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China's Changing Outbound Foreign Direct Investment Profile: Drivers and Policy Implications

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In 1967 Jean-Jacques Servan-Schreiber published *Le defi americain*, a call to beware of American multinationals buying up the world. In the 1980s and 1990s it was Japan's turn, spawning books like Clyde Prestowitz's 1993 *Trading Places: How We Are Giving Our Future to Japan*. Today it is China's outbound foreign direct investment (OFDI) that elicits the most anxiety.[1] China's OFDI has reached commercially and geoeconomically significant levels and begun to challenge international investment norms and affect international relations. Yet China's OFDI profile is poorly understood. Seen in context, China is a laggard in global investment, and the country faces considerable internal impediments to overcoming its disadvantaged position. Because of this, more-advanced economies can leverage their experience and comparative advantage as global investors to work with China in the international investment policy arena. This policy brief helps clarify the size, intent, sophistication, and sustainability of China's OFDI in order to lay the groundwork for related policy debates.[2]

A number of deals and policy measures announced in the first half of 2009 indicate an inflection point for China's OFDI. With the economic crisis depressing asset prices worldwide, Chinese firms have launched multibillion dollar bids for distressed resource firms, and the Chinese government is promoting outbound investment by easing and decentralizing regulatory procedures, broadening financing channels for firms with overseas ambitions, and openly advertising China's international investment appetite.[3] At the same time, however, global economic turbulence is making potential Chinese investors insecure. A recent survey found that more than half of Chinese firms are scaling back their overseas investment plans in response to the crisis (APFC and CCPIT 2009). The value of approved nonfinancial overseas projects in the first quarter of 2009 dropped to $3.7 billion, from more than $10 billion in the same period last year.[4] The Chinese government has become more cautious as well, withholding approval for deals in the

1. For clarity, we refer to direct investment into China as foreign direct investment (FDI) and direct investment out of China as outbound foreign direct investment (OFDI). As opposed to portfolio investment, we use the term "direct investment" only for long-term cross-border investment with a final stake of greater than 10 percent, following the OECD's widely used benchmark definition of FDI (OECD 2008a).

2. We will publish a longer study on this topic later in 2009.

3. Recent examples of greater international action include Chinese investment delegations' travel to OECD countries in the spring of 2009; several bilateral free trade agreements with far-reaching investment provisions, such as with Peru in April 2009; and the front-loading of an investment agreement in an initiative with Taiwan in May 2009.

4. The registered 2008Q1 OFDI volume was $19.34 billion, including financial deals like Industrial and Commercial Bank of China's (ICBC) $5.6 billion investment in South African Standard Bank and other high-profile deals, like Chinalco's $13 billion stake in the Australian mining firm Rio Tinto.

financial sector and publicly rebuking several high-profile firms in other sectors for their overseas investment plans.[5]

Despite short-term anxieties, Chinese OFDI is poised to grow markedly in the medium and long terms, and the importance of these investments to Chinese firms is changing fundamentally as the nation confronts the need to rebalance its growth model. For 30 years China has sustained high growth by producing goods for export to the world without a significant presence in the world beyond its borders. Expanding economies of scale in domestic manufacturing is no longer sufficient to fuel growth, and China's firms are increasingly being forced to fight for the vast profit margins they have traditionally conceded to foreign partners able to operate abroad.

China's OFDI has reached commercially and geoeconomically significant levels and begun to challenge international investment norms and affect international relations.

Meanwhile Beijing is publicly talking about making direct investments abroad as an alternative to holding US government debt securities, complementing the economic motives of China's firms. The implication that real-economy direct investments are somehow a menu option for investments otherwise made by official government entities casts a mercantilist light on China's outbound investment. In addition to stoking concerns about the demand for US treasuries, this talk may raise special national security questions about otherwise welcome investment inflows to a US economy in need of increased investment.

The changing nature of China's global OFDI position is a core concern for China's government and firms alike, and therefore the policy response from the United States, Europe, and elsewhere will be critical. The range of policy issues raised by China's outbound investment is extensive:

- **Connecting Chinese OFDI with other global challenges:** A successful integration of China into open cross-border investment flows will be necessary to solve some of the world's most urgent challenges. Mercantilist investment protectionism both in and against China would have negative consequences in a number of international policy areas, such as building a new climate policy regime and addressing old concerns in international development. Chinese investment flows can make positive contributions to global recovery and economic development in the years ahead.
- **Improving investment flow transparency:** China and other countries have aligned interests in securing a more-transparent global investment environment, such as through limiting the use of tax havens to hide FDI flows from regulators.[6] But China's OFDI data are out of line with international standards, and the value, destination, and sectoral mix of its OFDI are unclear. Maximizing the benefits of foreign direct investment requires better statistical clarity.
- **Limiting national security concerns in an era of high-value mergers and acquisitions:** Chinese OFDI will increasingly target higher-value assets in advanced economies, as commercial competitiveness joins resource security as a first-order motivation. This will increase the temptation for governments and firms in the nations where China invests to use national security arguments to block these new entrants. Worldwide, the commitment to cross-border investment openness is already shaky and protectionist sentiment is on the rise. Potential recipients of Chinese investments must not invoke national security inappropriately and should be more forthright about off-limit sectors.
- **Grappling with national economic security:** Attempts by some US firms and protectionist politicians to expand the US investment review system to include economic security irrespective of national security have been rebuffed in the past. However, China's size and pervasive government involvement in its commercial sector are rekindling this debate. Policymakers worry about the impact of noncommercial bidders on a market system, and concerns that official subsidies support China's OFDI are pervasive. Talk in Beijing about "using" corporate OFDI as an alternative to buying US treasuries only increases worry about financial security. Corporate bailouts worldwide have lately made China's firms less exceptional in terms of government ownership and control, but western officials remain concerned about China in particular. Chinese executives need clear US policy to determine beforehand whether bids may be rejected on national security grounds, and greater clarity on this issue would benefit the United States both by maximizing its asset values and preventing tit-for-tat treatment abroad.

5. The Bank of China did not receive approval for its $340 million investment in the French bank Rothschild, while the auto firm Geely and the machinery manufacturer Sany were publicly rebuked for their ambitious expansion plans.

6. Increased transparency and better information-sharing were major objectives articulated by China in the run-up to and during the G-20 meetings in November 2008 and April 2009.

- **Fixing China's domestic impediments**: Some of the biggest obstacles to China's firms going abroad are homegrown: lack of corporate vision and experience, inadequate overseas management skills, and schizophrenic political attitudes. Foreign officials, whether seeking to attract investment from China or to prevent it, must recognize this. China should avoid rushing to blame foreign investment rules and instead address firm-level and policy shortcomings. Otherwise, misdiagnoses of impediments will result in recriminations and protectionism in China and abroad.
- **Cementing an open investment environment**: China's national interest in an open environment for cross-border investment is increasing along with the economic forces that are pushing its firms abroad. The coming decade will offer a window of opportunity not only to integrate China into existing investment frameworks but also to jointly move beyond current investment regimes.

In the following sections we provide the background analysis needed to address these issues. This includes a review of China's OFDI profile in light of other financial flows and compared with other countries, the changing forces driving Chinese investment, and an analysis of barriers and impediments both homegrown and foreign. Finally we elaborate our principal policy findings.

CHINA'S CURRENT OFDI PROFILE

The history of outbound investment flows from China is short but spectacular. Virtually nonexistent on the eve of the economic reforms beginning in 1978, OFDI remained insignificant through 2004. But by 2007 the annual volume of OFDI had grown to around $25 billion, only to double to more than $50 billion in 2008 (figure 1). The stock of Chinese cross-border investments reached approximately $170 billion at year-end 2008.[7]

Data Accuracy and Potential Distortions

While the quality of China's data on cross-border investment has improved significantly over the past decade, reliability remains a serious concern. The primary official source for data on Chinese OFDI is the *Annual Statistical Bulletin on China's Outward Direct Investment*, which is compiled by the Chinese Ministry of Commerce (MOFCOM) and copublished with the State Administration of Foreign Exchange (SAFE) and the National Bureau of Statistics (NBS). Secondary sources for OFDI data are China's *Balance of Payments* (BOP) and *International Investment Position* (IIP), both published by SAFE. The *Bulletin* covers OFDI flows and stock based on investment approvals in the respective year, whereas the BOP/IIP numbers are based on actual recorded outflows yearly. Although authorities conform in principle to internationally recognized standards, including the OECD's *Benchmark Definition of Foreign Direct Investment* (OECD 2008a) and the International Monetary Fund's (IMF) *Balance of Payments Manual*, compilation methods are not fully consistent with these standards in practice, and MOFCOM's exact methodology for gathering OFDI data is opaque.[8]

Several factors distort the accuracy of China's aggregate data on OFDI. First, MOFCOM does not rely on direct enterprise surveys to compile data but rather on information collected by local commerce bureaus, where firms must register their overseas investments. This can result in significant underreporting by firms that wish to side-step approval procedures for a variety of reasons, thus dragging down the aggregate figures. Another major problem, resulting in undercounting, is that many Chinese firms do not report foreign earnings that are reinvested abroad as OFDI as required by international standards.[9] While these factors suggest that actual outflows could be much higher, there are also reasons to suspect that China's official statistics are too high. Limited capital account convertibility has long been understood as a motive to disguise hot money flows by overstating or understating direct investment values. Efforts to bring hot money out of the country may partly explain the sharp increase of outbound investment over the past four years. Another factor potentially contributing to overstatement of OFDI is "round-tripping": reporting OFDI (mostly to Hong Kong or tax havens) only to bring it back into China in order to enjoy preferential FDI treatment and other advantages.[10] There are no official estimates for round-tripping money flows, but some analysts think it could be more than one third of all inward FDI.[11] These distorting factors are known, but it is hard to weight them and to decide whether the aggregate number is understated or overstated.

7. The State Administration of Foreign Exchange (SAFE) recorded a stock of $169 billion in its 2008 *International Investment Position* (IIP). By adding the Chinese Ministry of Commerce's (MOFCOM) 2007 stock number ($118 billion) to the preliminary number for 2008 flows ($52 billion), we arrive at roughly the same number, although stocks are usually not measured as just the accumulation of flows but are adjusted for depreciation and asset revaluation.

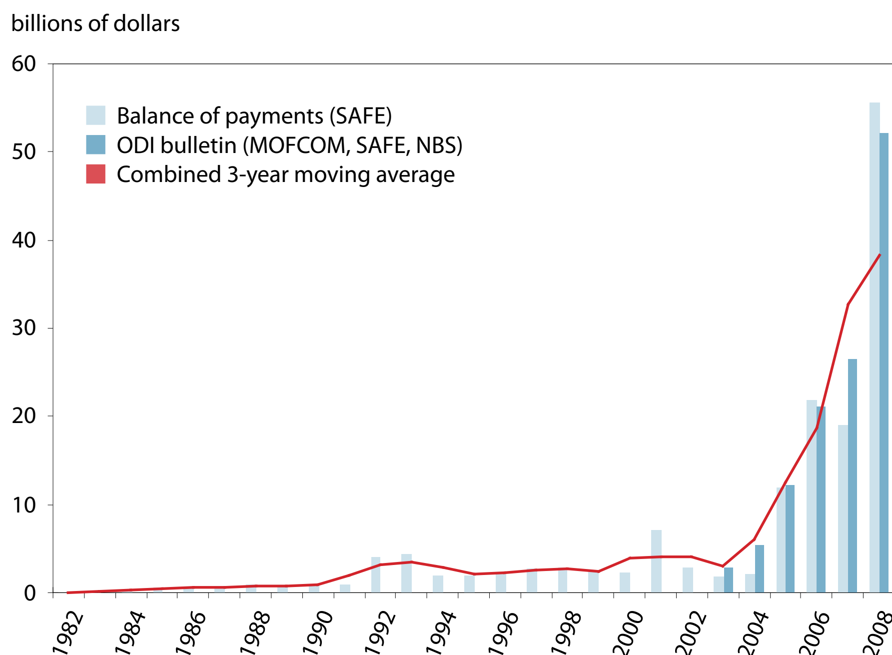
8. For a discussion of China's compliance with international FDI statistics, see OECD (2008b).

9. We learned this in interviews with industry executives and policymakers in Beijing and Shanghai in November 2008 and March 2009.

10. Some of the financial advantages enjoyed by foreign investors in China, including favorable tax treatment, have been phased out in recent years. But formally or informally, advantages remain in many circumstances.

11. Xiao (2004) suggests that 30 to 50 percent of FDI is money first siphoned out of the country in some way.

Figure 1 China's annual OFDI flows, 1982–2008, MOFCOM and SAFE



Source: SAFE, *Balance of Payments*; MOFCOM, *Annual Statistical Bulletin on Outward FDI*.

Unclear Disaggregated Data

The details in China's OFDI data are even more unclear than the aggregate. The confusion begins with the geographical distribution of OFDI, which is almost completely obscured. MOFCOM statistics provide an overview of Chinese OFDI by destination region and country. However this is based not on survey data but on information Chinese companies submit in the registration and approval process. Firms tend to report the first, not the final, destination of their investments, weighting the numbers toward stop-over locations such as Hong Kong and tax havens such as the Cayman Islands, the Bahamas, and the British Virgin Islands. In MOFCOM data around 80 percent of Chinese OFDI stock lies in Hong Kong or tax havens (figure 2).

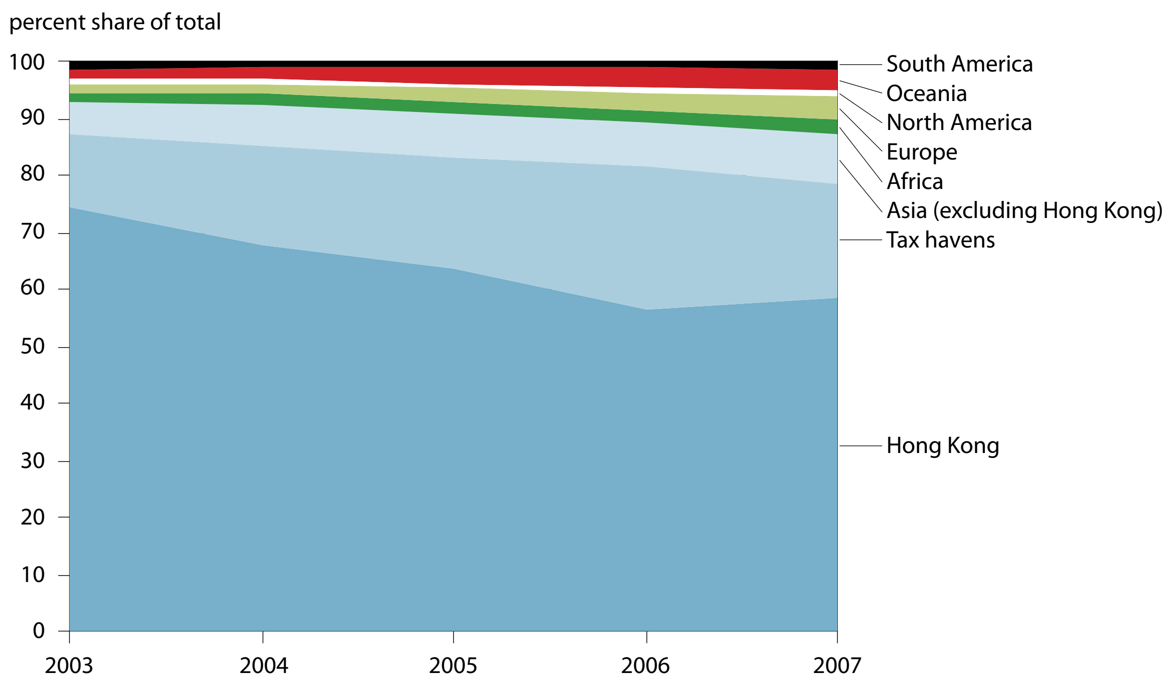
Just as OFDI is obscured by passing through stop-over locations, industry categories are not final, and MOFCOM data on the sectoral composition of the OFDI stock are distorted as well. In addition these statistics rely not on the International Standard Industry Classification (ISIC) system but on a Chinese alternative, so China's figures are not internationally comparable. Likewise, the data do not permit cross-referencing of regional and industrial distribution. A more accurate data set would help policymakers inside and outside China better understand the country's OFDI profile and allay some anxieties. For instance, aggregates from commercial mergers and acquisitions (M&A) databases suggest that the regional and sectoral distribution of China's OFDI is more diverse than commonly thought (appendix 1 table 1).[12]

Another metric that is important for policymakers and regulators abroad is the entry mode of Chinese investments. Cross-border investment can take place through "greenfield" projects (building new facilities from scratch), or by buying existing assets through mergers or acquisitions. Chinese authorities do not release regular official information on the share of each entry mode, and using available M&A data is difficult because many Chinese firms use special purpose vehicles (SPVs) in third countries, including Hong Kong and Singapore, to make acquisitions. Our M&A data set suggests that around 60 to 70 percent of total Chinese OFDI volume can be attributed to M&A deals, with the top three deals accounting for more than two thirds of the total M&A volume (figure 3).[13]

12. Note that our M&A sample only includes direct, cross-border M&A deals of mainland Chinese companies with a final stake of 10 percent or more.

13. The share of direct M&A for 2008 shown in figure 3 is exceptionally low because several high-profile deals involved special purpose vehicles (SPV) in third countries, such as Chinalco's $14 billion stake in Rio Tinto, which was executed through an SPV in Singapore.

Figure 2 Geographical distribution of China's OFDI stock, 2003–07



Source: MOFCOM.

Insufficient Investor Transparency

Even less is known about Chinese investors on the micro level. A range of government bodies and government-backed entities, including SAFE, the China Investment Corporation (CIC, China's sovereign wealth fund), and the National Social Security Fund (NSSF), hold overseas assets, and recently the state-owned China Development Bank (CDB) and the China Export-Import Bank (Exim) have begun to massively expand their overseas loan portfolios, often including long-term oil delivery contracts.[14] The lack of transparency surrounding these deals fuels perceptions that Chinese investment is all about government-directed vehicles. In reality, these state entities usually take minor stakes, and only in a very few cases do the stakes exceed the 10 percent threshold needed to qualify as FDI. In short, it is China's firms that generate the country's outbound FDI action.

Large state-owned firms with protected domestic market shares, especially in the natural resources, infrastructure, and logistics sectors, began investing overseas as early as the 1980s, and they still dominate the deal tables due to the inherently large project costs in these sectors. But the picture based on past deal value misrepresents the range of corporate actors and changes in recent years. According to MOFCOM, more than 7,000 Chinese firms ran a total of more than 10,000 overseas investment projects as of 2007. The number of firms going abroad each year grew from approximately 1,000 in 2004–06 to around 1,500 in 2007 and 2008.[15] The actual number is likely to be much higher, given that many firms circumvent registration and approval processes.[16] Unfortunately, MOFCOM does not publish a comprehensive aggregate list of firms engaged in OFDI by ownership, industry, or size. Such a breakdown would show that the momentum is in new sectors and no longer coming solely from state-owned resource companies (appendix 1 table 2).

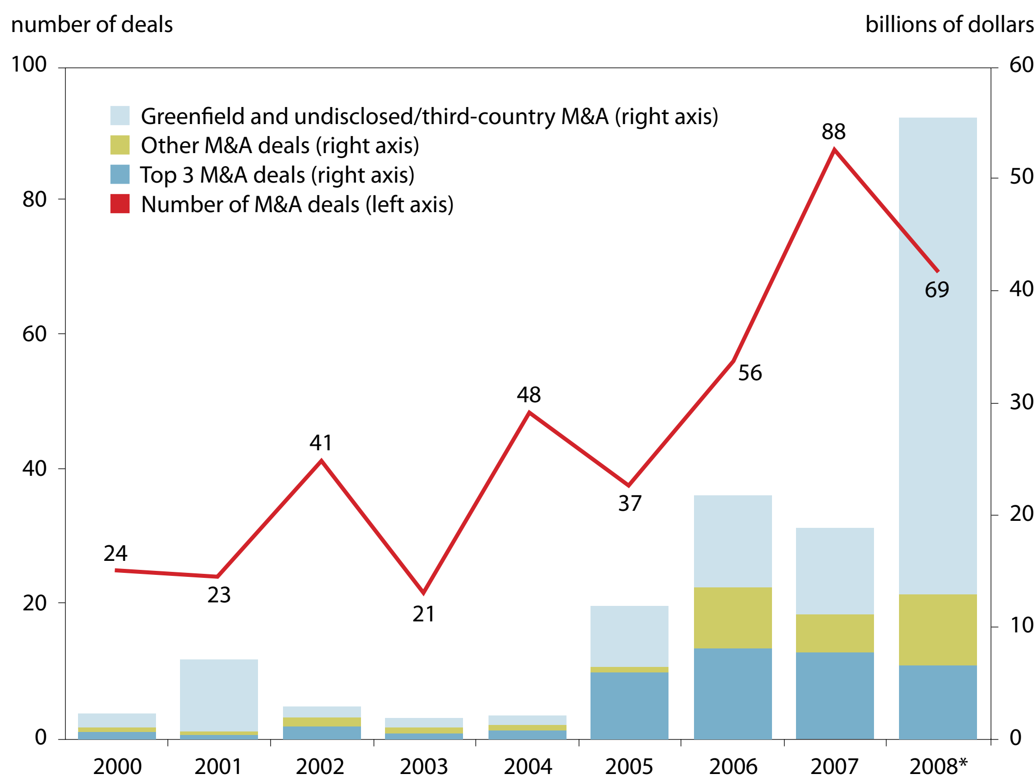
Finally, the general murkiness of China's corporate governance structures effects perceptions of OFDI motives. In the United States, shareholders motivated by profit can compel firm management to justify investment plans. In China, sharehold-

14. The volume of announced overseas loans by the CDB and the China Exim Bank totaled $46 billion from January to April 2009, with $25 billion to Russia, $10 billion to Brazil, $5 billion to Kazakhstan, $4 billion to Venezuela, $1 billion to Angola, and $1 billion to Ecuador.

15. These numbers are calculated from information included in the annual MOFCOM bulletins.

16. Some of our interview partners, among them government officials, estimated that the official statistics only capture about one half to one third of all OFDI projects in number terms.

Figure 3 M&A in China's OFDI profile, 2000–2008



Note: The share of direct M&A in 2008 is exceptionally low because several major deals were executed through special purpose vehicles. The M&A sample includes only completed, direct, cross-border deals with a stake of more than 10 percent; the M&A deal volume only includes deals with a disclosed value.

Source: Thomson Financial database; SAFE, *Balance of Payments*.

ers often do not have the same power, but nonowners like the secretary of the Communist Party Committee within each firm often have that power and more, while the senior management of state-owned enterprises (SOEs) is appointed directly by the Party. These considerations make it hard to definitively assess the motives and incentives affecting these firms. However, the commercial pressures on Chinese companies are growing rapidly, and the similarities between Chinese firms' considerations and those of OECD-country firms are mounting faster than the differences. The number of parties involved in the investment decision-making process is swelling accordingly. Aside from in-house staff, significant players in the process include domestic and international service firms, domestic government bodies that provide investment-related services and incentives, a broad range of foreign investment promotion agencies (IPAs), and corporate foreign partners. On the financing side, partners include commercial banks and private equity firms, as well as local governments, policy banks, and other government-backed funds.

THE GLOBAL WEIGHT OF CHINESE OFDI

Extensive media coverage of Chinese OFDI deals has provoked worries that Chinese firms are buying up the world. These concerns are exaggerated: China's role as a global investor remains minor in terms of both annual FDI flows and total FDI stock. From 2000–07 average Chinese outflows accounted for less than 1 percent of global flows annually, far below the share of the OECD economies and less than other transitional economies such as Russia (table 1).[17] China's 2007 outbound investment was comparable with Austria's and the Netherlands', while US investment flows were 14 times larger than China's.

The story for China's share of global FDI stock is similar. Global FDI has grown at a rate similar to Chinese FDI, so China's global share in 2007 was only 0.6 percent, roughly

17. All global comparators are from UNCTAD's FDI database, which uses slightly different numbers for Chinese OFDI in recent years than MOFCOM and SAFE.

Table 1 Selected countries' share in global FDI flows, 2000–2007 (percent)

Country/group	2000–2006 average	2007
EU-25	55.00	57.20
United States	17.10	15.70
United Kingdom	10.70	13.30
Germany	4.90	8.40
Japan	4.20	3.70
Russia	1.10	2.30
OPEC	0.90	2.30
China	0.80	1.10
Brazil	0.70	0.40
India	0.40	0.70

Source: UNCTAD (2008).

the same as a decade ago (figure 4). In 2007 China's OFDI stock surpassed that of Luxembourg and was approaching that of Finland. The OFDI stock of the United States was about 30 times that of China. The per-capita OFDI stock in China was approximately $70 in 2007, compared to $25 in India, $6,100 in the United Arab Emirates, $9,300 in the United States, and $15,000 in Germany.

While emerging economies do not account for a significant share of global FDI today, their modest baselines mean that they will be important drivers of new cross-border investment in coming years.[18] Among these emerging-market countries, China demands the most attention given its size, unique public-private hybrid economy, and because it is well positioned to significantly increase its outbound investment in the coming years. China is also notable for the countercyclical nature of its OFDI flows: In 2008 China's OFDI doubled while global FDI flows dropped an estimated 20–30 percent.

FDI in China's Global Investment Footprint

Other elements of China's international investment position provide context for the size of the country's outbound FDI. In 2008 China had an OFDI stock of $170 billion, compared to $2.75 trillion in other assets, primarily foreign exchange reserves (figure 5). Despite the rapid growth of China's OFDI, it is important to emphasize that China's net FDI position is still negative, with an inward FDI stock of $876 billion compared with an outbound stock of only $170 billion in 2008, leaving net FDI liabilities of $706 billion. There are $5 of FDI assets under foreign ownership in China for every $1 of Chinese direct investment assets abroad.

China is not only a net importer of FDI, but the gap between FDI inflows and outflows has consistently widened over the past years. Inflows have grown much faster than outflows, and SAFE's *Balance of Payments* records a doubling of net FDI inflows from approximately $50 billion in 2004 to an average of $100 billion in 2007 and 2008. Due to decreasing FDI inflows as a result of the financial crisis and several large-volume natural resources deals, this gap may significantly diminish in 2009, but any drop will likely be temporary, and China's road toward a sustainable and significant net FDI export volume is still a few years ahead.[19]

CHANGING DRIVERS AND MOTIVES OF CHINA'S OFDI

The rapid growth of Chinese OFDI is a result of economic necessity, as China's shift to a new model of economic growth is pushing firms from all sectors of its economy abroad. China has averaged 9 percent GDP growth per year for the past 30 years. When the country entered its period of extensive economic reform in 1978, per capita income was approximately $200 a year, domestic consumption was limited to basic necessities, production capacity had collapsed relative to other East Asian—let alone OECD—economies, and infrastructure was primitive. China has been able to achieve rapid growth by quickly ramping up the scale of production in manufacturing and by restarting investment flows. Throughout the 1990s the processing trade (importing intermediates for light processing and then exporting them) grew significantly, but net exports did not become a major component of China's GDP growth until 2004. By 2008 massive domestic investment and growing trade surpluses were the principle engines of expansion.

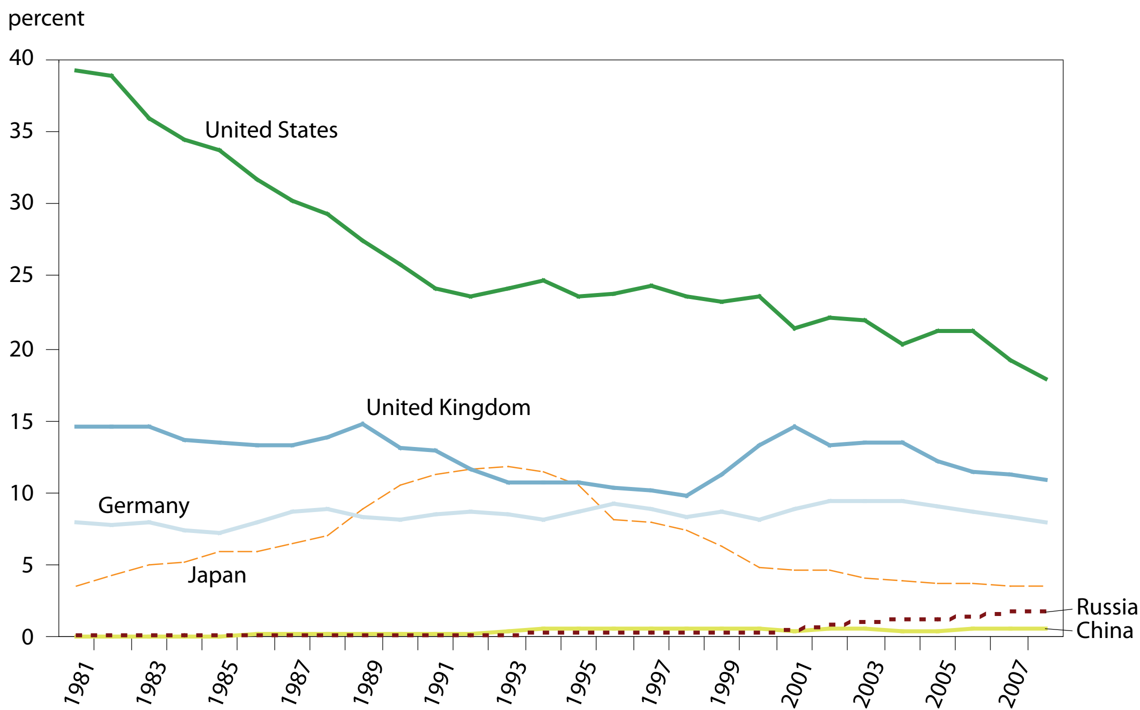
In this growth model, outbound investment played two limited roles.[20] First, OFDI helped to establish the infrastructure needed to integrate China into the global trading system by improving the country's logistics and establishing foreign offices for China's trading firms. Second, OFDI was used to secure the commodity inputs needed for growth. Infrastructure projects, urbanization, and production for domestic and foreign consumption drove domestic demand for iron, oil, cement, timber, and many other resources that are not abundant in China, and the country became a net importer of many of these commodities

18. See Sauvant (2005) or UNCTAD (2006) for a discussion of the new role of multinational corporations from emerging economies as global investors.

19. According to monthly MOFCOM statistics, inbound FDI to China was down seven months in a row from October 2008 to April 2009, averaging a year-on-year decline of around 20 percent.

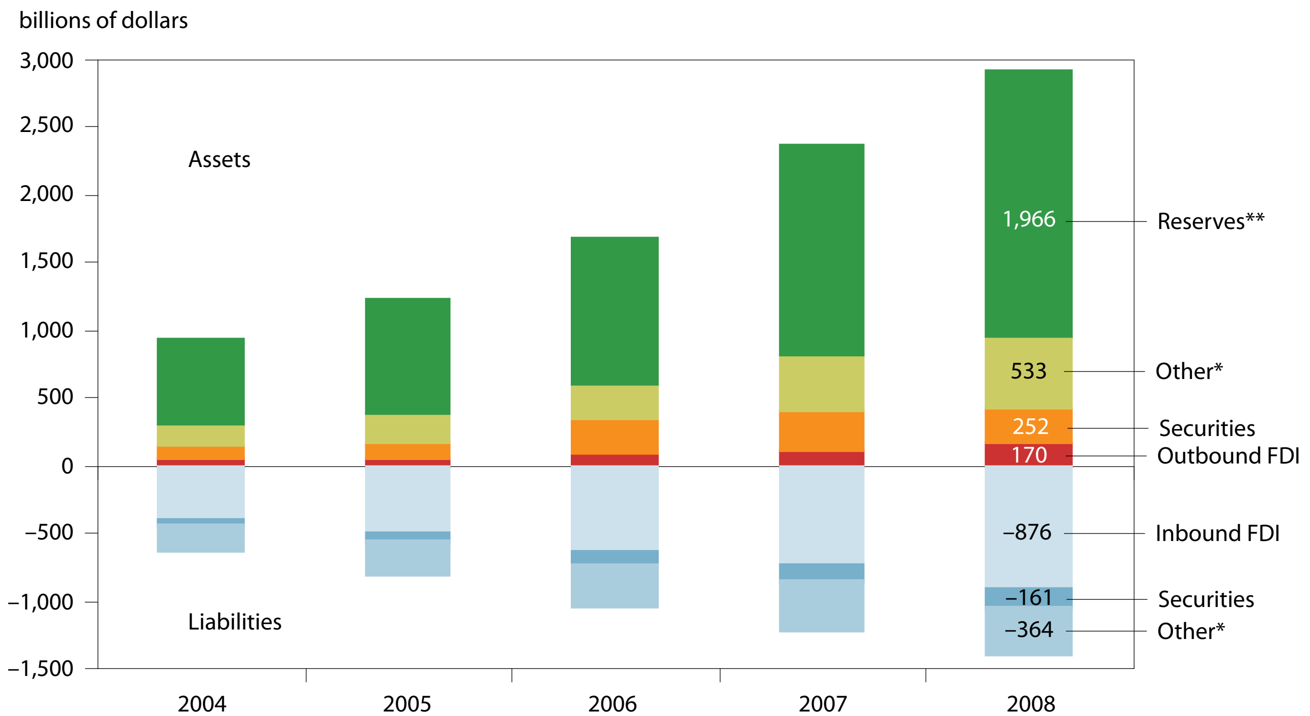
20. For an early assessment of China's outbound investment profile, see Cai (1999).

Figure 4 Selected countries' share in total global FDI stock, 1980–2007



Source: UNCTAD's FDI database.

Figure 5 China's international investment position, 2004–08



*Trade credit, loans, and other.

**Foreign exchange, gold, special drawing rights, and IMF reserves.

Source: SAFE, *China's International Investment Position*, via CEIC.

in the 1990s. Chinese firms, backed by official concerns about supply security, began to pursue global resource deals.

OFDI in a Rebalanced Economy

China has entered a period of economic adjustment as it transitions from this old growth model to a new one, a change popularly referred to as "rebalancing." China's old model relied on investing in ever-greater production scale and, since 2004, on large trade surpluses. Rebalanced growth, if it can be achieved, requires increasing household income and domestic consumption, while manufacturing growth must focus on greater value-added production rather than on further increases in the scale of production (Lardy 2007, He and Kujis 2007).

The biggest drag on China's firms is that they do not possess the management skills needed for long-term investments abroad.

The implications for China's OFDI of this transformation of the country's economic growth model are profound. With domestic economies of scale already maxed out, China's firms must capture a greater share of the production chain, both upstream and downstream from their factories, which often means going abroad. The microeconomic implications of rebalancing for the business segments described below are only reinforced by the macroeconomic adjustments that would arise from this new growth model. Currently foreign currency earned by exporters must be exchanged for renminbi once on shore. This is required in order to manage the exchange rate, and it makes reinvesting that foreign exchange Beijing's problem. Governments are usually limited to investing in securities, but firms are able to make direct investments that must then be managed as businesses. As rebalanced growth reduces reliance on exports, Beijing will no longer need to absorb as much foreign exchange to manage its exchange rate, leaving it to firms to decide how to use the dollars they earn.[21] Finally, this macroeconomic rebalancing is self-reinforcing because a stronger renminbi means greater purchasing power abroad, another incentive for outbound investment.[22]

21. See Pettis (2005) for a discussion of the monetary policy benefits of outbound investment.

22. For an early analysis of the impact of exchange rate appreciation on direct investment, see Cushman (1985).

Natural Resources: Here to Stay

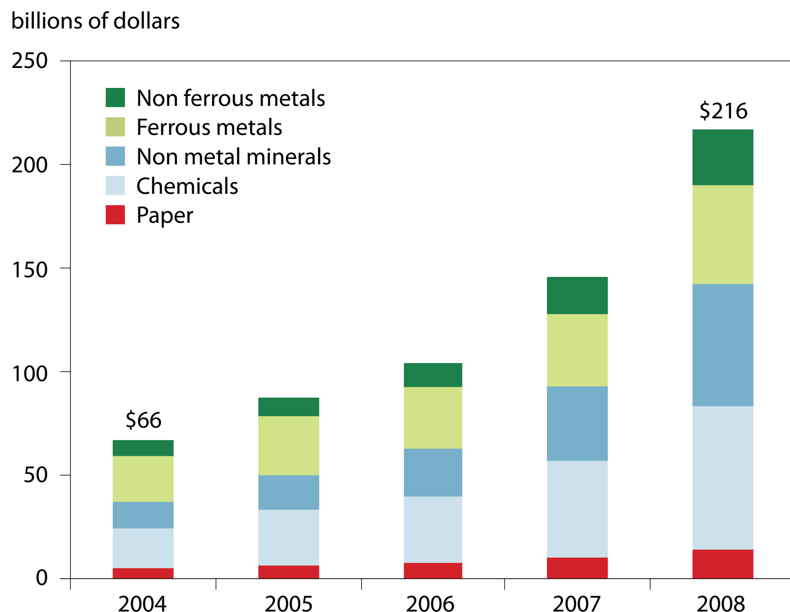
Outbound investment in natural resources will remain a very important component of China's OFDI in the future, although it is likely to fall in relative terms. Urbanization is incomplete: Only 45 percent of the population is urban, well below the global average and half the OECD level. Another 600 million people must migrate to urban areas before the minimum agricultural labor force of 100 million to 150 million is reached. Chinese resource firms have a huge interest in extraction investments abroad due to limited domestic deposits of most resources except for coal. Capital constraints and consolidation in the mining industry globally provide Chinese firms with an opportunity to take major stakes in established firms with good reputations and extensive experience in countries such as Australia and Canada, instead of in high-risk projects in unstable countries. New resource priorities are also emerging, for instance, in low-carbon energy, including natural gas, and in overseas farmland to offset the limited arable land in China.[23]

Heavy Industry: Outsourcing Production

Heavy industrial capacity has expanded massively in China since 2002, bringing an abundance of industrial goods but many problems as well. Heavy industrial manufacturing requires extensive financing but creates few jobs, causes environmental damage, and aggravates energy-security concerns (Rosen and Houser 2007). Rebalancing growth entails shifting capital from these sectors to more labor-intensive light manufacturing and services, where China's comparative advantage lies. China will need to rely on imports for a larger share of its heavy industrial needs than in recent years. In addition to the traditional logic of trade specialization, this greater reliance on imports will be prompted by China's need to minimize its energy footprint and to cut its carbon emissions from production. China's heavy industrial production in the current decade has entailed the energy-intensive, long-distance transportation of both raw materials (such as iron ore) and energy resources to China for initial processing. The combination of rising transportation energy costs and future carbon emissions reduction policies will incentivize restructuring the production chain so that initial processing occurs nearer to resource extraction, thus reducing carbon emissions. "Made in China" will be replaced by "made by China—abroad," as Chinese firms have already begun to build smelters, refineries, and other heavy industrial facilities

23. For a discussion of cross-border FDI in agricultural land, see Braun and Meinzen-Dick (2009).

Figure 6 Domestic investment in energy-intensive heavy industries, 2004–08



Source: National Bureau of Statistics of China.

abroad, a process Beijing has encouraged.[24] Domestic Chinese investment in energy-intensive heavy industrial activities grew by an average of 30 percent per year over the past five years (figure 6). This growth is likely to continue, but a significant share of future investment will take place abroad.

Manufacturing: Finding the Other 80 Percent of the Value Chain

While heavy industry will maintain its share of Chinese OFDI, outbound investment by China's mid-market manufacturers is poised to take off. The gains from increasing the scale of production have played out, external consumer demand growth is flat, and lower-wage countries are increasingly taking market share at the low end. To survive the current crisis, China's manufacturers must capture a larger share of the value chain. For a typical product manufactured in China, less than 20 percent of the final profit margin is captured by the Chinese manufacturer; the rest is enjoyed downstream in distribution, marketing, retail, and customer relations or upstream in product design, quality control, sourcing, branding, and research and development. These margins are obviously higher in foreign markets where consumers have a per capita income of $40,000 per year than in China with $3,000 per capita. In addition, China's manufacturers will pursue greater profit by improving the sophistication of their operations, which similarly points abroad. The hard-to-replicate elements of economic value-added activity are intellectual property, intangible brand value, and human resources with global operating talent. All three factors are abundant in the OECD countries but relatively scarce in China.

Both of these imperatives—upgrading the sophistication of Chinese manufacturing and competing for the most lucrative portions of the value chain—create powerful incentives for China's firms to go abroad. New outbound investment will target distribution networks, retail, management, high-tech and other professional human resources, and foreign brands (such as the recently announced purchase of Hummer by Tengzhong). This implies that the geographical distribution of China's OFDI will shift toward the OECD countries. A few pioneers have already begun this process, including Lenovo, Haier, Sany, and Huawei; many others are sure to follow.[25]

24. Recently announced or realized projects include a slab steel smelter in Brazil (a project abandoned in 2009), oil refineries in Saudi Arabia and Venezuela, and an aluminum smelter in Trinidad and Tobago.

25. We have a long-standing practice of asking Fortune 500 business executives to name three Chinese brand names that the average American would recognize. Few are able to do so. Some have observed that even Japan took time to achieve brand recognition abroad, but we note that 20 years after Japan began its postwar recovery, at least several dozen Japanese brands were

Services: Moving Beyond Trade

China's services sector OFDI is expanding beyond trade-facilitation, a trend that will only be reinforced as rebalancing puts greater economic emphasis on this sector. In services that are already well developed in China, firms will take their comparative advantages abroad. The construction sector is a good example: Chinese firms have become serious players in the global market for large infrastructure projects, winning prestigious bids such as the new Medina-Mecca railway line in Saudi Arabia. Overseas revenue in this sector grew from $11 billion in 2002 to $57 billion in 2008.[26] In most of the higher value-added services, domestic Chinese development is just beginning to take off—in healthcare, finance, information technology, and insurance—and China's firms will not go abroad for market share so much as to build their upstream capabilities through improved human resources, enhanced process and product knowledge, and cobranding.

THE POLICY ENVIRONMENT AT HOME

The commercial motives and macroeconomic forces affecting Chinese OFDI discussed above are now shaping Chinese policy, in contrast to past decades when the policy framework dictated the evolution of China's OFDI. Limiting outbound investment in favor of domestic capital formation and the rationing of hard currency were the main objectives at the outset of China's reform era, which produced an interventionist regulatory framework that gradually opened the door to Chinese OFDI, at least for some state firms.[27] In the late 1990s the Asian financial crisis and preparation for China's WTO accession precipitated a profound sense of China's exposure to globalization and with it a greater awareness of the importance of outward investment. A breakthrough "Go Global" policy, first announced in 1999 and implemented over the following years, resulted in more-active encouragement and support from the government for overseas investments (appendix 2 table 1). The transformation of the domestic policy framework over the past decade can be summarized under five broad trends:

- **From direct guidance to regulation**: Previously the Chinese government directly administered most firm-level overseas investment decisions, either through management proxies or through an approval system in which the default answer was "no." Today the state increasingly acts as a regulator and arbitrator instead, deferring assessment of the business case for OFDI to professional firm management, a trend seen in many other areas of the economy as well.[28] This transformation in the role of the state is by no means complete, and the government still extensively intervenes in high-profile deals. But the image of agents from the Politburo commanding state enterprises to "go buy the world" is largely fictitious.
- **Relaxing and decentralizing approvals**: Authorities have gradually eased approval procedures, generally shifting responsibility from central to local agencies. The latest step in this process was implemented in April of this year: New project approval rules effective May 1, 2009, reduced approval time, lifted value thresholds, and transferred authority to local MOFCOM branches (see appendix 2 table 2).
- **From negative to positive measures**: Along with lower barriers, Beijing has introduced policies to actively support firms in going abroad. These include facilitation services, such as risk assessment and insurance; commercial incentives, such as subsidies and tax breaks; expanded avenues for financing overseas operations (see below); and OFDI delegation participation to help bridge credibility and brand disadvantages. These supportive measures have also been localized, so most provinces now have their own budget and agencies to support firms going abroad.
- **Relaxing capital controls and broadening financing channels**: Parallel to MOFCOM's reform of the approval rules, SAFE has gradually relaxed capital controls and initiated rules allowing firms easier access to foreign exchange and more opportunities to raise capital. The latest changes to the foreign exchange management system will come into effect in the summer and fall of 2009 (see appendix 2 table 2). Other government agencies have supported SAFE's push to facilitate funding for overseas ventures. Since December 2008 commercial banks have been allowed to lend firms money for cross-border M&A.[29] A new trial program allows designated big firms to lend to their overseas subsidiaries and to make direct investments up and down their produc-

household names in the United States. We are now 30 years into China's reform era.

26. Revenue numbers from "overseas contractual projects" are released quarterly by MOFCOM.

27. See Voss, Buckley, and Cross (2009) for a more extensive review of Chinese policy and its impact on OFDI. Other major concerns that shaped China's OFDI policy were maintaining the government's ability to regulate assets held beyond China's borders and the prevailing worry that keeping assets abroad meant stripping them of collective ownership.

28. For a discussion of the emergence of a regulatory state in China, see Pearson (2005).

29. The China Banking Regulatory Commission (CBRC) issued new "Guidelines for Risk Management of Merger and Acquisition Loans by Commercial Banks" on December 9, 2008.

tion chains.[30] In 2009 firms were permitted to issue dollar-denominated bonds in China for the first time.[31] And both CIC and SAFE are reportedly considering expanding their OFDI exposure as an alternative to purchasing dollar securities.[32] These reforms will help firms to raise money, but small, medium-sized, and private enterprises still have limited access to funds for overseas expansion.

- **Integrating OFDI and broader foreign policy:** Until recently, the maxim most often used to describe China's OFDI to many developing nations was "no strings attached," in contrast to OECD-country investors, who are often compelled to consider the geopolitical and socioeconomic implications of their investments. But Beijing has discovered that this selling point comes with a cost. Anti-Chinese sentiment in host countries and concerns articulated by third-country governments and nongovernmental organizations have forced an internal debate between the steward of China's new-found soft power, the Ministry of Foreign Affairs (MOFA), and those concerned only with maximizing overseas access. As a result the foreign-policy tools used to support Chinese OFDI have become more sophisticated. Instead of simple oilfield diplomacy to push strategically important deals, outreach now includes conditional overseas development assistance, loans from policy banks coupled with service contracts or equity stakes for Chinese firms, missions and delegations to OECD countries to identify win-win investment opportunities, and more-intense efforts to conclude bilateral and regional agreements with investment codicils.[33]

The Reform Path Ahead

Trends in China's OFDI policy environment reflect the changing value attached to such flows by policymakers, who consider OFDI strategically supportive of China's interests, its role, and its reputation in the world and essential to the long-term competitiveness of Chinese firms, on which the nation ultimately depends for its wages and tax base. Despite past reforms, the liberalization process is far from complete. From a firm perspective, four residual reforms are needed to optimize the policy environment for OFDI in China:[34]

- **Completing the shift from an approval to a registration system:** The state must completely pull back from active intervention in firms' investment decisions and permit firms to make these decisions based on their own commercial assessments and risk appetites. The abolishment of ultimate government control must be compensated for by the implementation of a better corporate governance system that allows shareholders more control over investment decisions.

- **Liberalizing foreign exchange purchases and improving financing opportunities:** The government must permit firms to freely access and use foreign exchange for OFDI and ultimately allow a fully convertible currency. These steps must be complemented by reforms allowing firms to use basic financial innovations, such as bonds, to raise cash for overseas expansion and introducing new financing instruments, such as convertible debt or stock swaps.

- **Creating a nondiscriminatory OFDI framework:** The Chinese government must initiate a corporate "affirmative action" program that creates a transparent and nondiscriminatory framework for all firms regardless of their size and ownership, both for restrictive and supportive policies. OFDI opportunities must be opened to entities that are currently not permitted to invest overseas, such as individuals and partnerships.

- **Formulating a global strategy that better serves China's long-term interests:** Shielding pariah-state governments or providing "no strings attached" loans to the developing world might help some of the established OFDI players, but it hurts the reputation of China's firms among consumers and thus harms the interests of China's next generation of OFDI investors.

China will have to make further progress in the areas mentioned above to effectively promote and sustain the overseas expansion of its firms. The reasons the above steps have not yet been taken place lie in the complicated domestic political economy for reform and the deep-seated reluctance to abandon tools used to maintain the state's influence over the economy, natural

30. We learned this from interviews in Beijing and Shanghai in November 2008. We have heard this program referred to as the "corporate qualified domestic institutional investor program."

31. In April China National Petroleum Corporation received approval to issue $3 billion in three-year dollar bonds in the Shanghai interbank market.

32. After the poor performance of several investments, CIC recently signaled interest in diversifying its overseas portfolio by funding Chinese firms' overseas acquisitions. In February 2009 Fang Shangpu, the deputy director of SAFE, announced that SAFE is considering direct investments as an alternative to purchasing treasuries or foreign equities.

33. Aside from expanding bilateral investment treaties (BITs) and investment-relevant free trade agreements (FTAs) with developing countries, China has entered BIT negotiations with the United States and reached an investment agreement with Taiwan. For an examination of China's new generation of investment treaties, see Schill (2007).

34. This list is based on our interviews with industry executives, lawyers, consultants, and pundits.

resources, and industrial policy. But as liberalization over the past decade has shown, the costs of reform are outweighed by the benefits, and domestic policy is rapidly changing to accommodate those benefits. If the past liberalization path is interrupted and cross-border investment openness is rolled back, then the Chinese economy stands to lose the most.

BARRIERS AND IMPEDIMENTS

Given the growing commercial necessity to go abroad and the generally positive policy environment, Chinese OFDI is poised to grow on a large scale. The actual pace of this development, however, depends on how well corporate China can deal with the domestic and foreign impediments it currently faces.

Investment Reviews in Host Countries

Chinese policymakers and executives usually point to protectionism and high host-country entry barriers as the principal impediments to Chinese OFDI. Most OECD countries have regulatory mechanisms in place to prevent potentially harmful investments, and many governments have tightened investment rules in recent years, largely in response to the emergence of new investors from China and the Middle East (figure 7). In theory such policies are legitimate measures for sovereign states to protect their national security interests and they should not be a serious concern for foreign investors provided that the off-limit sectors are clearly defined and the review process is transparent and nondiscriminatory.[35] However, the reality in many countries does not meet the ideal: Investment protectionism is on the rise, investment rules are not very transparent, and review processes are politicized by domestic interest groups.

China has borne the brunt of these suboptimal rules and politicized domestic debates, most prominently in the case of China National Offshore Oil Corporation's (CNOOC) attempted takeover of the US oil firm Unocal in 2005. Recently heated debates with a strong political element have raged over Chinese investments in Australia (over a series of takeovers in the mining sector), in Korea (related to the bankruptcy of the automaker Ssangyong), in Russia (in reaction to the Baltic Pearl project), and in several developing countries.

These examples illustrate that politicized investment regimes remain an issue for Chinese investors. Looking forward, it is likely that the changing nature of Chinese OFDI will result in a relative shift from traditional national security issues, such as investments in natural resources and critical infrastructure, to new areas, most importantly the acquisition of high-tech assets. National regulators will have to deal with more deals involving security-relevant technology transfer to Chinese companies such as Huawei's bid for the US network manufacturer 3Com in 2007. This shift will also open new opportunities for domestic groups to politicize the debate, as some of the coming deals will also result in the reorganization of global value chains, including the transfer of jobs and technology to China.[36] The regional shift of OFDI toward OECD economies could also return the complicated issue of investment subsidies to the agenda once the dust of the current financial crisis has settled.[37]

Chinese Executives' Parochial Thinking

In the past decade, the profit margins for China's firms, despite their strong export orientation, largely derived from the domestic production process rather than from distribution and service provision beyond the border. Firm-level surveys in recent years have found that Chinese executives' growth strategies for the future still largely rely on domestic markets and exports.[38] In our interviews with Chinese firms, advisors, and academics in 2008 and 2009, we found that this domestic preoccupation is still the norm. Business leaders discount opportunities to operate outside China and consider the risks associated with overseas expansion to be high compared with the perceived short-term profit opportunities within China. Many Chinese CEOs have a gut feeling that they eventually need to go abroad but only a minority are trying to actually achieve this. At the other extreme, many CEOs outsource global business development to investment bankers who talk them into spectacular deals that would probably not have happened as part of a carefully developed strategy.[39] The fast-changing economic realities of China's new growth model will eventually affect the mindset of Chinese executives, but this can be accelerated with the right political incentives and a corporate governance structure that encourages long-term strategic planning.

35. There is a broad range of proposals on principles for the design of effective and transparent national investment rules. See, for example, OECD (2008c), Graham and Marchick (2006), and Moran (forthcoming).

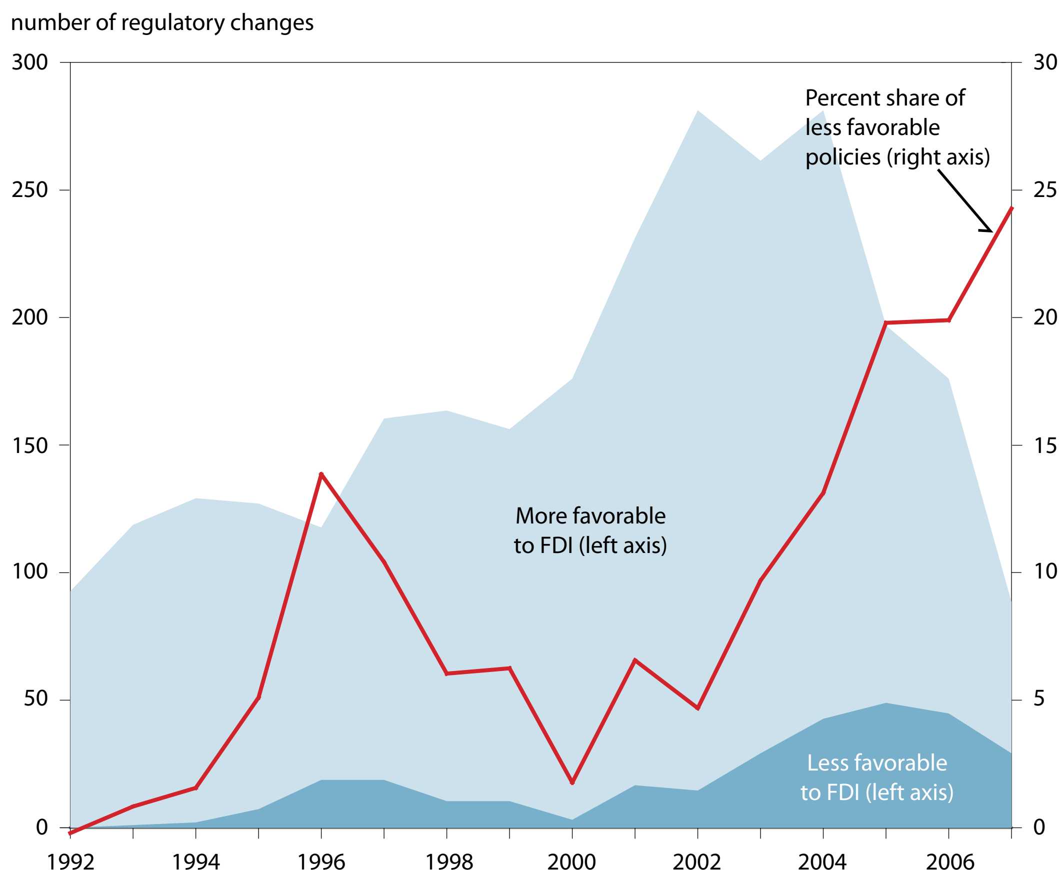
36. See, for example, the debates in Korea surrounding Shanghai Automotive's (SAIC) takeover of Ssangyong.

37. For a discussion of subsidies in cross-border M&A transactions, see Hufbauer, Moll, and Rubini (2008).

38. For example, the Economist Intelligence Unit (EIU 2005) found that more than 90 percent of surveyed Chinese executives were planning to focus on the domestic market for future growth. APFC (2005) and APFC and CCPIT (2009) illustrate that a surprisingly small share of Chinese companies with international exposure consider direct investment in order to serve higher-margin markets overseas.

39. The latest example is the announced acquisition of the US auto brand Hummer by the Chinese construction equipment manufacturer Tengzhong.

Figure 7 Global policy measures toward FDI, 1992–2007



Note: These numbers represent a count of regulatory changes, not weighted by relevance or impact.
Source: UNCTAD (2008).

Not at Home Abroad

The biggest drag on China's firms is that they do not possess the management skills needed for long-term investments abroad. Cross-border investments are complicated, and specialized skills are required to establish business strategies, to manage asset transactions, and to run an overseas unit. These tasks, unlike the initial acquisition, cannot be outsourced to consultants and financiers. The investor must bridge any cultural divides, possess the necessary market knowledge, comply with different regulatory standards and a new legal environment, manage expatriate and foreign staff, negotiate with organized labor and other stakeholders not present in China, meet quality and safety standards, adhere to tax and accounting rules, effectively manage foreign exchange risks, and have a suitable communication and public relations strategy.

Many Chinese firms have the cash to go abroad but lack the confidence to deal with these obstacles. By comparison, it is easy to buy mining assets in a lightly regulated environment in Africa, fly in a hundred Chinese workers to extract the resources, and ship them back to China. It is a much greater challenge to run manufacturing and service operations in Atlanta, Newark, or Cologne. Several high-profile firms have learned the hard way that they are ill-equipped to confront such challenges, among them Shanghai Automotive (SAIC) in its venture with the Korean car maker Ssangyong and the steel giant Baosteel with its now-abandoned steel slab project in Brazil.

The difficulties of leaving home are a seminal tenet of FDI theory. But because OECD-country firms come from heavily regulated markets, they do not have to play compliance catch-up when they move abroad. The multicultural workforces typical in the United States and much of Europe amplify the culture shock felt by Chinese executives coming from overwhelmingly Han China. Chinese managers abroad often struggle to convey

the seriousness of, for example, workplace antibias rules to a headquarters where discrimination based on employees' region of orgin, gender, sexual preference, medical conditions, physical disabilities, and even height is common.

Many Chinese CEOs have a gut feeling that they eventually need to go abroad but only a minority are trying to actually achieve this.

China's Vice Premier Wang Qishan nicely summarized these weaknesses, rebutting the CEO of the Chinese machinery manufacturer Sany following his request for more government support for OFDI at an event during the National People's Congress in March 2009:

> Do you have a handle on your own management capabilities? Have you analyzed the cultural differences of the two sides? Do you understand the relationship between unionized labor and management in that place? If the other side's engineers resign, are you really going to send people from Changsha [Hunan's capital] overseas, and make the whole company speak Hunanese [the local dialect]? If you don't know yourself and know your opponent, then this kind of confidence scares me.[40]

Stop & Go: The Domestic Political Economy

Domestic politics remains a barrier to overseas expansion as well. Despite the structural liberalization of the regulatory framework described above, Chinese firms still must seek approval for every single investment they make overseas, and projects can be vetoed by government bodies for any number of institutional motives: fear that bureaucrats would be held accountable for failures, concerns about hot money outflows, worries about state asset losses or backdoor privatization, or anxiety about unemployment and shifting jobs to lower-wage countries.

Even if a deal is approved in the end, the involvement of various government bodies with volatile attitudes toward overseas projects often delays decisions and makes the process much more resource intense and time consuming than it should be.[41] In the fierce competition for global assets, Chinese firms are at a significant disadvantage if they must wait several weeks or months for approval of overseas projects. It not only hampers individual firms' strategic planning but also damages the global reputation of all Chinese firms if an investment is withdrawn after a waiting period of several months, as seen with the Bank of China's proposed investment in the French bank Rothschild earlier this year, which was withdrawn after it failed to obtain approval from the Chinese authorities.

In addition to these bureaucratic traps, top-level sentiment is important in a nation where political favoritism is often the linchpin of business. While policy has moved to support overseas investment, politics have often blown in the other direction in recent years. Despite encouragement to "go global," CIC's money-losing investment in the Blackstone group and CNOOC's face-losing bid for Unocol were met with public admonition and even popular accusations of treason. The global financial crisis rekindled expectations that China would be buying, but lost value in US securities and another poorly performing investment in a US financial firm, this time Morgan Stanley, again turned the tide, prompting statements from Beijing that investment in distressed sectors abroad would be off limit. At present it again seems that the political wind is blowing outward, carrying delegations to "bottom fish" the United States and Europe. Yet the callousness with which Beijing has blocked a number of inward investments in the past raises questions about its seriousness toward cross-border investments both ways.[42]

CONCLUSIONS

In light of the changing trajectory and nature of China's outward direct investment we draw five principal conclusions with policy implications for US and other OECD policymakers.

First, the motives and targets of China's OFDI are changing rapidly, driven more by a readjustment in China's economic growth model than by political considerations. This insight is important for its own sake, because it impacts how we interpret Chinese investment patterns. But more pointedly, the focus of Chinese OFDI will shift toward commercial operations in advanced economies rather than the traditional focus on resource extraction in developing countries. This will make existing ambiguities in OECD countries' investment review processes more problematic. These ambiguities have been explored elsewhere (Graham and Marchick 2006), and the US Treasury Department has improved upon guidance in recent

40. Rick Carew, "Will China Buy the World? The Beijing Debate," Wall Street Journal's WSJ Blog, China Journal, available at http://blogs.wsj.com/china-journal (accessed on June 11, 2009).

41. Many executives and consultants we interviewed complained that local MOFCOM and SAFE bureaus often do not have the capacity to follow the written rules and adhere to approval periods.

42. The blocking of Coca-Cola's bid for Huiyuan, a juice maker, under the thin pretext of antimonopoly laws, is an egregious recent example.

years,[43] but the essential problem remains that Chinese firms do not know what the United States considers to be sensitive on national security grounds, and pursuing an investment without such clarity is potentially costly and embarrassing.

Recently there has been public discussion in Beijing about "using" corporate OFDI as an alternative to traditional foreign exchange reserve portfolio management. Because veiled threats have been made by some Chinese officials to use traditional foreign exchange operations, such as treasury bill holdings, to exert pressure in foreign relations, talk about using OFDI as a reserves management tool easily gives rise to national security concerns about inward investment from China. We emphasize, however, that FDI is illiquid and cannot be withdrawn in the event of hostilities. But while these concerns are therefore misguided, they are nonetheless popular. The danger of foregone investment flows, national recriminations, and tit-for-tat retaliation will only mount until this issue is adequately addressed. The issue has been exhaustively debated, but it takes on additional urgency in light of the structural forces that will drive rapidly increasing Chinese OFDI in future years, the need for new sources of investment in the United States due to impaired domestic finances, and the balance of payments disparity between surplus China and the deficit United States. Existing schemes of evaluating national security risks based on rational argumentation should be applied rigorously and in a way that is transparent for potential Chinese investors (Moran forthcoming).

The motives and targets of China's OFDI are changing rapidly, driven more by a readjustment in China's economic growth model than by political considerations.

Second, the consensus against including national economic security among the grounds for investment reviews will come under renewed pressure due to the exceptional degree of government involvement in the corporate and financial sectors in China. The concern here is that even without the intent or capacity to threaten traditional national security interests, a large volume of M&A bids for US businesses by Chinese firms, which face fewer budget constraints due to their privileged access to preferential loans and other financial subsidies, could undermine the efficiency and equity of the US marketplace.[44] Other concerns center on bad business practices and white-collar crime, technology transfers perceived as "asset stripping," and potential job losses.[45] The main arguments made in the past against broadening investment review to cover economic security are based on the difficulty of defining and implementing such a review without inviting endless protectionist use of the system by vested interests opposed to foreign investment for purely self-interested reasons. These arguments do not, however, claim that there is no economic security concern, but merely that existing ideas about how to deal with such concerns are unworkable (Graham and Marchick 2006, 172–73). As in the case of CNOOC's aborted bid for Unocal, the compelling concern will continue to be economic unfairness due to subsidized access to finance, and if host countries do not have an explicit system for dealing with those concerns then the temptation to find spurious grounds to disrupt investment overtures will prevail.[46]

Third, China's firms are late to globalize compared with their OECD-country peers, and China has more to gain than any other country from sustaining cross-border investment openness and more to lose if these flows are choked off. OECD-country firms are already globally present, typically in as many as 40 host nations (UNCTAD 2008). It is China's firms that have not yet applied for their passports. For this reason the coming decade will offer a unique opportunity to work with China to improve the existing global structures governing cross-border investment. China must play a major part in discussions to alleviate aversion to FDI, both because it has the most to lose from a failure to maintain international openness and because its domestic industrial-policy aspirations are a source of concern for others. This implies that China can be expected to shoulder part of the burden for maintaining forward momentum in global investment regimes, on bilateral investment treaties, and on its own domestic openness to FDI.

Because Chinese OFDI will play such a large role at the margin, it will have a disproportionate impact on the political

43. See, for example, the revision of Committee on Foreign Investment in the United States (CFIUS) rules in December 2008.

44. Whether in fact China's financial system does act as a subsidy channel either in general or for specific firms is a matter of real disagreement. The case can be made that it does, but it is not clear that the manner in which it does meets the standard for actionable subsidies under existing trade agreements. If it does act as a subsidy channel, should this be treated as grounds to block investment bids, or merely as a welcome offer to overpay the shareholders of targeted companies?

45. See Graham and Krugman (1995) for a discussion of such fears related to the wave of Japanese FDI in the late 1980s.

46. The argument that (a) competitive pressures from domestic-market competition are the primary driver of outbound Chinese investment and (b) government control and subsidies for corporate China are a rising concern for host-country reviewers may seem contradictory to some. It is not; both arguments are valid. Even in state-owned oligopoly industries, like oil, state giants behave in a profit-oriented manner. They maximize their access to government favoritism, but do not always heed the call to serve government purposes. And while they share ultimate ownership by the state, they compete aggressively with one another both at home and abroad. This is described in detail in Rosen and Houser (2007). Beijing has generally chosen competition before (and in some cases, without) privatization.

economy of developing-country hosts, for better or worse. It is not China's relative share of investment to a given host that matters but its share in the current period. If the Chinese government explicitly rejects any notion of conditionality or discipline on corrupt practices, then these large new investment flows from Chinese firms could destabilize fragile host-countries, and the blame will redound to China. This has precipitated a debate on whether "no strings attached" is in China's best interests (Zha 2005), and domestic policymakers have begun to discuss and to draft rules for more-responsible overseas business conduct.[47] We conclude that China will be increasingly amenable to cooperating with OECD-country efforts to manage the unintended consequences of FDI, and the case for such alignment of interests should be emphasized.

Fourth, China's particular imperative to catch up in terms of its global investment presence should be viewed in light of the country's importance for a range of issues beyond the FDI sphere. Global investment flows can help to solve a range of issues, including the restoration of global growth following the current financial crisis, poverty alleviation, rebalancing macroeconomic growth patterns in China and abroad, and mitigating climate change. This last point requires some elaboration. Conducting every step of industrial processing in China does not make sense from a carbon-minimization perspective, since it entails the high energy-intensity transportation of unprocessed raw materials over long distances. By investing in first-stage processing closer to resource-extraction areas, Chinese firms can retain the vertical integration they aspire to while significantly reducing total carbon intensity. Such restructuring of production chains while retaining Chinese firm involvement through OFDI are already a subject of analysis in Beijing according to our conversations with government economists in 2008 and 2009.

Fifth, maximizing the benefits of foreign direct investment must begin with better statistical clarity. Improving the quality of China's OFDI data may not be exciting for policymakers looking for big ideas on engagement with China, but none of the geoeconomically important recommendations above can be pursued without expeditious improvements in China's statistical tracking of its outbound FDI. Managing national security and national economic security concerns in advanced economies requires better Chinese data on who is investing, where the investment is made, and who controls investment decisions. Efforts to work with China to prevent negative consequences from large investment flows into fragile developing-country economies requires, at a bare minimum, clear data on how much investment is going to these countries. For want of transparency on Chinese investment flows and investors, the United States and other OECD nations will insist on vague and flexible investment review mechanisms that are prone to be abused and sure to provoke grievances in China.

Finally, an accurate understanding of China's overseas investment profile provides a useful reminder to US and other policymakers that China is not yet an across-the-board peer. To maximize its interests China will need help from more-experienced firms and individuals who know how to operate away from home, and cooperation from other governments to not only sustain but to enhance openness for cross-border investment. OECD-country firms compete globally; China's firms compete at home and as exporters with foreign value-chain partners. The more China operates abroad, the more its firms are met on a level playing field, rather than on their skewed home turf. The experience from this overseas interaction will make Chinese firms worldlier and, if well handled by leaders, will make China less threatening to its economic partners. In this light, China's outbound FDI has all the elements for top-level attention: local benefits as a source of funding in tough economic times, national significance as a component of rebalancing China's balance of payments position, and international importance as a moderating factor in how China perceives and is perceived by the world.

47. For example, MOFCOM and the Ministry for Environmental Protection (MEP) are reportedly working on environmental guidelines for Chinese firms' overseas projects.

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APPENDIX 1 MERGERS AND ACQUISITIONS BY CHINESE FIRMS

Table 1 M&A deals by industry and region of the target firm, 2000–2008 (number of deals)

Industry	Hong Kong	Asia	North America	Europe	Oceania	South America	Tax havens*	Africa	Total	Percent of total
Financials	52	15	5	1	0	0	4	1	78	19
Raw materials	9	8	16	8	22	6	1	4	74	18
Energy and power	7	16	8	7	4	4	2	4	52	13
Industrials	14	10	9	16	2	0	0	0	51	13
High technology	17	12	10	1	2	1	1	0	44	11
Consumer products/ services	6	5	7	5	0	0	0	0	23	6
Media and entertainment	14	1	4	0	1	0	2	0	22	5
Consumer staples	7	5	2	4	0	1	0	1	20	5
Telecommunications	8	2	4	3	0	0	0	0	17	4
Healthcare	3	2	5	0	0	0	1	0	11	3
Retail	6	0	1	0	1	0	0	0	8	2
Real estate	5	1	0	1	0	0	0	0	7	2
Total	148	77	71	46	32	12	11	10	407	

*Cayman Islands, British Virgin Islands, and Bermuda.

Note: Includes only direct, cross-border M&A with a Chinese buyer and a final stake of 10 percent or more.

Source: Thomson Financial.

Table 2 M&A deals by industry of the Chinese acquirer (number of deals)

Industry	2000	2001	2002	2003	2004	2005	2006	2007	2008	Total	Percent of total
Financials	10	5	9	5	12	5	17	18	16	97	24
Raw materials	0	1	3	1	8	4	9	23	12	61	15
High technology	7	6	3	2	5	3	10	13	8	57	14
Energy and power	1	2	6	6	8	4	6	5	9	47	12
Industrials	1	2	6	2	7	10	4	7	5	44	11
Consumer products/ services	2	3	0	1	2	2	2	3	8	23	6
Media and entertainment	0	0	0	1	1	6	4	5	3	20	5
Consumer staples	0	1	3	1	2	1	1	2	3	14	3
Telecommunications	2	1	4	0	1	1	0	4	0	13	3
Real estate	0	1	4	0	0	1	1	3	1	11	3
Healthcare	0	1	2	0	2	0	0	2	3	10	2
Retail	1	0	1	2	0	0	0	3	1	8	2
Other	0	0	0	0	0	0	2	0	0	2	0
Total	24	23	41	21	48	37	56	88	69	407	

Note: Includes only direct, cross-border M&A with a Chinese buyer and a final stake of 10 percent or more.

Source: Thomson Financial.

APPENDIX 2 CHINA'S OFDI POLICY FRAMEWORK

Table 1 Phases of China's OFDI policy

Phase	Description
Phase 1: Tight controls 1979–1983	Restrictive attitude toward OFDI due to ideological skepticism, inexperience, and low foreign exchange reserves. Only specially designated trade corporations could apply for OFDI projects. No regulatory framework was existent; firms had to apply for direct, high-level approval from the State Council on a case-by-case basis.
Phase 2: Cautious encouragement 1984–1991	As global markets gained more importance, the government gradually started to encourage OFDI projects that generated foreign technology, control over resources, access to overseas markets, and foreign currency. The first regulatory framework for OFDI was drafted in 1984-85, allowing companies other than trading firms to apply for OFDI projects. However foreign exchange reserves were still at a low level and only firms that earned foreign exchange from overseas activities could qualify for OFDI projects.
Phase 3: Active encouragement 1992–1996	The post-Tiananmen decision to accelerate economic reforms and global integration led to a policy of more active encouragement of OFDI. The goal was to increase the competitiveness of Chinese businesses, with a special focus on 100 plus state-owned national champions. The foreign exchange regime shifted from an "earn-to-use" to a "buy-to-use" policy and the OFDI approval procedures were gradually eased and localized.
Phase 4: Stepping back 1997–1999	Government tightened regulatory processes for OFDI projects and recentralized foreign exchange acquisition against the backdrop of the Asian financial crisis, which revealed that many firms had used OFDI projects for illegal and speculative transactions, leading to heavy losses of state assets and foreign exchange reserves.
Phase 5: Formulation & implementation of the "going global" policy 2000–2006	In anticipation of WTO accession and growing competition in domestic markets, policymakers returned to their previous stance of encouraging OFDI and announced a policy package aiming at supporting Chinese firms from various sectors to "go abroad". In 2004, the regulatory process was reformed and foreign exchange controls were further eased and localized. Central officials and local governments begun to provide broad and active political and practical assistance for firms with overseas expansion plans.
Phase 6: Growing political support for transnational corporations and a new push for liberalization 2007–present	Policymakers' support for outbound FDI further increased both because of China's massive foreign exchange reserves (surpassing $1 trillion in 2006) and the need to build up competitive transportational corporations to sustain a change in China's economic growth model. A new regulatory framework implemented in May 2009 further eased and decentralized the approval procedures. New rules proposed by SAFE in the same month will significantly ease the foreign exchange management for overseas projects and broaden the sources of financing available for outbound investment.

Source: Authors' compilation from policy documents, and Voss et al. (2009).

APPENDIX 2 CHINA'S OFDI POLICY FRAMEWORK *(continued)*

Table 2 The 2009 changes in the regulatory framework for OFDI

	Project approval
Ministry of Commerce (MOFCOM) Administrative measures on regulation of outbound investment Effective May 1, 2009	■ All outbound investments need to be submitted to MOFCOM for approval; outbound investment is defined as (a) establishing new overseas firms; (b) merging with, acquiring, or obtaining controlling stakes in an existing firm; or (c) reinvestment in an existing overseas subsidiary. ■ An investment needs to be approved by central MOFCOM if the investment volume exceeds $100 million, involves an offshore purpose vehicle for the purpose of listing overseas, if it concerns the interests of multiple countries, or if the investment is to take place in a politically sensitive territory (as defined in a list by MOFCOM and other relevant authorities). ■ An investment needs approval by provincial-level MOFCOM authorities if the investment volume is between $10 million and $100 million, or if the investment is made in the areas of energy and natural resources. ■ If the investment is below $10 million and does not meet any of the above mentioned criteria, it qualifies for a special approval procedure: The application can be submitted electronically to the responsible MOFCOM bureau (local offices for local firms, central MOFCOM for centrally administered firms); the approval process should not take more than three business days. ■ If approved, firms get an outbound investment certificate, which they can use for the following 2 years to proceed with other necessary formalities, for example foreign exchange purchase or bank loans. ■ In addition to MOFCOM approval, investors must also consider the interests of other competent government agencies, if applicable; this includes entities such as National Development and Reform Commission (NDRC), the State Administration of Foreign Exchange (SAFE), the State-Owned Assets Supervision and Administration Commission (SASAC), or industry regulators such as the China Banking Regulatory Commission (CBRC) or the China Insurance Regulatory Commission (CIRC).
	Foreign exchange management
State Administration of Foreign Exchange (SAFE) Draft regulations of foreign exchange administration for domestic enterprises' overseas direct investments Draft rules published for comment in May 2009	■ Firms will no longer have to submit an application including the source of funding for approval to SAFE; instead, companies must register at the local SAFE bureau and can report the funding source after the investment took place. ■ Companies will be allowed to use a broader range of funding sources for overseas investments than in the past: they can use their own foreign exchange, recycle retained profits from overseas, and purchase foreign exchange with renminbi; renminbi-denominated OFDI will also be permitted on a trial basis. ■ Domestic institutions will be allowed to provide loans, financing guarantees, and follow-up financing for overseas firms in which they are invested. ■ Remittances will only have to be registered ex post instead of being approved in advance, and early-stage expenses of up to 15 percent of the total investment volume will be allowed. ■ SAFE will further streamline its administrative procedures with other regulatory authorities; there will be an annual joint examination of outbound FDI projects together with MOFCOM.
State Administration of Foreign Exchange (SAFE) Notice on the administration of cross-border loans by domestic enterprises Effective August 1, 2009	■ All firms that meet certain standards will be allowed to make cross-border loans to overseas units. ■ Eligible firms can transfer up to 30 percent of the value of their total equity to offshore subsidiaries. ■ The permitted sources of loan funds include firms' own foreign exchange reserves, renminbi-purchased foreign exchange, and other funds approved by local SAFE bureaus.

Source: Authors' compilation from policy documents.