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In the past half decade Chinese foreign direct investment has become a major element of global capital flows. Chinese investment abroad represents a new dimension of China's integration into global economic and political systems. The upward trend is clear. As China relaxes restrictions on outbound capital flows, an increasing share of the country's foreign asset holdings will likely shift from official holdings of foreign exchange reserves to direct investment abroad by Chinese companies.

The Chinese government's encouragement for companies to 'go global' has seen Chinese state-owned enterprises (SOEs) secure a growing share of the international investment market, with particular interest in resource investment during the current global commodities boom or in technology acquisitions. With huge foreign reserves and access to low-cost funding, Chinese firms have begun to make a big wave.

But Chinese corporations have faced a number of problems in going global, including resistance in host countries, especially in the developed world; claims of neo-colonial motives in the developing world; and colourful reporting of their operations by foreign media. Chinese investors face a steep learning curve.

Host countries, too, are still working out how to judge their interests correctly in capturing the benefits from Chinese direct investment abroad—a major new source of investment when capital from developed economies is drying up.

Business abroad involves more than merely economic interaction between foreign enterprises and the state: it entails significant political interaction as well. This is particularly the case with China, as many of its overseas investors are SOEs. There is growing debate globally about whether and how the role of SOEs affects the benefits that host countries gain from Chinese investment abroad—a debate that is really about the interaction between national political institutions that are ordered around different principles and political constitutions, and how these institutions evolve in settings governed by market disciplines.

This issue of *EAFQ* assembles perspectives from top analysts to review the issue. It provides a start in serious and objective analysis of how we should properly look at the growth and reception of Chinese direct investment on the international stage.

Peter Drysdale and Shang-Jin Wei
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CONTRIBUTORS & STAFF

Ilan Alon is Cornell Professor of International Business and Director of the China and India Centers at Rollins College. He is also a visiting scholar and Asia Fellow at Harvard University.

Shiro Armstrong is a research fellow in international development economics at the Crawford School of Public Policy, the Australian National University.

Deborah Bräutigam is Professor of International Development at the School of International Service, American University, Washington DC, Professor II at the University of Bergen, Norway, and a senior research fellow at the International Food Policy Research Institute.

Peter Yuan Cai is an Australian journalist and a former Commonwealth Treasury policy analyst.

Jeremy Clegg is Jean Monnet Professor of European Integration and International Business Management, University of Leeds.

Peter Drysdale is Emeritus Professor and Head of the East Asia Forum and East Asia Bureau of Economic Research at the Crawford School of Public Policy, the Australian National University.

Gao Xiqing is Gao Xiqing is Vice-Chairman and General Manager at the China Investment Corporation, Beijing.

Yiping Huang is Professor of Economics at Peking University and at the China Economy Program, the Australian National University. He is also Chief Economist for Asia at Barclay's Bank, Hong Kong.

Luke Hurst is a doctoral candidate in economics at the Crawford School of Public Policy, the Australian National University.

Raphael Kaplinsky is Professor of International Development at the Open University.

Barbara Kotschwar is a research associate at the Peterson Institute for International Economics.

Terence McNamee is Deputy Director at the Brenthurst Foundation, South Africa.

Curtis J. Milhaupt is Parker Professor of Comparative Corporate Law and Fuyo Professor of Japanese Law at Columbia Law School.

Greg Mills is Director at the Brenthurst Foundation, South Africa.

Theodore H. Moran is the Marcus Wallenberg Chair in International Business and Finance at the School of Foreign Service, Georgetown University, and a senior fellow at the Peterson Institute for International Economics.

Julia Muir is a research analyst at the Peterson Institute for International Economics.

Miguel Pérez Ludeña is an economist at the United Nations Secretariat.

Daniel Rosen is partner at the Rhodium Group and visiting fellow at the Peterson Institute for International Economics, and a long-standing Adjunct Professor at Columbia University's School of International and Public Affairs.

Karl P. Sauvant is Senior Fellow at the Vale Columbia Center on Sustainable International Investment, Columbia Law School, and The Earth Institute, Columbia University.

David Shambaugh is Professor and Director of the China Policy Program in the Elliott School of International Affairs at George Washington University and a non-resident Senior Fellow in the Foreign Policy Studies Program and Center for Northeast Asian Policy Studies at the Brookings Institution in Washington, DC.

Graeme Smith is a postdoctoral research fellow at the China Studies Centre, University of Sydney Business School, and an Australian Development Research Award fellow at the Australian National University.

Hinrich Voss is a Roberts Academic Research Fellow at the Centre for International Business, University of Leeds.

Bijun Wang is a doctoral candidate in economics at Peking University.

Shang-Jin Wei is Professor of Finance and Economics, Professor of International Relations, N. T. Wang Professor of Chinese Business and Economy and Director of The Jerome A. Chazen Institute of International Business at Columbia University.

Yao Yang is Director at the China Center for Economic Research and Deputy Dean at the National School of Development, Peking University.

Issue Editors
Peter Drysdale and Shang-Jin Wei.

Editors
Peter Drysdale, Head, East Asia Forum and East Asian Bureau of Economic Research, Crawford School, ANU.

Shiro Armstrong, Executive Director, EAF and EABER, Crawford School, ANU.

Editorial Staff
Luke Hurst, Crawford School, ANU; Mark Fabian, ANU; Madeleine Willis, ANU; Carolina Caliaba Crespo, ANU.

Editorial Advisers: Peter Fuller, Max Suich.

Production: Peter Fuller, Words & Pics.

Original design: Peter Schofield.

Email Peter.Drysdale@anu.edu.au, Shiro.Armstrong@anu.edu.au

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Published by ANU E Press
The Australian National University
Canberra ACT 0200, Australia
Email: anuepress@anu.edu.au
Web: http://epress.anu.edu.au

COVER: Molten iron being poured in a factory in Dalian, Liaoning province. Iron ore is an important focus of Chinese direct investment overseas. PICTURE: Liu Debin / ChinaFotoPress / AAP.

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The globalisation of Chinese capital

ILAN ALON

THE globalisation of Chinese capital will be one of the hallmarks of 21st-century economics, shaping debates over state capitalism, 'free' markets and international institutions. China internationalised its product markets and upgraded its manufacturing prowess towards the end of the 20th century by allowing inward foreign direct investment (FDI) and by promoting export trade. This was supported in part by cheap labour, and resulted in growing trade surpluses with key trading partners—particularly the US. Outward FDI was discouraged in order to preserve foreign reserves, and together these policies have helped China accumulate significant amounts of capital, now making it a multi-trillion dollar reserve holder.

During this period of increased inward foreign investment, Chinese companies were encouraged to establish joint ventures with multinationals and to absorb Western technology by working with Western firms. Multinationals, in turn, saw these joint ventures as an opportunity to enter the Chinese market, lower their manufacturing costs and outsource some of their production activity, focusing on 'higher value-added' activities. China quickly evolved into the manufacturing hub of the global economy, working across a wide variety of industrial sectors. Despite creating a niche as a world leader in original equipment manufacturing, Chinese companies are no longer satisfied with this position in the value-added chain. Profits reside with the design and brand owners, which are often Western multinational companies. So although China has received employment and investment benefits from Western investors, it has not reaped a proportionate share of the profits.

Chinese companies are now armed with plentiful hard currency at a time when the global community is hungry for international capital. Cash-starved multinationals can sell their brands, channels of distribution, know-how and customer bases, thereby allowing Chinese multinationals to develop advanced capabilities in technology, design and branding. With this backdrop in mind, China's Twelfth Five-Year Plan has put a number of parameters in place to allow Chinese multinationals to gain global ground. This includes a number of plans to further economic reform and opening, to position Hong Kong for a leadership role in global finance, and to increase research and development spending as a percentage of total GDP. The plan also envisages that China will move up the value-added chain in strategic industrial clusters, modernise key industries and invest in infrastructure, all the while encouraging Chinese companies to 'go global'.

> . . . concerns about China's future world domination are exaggerated; Chinese outward investment as a percentage of overall GDP is much lower than that of most developed countries . . .

State-owned enterprises (SOEs) are vital to China's advancement in technology and globalisation and will play an important role in achieving these objectives. They are directed to seek out investments in natural resources to fuel economic growth, invest in new technologies and find international markets for Chinese goods. Chinese firms are not only market- and resource-seeking investors, like their Western counterparts, they are also interested in strategic assets and investments in know-how so as to move from manufacturing-led to knowledge-driven growth. And while the recent global economic environment has certainly facilitated China's desire to 'go global', Beijing's monetary policy—and its exchange rate policy in particular—has also affected China's economic prospects.

China's currency, the renminbi, is increasingly involved in international settlements and contracts, and is

PICTURE: AFP PHOTO / AAP

Workers making toys at a factory in Jinjiang: China quickly evolved into the 'manufacturing hub' of the global economy but the Twelfth Five-Year Plan sees China moving up the value-added chain in strategic industrial clusters, modernising key industries and investing in infrastructure.

already considered among the world's most stable currencies. Demand for Chinese goods has facilitated support for its exchange rate, which is currently semi-fixed against the US dollar. If China's fixed exchange rate regime were eliminated, the renminbi would likely appreciate anywhere from 20 per cent to 50 per cent, giving Chinese investors an immediate advantage in buying international assets. Although the peg is unlikely to be abandoned in the near future, international pressure on China to appreciate the renminbi will intensify, especially with imports worsening the balance-of-payments situation and harnessing GDP growth rates in many countries around the world. This means the renminbi is likely to appreciate against the dollar in the medium to long term, further fuelling outward investment when the change takes place.

THE rise of Chinese multinationals has inflamed global fears about China 'taking over' the world. It is true that Chinese companies with global ambitions are on an international buying spree and that international mergers and acquisitions are on the rise. But current concerns about China's future world domination are exaggerated; Chinese outward investment as a percentage of overall GDP is much lower than that of most developed countries and its share of global outward FDI is less than 2 per cent.

The great majority of Chinese international investment is carried out by state-owned companies, and their motivations can seem suspect to political figures in host countries. Consequently, Chinese companies effectively end up paying a premium over other bidders in order to offset this political uncertainty, which in turn serves to limit the economic benefits of any potential deal. In 2005, for example, Unocal accepted Chevron's takeover bid instead of CNOOC's offer because the premium offered by the Chinese SOE was too low to offset US congressional concern over the purchase. Given that much of Chinese outward FDI is state led, domestic as well as host government involvement will likely complicate international transactions and the perceived intentions of each side.

A 2011 study gathered data from top executives of leading SOEs, representing 20 diverse industries, to determine their motivations for investing overseas and to clarify the extent of this investment. The first primary push factor propelling the internationalisation of Chinese SOEs is the central government's 'go global' policy and related incentives, while the second relates to the business strategies adopted by enterprise leaders. Most SOEs are pursuing business potential or access to natural resources, although about 20 per cent of the sample sought brands and technologies. The largest portion of China's outward FDI goes to Asia (24 per cent) and most of this to Hong Kong. Africa and Europe both receive around 20 per cent, while investment in North America accounted for about 11 per cent. Subsidiary and representative offices were the most likely modes of entry into these host economies; Chinese SOEs seem to prefer investments in wholly owned or predominantly owned facilities, and most future investments are expected to focus on the expansion or upgrading of existing facilities (44 per cent) or new greenfield investments (38 per cent).

Research on international mergers and acquisitions, meanwhile, is quite clear: most fail to create value for shareholders. Will the Chinese experience be different? Despite government support, Chinese companies are likely to suffer major losses from acquisitions abroad due to a lack of internal capability and resistance from foreign governments. Although Chinese companies have developed excellent manufacturing capabilities, their skills in technological development, marketing and branding, and international management remain weak. Many international managers do not speak English and have little experience in dealing with foreign regulations, cultures and business norms. Integrating the competencies of acquired companies requires a dynamic absorptive capacity that many Chinese firms lack. It is one thing to buy a company possessing certain technologies, but it is quite another to retain the talent required to further develop and apply these technologies after the acquisition.

As Chinese SOEs and private companies increasingly 'go global', questions will also arise about the practices of these firms both within China and abroad; the involvement of the Chinese government in the promotion of investment; and the contrasting political, economic and management systems—or ideologies—of each party. China's pool of labour will likely become more expensive and the renminbi could well appreciate, meaning China will shift from export to foreign investment modalities of internationalisation. In the next decade, Chinese outward investment as a percentage of exports, GDP level and global outward FDI will also significantly expand, in turn raising questions about sovereignty, control of economic resources (particularly natural resources), reciprocal treatment and the application of international rules.

> It is hoped that reactions to the 'China threat' or the 'China challenge' will be informed by data and logic rather than propaganda and perceptions . . .

Whether China will be able to continue developing its state sector abroad will largely depend on how these companies, and China more generally, are perceived by others in the future—and how Chinese investors address these questions. Governance of SOEs based on Communist Party political leadership may embolden foreign leaders in democratic and free-market countries to reject acquisition attempts and to block full engagement. It is hoped that reactions to the 'China threat' or the 'China challenge' will be informed by data and logic rather than propaganda and perceptions. But it is not yet sure how China will react to the current debates over trade, investment and development, and whether Chinese management approaches, as well as its economic and trade policies, will spill over to other countries seeking to steer away from the Washington Consensus and from those management systems developed in the West over the last century. In any case, China is likely to dominate Asia's economic landscape in the 21st century. Chinese historical and cultural ties to Asia, along with its physical proximity and economic attractions, will be key to elevating China's regional power base in the years to come. EAFQ

Are China's multinational corporations really multinational?

DAVID SHAMBAUGH

FOLLOWING the Chinese government's mandate that companies should 'go out' (走出去) or 'go global' (走向世界), many observers anticipate that Chinese multinational corporations (MNCs) will secure a growing share of the international consumer market around the world. This may eventually occur, but for the time being China's multinational corporations remain a very long way from playing in the premier leagues of international commerce.

How many Chinese corporations can you name? Most likely fewer than 10, or even five. We are all familiar with Tsingtao beer, Air China, Bank of China and Lenovo computers—and some may know names like Huawei Technologies, Haier appliances or China Mobile. But not a single one of these firms made the 2011 'Top 100 Global Brands' list compiled annually by *BusinessWeek* and Interbrand. The global brand presence of China's best-known multinationals is nowhere near the likes of Coca-Cola, GE, Intel, McDonald's, Google, Disney, Honda, Sony, Volkswagen and similar global giants.

Yet when measured in terms of total revenue, it is clear that Chinese companies have steadily climbed up the global rankings. Twelve Chinese companies were included in Fortune's Global 500 list in 2001. And only a decade later, in 2011, that number rose to 61 (including four with headquarters in Hong Kong). China now ranks third on the global list, only slightly behind Japan but well behind American firms. In 2010 these 61 Chinese enterprises had a combined annual revenue of US$2.89 trillion and an estimated overall profit of US$176.1 billion. Of the 57 mainland companies, 49 are state-owned enterprises (SOEs).

While ranking on the Fortune Global 500 list indicates the growing clout of Chinese corporations, it does not mean that a company is internationally active or even that it is a real multinational. When these companies are ranked by foreign assets and sales, it becomes clear that, with few exceptions, they all operate predominantly within China. In other words, despite the government's directives and financial incentives to 'go global', many leading Chinese corporations have yet to do so.

So why have Chinese multinational corporations encountered difficulties in going global? Ten possible factors may explain it.

First, very few Chinese firms can operate truly globally. Haier, Huawei and the national oil companies Sinopec, CNOOC and CNPC are often the only ones that have capital, operations and sales on a global scale. Many of China's other multinationals (banks, auto companies, natural resource companies or IT) really only invest in and operate on some continents; most are far from possessing global production, marketing, distribution, logistics, supply, research and development, and human resource networks.

Second, the Achilles heel of Chinese multinationals is human resources—particularly management. Multilingual and multicultural managers are few and far between, and all assessments of Chinese corporations note this to be a fundamental weakness. A 2005 study by the global multinational consulting firm McKinsey & Company estimated that Chinese multinationals will require 75,000 global managers by 2020. As a result, Chinese students are flooding into foreign MBA programs as well as business schools in China. Distance-learning MBAs tailored to the Chinese market are also taking off. But classroom training alone will not suffice because there is no substitute for extensive international experience. Some Chinese companies have taken advantage of the global financial downturn by hiring (preferably young) laid-off staff in New York, London, Hong Kong and elsewhere. In 2010, for example, the *China Daily* reported that Chinese companies operating overseas had hired a total of 800,000 foreign employees.

Third, and related, Chinese companies and their management have displayed an inability to escape their own national corporate culture and business practices. Chinese business culture values interpersonal over institutional relationships, and

PICTURE: AAP

Sinopec is one of the few Chinese firms that has capital, operations and sales on a global scale.

business decisions are often oriented towards short-term profit. There is also a lack of transparency and oversight, which has been linked to a high degree of corruption. Moreover, Chinese companies are politicised: that is, many have Communist Party cells and members embedded within the firm. Most of China's state-owned 'national champion' firms have CEOs appointed by the Organisation Department of the Chinese Communist Party, and this is also true of multinationals. Unlike their Chinese competitors, though, most Western multinationals are apolitical. And this is not where the differences end. Western business culture emphasises teamwork and cooperation between management and staff, detailed long-term planning, transparency and oversight, multiculturalism, prosecution of corruption, and the institutionalisation of relationships.

Fourth, as noted above, Chinese companies have a very poor global brand presence. Establishing this type of presence requires investing large and sustained resources into advertising and cultivating clientele. Having distinctive, non-Chinese names will also help in this endeavour.

FIFTH, mergers and acquisitions have become the preferred modality for Chinese corporations to go global because they are a quick means of acquiring advanced technology, sales networks, established brand names and other strategic assets overseas. Precisely because Chinese corporations have very few multilingual staff who have experience working in cross-cultural environments, and many who are inexperienced in local business practices, it is much easier for Chinese multinationals to simply buy a share of an established foreign firm in order to gain these elements and offset their deficits in one stroke. Even though in recent years China's mergers and acquisitions have spiked in number and sometimes in value, they have not been very successful so far. One report estimates that 90 per cent of China's 300 overseas mergers and acquisitions conducted between 2008 and 2010 were unsuccessful, with Chinese companies losing 40–50 per cent of their value after the acquisition. This has particularly been the case in the technology, communications and natural resource sectors.

Sixth, while some Chinese firms develop business plans and strategies to globalise, the majority do not. Instead, efforts to 'go global' tend to be driven by pent-up cash in search of a place to invest outside China's saturated domestic market; a strong mandate by the government to 'go out', with incentives to do so and penalties for not doing so; naïveté about the complexities of foreign countries; a desire to maximise profits as quickly as possible, rather than produce steady revenue streams; and a fickle management tendency to frequently change decisions and directions.

Seventh, while Chinese firms

do tend to have clear performance indicators and incentive programs and do provide job security, they do not score as well in other aspects of management. Big Chinese firms—and the Chinese government is no exception—are extremely hierarchical. Chinese organisational culture stresses discipline and conformity, which creates a climate of risk aversion and discourages initiative. Being entrepreneurial (which Chinese companies certainly are) is different from being innovative and creative. Moreover, the Chinese notion of teamwork is geared towards following leaders' instructions, rather than the more egalitarian and collegial model prevalent in Western organisations. This preference for clearly defined workplace roles and hierarchies often means that Chinese do not adapt well to management structures that prize decentralisation and individual initiative—and this has resulted in repeated culture clashes in Chinese mergers with Western companies.

The practice of mid-career (re) training is similarly alien to Chinese multinationals, while it is intrinsic to most Western corporations. Chinese firms tend to train a worker for a precise skill and job, which they are expected to do indefinitely, whereas many Western firms adopt much more flexible personnel policies that emphasise self-improvement, retraining and job mobility within the firm, and generalisation over specialisation. Oftentimes this is done within the firm through training aimed at developing new job skills, but also via mid-career management training outside the firm—so-called executive education. A one-month stint in an 'Executive Ed' program at the Wharton School, the Kennedy School, INSEAD, London Business School or similar institutions offers an 'escalator effect' for corporate management. Chinese business schools—such as Shanghai's China Europe International Business School, Hong Kong University of Science and Technology's Business School, or Peking University's Guanghua School of Management—are all seen to be improving, but are yet to enter the premier league internationally. Though mid-career training has become *de rigueur* in the Chinese Communist Party and government, this organisational culture is yet to become prevalent in the corporate world.

EIGHTH, Chinese companies have demonstrated difficulties in adapting to foreign legal, regulatory, tax and political environments. Transparency and corporate governance are not exactly attributes associated with Chinese companies, which have a reputation for opaque decision-making processes, frequently corrupt business practices, and often-fraudulent accounting procedures. Few Chinese firms have in-house legal counsel who are knowledgeable about foreign legal and regulatory environments. This impatience with the regulatory environment of host countries has had a negative impact on business operations abroad, particularly when Chinese companies have tried to list on foreign stock markets: many Chinese companies have filed fraudulent information with securities regulators in the US before their initial public offerings. They also often run afoul of foreign politicians who are suspicious of Chinese investments on national security grounds.

Ninth, Chinese firms rarely apply due diligence when dealing with their competitors abroad, which often means they overlook both the strengths and weaknesses of their potential partners and competitors. As a result, they find it harder to exploit comparative advantages.

Finally, in looking for foreign partners, many Chinese multinationals run up against the 'reciprocity problem'. Many foreign multinationals with whom Chinese corporations seek to partner have either been operating in China for many years or are seeking to enter the Chinese market. The former have most likely experienced years of Chinese red tape, investment obstacles, and have had very frustrating and costly experiences (even if they have become profitable), while the latter want an entrée. In both cases they look to the Chinese firm to make life easier for them inside China; for them, there is an informal quid pro quo: you help us in China, we help you abroad. The problem is that many Chinese multinationals have a bifurcated corporate structure, which means that domestic and international divisions often have a bureaucratic firewall between them and do not communicate well with each other. Moreover, the Chinese partner firm is not necessarily responsible for improving a foreign company's situation or solving its problems in China—this is often the domain of domestic government authorities. These competing motivations often lead to a mismatch of expectations between Chinese and foreign multinationals.

For all these reasons, Chinese corporations face a number of impediments in going global. They have a steep learning curve ahead. Over time, they will no doubt learn and adapt—as Chinese in all professional pursuits seem so capable of doing—but these obstacles are not insignificant. China's multinationals are still taking baby steps in global business. EAFQ

A new form of colonialism?

YAO YANG

IT IS news to none that China is expanding its resource-acquisition activities across the world. And in its search for mining and drilling rights, China seems more than willing to work with any government that will help secure such investments, including those accused of rampant corruption or severe human rights violations. Even in countries with more benign governments, resource exports still may not help to improve living standards for ordinary people, as resource exploitation often leads to environmental degradation and adverse effects from the so-called Dutch disease. China is routinely accused of importing resources from countries caught up in this 'disease', before then 'dumping' cheap manufactured goods on them. As a result, Chinese international investment is often seen as a form of 'new colonialism'.

The reality is that Chinese resource companies differ very little from resource companies the world over—except that Chinese companies often operate in more marginalised countries, mostly because the markets in more secure countries are already controlled by Western companies. In addition, China's resource-acquisition projects have been shaped by its domestic priorities, including those formulated by its domestic politics.

China's desire to acquire natural resources is determined by its domestic industrial policy. While the government aims to lower China's energy intensity to 40 per cent below 2005 levels by 2020, China's energy policy does not encourage progressive savings on energy consumption, with the country's energy prices currently set lower than in most other countries. For example, gas prices are about the same as those in the US and less than half of those across many European countries. But China's low energy prices are supported by companies and ordinary consumers alike. Raising energy prices would be a very unpopular move for the government; hence its general lack of action on this particular front.

In addition to low prices, the growth of energy consumption is also supported by China's industrial structure. The share of heavy industry in China's economy has steadily increased since the early 2000s. China now produces more than half of the world's steel and cement output, and the growth of heavy industry is one of the major factors responsible for China's rising energy consumption. While the fast growth of China's real estate sector and infrastructural building has increased the country's demand for cement, steel, copper and other metals, the government's role in this development strategy cannot be ignored. By providing subsidies and capital to the manufacturing sector, the Chinese government is effectively encouraging capital-intensive industries.

It is also worth noting that large state-owned enterprises are themselves active players in shaping the government's policy on resource acquisition. Take, for example, the three big oil companies that have been at the forefront of China's drive for natural resources—CNOOC, CNPC and Sinopec. The Chinese government often insists that the reason for supporting their purchases of overseas oil fields is that equity oil is crucial for China's energy security.

CHINESE oil companies are newcomers to the global oil market and there is now little room for them to enter politically stable countries; instead, they have focused their investments in countries with less-favourable political environments. In turn, the Chinese government has also played a vital role in providing a guarantee for its oil companies by entering into country-to-country agreements with host country governments.

China's overseas energy and mineral policy is the combined result of narrowing international investment space and domestic interest-group politics. Given this situation and the options now available to Chinese companies investing abroad, China should be aiming to wisely manage its international image. It has done a great deal of work on the ground by building schools, hospitals, stadiums and conference facilities, and by undertaking other public projects in resource-exporting countries. But China also needs to learn to improve its international image in 'softer' areas, such as winning the support of intellectuals in recipient countries. Intellectuals shape the public discourse in the international community as well as inside those countries. It is crucial for China to win their support to manage a more positive image. EAFQ

FITTING IN

New kid on the block learning the rules

KARL P. SAUVANT

CHINA has arrived in the global outward foreign-direct-investment (FDI) market. The country's outflows, which doubled between 2007 and 2008 to US$54 billion, held steady during the Western economic and financial crisis—at a time when world FDI outflows halved. When the country's outward investment flows reached US$68 billion in 2010, China became the world's fourth-largest outward investor (not counting Hong Kong). The country's outward FDI stock in 2010 stood at US$298 billion, invested in more than 34,000 foreign affiliates controlled by some 12,000 Chinese parent companies. This is an impressive performance when one considers that, only a decade ago, China was a very marginal player in the global outward FDI market.

Because Chinese multinational enterprises (MNEs) are new kids on the block, they face various challenges. To begin with, they lack experience in establishing and managing integrated international production networks, and so they need to function on a steep learning curve. Meeting the internationalisation challenge means they not only have to learn how to enter foreign markets successfully, but to operate and prosper in them as well.

The principal entry mode for many firms looking to access international markets is through mergers and acquisitions—but achieving success can prove difficult. Even experienced enterprises frequently fail in this respect: Daimler Benz's unsuccessful acquisition of Chrysler is a case in point. Being a foreigner abroad is another liability that Chinese enterprises have to overcome. This is particularly challenging for Chinese firms because the gap between the operating environment in China and that in many host countries (especially in developed ones, in which ever more non-natural resource foreign investment is taking place) is particularly wide. Finally, foreign firms need to be good corporate citizens in their host countries, which requires all sorts of activities—some of them involving corporate social responsibility. Chinese firms typically are not familiar with these challenges, so their success is tied to retraining their executives and staff.

. . . mergers and acquisitions conducted by Chinese firms are receiving more regulatory attention in a number of host countries, similar to Japanese firms in the 1980s

Another set of challenges relates to the FDI regulatory environment, as this environment is becoming less welcoming in a number of host countries, especially in developed countries. The host country challenge is particularly acute when it comes to inward mergers and acquisitions in sensitive industries, or when these involve national champions, or when mergers and acquisitions are being undertaken by state-controlled entities—be they state-owned enterprises or sovereign wealth funds.

CHINA suffers in this respect, as some countries regard Chinese inward investment with suspicion, especially when it takes the form of mergers or acquisitions, because China is a communist country and is often considered a strategic competitor. In addition, most of its outward investment is undertaken by state-controlled entities (mostly state-owned enterprises) that, rightly or wrongly, are seen to pursue interests beyond the commercial domain, and many believe they benefit from all sorts of (financial, fiscal, competitive) advantages. It is difficult to gauge the extent to which this might be the case and to speculate how the situation differs from state-controlled entities and private firms headquartered in developed countries. But it does raise the question of 'competitive neutrality' in the global outward FDI market, an issue that is likely to garner more

PICTURE: YM YIK / EPA / AAP

A decade ago, exports were the focus of Chinese commercial activity and the country was only a marginal player in the global outward foreign direct investment market. Now it is among the world's largest overseas investors.

attention in the future. The upshot is that mergers and acquisitions conducted by Chinese firms are receiving more regulatory attention in a number of host countries, similar to Japanese firms in the 1980s. This implies that Chinese firms need to be extra careful when expanding abroad in this way: they have to prepare their moves and they need to learn how to navigate the corridors of power in important capitals.

Finally, there is the home country challenge. Chinese firms are lucky in that they benefit, like their competitors headquartered in developed countries, from a regulatory framework that not only allows outward investment but encourages it. (Firms in most other emerging markets do not enjoy this advantage.) But given the relative inexperience of Chinese enterprises, the Chinese government has a particular responsibility to keep an eye on the manner in which China's outward investment is conducted. Most notably, firms need to be reminded that, since host countries consider foreign investment a tool to advance their development, this investment needs to be sustainable. In other words, FDI needs to take place on the basis of fair-governance mechanisms (especially when it comes to contracts) and contribute as much as possible to the host country's economic, social and environmental development. If the country's FDI is not sustainable in this manner, it may well suffer a backlash in the years to come.

All of these challenges can be overcome, but they need decisive action and good will on the part of all concerned. In time, as with Japanese and South Korean multinationals before them, Chinese firms will cease to be the new kids on the block. They will become regular players in the global FDI market, their outward investments improving corporate competitiveness and contributing to the development of host countries. EAFQ

The changing face of Chinese investment

YIPING HUANG

FOR years, China has been one of the world's largest recipient countries of foreign direct investment (FDI). In 2010, however, its outward direct investment (ODI) reached an unprecedented US$68 billion and China became the world's fifth-largest overseas investor. China's cumulative ODI of US$310 billion is still relatively small compared with its cumulative FDI of US$1.5 trillion. But Chinese ODI will undoubtedly become more important in the near future, as the Ministry of Commerce expects annual outward investment to outpace FDI by 2015.

As a middle-income country, China holds an outsized net international investment position of US$1.7 trillion due to government intervention in the foreign exchange markets. About 83 per cent of its total assets of US$3.4 trillion are foreign exchange reserves, mostly invested in foreign sovereign bonds. But 87 per cent of its total liabilities are equities, and such a mismatch not only affects returns on China's international investments, but also constrains the private sector's ability to expand overseas.

This picture may change soon, as the Chinese authorities are now acting to internationalise the renminbi. Of course, whether or not the renminbi will become an international currency is scarcely a call for China to make on its own. But in order to internationalise the currency, the government plans to implement reforms in three key areas—the liberalisation of interest rates, exchange rate policy and the basic convertibility of the capital account—which should help the process along.

These reforms will likely have significant implications for the world, as well as for China. With greater flexibility of the exchange rate, the renminbi may show more two-way movement, although rapid appreciation would probably persist. The current account surplus, which already fell from 10.8 per cent in 2007 to 2.8 per cent in 2011, may continue to narrow. And as China's accumulation of foreign exchange reserves slows and even becomes negative, an equally important shift could occur through increases in its international equity investment, including through ODI.

> . . . as production costs continue to rise rapidly, some Chinese companies producing garments, toys and footwear are already looking for new production bases in Southeast Asian countries and in inland Chinese provinces

Chinese ODI is a relatively new phenomenon. In 2002, the first year after China's accession to the World Trade Organization, China's total ODI was less than US$3 billion. By 2010, however, it had already increased to more than 20 times this amount. According to forecasts by economists at the Hong Kong Monetary Authority, if China does liberalise its capital account, Chinese ODI stock could rise from US$310 billion in 2010 to US$5.3 trillion by 2020. If this prediction turns out to be correct, then China may well become the world's largest outward direct investor by this time. While the scenario is entirely possible, China will need to overcome several major obstacles if it is to develop successful ODI practices.

To start with, Chinese authorities will have to lower regulatory barriers. At the moment, a company wishing to invest directly overseas has to obtain approval from three different government departments: the National Development and Reform Commission, the Ministry of Commerce and the State Administration of Foreign Exchange. Administrative costs for this process remain high, especially for non-state companies, which could potentially deter private sector involvement—although policy makers often claim that these departments rarely stop any ODI project.

PICTURE: AFP PHOTO / AAP

Car workers assembling vehicles at a plant in Hefei, Anhui province. With Chinese outward direct investment, a company's main production facilities will usually remain in China rather than relocating abroad.

China can only become a dominant ODI investor globally if the private sector plays a more prominent role. China's state-owned enterprises (SOEs) often face tougher challenges overseas because of their perceived linkages with the Chinese state. Regulators and competitors in host countries regularly accuse SOEs of using state-provided resources to achieve government objectives in their investment projects, even if these investments are purely commercially orientated. To be fair, this suspicion is not completely groundless, as SOEs often use their state linkages to disadvantage domestic competitors.

It is also true that Chinese ODI exhibits several unique characteristics that set it apart from more-familiar practices. Economists generally identify two different types of ODI: the American type, whose main purpose is to gain market entry; and the Japanese type, whose main purpose is to take advantage of low production costs. Despite these differences, the two styles do have one thing in common—both American and Japanese companies generally relocate their main production facilities to the host country once an investment is made. Chinese ODI, on the other hand, is quite different because a company's main production facilities will usually stay in China.

Chinese companies also tend not to invest in areas where they already have a comparative advantage. Instead, they focus on three key areas of investment: first, companies operating in the same industry as the investor, but which have advanced technology, management or brand names; second, commodities which are used intensively in Chinese production; and third, service companies that could facilitate exports from China-based factories.

China's unique approach to ODI is largely determined by its current stage of economic development and the level of its production costs. China still enjoys significant cost advantages—at least productivity-adjusted cost advantages—compared with many other developing countries. In general, relocating factories overseas can yield only limited financial gains, although this is gradually changing. This means that, for now, the purpose of Chinese-style ODI is to strengthen domestic production facilities—not to move these factories overseas.

But this can only be a transitory phenomenon. For instance, as production costs continue to rise rapidly, some Chinese companies producing garments, toys and footwear are already looking for new production bases in Southeast Asian countries and in inland Chinese provinces. So, the Chinese style of ODI may gradually evolve to more closely resemble the Japanese or even the American type of ODI. China has already been one of the world's largest investors for the past decade and it may keep this position over the coming decade, but there must be change during this time. The People's Bank of China will likely give way to the private sector as China's dominant overseas investor, and the shift from sovereign bonds to direct equities as the main focus of this investment could prove to be an historical event for the world economy.

> Chinese ODI will likely contribute to the formation of new divisions of labour around the world,

Declining Chinese demand for 'safe assets' (sovereign bonds) could point to relatively weaker support for the traditional reserve currencies such as the US dollar and the euro. And China itself may also become a supplier of safe assets as it opens up its capital account and develops its government bond market. Consequently, China's yields should rise in general, adding further pressure to the fiscal sustainability challenge faced by many developed economies.

But this pressure may also provide an historical opportunity for the global economy to benefit from such large-scale change. Chinese ODI will likely contribute to the formation of new divisions of labour around the world, and this should produce direct benefits for countries with comparative advantages in labour-intensive industries. Even developed economies could benefit from Chinese capital and experiences in economic development. It all depends on which countries are willing to take advantage of this new opportunity. EAFQ

The media narrative and public debate

PETER YUAN CAI

CHINA'S emergence as a major new force in the international investment arena is causing anxiety in the world's capitals, from Washington to Canberra. Overseas Chinese investment no longer simply represents an emerging economic trend, but a polarising political issue for recipient countries.

Last year, an election in Zambia was fought over the issue of Chinese investment, and culminated with the populist leader Michael Sata winning the vote on an anti-Chinese investment platform. There were bouts of bad publicity surrounding Chinese companies that operate across the African copper-belt, with both local and international media extensively covering the shootings of several Zambian workers by their Chinese managers.

Similarly, China's investment ventures in Australia and the US have been greeted with unflattering press coverage. For example, Australia's national broadsheet daily, *The Australian*, was splashed with the headline 'Say no to Chinalco' in 2009, at a time when the Chinese aluminium giant was making a bid for a significant portion of the Anglo–Australian miner Rio Tinto.

The editorial called for Canberra to reject the proposed deal on both economic and geostrategic grounds. And that was just one example of media coverage pertaining to Chinese investment, which eventually contributed to a rather poisoned environment in which to conduct related policy debate.

The contemporary portrayal of Chinese investment echoes the media coverage of Japanese investment in the 1980s. The concerns of two decades ago—namely, the close relationship between government and corporations—seem to still resonate with commentators today. In the 1980s one of Australia's most influential metro newspapers, *The Sydney Morning Herald*, described the connection between Tokyo and its corporate giants as 'a single piece of seamless fabric—companies interwoven with government'. Two decades later, *The Australian* simply tagged Chinalco as 'an arm of the Chinese government'.

Media thus plays an influential role in setting the tone and context of public debate surrounding Chinese investment. Most importantly, it can also feed into the foreign investment screening process.

. . . media coverage of issues surrounding foreign investment has become a subtle and yet influential force on the decision-making process

It is widely held that the Australian Foreign Investment Review Board decides whether to approve or reject foreign investment proposals when, in fact, it is simply an advisory body to the treasurer, who is vested with vast and discretionary power under the *Foreign Acquisition and Takeovers Act*. The Australian system operates on the same principles as the Committee on Foreign Investment in the US, where an inter-departmental advisory body advises the ultimate decision-maker, the US president. Though bureaucrats oversee and assess investment proposals, politicians have to sign off on these deals and are ultimately responsible for approving or rejecting foreign investment transactions.

Given politicians' sensitivity to and—one might even say—obsession with the news cycle, it should come as no surprise that media coverage of issues surrounding foreign investment has become a subtle and yet influential force on the decision-making process.

Sensationalist reports by the tabloids and radio shock jocks can quickly build heat around specific issues, with foreign investment in Australian agribusiness and rural land being the most recent example. If there is one thing worse than selling mineral wealth to Beijing—so the argument goes—it has to be allowing foreign landlords to take control of Australian farms. Politicians are naturally afraid of being accused by the media of 'selling the family silver' or of 'failing to protect the national interest'. For this reason, politicians can be reluctant to defend Chinese foreign investment and are more prone to take a supposedly hardline approach to placate their anxious voters—sometimes just for the sake of appearances.

Chinese companies' insufficient understanding of media culture, and of this difficult political situation, has made their already precarious situation even worse. With few exceptions, Chinese investors in Australia are reluctant to engage with the local media. And this wall of silence invites natural speculation and suspicion.

One notable exception to the rule is Huawei Technologies, the Chinese telecommunications giant whose media outreach program is possibly the most active among Chinese investors. Privately owned companies are more media-savvy than their state-owned counterparts, which still operate like the old bureaucracies. Yet Huawei's recent failure to secure supply contracts for the Australian national broadband network illustrates the limits of its charm offensive.

Individual corporate actors may go to great lengths to improve transparency, but they simply cannot compensate for the general murkiness of 'China Inc'. For as long as Beijing retains its sprawling influence in the running of the economy and stubbornly holds on to its authoritarian political system, there will always be reason to maintain suspicion about the motives of Chinese companies investing overseas.

Better public relations management may allay some fears about Chinese companies, but it can never fully address the most fundamental problem: a simple lack of trust in the Chinese government. Full political and community acceptance of Chinese investment will only be possible when Beijing gets its own house in order. China's demand that foreign regulators act transparently and in accordance with due process will seem laughable so long as Beijing fails to implement the same conditions at home, such that Chinese domestic reform should also have the added benefit of alleviating fear abroad. EAFQ

Huawei in action: Canberra Raider Dane Tilse bursts through North Queensland Cowboys' defence in April 2012. Huawei's media outreach program, exemplified by its Raiders sponsorship, is one of the most active among Chinese investors in Australia.

PICTURE: COLIN WHELAN / NRL PHOTOS

Barriers and pitfalls on foreign paths

PICTURE: AAP

Graduates at Fudan University, Shanghai: China needs to develop the capacity to train and build a reserve of 'talented, internationally savvy managers'.

GAO XIQING

CHINA has been making acquisitions abroad for only a short time, but despite the challenges there are huge opportunities that should be seized.

Chinese overseas investment has grown from zero—before reform and opening-up in the late 1970s—into a global force today. It is projected that China's total overseas investment will reach US$500 billion during the Twelfth Five-Year Plan, which covers the period 2011–15. Due to the immensity of the country's foreign exchange reserves and its active expansion of overseas investment, Chinese investors have captured the world's attention since the 2008 financial crisis. While investment abroad has gone reasonably well so far, Chinese investors still face many external and internal challenges.

Every nation has laws and organisations to supervise foreign investment. Chinese firms face two main challenges in the investment regimes that they have to deal with abroad. The first is that the laws and regulations of some countries are complicated. In these countries, it is easy to wander down the path of illegality if an investor pays too little attention to regulatory systems for even a moment. The second is that some countries put in place obstacles to Chinese investment via legal or supervisory systems because of ideological or political concerns.

Another major challenge for China's

new overseas investment drive is the lack of relevant experience. First and foremost, Chinese investors lack an understanding of investment products. Many foreign investment products abroad are either completely non-existent in China or have just emerged, whether they are swaps, hedging or stock index futures. In developed markets these products or vehicles have grown to be complex and sophisticated. Without competence in handling the technical aspects of these products, even the slightest misunderstanding can easily result in substantial losses. The Chinese are probably more familiar with direct investment. But in many countries and industries, investors have no precedent to follow even in direct investment, and lack of experience exacts greater demands in risk management.

Experience is also lacking in project design, investment structures and negotiations. How can Chinese investors identify good opportunities, develop projects and find suitable partners? How can they design an effective structure to manage investments and taxes, and to repatriate investment profits? And how can they extract better terms and conditions from negotiations? These questions require careful study and a sound response from Chinese investors. They must make full use of highly experienced talent, including lawyers, accountants and other intermediaries from overseas.

China also has insufficient understanding of foreign cultures and societies. Many of its investment activities cause cultural or societal friction in target countries, with some states developing equivocal attitudes towards China in light of its rapid growth. And many people in those countries (not only the supervisory authorities) look at China through culturally or ideologically coloured lenses. The world still has not entirely adjusted to the reality of China's rise, nor is its rise welcomed everywhere. Chinese investors must be prepared for some setbacks when investing abroad. It is critical that Chinese investors maintain the stability and safety of their investments, and avoid passively becoming entangled in local political, economic or social conflicts.

Chinese investors are making great contributions to the growth and stability of the global economy, but they must also avoid some attitudes. While it is true that Chinese corporations are becoming a force to be reckoned with in international investment markets, some are arrogant in their approach—as though they believe that everybody ought to seek out their business. This attitude is not good for their business or for China's image. It will have a negative effect on an investor's ability to attract opportunities, and in the long term it will harm development potential.

> The West has been involved in overseas investment for several hundred years, so its pool of international investment know-how is vast. But Chinese investments have only just begun.

One big difference between Chinese overseas investment and that of developed Western nations is that, at this stage, Chinese investors lack comparable talent. The West has been involved in overseas investment for several hundred years, so its pool of international investment know-how is vast. But Chinese investments have only just begun.

China's greatest challenge is to establish a mechanism to attract talent, retain it and allow talented employees to rise to their full potential. It is not enough simply to hire talented individuals; China must also be able to train them and build a reserve of talented, internationally savvy managers.

These are just some of the challenges facing China as a newcomer to international investment. All these problems are part and parcel of development, and China should have faith that it can resolve them in the not-too-distant future. Despite the challenges, many new opportunities are appearing in the international market. Many high-quality assets have been devalued due to the current international market turmoil, for example, and the need of some sellers to urgently raise cash means that Chinese investors can negotiate provisions and agreements that would be difficult to obtain under normal circumstances. As long as Chinese investors analyse issues scientifically and approach them carefully, they can seize these opportunities at the same time as they fulfil their fiduciary duty.

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Financial repression and outbound investment

DANIEL ROSEN

CHINA has until now chosen to maintain financial repression—suppressing returns on domestic savings—while allowing its outbound investment flows to accelerate. Can it continue down this path? The Chinese system of assuring capital formation for the industrial economy has come under pressure in recent years, and financial repression and restrictions on outbound direct investment are both in flux.

Since its inception in the 1970s, China's economic reform program has depended on marshalling enough capital to pay for growth. Foreign technology, know-how, financial services, commodities and other needs were in short supply at home and were not going to be acquired for free. Consequently, strict foreign exchange surrender requirements were placed on firms involved in international trade, and outbound direct investment was strictly limited, allowing Beijing to coordinate the use of scarce hard currency. The need to stockpile enough foreign exchange to pay for imports and protect the nation from the risks of balance-of-payments crises, such as those that hit Latin America in the 1980s and Asia in the 1990s, became an overwhelming imperative. Exchange rate management, interest rate structure and other policy regimes served this singular purpose. The gargantuan external surpluses of the 2006–08 period were the unintended consequence of this objective, which had been hard-wired into the Chinese system in an earlier era and then persisted beyond the point of usefulness.

Beijing seems almost ready to leave the currency's value up to the markets . . .

In the Chinese context, 'financial repression' refers to the condition of low or negative real returns on savings, with the marginal revenue product of capital disproportionately retained by borrowing firms rather than depositors. In inflation-adjusted terms China's hard-working households have not just been short-changed; they have been robbed, because for most of the past decade the effective interest on their savings has been negative. The resulting disincentive to entrust banks with one's savings is now creating problems for China, with a housing bubble inflated by individuals searching for a better store of value than negative-rate savings accounts and the growth of high-risk alternative deposit schemes. It has also required Beijing to forestall a fuller liberalisation of the financial sector for fear that, if their industry were forced to be consumer-oriented, banks would bid up deposit rates to attract customers.

The strategy of capping domestic deposit rates would have failed if Chinese people had been allowed to take their savings across the border and access higher returns abroad. Therefore they were not generally allowed to do so, and limitations on cross-border household financial transactions still remain, even if existing quotas for sending money abroad are being slowly increased.

Rules governing the ability of China's state-owned and private firms to make investments abroad are relaxing more quickly, for several reasons. For example, since China is now swimming in a huge pool of foreign exchange, scarcity is no longer an issue—overabundance is. If Beijing agglomerates all the foreign exchange in the nation, it is left with the burden of recycling it, making Beijing overly dependent on foreign government debt securities because it does not know how else to run real businesses. By leaving more dollars and euros in businesses' hands it reduces the problem, but the government must then refrain from manipulating the renminbi's exchange rate. After years of half-measures, Beijing seems almost ready to leave the currency's value up to the markets—at least to a certain extent. With US$3.5 trillion in foreign exchange, of course, Beijing can use the resources already at hand to engage in this type of manipulation for a while, rather than having to harvest new foreign exchange reserves.

But Beijing's readiness to unburden itself of foreign exchange intervention chores is only half the story. China needs to let its firms take cash abroad to make investments, for three reasons in particular. First, they must move upstream to take a more prominent role in natural resource extraction because only the Chinese appear willing to invest in enough extractive capacity to stay ahead of their demand growth. Second, with the profit margin available to contracting manufacturing and assembly inside China now falling rapidly, Chinese firms are eager to invest both upstream and downstream in more value-added activities closer to foreign consumers—or else they risk losing global market share in the light-manufacturing sector they presently dominate. Third, a consolidation of market structure is taking place in many industries across China, leading firms to scramble abroad to obtain technologies, brands and other competitive advantages on the quick.

There are, of course, other reasons for Chinese firms to demand the end of restrictions on outbound investment, but the forces mentioned here are sufficient to have sent a clear message that the old order must change. In recent years US$60–70 billion a year in outbound direct investment has left China, and major new initiatives to allow east coast entrepreneurs to follow suit have recently been announced. It is not that the banking system no longer needs captured capital such that outflows are now being permitted; it is that outflows are essential—a reality the banking system will be forced to deal with sooner rather than later.

There will be both victims and winners in this structural adjustment in financial intermediation. The most capital-addled, state-related firms will use their balance sheets to sustain the flow of lending, leaving some firms in China to be squeezed. If Beijing accepts the necessity of privatising most state-owned enterprises and introducing competition in all but natural monopoly sectors, then China will emerge far more efficient and rebalanced in the next three to five years. If industrial planners succeed in deferring those steps indefinitely, then—as many of China's best economists are warning already—growth rates will soon fall to new lows. EAFQ

Poor interest returns have created a disincentive to entrust banks with savings—a factor that is now creating problems for China. PICTURE: AAP

Benchmarking performance: how large is large?

SHIRO ARMSTRONG

CHINA'S rapid rise as a source of international investment has certainly caused a great deal of anxiety in a number of countries where China is buying up big. But it is not always easy to understand the strong response that China's economic rise has occasioned in developed countries like Australia or the US, and in regions like Europe, where openness to foreign investment and institutional and regulatory structures for managing it are fairly well entrenched. Japan is a little different.

Some of the anxiety has arisen because Chinese state-owned enterprises (SOEs)—about which the world is largely ignorant—are now the big players in international investment. But mostly it is the scale of it that has caught everyone by surprise and has elicited fear and xenophobia similar to the sentiments provoked by Japanese investment in the 1970s.

> Chinese investment throughout the world is also lower than might be expected, given its size and location in the global economy

Foreign direct investment (FDI), flowing both in and out of China, is one of the most important dimensions of China's economic engagement with the world and integration into the global economy. China is now the world's largest exporter of goods, the second-largest trading nation, the second-largest FDI recipient and the second-largest economy globally. So it is no surprise that China is rapidly becoming a major source of FDI and is already the sixth-largest source of FDI for the rest of the world. The expansion of the Chinese economy has inevitably, and more or less commensurately, increased trade and investment flows, too.

Investment from China was an insignificant factor in the global economy until recently, but China's rapid growth has changed all of that. A look at the raw numbers now tells us that annual investment flowing out of China into non-OECD countries increased from US$1.47 billion in 2003 to US$49.42 billion in 2008, while Chinese investment in OECD countries rose from US$364 million to US$2.99 billion.

But the question is whether current Chinese investment is unusually large or around expected levels, given China's size, level of development, and its resource and other economic endowments. It is difficult to say without properly benchmarking performance.

In order to accurately conclude whether Chinese investment in particular destinations is larger or smaller than expected, economic fundamentals such as distance, scale, factor endowments and competition from neighbouring countries all have to be taken into account. Once these factors are considered, it is possible to compare actual Chinese investment flows with what we could reasonably expect them to be. A potential investment flow can be estimated using a technique that takes the characteristics of the most-liberal and free-flowing investment relationships globally, such that each bilateral relationship has a potential amount against which the actual investment can be compared.

With this properly calculated benchmark, inferences can be drawn about how Chinese investment fares in various markets, compared with how it might be normally expected to fare. It is then possible to judge whether Chinese investment is facing more or less resistance in particular markets, or indeed how open and attractive some

PICTURE: CHEN WEIFENG / EPA / AAP

Officials prepare to take samples from imported iron ore in the port of Rizhao in China's Shandong province. Chinese investment has more open access to Australia than to any other country, achieving 57 per cent of its potential after accounting for Australia's natural resource endowments.

destinations are once all measurable economic factors are accounted for.

Chinese investment has more open access to Australia—achieving 57 per cent of its potential (after accounting for Australia's natural resource endowments)—than to any other country in the world. This includes Brazil (where China has achieved 40 per cent of its potential) and other target resource investment hosts. Despite the trouble that Chinese firms are perceived to have encountered while investing in Australia—with one or two highly publicised and politicised projects—Chinese investment has performed much better than in other countries.

Chinese investment throughout the world is also lower than might be expected, given its size and location in the global economy, compared with that of other major investment sources—mostly OECD countries. Chinese investment in the US is roughly on par with the levels that might be expected when considering China's global average achievement of potential, standing at around 40 per cent. Despite this relative success in the US, China is not performing as well in Japan (30 per cent of potential), the United Kingdom (36 per cent) and Germany (31 per cent). These countries can expect much more investment from China in the future if the strong force of economic fundamentals is allowed to have its way without more policy frustration. How much they benefit from, and share in, the growth of Chinese investment will depend on policies and institutional responses. Whether they can attract more than their fair share of Chinese investment, as Australia has, will also depend on how their foreign investment regimes can manage, accept, influence and welcome investment from a very dynamic China.

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No simple pattern to Chinese foreign investment

RAPHAEL KAPLINSKY

AN INCREASING share of China's foreign direct investment (FDI) is destined for low- and middle-income developing economies. In some regions, such as sub-Saharan Africa, annual inflows of Chinese investment now exceed those from the historically dominant industrial economies, although the accumulated stock of Chinese FDI remains a small proportion of northern-sourced investment as a whole.

Many observers claim that we are witnessing a new phase of rapacious imperialism. China is accused of sweeping up natural resources in Africa and elsewhere, and in the process destroying local industrial capabilities, engaging in corrupt practices, employing imported Chinese (prison) labour, and undermining attempts by northern governments and international institutions to promote good governance and better labour and environmental standards. While there is evidence to support most of these accusations (although not, as it happens, that Chinese foreign investors employ Chinese prison labour), the public debate on Chinese investment is generally uninformed and fails to give a rounded picture of the nature of these investment flows. Perhaps most reprehensively, it lumps all Chinese investment together, ignorant of its diverse and dynamic character and leading to sweeping generalisations on the 'impact of Chinese FDI on country X' or a category of countries such as developing economies.

How might we make sense of the heterogeneity of Chinese foreign investment and its diverse and complex impact on the developing world? In the first instance we need to recognise the different motives for external investment, drawing on the experience of previously dominant global foreign investors.

Here we can identify four major drivers of FDI.

The first is resource-seeking, feeding the needs of home-country industry and consumers. Traditionally, this was the primary initial factor leading to investment outflows from Europe and the United States in their search for grains, cotton and other raw materials.

The second broad motive is market-seeking, in which outward investment is a vehicle for maximising global sales. A local presence, particularly when it benefits from protection, facilitates sales in foreign markets. Again, this was an early driver of outward foreign investment from Europe and the US.

Third is cost-reducing investment, in which foreign investors locate some of their operations in another country to take advantage of low production costs, before exporting to third-country markets. This became the dominant form of global FDI after the 1980s as transnational corporations fractured their value chains and took advantage of cheap assembly costs—particularly in China and other East Asian economies—to serve global consumer markets.

Fourth, and equally recent, is the advent of asset-augmenting investment, in which firms invest abroad in order to gain technological capabilities and knowledge. Firms in low- and middle-income economies have widely adopted this latter form of FDI, with examples including India's Tata Group (which now owns Jaguar Land Rover and a large chunk of Europe's steel industry), China's Zhejiang Geely (which now owns Volvo) and Suzlon (an Indian firm producing wind-power generators).

A SECOND factor that enables us to make sense of the heterogeneity of Chinese FDI and its impact on developing economies is the diverse nature of China's external investors. Here we can identify a spectrum of actors, which in turn can be loosely grouped into five categories.

The first category comprises the large state-owned enterprises (SOEs) which have access to 'patient' long-term finance and concessionary aid offered to recipient countries, and which also benefit from the muscle of the Chinese state to gain market entry. In the most extreme cases these enterprises operate in the so-called Angola mode, where Chinese investors ride on the back of state-to-state links, have preferential access to finance from the Export-Import Bank of China, are required to source most of their inputs from China and are repaid with the receipts of resource exports.

These are ‘bundled’ investments in which there is no clear discerning line between Chinese aid and investment.

A second and closely related type is the portion of state enterprises owned by Chinese provincial governments. These firms operate in a similar mode to the central SOEs, but often have greater freedom of movement than their Beijing-controlled counterparts.

Third are the large privately owned Chinese firms such as ZTE in telecommunications and COSCO in shipping. Their operations are not dissimilar to northern transnational corporations, in that they are largely market-driven. But they are generally less risk-averse and have access to cheaper and longer-term finance than their northern competitors.

Fourth are the small- and medium-sized Chinese firms that are forced out of China by intense competition and that often see their investments in low-income economies as opportunities to learn about foreign investment in less-demanding global markets.

FINALLY there is the very large number of Chinese ‘migrants’ who either move to foreign countries independently (as European migrants moved to the US in the 19th century) or who worked for Chinese state enterprises and large private investors abroad and then stayed on, operating ‘below the radar’.

Putting these two sets of differences together, we can observe a complex pattern of Chinese investment in developing economies. Large central and provincial SOEs generally focus on the resource sectors and fit the ‘bundled’ category of FDI. This is often characterised as investment where ‘China has a strategy for a region (such as Africa)’, while the region in question ‘has no strategy for China’. These same firms also operate in the infrastructure sectors, representing a form of market-seeking investment.

The very large and middle-sized Chinese foreign investors are similarly focused on market entry, as are the very small Chinese migrant firms. But neither of these sets of private firms gains from the close support of the Chinese state—they do not fit the ‘China has a strategy for’ moniker which is so frequently used to explain the character of Chinese investment in the developing world. Almost wholly absent from China’s FDI—at least at present—are the cost-reducing, global value-chain investments which have been a large driver of industrial-country foreign investment in recent decades. Finally, asset-augmenting foreign investors have been less concerned with gaining technology in their external operations in developing economies than with learning how to operate in external markets.

Chinese foreign investment is not just growing rapidly, it is also changing in character. In the context of strong global demand and constrained supplies of raw materials, we can have confidence that this concern will remain a major motivation for outward investment to developing economies. Similarly, given the relatively rapid growth of many developing countries, market-seeking FDI will also be sustained.

THE MAJOR change that we can anticipate is that as wage costs continue to rise in China, there will be an increase in cost-reducing foreign investment as leading Chinese firms seek to mirror the behaviour of northern firms and to fracture their value chains and outsource labour-intensive and technologically simple tasks. The most likely beneficiaries of these new investments will be surrounding low-income economies in the East Asian region.

Despite widespread optimism among African policymakers, there are few signs that either Africa or Latin America will become sources for cost-reducing Chinese investments in the near future or medium term. The flow of migrant-led, small-scale FDI is likely to continue unabated, although political opposition to these Chinese migrants is likely to rear its head frequently as indigenous entrepreneurs seek to fill the same space as migrant-led foreign investments. EAFQ

'MUTUAL BENEFIT'

Using official development aid to support investment

DEBORAH BRÄUTIGAM

CHINA does (and does not) use its official development assistance (ODA) to support investment. More specifically, the kinds of large-scale natural resource investments by Chinese firms that have made headlines in many regions are almost never supported by China's relatively small budget for foreign aid. At the same time, policymakers in Beijing use a number of other instruments to support the business activities of Chinese companies overseas. These other instruments are often regarded as 'aid' by casual observers who are either unfamiliar with the kinds of activities normally regarded as ODA, or who do not understand the nature of these activities undertaken by the Chinese.

In discussions of ODA, it is helpful to use standardised terminology developed by the OECD's Development Assistance Committee. First, the purpose of ODA finance must be primarily to promote economic development and welfare in the recipient country. Second, ODA must be provided on a concessional basis. Export credits do not generally qualify as ODA, nor do grants and subsidies to support private investment. Chinese definitions of external assistance are not very different from this, and their foreign aid budget is generally used for roads, health stations, rural telecommunications projects and so on, although they will also finance 'prestige projects' and public works like stadiums and conference centres.

> The overlap between Chinese official aid and the activities of Chinese companies is small, but it does exist

The overlap between Chinese official aid and the investment activities of Chinese companies is small, but it does exist. The first projects displaying this overlap date from the 1980s and involved debt equity swaps, where debts owed to the Chinese government (usually for productive, state-owned projects such as factories) were transformed into equity shares in the project, which would then be assigned to a Chinese firm.

In 1995, Beijing began to establish around a dozen centres for trade, investment and development. These public–private partnerships followed a standard build-operate-transfer model. In the Benin centre, for example, China's aid budget provided

60 per cent of the construction cost. The Chinese company that was to operate the centre contributed 40 per cent and the host government provided the land. The company would rent out space in the building, while also providing services to other businesses (predominately, but not solely, Chinese firms). After 50 years, the host government would receive the building. The entire package mixes aid and investment, and is clearly meant to boost the opportunities for Chinese firms, while also serving as a (long-term) real estate investment for the host government.

The Chinese government is also subsidising the cost of building 15 overseas industrial and trade zones. Initially, a minimum of 10 zones were to be established abroad, with the hope that 500 'mature' Chinese companies, particularly small and medium enterprises, would use these to go offshore, investing a projected total of US$2 billion. More than half of the zones are located in Asia; six are being built in Africa. Again, although this might look like foreign aid, it is not. The subsidies are given directly to Chinese companies and they do not come out of the foreign aid budget.

Like other countries, China also has an export credit agency (China Export-Import Bank, or Eximbank) that supports Chinese exports to less-developed countries. China Eximbank and the state-owned China Development Bank also have loan funds to support Chinese investors overseas, particularly to help them purchase equipment and machinery from China. Loans from Eximbank can be extended to host governments to help them purchase telecommunications equipment and installation services from Chinese firms, agricultural machinery or planes, or to build infrastructure.

PICTURE: AFRICAN UNION DIRECTORATE OF INFORMATION AND COMMUNICATION

The African Union Conference Center and office complex in Addis Ababa, Ethiopia, built with Chinese assistance. Chinese external aid will also finance prestige projects and public works.

Although these loans can be provided to joint ventures between Chinese and foreign firms, they would not qualify as ODA if their primary purpose was to support private investment or exports.

In some countries, such as Brazil, Angola and Venezuela, the Chinese have provided large lines of credit that are backed by the country's existing exports to China in long-term trade agreements. These 'mutual benefit loans' are provided at market rates (LIBOR plus a margin) and are not seen as concessional. Because they are secured by natural resource exports, which lower risks, these loans can be provided at competitive rates, much as Western bank consortia have done in places like Angola for several decades. Neither the Western bank resource-secured loans, nor the Chinese loans are viewed as 'development aid'. It is not necessary for the resources that secure these loans to come from a Chinese investment, but the borrowing government must have control over the exports, in order to boost the credibility of its pledge to repay the money.

China has many instruments that can be used to promote what its government labels 'mutually beneficial cooperation'. These instruments need to be disentangled from the official aid program, and viewed for what they are: part of the portfolio of tools used by an activist, developmental government with a clear vision of what it needs to do to promote its national goals overseas. And in viewing them for what they are, we have a chance to re-examine the conventional wisdom that excludes these kinds of activities from the portfolios of most traditional donors. EAFQ

GLOBAL STANDARDS

Resource procurement: not just a zero-sum game

THEODORE H. MORAN, BARBARA KOTSCHWAR AND JULIA MUIR

WITH the support of the Chinese government, Chinese companies have been acquiring equity stakes in natural resource companies, extending loans to mining and petroleum investors, and writing long-term procurement contracts for oil and minerals in Africa, Latin America, Australia, Canada and other resource-rich regions. These activities have raised concerns that Chinese efforts to procure raw materials might be exacerbating the problems associated with strong demand by locking up natural resource supplies, gaining preferential access to available output and extending control over the world's extractive industries.

But Chinese investments in Africa, Latin America and elsewhere need not have this zero-sum effect; Chinese efforts to procure raw materials might help to solve the problems of strong demand. Positive outcomes for Chinese procurement arrangements depend upon whether these arrangements solidify a concentrated global supplier system (and enhance Chinese ownership or control within that system) or expand, diversify and make the global supplier system more competitive, using Chinese ownership or control as a lever for such expansion, diversification and enhanced competition.

Research on Chinese investments in the extractive sector has identified four basic types of procurement. In the first procurement arrangement, Chinese investors take an equity stake in a very large established producer so as to secure an equity share of production on terms comparable to other co-owners. In the second type of arrangement, Chinese investors take an equity stake in an up-and-coming producer so as to secure an equity share of production on terms comparable to other co-owners. In the third type, Chinese buyers and/or the Chinese government make a loan to a very large established producer in return for a purchase agreement to service the loan. And in the fourth type of procurement arrangement, Chinese buyers and/or the Chinese government make a loan to finance an up-and-coming producer in return for a purchase agreement to service the loan.

> The impact of Chinese procurement arrangements on the structure of natural resource industries is only one dimension of the geopolitical challenges surrounding these endeavours

These four structures provide the basis for giving an operational definition to 'tying up' supplies. If the procurement arrangement simply solidifies a legal claim to a given structure of production, as in the first and third structures, 'tying up' or gaining 'preferential access' to supplies has zero-sum implications for other consumers. But if the procurement arrangement expands and diversifies sources of output more rapidly than growth in world demand, as per the second and fourth structures, the zero-sum implication vanishes, as all consumers have easier access to a larger and more competitive global resource base.

Earlier Peterson Institute for International Economics (PIIE) research examined the 16 largest Chinese natural resource procurement arrangements around the world within these four categories. The results showed a few instances in which Chinese natural resource companies take an equity stake to create a 'special relationship' with a major producer. But the predominant pattern (13 out of 16 projects) is to take equity stakes and/or write long-term procurement contracts with the competitive fringe. A brief review of four smaller Chinese procurement arrangements undertaken at the same time suggests there is no significant selection bias in looking at these 16 largest projects. Three projects in Australia, Myanmar and Canada present the characteristics of the second type of arrangement, where Chinese investors take an equity stake in an up-and-coming producer. One project in Indonesia, on the other hand, resembled the first type of arrangement more closely.

Building on the findings of this earlier report, a comprehensive examination of 34 Chinese natural resource investment and procurement arrangements in Latin America concluded that 25 of them help to diversify and boost the competitiveness of Latin American natural resources. This is a good outcome for host countries because it indicates that Chinese investors will be more willing to take on new frontier—or even fringe—projects that more-established oil and mining companies might pass by.

This is not a new strategy, as those who have examined the evolution of the Japanese approach to natural resource procurement know all too well. In the early resource struggles of the 1970s, the Japanese government entertained the idea of creating the country's own major national champion resource companies as a strategy—based on the first and third procurement arrangements—to secure a special relationship with major resource companies and/or producer governments. But from the late 1970s through the 1980s there was a shift, and Japanese overseas investment increasingly targeted up-and-coming producers, as highlighted by the second and fourth types of procurement. Japanese procurement thus became a major force in enhancing the competitive structure of global extractive industries and diversifying the geography of production. Japan's participation in Latin American mining projects today consists primarily of minority equity stakes in a large array of extractive projects, backed by purchase contracts for a portion of the output.

By multiplying and diversifying sources of supply for energy and minerals, Chinese investment—like Japanese investment in previous decades—continues to help solve demand-side problems by multiplying and diversifying sources of supply for energy and minerals.

YET NOT all Chinese strategic manoeuvres to procure natural resources reflect the predominant trend towards making the supplier base more competitive: Chinese policies to exercise control over rare earth mining run in the opposite direction. Rare earth elements are crucial for a growing array of civilian and military products. In 2009–10 China's Ministry of Industry and Information Technology took steps to control mining by setting an export quota of 35,000 tons per year, with a potential ban on exports of at least five types of rare earth elements. At the same time, Chinese investors have sought to acquire equity stakes in new producers, particularly in Australia. Beyond the economic sphere, Chinese manipulation of rare earth elements exports has also played a role in geopolitical manoeuvres vis-à-vis Japan, with Chinese customs authorities temporarily refusing to issue export licenses for rare earths destined for Japan in 2010.

The impact of Chinese procurement arrangements on the structure of natural resource industries is only one dimension of the geopolitical challenges surrounding these endeavours. Other dimensions are

Loading rare earth minerals for export at Lianyungang, Jiangsu province. In 2009-10 China set an export quota of 35,000 tons per year.

PICTURE: AP PHOTO / AAP

much more problematic. The fact that Chinese natural resource investments flow to problematic states and regions such as Iran, Sudan and Myanmar is one example. Host countries in the developing world may be exposed to 'resource curse' practices, including illicit payments, graft and corruption, plus poor worker treatment and lax environmental standards. The link between transnational corporations, extractive industries and development is discussed at length in UNCTAD's *World Investment Report 2007*. This report agreed with other authoritative sources that non-OECD investors—most prominently Chinese investors operating under the officially sanctioned doctrine of 'non-interference in domestic affairs'—have often undermined hard-won governance standards observed by multinational corporations. These governance standards include home country legislation that conforms to the OECD Convention on Combating Bribery.

To investigate how Chinese investors in the extractive sector compare to their OECD counterparts, a team of researchers from the PIIE undertook structured comparisons in Peru between two OECD-owned mining companies and two Chinese mining investments.

Of the two OECD-owned mining investments studied, Newmont's Yanacocha gold mine was accused of bribing officials in the Fujimori regime in the mid-1990s, and was fined for a serious mercury spill in 2000. By 2008, however, Yanacocha had cleaned up its act to the point that its environmental practices received ISO 14001 certification. The company pays wages that are 24 times higher than the national average. The other mine, Antamina, pays even higher wages—the highest in Peru's mining industry. Antamina became ISO 14001 compliant in environmental practices in 2009. The parent companies of both mines (Newmont Mining, BHP Billiton, Xstrata, Teck and the Mitsubishi Corporation) support the Extractive Industries Transparency Initiative, or EITI—a coalition of governments, companies and other stakeholders that has developed international standards for the systematic reporting and auditing of payments by resource-extracting companies. And both Yanacocha and Antamina are members of corporate groups devoted to identifying best practices in mining and community fora, such as the Grupo Diálogo Perú, which are concerned with the environment and sustainable development.

> . . . evidence suggests that Chinese companies . . . are being pushed away from a long-standing neglect of social and environmental issues

As for non-OECD investors, the Shougang Corporation was the first Chinese firm to invest in a Peruvian mine, arriving in 1992. At the time it was established, Shougang Hierro Perú brought in Chinese labourers and reduced the local labour work force from 3000 to 1700. Wages at the mine are among the lowest in Peru's mining industry (less than half the national average), with repeated bouts of contentious strikes. Shougang has been fined repeatedly for breaches of health, safety and environmental standards. But there are grounds to expect improvement because its current expansion program is being financed by external creditors, including Citibank, BCP, HSBC and Santander, which may be held accountable for violations of globally accepted standards. The second Chinese investor, Chinalco Toromocho, has not yet launched operations but already faces a major challenge in having to pay US$100 million to relocate a town of 3400 inhabitants away from the site where the mine will operate.

Neither Chinese company supports EITI or international industrial bodies; neither participates in Grupo Diálogo Perú. But one major difference between Shougang and Toromocho is that the latter's parent company, Chinalco, has secured large financial support from the China Export-Import Bank. Since 2007 this financial institution has instructed loan recipients to follow host country laws and regulations and to carry out social and environmental assessments for overseas projects, which explains Chinalco's more recent efforts to meet international standards. Even before starting operations, Chinalco established a social fund and it will invest US$20 million in infrastructure for the local community. An environmental impact study has been conducted, and Chinalco has convened public hearings with the local community as part of these proceedings.

The evidence thus suggests that Chinese companies are beginning to respond to local and international pressure. They are being pushed away from a long-standing neglect of social and environmental issues and being urged instead to adopt standards of behaviour that are similar to their OECD-country counterparts. EAFQ

Australia: time to adapt

PETER DRYSDALE

THE SURGE in Chinese investment abroad is the latest development in, and a major element (beyond trade) of, China's integration into global economic and political systems.

Australia is the largest single ultimate destination for Chinese direct investment, bigger than the US and as big as all of Europe or any other single country in the world. Though a relatively small economy, it is likely to remain one of China's largest foreign investment destinations for a while to come. At the same time, the scale and pace of growth in Chinese direct investment has led to populist reactions that have challenged the open investment regime in Australia and, in particular, raised policy questions about whether investments by state-owned enterprises (SOEs) need to be treated differently from private investment.

More than trade, business abroad involves significant political, not merely economic, interaction between foreign enterprises and the state. This is particularly the case with China, as its dominant investors abroad are SOEs. There is growing debate globally about whether and how the role of SOEs affects the benefits that host countries gain from Chinese investment abroad—a debate that is really about the interaction between national political institutions that are ordered around different principles and political constitutions, and how these institutions evolve in settings governed by market disciplines.

Many countries enjoy the economic benefit of China's integration into the world economy, few more so than Australia. But these countries are also taking active positions in managing both their economic and political interests as they are affected by the impact of developments in China, and as these changes affect the structure of international markets for goods, services, capital and investment.

The changes associated with China's integration into the global economy have seen China seek to conform to established international norms and institutions, including through its accession to the WTO. But despite the significance of these changes and China's increasingly important role on the world stage, China's economy is still in transition, with wide-ranging reforms still in progress, and this affects the way in which the market operates across all sectors of that economy. China also has a political system that differs greatly from the broadly representative political systems that typify the established industrial economies.

THERE is no system of international governance for foreign direct investment, as there is in the WTO for trade. But in no dimension of China's international economic engagement is the interaction between the economic and political systems more prominent and important than in respect of China's overseas direct investment (ODI).

These issues have become a prominent and urgent undercurrent in popular and policy discussions around the subject of China's investment abroad. In Australia, the policy response to this surge of foreign investment has been far from sure-footed; an established and well-functioning foreign investment regime has been severely shaken by undercurrents of national political populism and foreign security dog-whistling.

AUSTRALIA'S Foreign Investment Review Board (FIRB) has introduced new investment guidelines to deal with the rush of Chinese SOE investment, but this has occurred on a largely ad hoc basis. The delay in considering Chinalco's bid to buy into Rio Tinto during the global financial crisis, for example, saw the bid fall over commercially, and raised questions in China about Australia's investment regime. The Australian security agencies hav recently restricted the business dealings of telecommunications giant Huawei Technologies, a big player internationally and increasingly in Australia, too. And with Chinese investors reportedly suspending all investments in magnetite projects in Western Australia as of 2011, it seems that China no longer regards Australia as such a favourable investment destination. The retreat of Chinese ODI from Australia is likely to gather pace unless Australia's drift on foreign investment policy receives an urgent makeover.

Both the element of populism in Australia's response to the rapid growth of Chinese ODI and the particular ownership characteristics of large Chinese investment projects have acted as sources of political confusion in Australian policy development and

CONFUSED RESPONSES

in Chinese perceptions of Australian policy. Some of the confusion relates to uncertainty about how to respond to the rapid growth of Chinese investment interest in the Australian resources and energy sectors. The issues of state-owned investment, market competitiveness and other political or security matters are not being appropriately dealt with through additional restrictions and tests on Chinese or other foreign investment proposals. Uncertainty around these issues runs the risk of hindering the industry's potential and damaging Australia's longer-term political and security interests. Some of the uncertainty has also been introduced by interested commercial and political parties in play around the market.

THE BEST way to dispel this uncertainty and policy confusion would be, first, to re-assert the market framework within which all foreign investment proposals are examined in Australia and, second, initiate government-to-government arrangements for routine consultations between Australian and Chinese authorities. This would help to facilitate scrutiny of competition, corporate governance and financial transparency issues related to investment by SOEs. The details of this sort of initiative need to be the subject of discussion and further careful study.

Australia cannot expect to capture new Chinese markets without the links that Chinese ODI provides. And without more transparent foreign investment screening and common sense in the formulation of foreign investment policy, Australia is also likely to damage its foreign investment standing more broadly. EAFQ

PICTURE: WORDS & PICS

Australia's dumb luck and Chinese investment

LUKE HURST AND BIJUN WANG

Where China is concerned, Australia's Foreign Investment Review Board appears to have been making up regulations as it goes along.

AUSTRALIA has certainly lived up to its billing as 'the lucky country' over the last decade—the scramble to feed China's appetite for minerals has pushed Australia's terms of trade to historic highs. But as Chinese investors face growing operational difficulties and new supply alternatives for their natural-resource demands, Australia must now work to make its own luck to attract Chinese money in mining and in other sectors. This recent change in fortune has been driven to some extent by factors outside Australia's control, but Australian regulatory confusion is not without blame—the policy mess that surrounded Chinalco's failed bid to buy into Rio Tinto is but one example.

Australia has been among the top recipients of Chinese overseas direct investment (ODI) in recent years, apart from Hong Kong and tax havens such as the Cayman Islands. The Heritage Foundation's China Global

Investment Tracker estimates that between January 2005 and December 2010 Chinese ODI to Australia was around US$34 billion, the largest single destination for Chinese direct investment overseas.

For China, the draw of Australia's natural resources is their abundance, high quality and geographic proximity—more than 80 per cent of Chinese ODI goes to the mining sector and nearly half of that into iron ore. ODI provides a degree of security for China's resource-intensive development, which is not presently achieved through trade or portfolio investment. But Chinese ownership also raises security and sovereignty considerations for Australia.

Australia's Foreign Investment Review Board (FIRB) has traditionally provided an effective way to protect Australia from foreign investments that were perceived to encroach on 'national interests'. But in recent years, when dealing with Chinese investment activity, the FIRB appears to have been making up regulations as it goes along. Independently, the Australian security agencies have now put onerous business restrictions on Chinese telecommunications giant Huawei, a growing player in the Australian market. These actions show little regard for the fact that foreign investment has played a key role in Australia's development, linking Australia to important new markets in Japan, elsewhere in Asia, and now to China. Chinese investment in the agricultural sector is now also being treated with suspicion.

Confusion over Australia's foreign investment policy is likely to turn away future potential investors. Confusion is not only the fault of the Australian regulator; it also results from the inexperience of Chinese investors. Sino Iron's CITIC Pacific project would have been a significant step for Australia's budding magnetite iron ore industry, but cost overruns and delays resulted from a lack of understanding of Australia's policy environment more broadly. A key assumption underpinning the project was the cost savings it hoped to gain from importing Chinese engineers and workers to build the mines. When standard restrictions on imported labour were discovered the budget blew out significantly, and Chinese investors have suspended all investments in magnetite projects in Western Australia as of 2011.

It is legitimate to protect the 'national interest', but Australia's treatment of Chinese investors has increasingly failed the test of transparency as to which national interests are being protected and from what they are being protected.

The heterogeneity of China's state-owned enterprises (SOEs) and the reforms sanctioned by China's State-owned Assets Supervision and Administration Committee (SASAC) seem to be incompletely understood by Australian authorities. The reality is that commercial pressures on SOEs and their executives are mounting rapidly. For example, SASAC's dismissal of Sinosteel's CEO was largely due to the huge losses incurred on its Australian investment, Midwest Corporation.

. . . Australia cannot afford to miss out on its piece of the expanding Chinese ODI pie

Increasing household income and domestic consumption, moving up the manufacturing value chain, and mitigating environmental pressures will all be vital to China's continuing and successful development. China's medium-term goals require reduced resource intensity; a shift away from heavy industrialisation; and technological advancement in agriculture, manufacturing and services.

The Australian resource sector will continue to be an important component of Chinese supplies, as China is still a manufacturing superpower and its urbanisation is far from complete. But reliance on Australia's mineral resources will decrease as other resource-rich countries, such as those in Africa, emerge as alternatives for Chinese investment.

China's growing ODI is no longer earmarked for Australia, and its retreat is likely to gather pace following the publicity over the treatment of Huawei—a private, not a state-owned, Chinese company. Australian policy naivety, combined with a touch of xenophobia, has undoubtedly played a role in choking the growth and market access that sustained ODI would have otherwise brought.

In a global economy now significantly driven by China's growth and capital exports, Australia cannot afford to miss out on its piece of the expanding Chinese ODI pie. It assuredly will unless it revisits its haphazard approach to foreign investment policy, and institutes more-transparent screening and common sense in foreign investment policy formulation. Australia needs to rebrand itself, and soon, from 'the lucky country' to 'the savvy country', in all matters to do with Chinese ODI. EAFQ

A case of déjà vu for the United States

CURTIS J. MILHAUPT

IT SEEMS like we have been here before: a rising East Asian economic power is on the verge of a major investment surge into the US, leading members of Congress to rattle their protectionist armour. Talk of currency manipulation and unfair trade is in the air.

Twenty-five years ago, Japan's economic might—ostensibly backed by smart industrial policy, cartel-like *keiretsu* linkages and cheap bank credit—was the source of fear and loathing in Washington. Today, of course, all eyes are on China, but the atmosphere surrounding Chinese investment in the US has a very familiar feel.

Congress established the US–China Economic and Security Review Commission in 2000 to monitor the national security implications of bilateral economic ties with China. A hearing in February 2012 (at which I participated as a witness) was called to examine policy responses to Chinese state-owned enterprises (SOEs), and more specifically the challenges that Chinese government ownership poses to US companies competing in China and within the US. It is only a slight exaggeration to say that at many points in the proceedings, if the word 'China' were substituted for 'Japan', the debate could literally have been a transcript of congressional testimony in the 1980s. This sense of déjà vu may be either wearying or amusing depending on one's appreciation of political theatre.

Despite some important differences between US–Japan and US–China bilateral relations, the Japanese experience may provide important clues as to what we might expect as Chinese firms begin navigating the complex political, legal and cultural landscape of foreign investment in the US. A few observations can be made in light of this history.

Most basically, we need to distinguish between the political and legal environment for foreign direct investment (FDI) at the federal level and in the local communities where the investments are actually made. At the national level, Chinese firms (particularly SOEs) will confront substantial wariness when dealing with Congress and federal agencies. Before a foreign buyer acquires a US firm, the transaction should be cleared by the Committee on Foreign Investment in the United States (CFIUS), which is charged with screening foreign acquisitions of US companies for threats to 'national security' and 'critical infrastructure'. These exceedingly broad and vague terms are left undefined in the law—thus increasing the discretion of CFIUS.

This process was established in the 1980s in response to congressional fears of strategic technology transfer and industrial espionage by Japanese acquirers. Technically, submitting a transaction for review is voluntary, but failure to do so leaves the deal open to being unwound on national security grounds—meaning any well-advised foreign acquirer, particularly a Chinese acquirer, treats the process as mandatory. Yet the prospect of triggering regulatory scrutiny almost certainly deters some Chinese investments, particularly in the aftermath of CNOOC's infamous—and unsuccessful—bid for Unocal in 2005. The CFIUS process was a focal point in the political firestorm that led CNOOC to abandon its offer.

GIVEN the prevailing sentiment during the congressional hearing in Washington, it seems possible that Congress will attach additional screening measures to the CFIUS process out of its wariness of Chinese FDI. Members of the commission seemed attracted to the Canadian approach to screening foreign investments, which includes a 'net benefit' test. That is, government reviewers are required to assess whether an acquisition of control by a non-Canadian company is of net benefit to Canada. In the case of a foreign SOE acquirer, the reviewers assess whether the Canadian business will still have the ability to operate on a commercial basis. The net benefit approach seems like an invitation to endless holdups and logrolling by domestic corporate and political stakeholders. Yet it is hard not to sympathise with policymakers in Washington; the US foreign investment regime (and many other aspects of its market regulation, such

PICTURE: TOYOTA MOTOR NORTH AMERICA INC.

An assembly-line worker in Toyota's Indiana plant puts the finishing touches on a vehicle. Despite the clamour in the 1980s, Japan is now an uncontroversial source of foreign direct investment in the United States.

as the antitrust regime and securities laws) was not designed with Global Fortune 500 companies connected to an authoritarian party state in mind.

The Japanese experience suggests that while the federal political and regulatory climate may be very problematic for Chinese firms, US state and local governments, as well as communities—where the businesses will actually operate—are likely to be much more receptive to Chinese investment. This is particularly true of greenfield investment, as opposed to acquisitions, although most economists view the two forms of FDI as essentially interchangeable. Japanese investors learned the hard way that passage into the US is much smoother if a foreign firm integrates fully into the local community. Integration is facilitated by consistent and positive interaction with local suppliers, business people and politicians, and by learning as quickly as possible what it means to be a 'good corporate citizen'—through employment practices, philanthropy and community involvement. Admittedly, for some Chinese firms, especially SOEs, this process may be significantly complicated by government ownership and Communist Party involvement in corporate personnel decisions.

Japan's long-term experience of investing in the US ultimately provides a positive example for Chinese investors. Despite the clamour in the 1980s, Japan is now an important, uncontroversial source of US-directed FDI. Japanese affiliates employ hundreds of thousands of American workers, and a solid network of government and private sector actors help to sustain a relatively healthy bilateral investment climate. While a significant increase in Chinese FDI will almost certainly be met with considerable political backlash, 20 years from now, congressional and media attention will likely be elsewhere, while Chinese affiliates quietly go about their business in the US. EAFQ

STRATEGIC ADVANTAGES

Helping out the eurozone

HINRICH VOSS AND
JEREMY CLEGG

THE CHANGING fortunes of the world's mature economies relative to the emerging economies have prompted a remarkable reversal of roles when it comes to who might be able to help whom. And while it would be in everyone's best interest to help one another in the wake of the global financial crisis, international investment in real assets (as opposed to the purchase of bonds or titles to debt) is the outcome of hard-nosed commercial business decisions. So the question to ask is: why would China and Chinese companies wish to help the eurozone?

There are, as it turns out, some very good reasons for doing so, and strengthening the position of Chinese firms in an important export market is one of them. But there are also some good reasons why Chinese investors should steer clear of investing too much or unwisely—particularly at an early stage of their own relatively recent internationalisation.

One thing needs to be clear, though: there is a big difference between portfolio investment and direct investment. Economists and economic statisticians define portfolio investment as any investment in a company in the host economy that weighs in at under 10 per cent of equity. Direct investment must involve at least 10 per cent of equity, above which threshold the investor can generally appoint a director to the board, thus securing a say in the management of the company. This, in turn, has vast flow-on implications; it enables the Chinese parent company to have a real input in the strategic decision-making and long-term development of their European business partner.

This is well illustrated by the recent acquisition activities in the German automobile supply sector. Since January 2011 Chinese firms have acquired a series of small- and medium-sized companies that were previously managed by private equity firms, including Kiekert, Preh, Saargummi, KSM Castings and Sellner. Sound business logic informed each of these acquisitions. In two instances, the German firm had already established a joint venture with the Chinese partner, which facilitated the process of entering the Chinese market. And in all cases, the acquirer came from the same industry sector and brought Chinese technology and market knowledge to the business.

> . . . favouring brownfield over greenfield investments . . . enables Chinese investors to gain quicker access to the host-country assets they seek, which complement the assets they bring to eurozone economies.

Here it is easy to see how Chinese investment can have a positive impact on the European economy. Greater access to the Chinese market will support the growth trajectory of European firms, thus generating employment. The combination of Chinese and European technologies can also lead to the development of innovative products to serve new customer segments. And this reinforces the positive business relationship between economies that enjoy significant two-way investment and trade flows.

But is the picture as rosy when we look at European economies other than Germany? Within the eurozone, the struggling economies of Portugal, Italy, Greece and Spain (the so-called PIGS) receive fairly small amounts of Chinese investment, which dropped from 9 per cent of total Chinese FDI in the European Union in 2007 to as little as 4 per cent in 2010. So the relative importance of these countries as FDI hosts within the EU has actually fallen since the beginning of the crisis, while the eurozone overall has strengthened its position as a recipient of Chinese investment. This contrasts with the general perception that surplus assets available for purchase across the PIGS will stimulate an increase in Chinese investment.

In fact, data on mergers and acquisitions indicate that Chinese deals have remained stable or increased in these economies. These figures also indicate—at least on the face of it—that Chinese corporations are increasingly favouring brownfield over greenfield investments. This enables Chinese investors to gain quicker access to the host-country assets they seek, which complement the assets they bring to eurozone economies. Chinese firms usually seek skills, technology and pan-European distribution channels, so the Mediterranean seaboard location of the PIGS countries makes them particularly attractive for brownfield investment.

Finally, it is also important to consider sovereign wealth funds. According to data from the SWF Institute, significant Chinese examples include the China Investment Corporation (with projected assets of US$439.6 billion by mid-2012), the SAFE Investment Company (US$567.9 billion) and the National Social Security Fund (US$134.5 billion). These funds are primarily engaged in portfolio investment. But as the scale of investment rises, Chinese sovereign wealth funds have started to cross the 10 per cent threshold, as they feel the need to exercise a voice in the management of their money.

Meanwhile, the EU looks towards these funds for investment in large capital cost projects, such as road and water infrastructure. The hopes of EU governments are pinned on such investments because they could provide a fillip to local economies and accelerate the rate of recovery when, in due course, the European economy turns the corner in a return to growth.

So can Chinese investment help the Eurozone? In a word, yes. While it is not expected that the volume of Chinese FDI will match US or even Japanese investment in the Eurozone anytime soon, Chinese firms that play to their strengths while developing key business ventures will certainly energise static European markets. EAFQ

Disaggregating Chinese actors in Africa

GREG MILLS AND
TERENCE MCNAMEE

Most discussions on Africa 15 years ago would have focused on topics regarded today as no longer relevant.

For example, while the continent is still dealing with the consequences of HIV/AIDS and the rates of infection are the highest worldwide, the disease is no longer a defining issue. And no longer is there a Manichean debate about the role of the state and the market. It is broadly accepted that both an efficient state and open markets are necessary for development to occur, even though some governments are uncertain or incapable of creating one and lukewarm on allowing the other.

Even during the 1990s the debate over how Africa could most quickly develop centred on the role of external actors, and the relationship between aid and poverty alleviation. This reached its zenith during the 2005 Gleneagles G8 summit when, at the urging of activist leaders such as British prime minister Tony Blair, it was agreed to double aid to the continent. Similarly, the African debt issue was virtually taken off the table through a combination of the Highly-Indebted Poor Country initiative and the Gleneagles proposals—which agreed to write off US$40 billion in debt owed by 18 poor countries to the International Monetary Fund, World Bank and African Development Bank.

Africa was also at the start of a period of 'redemocratisation' in the mid-1990s. At the end of the Cold War, 70 per cent of African countries were considered to have 'unfree' political systems, as classified by Freedom House. By 2010, more than two-thirds were 'free' or 'partly free'. Much debate then looked at how best to keep militaries in the barracks while restoring respect for civil–military boundaries.

Today, Africa is in the midst of a global commodity boom which, combined with profound technological changes in the form of digital communications, has driven up growth rates. Whereas by the mid-1990s African telephone connectivity was just one-tenth of the global average, today it is half this average, even though the global figure has increased fourfold to 70 connections per 100 people. In the 2000s, meanwhile, sub-Saharan Africa enjoyed its best growth decade on record since independence.

Rather than engaging in the old state-versus-market debate, there is now a common appreciation of the centrality of economic growth as a necessary (if insufficient) condition for development. There is much more scepticism about the value of aid, at best viewed as a facilitator—not a generator—of development, and as comprising a range of deleterious side effects, not least the often broken link of accountability between leaders and the electorate.

China has also emerged as a major force, not only as a provider of cheap goods and African infrastructure, but as a purchaser of African commodities and assets. Perhaps more than any other single factor, China's interest in Africa has illustrated that the continent is not only a place where problems need solving, but somewhere business can be conducted and profits made.

A welter of statistics is routinely trundled out to describe this engagement: that China's trade with Africa has risen, for example, from under US$5 billion in 1995 to over US$130 billion in 2010; or that sub-Saharan Africa accounted for nearly 15 per cent of Chinese outward investment between 2005–10, having started with very little immediately before this.

BUT China's investment in Africa has to be carefully segmented, with each of these aspects in turn containing different challenges for African countries and other external partners. China's growing role is not one-dimensional, since there is a whole range of Chinese investors and players in Africa, from those in the natural resource sector—including big state actors, smaller individual actors and those employing aid or assets-for-commodities swap deal methods—to the myriad small Chinese businesses across the continent. Each of these levels of engagement produces different outcomes and issues for governance, and domestic and international politics; for governments and private individuals; and for competing businesses. Hence they also give rise to a set of different development and strategic choices, meaning a deep understanding of these aspects is absolutely critical.

There are many diverse impacts resulting from this expansion of interest into Africa, not least for matters of governance, and not all of them positive. In September 2007, for example, the Congolese government and a group of Chinese state-owned enterprises signed a bilateral investment and trade agreement under which the Chinese committed to construct a number of roads, railways and hospitals. The initial deal stated that the project would be carried out by Chinese companies and financed by loans from the Chinese Export-Import Bank, and was estimated to be worth US$9 billion. In return, a Congolese–Chinese joint venture with Chinese majority participation was to be created to extract and sell Congolese copper, cobalt and gold. This would ensure the loans were reimbursed.

Though there is an infrastructure dimension, even in its newly revised form such a deal can do little to change Africa's status as a raw material exporter and will do little to achieve Africa's aim of increasing diversification and local job creation. And further loans to a country like Congo can only see it become stuck deeper in the mire—one reason the multilateral agencies initially objected to the deal. Yet such swaps are mostly about the elite's ability to capture resource rents, with little hope of further redistribution or the promotion of democratic values.

There is also a displacement effect on the local economy from increased investment. For example, Guy Scott, the vice president of Zambia, has noted about Chinese migrants in his country: 'the guys we've got ... are people who have difficulty getting work back in China ... They have started to compete with Zambians at quite a low economic level—raising chickens, for example ... They don't take weekends off, and they live four to a room. And they get money at 6 per cent interest from the Bank of China, compared with 25 per cent that Zambian contractors have to pay'.

Recent research by the Brenthurst Foundation focusing on small Chinese traders across five southern African countries shows how these businesses receive no Chinese or African state support and are deeply mistrustful of the local people and authorities. The key question for Africa to come out of this research is why Chinese entrepreneurs with limited local knowledge and support bases often succeed in the very areas where local Africans should be more competitive.

CHINA, of course, is not the only new actor. Other countries, including Turkey, Brazil and India, have also shaped a more positive view of Africa as a place to do business. In 2011, for example, India announced US$5 billion worth of development deals in Africa for a three-year period. Still, the continent has a lot for which to thank China in particular. Chinese growth has driven up commodity prices to the benefit of many African countries, even if this is only temporary, and Chinese investment has also opened the world's eyes to African opportunities.

But these countries would do well to ignore grand political statements on south–south cooperation from Beijing: China is relentlessly pursuing its own interests in Africa, make no mistake about it. That doesn't make it any less of an opportunity for African states, but it does require them to devise a clear development strategy to engage with China, and other potential investors, in accordance with their own interests. EAFQ

CHANGING STRATEGIES

Adapting to the Latin American experience

MIGUEL PÉREZ LUDEÑA

CHINA became the third-largest investor in Latin America in 2010—behind the US and the Netherlands—while the Economic Commission for Latin America and the Caribbean estimated that Chinese foreign direct investment (FDI) reached US$15 billion for the year. Ninety per cent of this was in extractive industries. Chinese FDI may have been somewhat smaller in 2011, but the presence of Chinese companies in the region continues to grow: Sinopec in Brazil and Sinochem in Argentina have carried out numerous acquisitions, and other corporations have favoured greenfield projects such as the copper mining operations of Chinalco and Minmetals in Peru, or the Chery automotive plant in Brazil.

Chinese investment in Latin America has become a hot topic in the last couple of years, yet Chinese companies have been in the region since the early 1990s. The China National Petroleum Company—originally the Chinese Ministry of Petroleum—signed extraction deals with governments and state-owned corporations in Peru in 1994, Venezuela in 1998 and Ecuador in 2003. Outward Chinese FDI has taken the shape of government-to-government deals in many countries, and especially in the extractive industries, where all large Chinese corporations are state owned. This was the preferred approach in 2006, when Minmetals signed a deal with the largest copper producer in the world, the Chilean state-owned mining company CODELCO. In exchange for US$500 million, CODELCO agreed to sell 55.75 tons of copper over 15 years at a fixed price and granted the option of acquiring 49 per cent of Mina Gaby, a mining project in northern Chile. The first part of the deal is still in force today, and has proved particularly lucrative for Minmetals since 2006, when the price of copper rose significantly. But the joint venture option was derailed by trade-union opposition in Chile around the same time, and was finally cancelled without any compensation to Minmetals.

Chinese companies are not the only ones to suffer setbacks in acquisitions, but they have a higher percentage of failure (at 11 per cent) than, for example, US or UK firms (2 per cent and 1 per cent, respectively). Chinese takeovers face stronger opposition for many reasons, and it is often remarked that the main cause of failure is that almost all Chinese multinationals are state owned. In the US this has raised concerns about national security, for example in relation to the operations of Huawei, a non state-owned company but allegedly state controlled. For their part, Latin American commentators have criticised the lack of transparency and accountability in negotiations surrounding company acquisitions.

> Chinese takeovers face stronger opposition for many reasons . . .

A great deal of direct investment in the region still takes place through government-to-government deals, especially in the smaller economies of Central America and the Caribbean. But since 2006 Chinese multinationals have generally favoured direct takeovers of private companies and joint ventures with other multinationals as their preferred mode of entry into Latin American economies. For example, while in Peru Chinese companies have bought junior mining companies and started building mines, Chinese oil companies operating in Brazil have partnered with the Spanish Repsol and the Norwegian Statoil.

Some of the Chinese companies which have entered Latin American markets in this way have taken a back-seat position in their subsidiaries. Such is the case of Wuhan Steel, for example, which has a minority stake in the Brazilian miner MMX. Other companies are managing their operations more directly. This has confronted Chinese companies with another problem: handling their relations with communities affected by the company's operations. This is especially problematic in relation to large oil and mining projects.

Coming from a country where the government takes direct responsibility for any externalities caused by their operations, Chinese companies have

PICTURE: MARTIN BERNETTI / AFP / AAP

Visitors inspect an open cut copper mine near Calama, Chile. Increasingly, Chinese corporations are adapting their strategies to cope with their international expansion, including those in Latin America.

faced difficulties in adapting to an environment in which civil society demands compensation from companies—although the track record of Chinese firms operating in Peru's mining industry shows there has been consistent progress since the early 1990s.

Many Latin American businesses also complain that investment opportunities are not reciprocal, and that it is hard for foreign companies to make direct investments in China. Unlike many manufacturing companies from Europe, Japan or the US (which have been investing in China for decades), most 'multilatinas' operate in natural resource and services sectors that are practically closed to FDI in China.

But despite complaints from social activists and communities on the one hand, and Latin American corporations on the other, Mina Gaby remains the only major setback to confront Chinese multinationals in Latin America. Governments may have taken measures to restrict Chinese investment in agriculture, but these are not intended to discourage investment altogether. There are no reliable figures for the amount invested by Chinese companies in Latin American agribusiness, but the perception that Chinese companies (again, mostly state owned) were acquiring large amounts of land led the Brazilian government to pass legislation limiting this practice in 2010, with Argentina and Uruguay following suit in 2011. These restrictions do not represent a ban on Chinese investment in agriculture, but they will force the Chinese to enter into partnerships with local companies or reach agreements that will not involve land ownership, such as contract farming. In the next few years Chinese companies will learn to become more transparent in their procedures and to rely more on local management and less on imported labour.

Multinational corporations from Europe and the US have learnt over time to conduct business successfully in Latin America and other regions. Chinese corporations are increasingly adapting their strategies to cope with their international expansion, but further changes will be needed. A generational change in management will no doubt help to bring about this change; as younger, more worldly executives reach decision-making positions in Chinese companies, we can expect a change for good in their business practices. EAFQ

Retail and infrastructure the focus in Papua New Guinea

GRAEME SMITH

CONVENTIONAL wisdom about Chinese engagement with the Pacific holds that it is all about resources, all about Taiwan, or perhaps a bit of both. But researchers at the Investment Promotion Authority (the agency that monitors foreign investment in Papua New Guinea) suggest that investment in the retail and infrastructure sectors is more significant than in mining, overshadowing even the much-publicised Ramu nickel project. How, then, are these factors playing out in Papua New Guinea and how are they affecting local communities?

While the Chinese state is effectively absent from the lives of its expatriate retail investors in Papua New Guinea, these shopkeepers dominate the retail trade in major towns across the country and were the target of nationwide riots in May 2009. They have become a source of resentment for local inhabitants, who believe Chinese entrepreneurs are monopolising business and employment opportunities and preventing local participation in the retail sector. The Papua New Guinean state recently responded to these concerns by launching a A$56 million campaign to assist local entrepreneurs trying to compete in the retail sector.

While smaller-scale Chinese investors are now beginning to expand beyond this sector, the capital raised for their ventures is still privately sourced. The Chinese state has only a limited influence on these entrepreneurs' lives, mostly through its embassy in Port Moresby. The embassy assists with setting up friendship associations and mutual aid groups, but it has little capacity or inclination to intervene beyond social initiatives of this type—a policy that Chinese expatriates, in turn, have come to resent. As one shopkeeper complained: 'Even when someone gets killed, they're no use. They'll just send out a notice telling you to take extra care, and not to go out.'

Meanwhile, researchers from the Lowy Institute have devoted much ink to Chinese infrastructure aid in the Pacific, calling on the Chinese government to address issues of transparency, project quality and the impacts of debt. Yet for Chinese infrastructure providers in Papua New Guinea, there is nothing particularly remarkable about international 'aid', which they treat as just another type of investment, rather than funding in need of extra standards of quality and oversight.

> . . . the implications of Chinese investment in Papua New Guinea are more complex than media reports of 'neo-colonial slavery' suggest

For companies such as the Chinese Overseas Engineering Group (the Asian Development Bank's favoured contractor for road-building projects in Papua New Guinea) and China Harbour Engineering (which recently won a US$285 million project to build Phase I of the Tide Terminal project in Lae), Chinese government aid projects are only a small part of their overseas business strategy. Moreover, companies such as these are influential enough to attract support from the Chinese state for projects developed in collaboration with local partners in Papua New Guinea. Consequently, what first appears to be state-run aid often turns out to be company-driven outward direct investment (ODI), and international aid projects are simply assimilated into these companies' overall business dealings. Indeed, these types of infrastructure projects are increasingly dominant in Chinese investment in Papua New Guinea, overtaking China's long-standing focus on natural resource acquisition.

To date, China's most significant investment in Papua New Guinea's mining sector is the Ramu nickel project, managed and majority owned by China Metallurgical Group Corporation (MCC). After nearly two years of court delays, MCC recently conducted the mine's first on-load test, which produced nickel and cobalt

PICTURE: LLOYD JONES / AAP

Chinese engineers survey work at the Basamuk processing plant near Madang, part of China Metallurgical Group Corporation's Ramu nickel project in Papua New Guinea. Each site in the Ramu project has 'a distinctive work culture based on shared histories, cultural preferences and local dialects'.

hydroxides, although it is expected that final processing into sulfates will be undertaken in China.

Local resistance to the project has centred on environmental and labour issues so far, but future disputes may involve the issue of royalty payments to landowners. Under the mining development contract, which was negotiated with the former Somare government, MCC will pay a low rate of royalties on revenue from resource sales, at 1.25 per cent. This figure is in accordance with Papua New Guinea's *Mining Act*, rather than the 2 per cent generally paid by other mining projects. So if the project fails to deliver substantial royalties, it could face a new source of local opposition.

Despite being run by a company whose director argues that 'central government enterprises that secure mines overseas are in reality securing resources for China', this project is not controlled from Beijing. Due to the emergence of MCC from the former Chinese Ministry of Metallurgy, the corporation is divided into province-based corporations; the Ramu nickel mine, for example, is staffed by contractors from Sichuan province. These contracting companies are brought in for specific tasks, and are financially independent from MCC's head office. Rather than constituting a single work unit, each site has a distinctive work culture based on shared histories, cultural preferences and local dialects. This level of fragmentation and complexity presents numerous opportunities for Papua New Guinea, as it means Chinese actors are often more flexible and willing to compromise than other companies.

Given all of these factors, the implications of Chinese investment in Papua New Guinea are more complex than media reports of 'neo-colonial slavery' suggest. Some analysts have called on the Chinese government to do more to rein in the broader effects of this sudden increase in ODI, such as illegal immigration and the reluctance of Chinese infrastructure companies to employ local labour, and there is evidence that elements within the Chinese state share these aspirations. But as Chinese ODI becomes an increasingly organic phenomenon in Papua New Guinea and beyond, the leverage of the Chinese state is becoming ever more limited.