China Goes Global:
The Implications of Chinese Outward Direct Investment for Canada

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Abstract

This paper traces the development of China's outward direct investment policies and presents some findings from a recent survey on Chinese outward investment intentions conducted by the Asia Pacific Foundation of Canada and the China Council for Promotion of International Trade. It also discusses the current state of Chinese FDI in Canada and prospects for future investments.

Introduction

The emergence of China as a global economic powerhouse is now widely recognized among business and policy circles in Canada. It has become conventional wisdom, for example, to speak of the imperative for all businesses, indeed all government departments even, to develop a "China Strategy", whether or not these entities do any direct business with China.

Most of the attention on China's economic prowess has been directed at its sustained high economic growth of the last two decades, driven in part by massive inflows of foreign direct investment (FDI) and by the rapid expansion of exports. China's openness to foreign investment, chiefly in the manufacturing sector, has reshaped global supply chains, and affected production, sourcing, and investment decisions from Turin to Toronto. China has in fact overtaken the United States as the leading destination for FDI, accounting for 9.4% of global cross-border flows in 2004.

In contrast, much less attention has been given to China's role as a source of outward direct investment (ODI). The flow of Chinese ODI has risen from virtually nil at the start of economic reforms in 1978 to US$5.5 billion by the end of 2004. While Chinese ODI is still very small relative to global flows, the rate of growth is among the fastest compared to other source countries.

The prospect of China becoming a major source of FDI is received with a mixture of enthusiasm and apprehension by many recipient countries. While most economies would welcome the inflow of long-term equity investment, there are concerns -- especially in

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industrialized countries -- about the motivations and quality of Chinese capital. These concerns include the fear of ceding sensitive technologies to a potential military competitor; loss of control over natural resources in the event of global scarcity; poor management and governance practices; and the unsavory human rights reputation of the Chinese government and, by extension, of its stable of state-owned companies. The public debate in late 2004 around the proposed acquisition of Noranda Inc. by China's Minmetals exposed many of these fears. Likewise, the failed attempt by China National Offshore Oil Corporation (CNOOC) to purchase a small US energy company (Unocal) generated much heat and passion among US legislators and editorialists.

While some of the concerns around Chinese ODI are not without merit, it would be foolhardy for recipient countries, including Canada, to ignore the phenomenon of China as a capital exporter or, worse, to reject Chinese investment on the basis of gross generalizations about the motivations and practices of the Chinese government and of Chinese industrial concerns. It is beyond the scope of this paper to chart the possible trajectory and form of Chinese capital exports, but China will very likely continue to be an exporter of capital for the foreseeable future, inasmuch as it will continue to run large current account surpluses (estimated to exceed four percent of GDP in 2005). Furthermore, the October 2005 shift to a "exchange rate basket" management system is likely to lead to a gradual appreciation of the Yuan, which will increase the purchasing power of the Chinese currency, making the acquisition of overseas assets all the more attractive to Chinese firms.

This brief paper traces the evolution of the Chinese government's policies on FDI and presents some findings from a recent survey on Chinese outward investment intentions conducted by the Asia Pacific Foundation of Canada and the China Council for Promotion of International Trade. It also discusses the current state of Chinese FDI in Canada and prospects for future investments.

Chinese Outward Direct Investment: Policy and Performance

Compared with major source countries for FDI, Chinese outward investment is highly regulated. In fact, Chinese ODI was generally discouraged by the central authorities until 2002, when the leadership announced a new strategy to encourage enterprises to "Step Out" by investing in overseas markets. Before the new strategy was articulated, China's ODI policy was driven chiefly by central government priorities. There were many shifts in the policy through the 80s and 90s, but many of these adjustments were of a political or administrative nature. The impetus for deeper reform in ODI policy has only come about in the last few years, coinciding with China's increased presence on the global economic scene, and with the ability and desire of Chinese firms to spread their wings internationally.

Broadly speaking, Chinese ODI policy can be divided into five stages:

STAGE ONE (1979 – 1983): Case-by-Case Approval

The only entities permitted to invest overseas were state-owned trading corporations and provincial or municipal-based international economic and technology cooperation enterprises, on a case-by-case basis. The State Council was the sole authority responsible for examining and approving overseas investment. Outward investment was in effect prohibited unless specifically approved by the State Council, and hence there were no regulations on ODI as such.

STAGE TWO (1984 – 1992) Standardization of Approval Procedures

Prohibitions against ODI were liberalized during this period as the government allowed a wider range of enterprises to invest overseas. Non-state firms, for example, were permitted to establish subsidiaries in other countries. Prior approval was still required from the central authorities, but the approvals process moved gradually from a case-by-case approach to more standardized procedures.

STAGE THREE (1993 – 1998) Greater Scrutiny of Overseas Investment Projects

A surge in outward investment in the previous period, encouraged both by the relaxation of ODI rules and by an overvalued exchange rate, led to a number of debacles by Chinese entities speculating on the Hong Kong real estate and stock markets. As a result, Beijing introduced a more rigorous process for screening and monitoring ODI projects to ensure that these investments were for "genuinely productive purposes".

STAGE FOUR (1999 – 2002): Overseas Investment in Processing Trade Activities

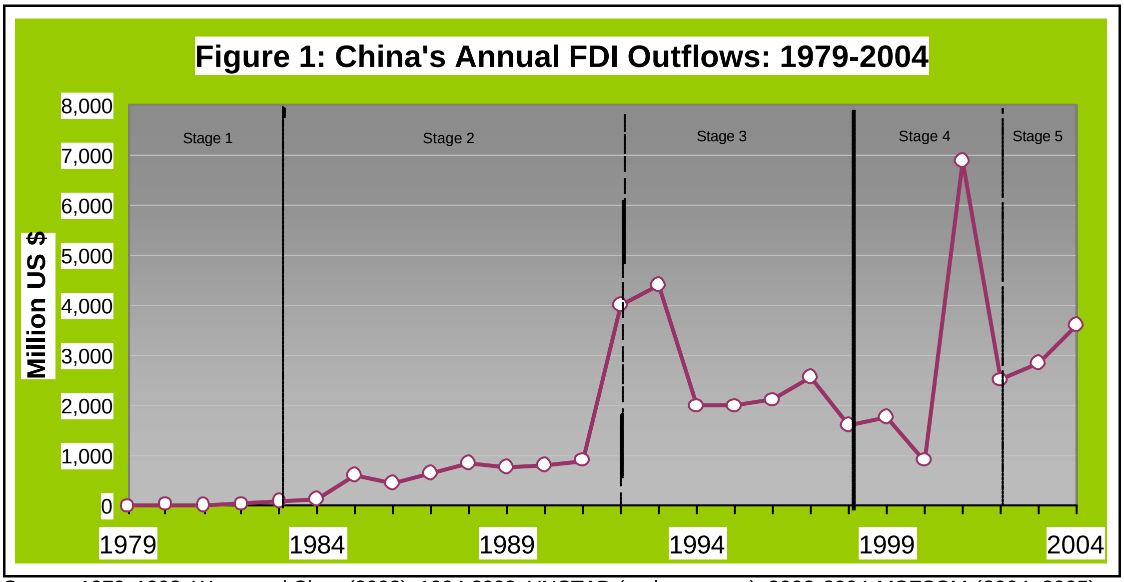
The period straddling China's entry into the World Trade Organization was a turning point in Chinese policy towards ODI. Recognizing the increasingly important role of Chinese enterprises in global trade and production networks, Beijing put in place new policies to encourage firms to engage in overseas activities that augmented China's export drive, also known as "processing trade" projects. The light industrial goods sector, for example textiles, machinery and electrical equipment, was encouraged to establish manufacturing facilities overseas that would use Chinese raw materials or intermediate goods. The Chinese government offered a variety of incentives including export tax rebates, foreign exchange assistance, and direct financial support.

STAGE FIVE (2002 – Present): The "Stepping Out" Strategy

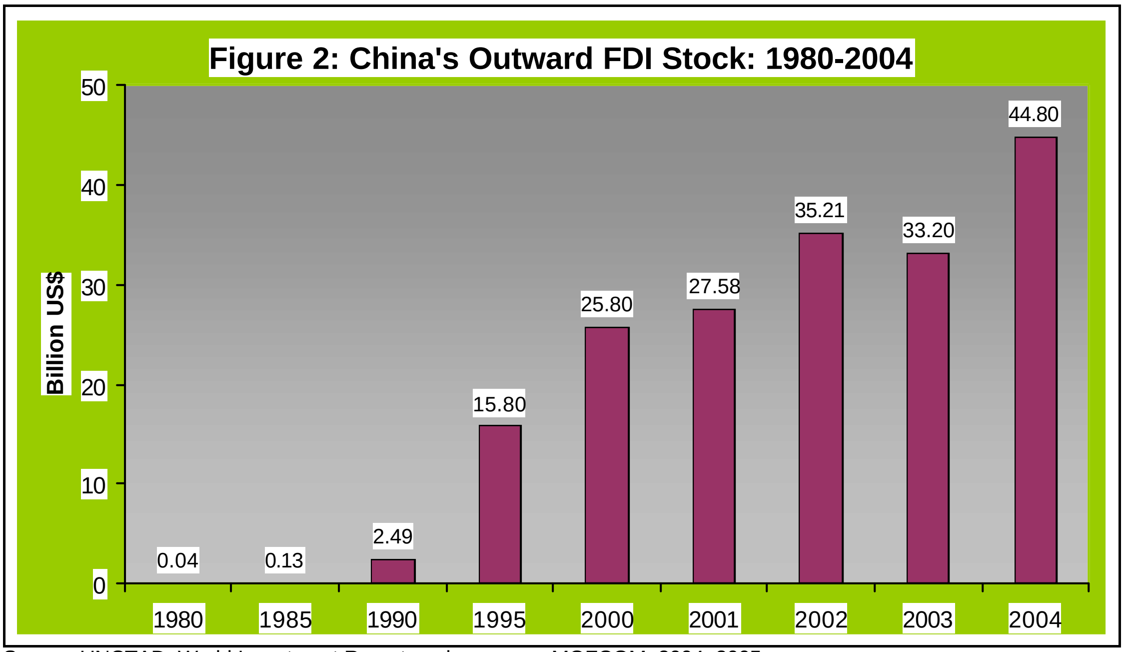
At the Chinese Communist Party's Sixteenth Congress in 2002, the leadership announced a new strategy of encouraging Chinese companies to "Step Out" into the global economy not only through exports, but also by investing overseas. This policy shift was seen as a necessary concomitant to the successful inward investment and export policies of the 80s and 90s, and as part of the ongoing reform and liberalization of the Chinese economy. It also reflects a desire on the part of the Chinese government to create world class companies and brands, whereby Chinese firms are seen as more than secondary nodes in production networks that are ultimately controlled by multinationals based in industrialized countries. Recent changes in ODI policy have focused on five areas: creating incentives for outward investment; streamlining administrative procedures, including greater transparency of rules and decentralization of authority to local levels of government; easing capital controls; providing information and guidance on investment opportunities; and reducing investment risks.

While there is no guarantee that ODI policy will continue on a path of liberalization, the last 20 years testify to the dramatic change that has already occurred in Beijing's attitude towards outward investment. Since 1980, the emphasis on political objectives in determining Chinese ODI policy has gradually given way to the primacy of commercial interests. At the same time, the approval process for ODI has been greatly simplified, with decision making authority delegated first from the central government to local governments, and more recently to the enterprise itself. The motivation for outward investment, in turn, has generally evolved from one that was based largely on accessing natural resources to a more complex set of objectives related to securing access to markets, technology, and brands, as well as the traditional interest in natural resources.

The evolution of Chinese ODI policy over the last two decades is reflected in Figures 1 and 2. China's flow of overseas non-financial investment reached a record US$5.5 billion in 2004, up 93 percent from the previous year. By the end of 2004, cumulative overseas investment from China was around US$45 billion. It is estimated that there are some 5,163 Chinese enterprises with investments in 149 countries or regions.



Source: 1979-1993: Wong and Chan (2003); 1994-2002: UNCTAD (various years); 2003-2004: MOFCOM (2004; 2005).



Source: UNCTAD, World Investment Report, various years; MOFCOM, 2004; 2005.

Outward Direct Investment Intentions of Chinese Enterprises

In May-June 2005, the Asia Pacific Foundation of Canada partnered with the China Council for the Promotion of International Trade (CCPIT) to carry out a survey on Chinese companies' outward investment intentions. The survey covered 296 member companies of CCPIT and included questions on current investments, the motivations for future investment, and targeted sectors/destinations. Some of the main findings include:

Chinese ODI is set to rise in the years to come. The survey found that 23% of respondents intend to increase their ODI within the next 12 months and that over 40% intend to invest overseas within 2-5 years.

Motivations for outward investment will increasingly be driven by market considerations rather than by policy directives. The survey results suggest that respondents' current investments overseas were driven as much by the Chinese government's Stepping Out policy and related incentives, as by pure business considerations. When asked about future investments, however, the importance of policy direction and incentives is given much less weight by respondents. "Business potential", on the other hand, is seen as the primary motivation, which suggests that Chinese ODI is entering a more mature phase of growth.

Outward investment is not limited to large, state-owned enterprises. While large State owned enterprises (SOEs) are currently the dominant players in Chinese overseas investments, the survey suggests that non-SOEs, particularly private companies, are also nurturing global ambitions. Many of these are small and medium-sized companies. In general, publicly-listed Chinese companies are more likely to invest abroad than their State-owned counterparts.

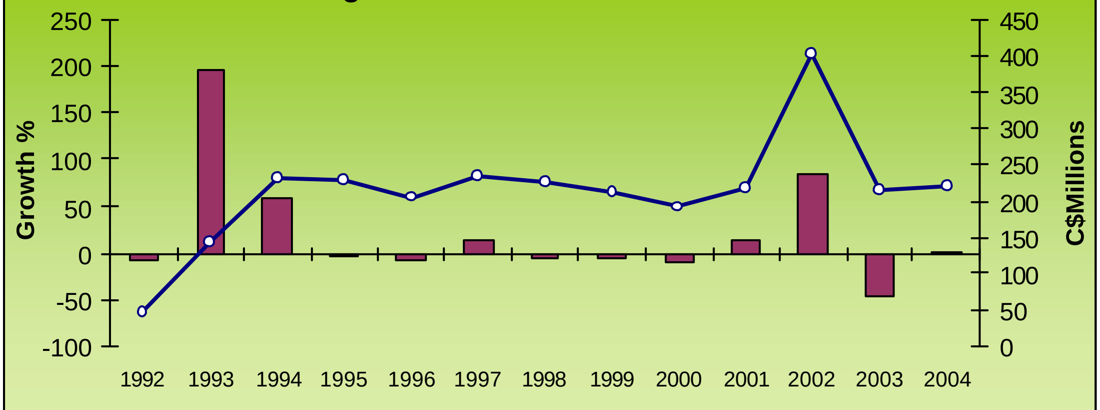
Chinese enterprises favor majority control of joint ventures for their overseas investments. Our survey results show that over 60% of existing ODI was carried out through joint ventures, as opposed to greenfield investment or mergers and acquisitions. According to the survey, some 90% of existing Chinese overseas projects are wholly owned or majority owned by Chinese investors.

Chinese ODI interests extend well beyond energy projects. Recent Chinese investments or attempted investments in energy projects have generated worldwide attention. Our survey suggests, however, that Chinese enterprises are interested in a much wider range of overseas investment opportunities. The top three target industries named in our survey are auto and auto parts, food and beverage, and mechanical and electrical machinery.

Chinese FDI in Canada and Examples of Recent Investments

According to Statistics Canada, the stock of Chinese foreign direct investment to Canada in 2004 was C$220 million, which represents 0.06% of the total FDI stock in that year. To date, China has been an insignificant source of FDI for Canada, ranking 27th among source countries. There is reason to believe, however, that Chinese FDI in Canada is underreported, as is the case with most international investment flows. Recent announcements of Chinese acquisitions in Canada suggest that the extent of investment activity may be greater than the statistics suggest.

Figure 3: Chinese FDI in Canada



Source: Statistics Canada, CASIM 376-0051, May 2005

The bulk of recent Chinese investment in Canada has been in the energy and resource sectors. In October 2005, **Jinchuan Group Ltd.**, China's largest nickel producer and smelter operator, invested C$3.06M in GobiMin, a nickel producer headquartered in Vancouver, by acquiring 5.1M GobiMin common shares or 9.996% of the total shares issued and outstanding. Earlier in the year, **SinoCanada,** a subsidiary of China-based

Sinopec Group and Calgary-based Synenco Energy Inc**.,** entered into a series of agreements under which Sinopec will pay approximately C$105M for a 40% interest in the Northern Lights oil sands project located in north-eastern Alberta. Similarly, **CNOOC Ltd**. announced that its wholly-owned subsidiary CNOOC Belgium BVBA had signed an agreement with Calgary-based oil sands company MEG Energy Corp. (MEG), to acquire a 16.69% stake in MEG. CNOOC Ltd. acquired 13,636,364 common shares of MEG for C$150 million.

There are a growing number of Chinese investments in Canada outside of the energy and resource sectors, even though these deals are small in value terms compared to resource sector acquisitions. Some examples from 2005 include the following:

China Telecom Corporation Ltd. (a US subsidiary of the Chinese telecom giant) opened an outlet in Toronto as part of its international expansion strategy. Toronto-based TCM Inc., which exports Canadian wood frame construction technology and building materials to China, signed joint-venture agreements with **Wuhu Shijie Hardware Co. Ltd**. to open a subsidiary-branch outlet in Toronto; with **Taizhou Baile Pumps Ltd**. to open a subsidiary-branch outlet in Toronto; and with **Zhejiang Huarong Exhaust Purification Co. Ltd**. to open a subsidiary-branch outlet in Toronto. **Jilin Provincial Huang Investment Group Co. Ltd**. signed a Letter of Intent with Regina-based A1 Soybean Enterprises Ltd. to invest in reforestation activities in Canada using Jilin Provincial's irrigation technology. And Chinese national retail giant, **Hualian Supermarket Co. Ltd**., has opened a store in Richmond, BC, marking the first major Chinese investment in the Canadian retail sector. It is not clear that all of these deals will count as Chinese FDI in Canada, since some of them involve the use of subsidiaries in other countries and/or the use of capital that is technically sourced from within Canada but which may well have originated in China.

Prospects for Increased Chinese Investment in Canada

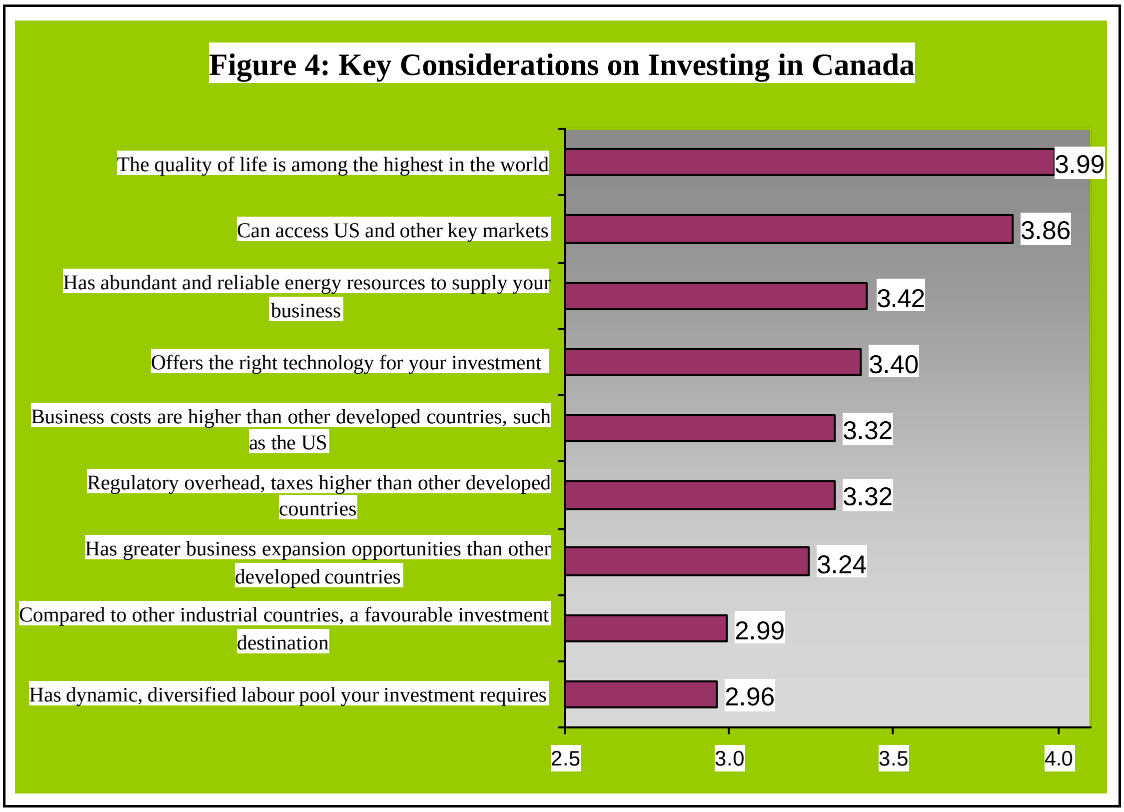
While Chinese ODI is still small compared to major source countries, the economic fundamentals of rapid GDP growth, deepening integration into global production networks, persistent current account surpluses, and a rising currency suggest that outward investment will expand steadily in the years ahead. A shift in policy to support outward investment since 2002 has accelerated the liberalization of regulations on ODI and has led to the creation of incentives and other mechanisms to encourage Chinese enterprises to "step out" as global investors. Our recent survey confirms that a significant percentage of Chinese firms intend to invest overseas in the next 2-5 years.

The same survey suggests, however, that Canada is generally not on China's ODI radar screen. Only 8% of respondents said they would consider investing in Canada. Moreover, 40% of respondents said they did not have a basic knowledge of investment opportunities in Canada. Curiously, respondents ranked the auto industry last among sectors in Canada considered to have good investment potential even though the same sample listed the auto and auto parts industry as the top priority for global investments

Table 1). When asked about the key considerations for investing in Canada, respondents ranked "quality of life" as the most important factor, followed by "access to the US market" and availability of "abundant and reliable energy resources" (Figure 4). A number of core business attributes often touted as key draws for investment in Canada, such as the availability of a skilled labour force, ranked surprisingly low on the scale of Chinese investor perceptions.

Table 1: Chinese Companies Perceived Most Promising Sectors in Canada

Ranking	The most promising sectors for investing in Canada are:
1	ICT
2	Energy
3	Biotech
4	Forestry
5	Minerals
6	Agriculture and Agri-food
7	Autos and auto-parts



It is not clear why Chinese enterprises do not rank Canada highly as an investment destination (setting aside a number of high profile energy-related opportunities such as the oil sands in Alberta, which have clearly captured the attention of the Chinese, among other potential investors). During the Minmetals-Noranda acquisition talks, the antipathy and, in some cases, outright opposition that was expressed by some civil society groups, public intellectuals, and government officials was portrayed in the mainland Chinese press as a more generalized rejection of Chinese investment in Canada. This interpretation is of course unfounded, but it may play an enduring role in conditioning Chinese attitudes towards investment opportunities in Canada. Government and business leaders have attempted to dispel these misconceptions through a series of public pronouncements and promotional activities in Canada and in China. Recent visits by the Premiers of Quebec, Saskatchewan, and Ontario underscored the attractiveness of the respective jurisdictions as destinations for Chinese outward investment. Premier Dalton McGuinty of Ontario put it most directly. In a speech to a largely Chinese business audience, he said: "We understand China's strategy of encouraging its enterprises to 'Go Global', and we welcome Chinese investment in Ontario." The Federal government, in turn, is placing greater effort to target China as a source of potential FDI for Canada, including seminars in China on Canadian investment opportunities. If the survey results are anything to go by, there is much work to be done in educating Chinese industrialists on Canada's business climate and on investment opportunities outside of the resource sector.

More importantly, the recent visit to Canada of President Hu Jintao has resulted in the creation of a "strategic partnership" between the two countries. Implicit in the idea of a strategic partnership is the need to be open to two-way investment flows, including the possibility of Chinese investment in so-called sensitive resource sectors in Canada. While any such investments will obviously have to meet a market test, the signal from political leaders may be the encouragement needed for Chinese and Canadian counterparts to put deals to such a test. It will take no more than a handful of high profile Chinese investments in Canada to serve as a demonstration effect for other Chinese enterprises to take a closer look at opportunities in this country. A little success can go a long way.

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