy is most likely to be dominated by China's national interest. In simple terms that means a strong China. China's investments, whether they are to secure resources, energy or market access, are there to strengthen China's international position and serve its domestic interests. In engaging with this, the UK needs to have a clear understanding of its own national interest.

- The Chinese are no strangers to Western practices and the Western business environment. In the space of one generation China has gone from a closed environment to one of the most open in the world. They have sent hundreds of thousands of students abroad, and allow increasing numbers of party officials to study abroad. The knowledge deficit is now with the West. This needs to change, and change quickly. The era of labelling China as different is over.

- Sun Tzu famously stated in `The Art of War' that one should `know your enemy'. While the UK and China are not enemies, there are clear areas where of difference. The UK has a liberal economy, strong tradition of rule of law, high expectations of corporate transparency and a powerful independent press. China remains a one-party state, with an evolving but flawed rule of law and a press under strong state control. In the months and years ahead, the UK should see China for what it is, not what we want it to be, or what we fear it might be. We cannot engage in this process on the basis of illusion.

Final Recommendations

- The UK is well placed to attract, and benefit from Chinese ODI. It should send clear messages to the Chinese government that it is open to Chinese ODI, as proved by the Barclays deal and others.

- The UK must clearly position itself as China's preferred ODI destination. All major strategic levers should be used to achieve this. But the UK should be clear about what the cut off point for Chinese investment is, in which sectors and to what degree.

The UK should be confident in the robustness of its political system, and its ability to ensure stability and optimum economic performance. It should seek ways to influence, and improve Chinese corporate governance by encouraging more Chinese firms to operate in its environment. Ultimately, further co-operation is needed between China and the UK to ensure that outcomes are mutually beneficial.