

China's Investment in the United States

--- National Initiatives, Corporate Goals, and Public Opinion

By Charles W. Freeman III and Wen Jin Yuan

November 2011

A Freeman Briefing Report

The Freeman Briefing offers analysis of major economic, trade and related developments in China of interest to the international business community, drawing largely from Chinese language sources.

China's Investment in the United States

--- National Initiatives, Corporate Goals and Public Opinion

By Charles W. Freeman III and Wen Jin Yuan¹

Introduction

The past decade has seen an unprecedented boom in Chinese investment flows to the United States. China has been using its massive dollar reserves to purchase U.S. Treasury bills and it is now the largest foreign holder of Treasury securities. By August 2011, China held US\$1137 billion in Treasuries, while Japan, the second largest holder, only had US\$936.6 billion.² Moreover, China's Outward Foreign Direct Investment (OFDI) to the US has also soared in recent years. In both 2009 and 2010, the value of China's direct investment assets in the United States increased by 130%. The total investment flow in 2010 was in the vicinity of US\$5.3 billion, bringing accumulated Chinese direct investment in the US to roughly US\$11.6 billion since 2003.³

With the growing amount of Chinese investment inflows, there is an increasing concern among some in the United States, that China's investment in the United States is a strategic endeavor of the Chinese government, and one not made based on solely commercial merits, but rather as part of a larger government policy to secure access to natural resources and core technology for China's rapidly growing economy. The subsequent conclusion is that the security of U.S. strategic assets and technology may be threatened by China's government-controlled investment. On the other hand, those who support increased investment from China assume that the United States is able to encourage further investment flow from China through lobbying the Chinese central leadership, operating under the perception that the investment is entirely government-controlled.

Given the high financial, economic, and security stakes of China's growing investment in the United States, this briefing aims to:

- Offer an overview of China's current investment flow to the US and examine the degree of the Chinese government's role in those investments.

¹ The authors would like to thank the Chinese scholars who agreed to be interviewed for this briefing. We have respected their preference to remain anonymous and therefore do not cite them by name. For further information regarding this briefing please email: FreemanChair@csis.org and wjyuan@csis.org

² "Major Foreign Holders of U.S. Treasury Securities," *U.S. Department of Treasury*, August 2011, <http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt>.

³ Daniel H. Rosen, "Testimony before the U.S.-China Economic and Security Review Commission--Regarding Chinese Investment in the United States," March 30, 2011, (p 25), http://www.uscc.gov/hearings/2011hearings/written_testimonies/11_03_30_wrt/11_03_30_rosen_testimony.pdf.

- Explore the recent trends in China's Outward Foreign Direct Investment (OFDI), particularly the growing amount of investment in energy and natural resources sectors, as well as in the technological sector, and explore the reasons and motivations behind these trends.
- Analyze the investment flow from China's private enterprises to the United States and examine what challenges Chinese private enterprises are facing when investing in the US.
- Ascertain what the strategic implications are for the United States down the road, given the current trend of China's investment flow to the US.

China's Current Investment Flow to the US

China's investment flows to the United States can mainly be divided into three categories: 1) The People's Bank of China (PBOC) using the majority of China's foreign reserves to invest in U.S. Treasury securities; 2) Chinese sovereign wealth funds, including China Investment Corporation and Hua An Fund Management Corporation, using part of China's foreign reserves to invest in equities; and 3) China's outward foreign direct investment which includes both greenfield investment as well as mergers & acquisitions (M&A). Among them, the Chinese government exerts tight control over the first and second category of investment, while the third category is a hybrid: part of it is government-controlled OFDI and part of it is market driven.

The capital used by the Chinese government to invest overseas in the U.S. mainly consists of the foreign reserves China has accumulated in the past several years. China's reserves, which have increased significantly since 2000, reached US\$ 3.2 trillion in June 2011 and now account for around one-third of the world total. Around 70% of this amount of US\$ 3.2 trillion said to be denominated in U.S. dollars. Between 2000 and 2005, China mainly used these reserves to purchase U.S. treasury securities; however, with the burgeoning U.S. budget deficit of recent years, China is feeling vulnerable to dollar volatility. The Chinese leadership circle has decided to adopt a portfolio investment strategy aimed at lowering the overall investment risk.

In September 2007, China's ruling executive body, the State Council, authorized the establishment of the China Investment Corporation (CIC), a Chinese sovereign wealth fund, to invest part of China's foreign reserves overseas. The Chinese Ministry of Finance borrowed US \$208 billion in issued bonds from the PBOC to acquire enough capital for the CIC to operate effectively.⁴ The CIC is technically under the control of the Ministry of Finance. Separately, PBOC directly controls the Hua An Fund Management Corporation which directs a portion of reserve holdings to invest in overseas medium to long-term equities.

⁴ Amadan International, "The Creation of the China Investment Corporation," January 30, 2008, <http://taighde.com/reportfiles/TheCreationoftheChinaInvestmentCorporation.pdf>.

Apart from investing in short-term Treasury securities and medium term equities, the third component in the Chinese government's portfolio is long-term outward foreign direct investment. The Chinese State-Owned Assets Supervision and Administration Commission (SASAC), under the State Council, is the supervisor for China's outward FDI of state-controlled enterprises, including the oil giants -- China National Offshore Oil Corporation (CNOOC), PetroChina and Sinopec. However, it is worth noting that though the Chinese state-owned enterprises have a large share of the overall volume of outward FDI, Chinese private firms are playing an increasing role in Chinese OFDI to the United States. According to research by Daniel Rosen and Thilo Hanemann, 170 out of 230 Chinese foreign direct investments in the US between 2003 and 2010 originated from private Chinese firms – which the researchers define as having 80% or greater non-government ownership. In terms of overall amount of investment however, state-owned firms account for 65% of the total. The high percentage mostly can be attributed to three large-scale acquisitions and one large greenfield project by state-owned firms.⁵

Rosen and Hanemann suggest that for the period of 2003 to 2010, the 230 recorded foreign direct investments in the US are almost equally split between greenfield projects and acquisitions. In value terms, however, acquisitions account for 77% of the total—US\$9 billion as compared to US\$2.7 billion for greenfield investments. Rosen and Hanemann also find that Chinese firms' OFDI initiative is spread across a spectrum of different sectors: one third of China's OFDI are services-related, and two thirds are industrial, which includes industrial machinery and equipment, electronics, oil and gas, automotive, communications equipment, medical devices, renewable energy equipment, etc. Moreover, China's OFDI growth after 2008 is targeted more towards technology-sector acquisitions of existing facilities, as well as a growing number of greenfield investments.⁶

The existing literature states that greenfield investments are usually better in creating domestic jobs than acquisitions. For instance, using the United Kingdom (UK) as an example, David Williams find that greenfield entrants created more jobs in the UK than those firms which adopted other entry modes such as acquisitions.⁷ Similar results could be found in Pigozzi and Bagchisen's study in 1995 indicating that greenfield projects have a more significantly positive employment impacts on the foreign manufacturing sector in the United States than acquisitions.⁸ With a recent boom of Chinese greenfield investments in the US, Rosen and Hanemann conclude that recent Chinese deals have “added a significant number of employees to the payroll,” and

⁵Daniel Rosen and Thilo Hanemann, “An American Open Door? -- Maximizing the Benefits of Chinese Foreign Direct Investment,” *Asia Society*, May 2011, (p 33),

http://asiasociety.org/files/pdf/AnAmericanOpenDoor_FINAL.pdf.

⁶ *Ibid*, (p 28-30).

⁷ David Williams, “Foreign Manufacturing Firms in the UK: Effects on Employment, Output and Supplier Linkages,” *European Business Review*, December 1999,

<http://www.emeraldinsight.com/journals.htm?articleid=869191&show=abstract>.

⁸ Bruce Pigozzi and Sharmistha Bagchisen, “Impacts of Acquisitions and New Plants on the Employment in US,” *Journal of Economic and Social Geography*, September 1995,

<http://onlinelibrary.wiley.com/doi/10.1111/j.1467-9663.1995.tb01362.x/abstract>.

most Chinese manufacturing investments focus on establishing long-term operations in the US that will facilitate local job creation.⁹ Moreover, Rosen and Hanemann also conclude that inward FDI from China has the same positive macroeconomic effects as FDI from other countries: Chinese firms have brought in competition, reduced production costs and consumer prices, and have in turn brought about better value and a wider selection for U.S. consumers.¹⁰ Therefore, the impact of China's OFDI on the U.S. economy is mainly positive since it contributes to overall economic growth as well as local job creation.

The Motivations and Constraints of China's Increasing Outward FDI in the US

The recent surge in Chinese OFDI to the United States can in part be attributed to a government campaign to promote overseas investment. Since the beginning of the millennium, China's central government has promulgated a "Going Out" campaign, part of which encourages domestic companies to increase their overseas investment. In 2001, head of the National People's Congress, Wu Bangguo, encouraged "competitive enterprises" to invest abroad and "go global."¹¹ Since then, China's OFDI regime has loosened up. According to the analysis from Rosen and Hanemann, the initial wave of China's outward FDI centered on energy and resources, while the most recent wave has focused on acquiring advanced technology.¹²

China's OFDI in the energy and resources sectors comes mainly from the state-controlled oil giants. This trend fits into the larger Chinese Government strategy of securing more natural resources to ensure the economic security of the nation, as well as to hedge against potential inflation risks. As China's demand for energy and natural resources rises in line with its economic growth, the country has become a net importer of crude oil and other natural resources. Meanwhile, China is unlikely to reduce its large expenditures on resource imports in the face of limited domestic supply and a growing consumption demand. According to a report from the Chinese Ministry of Industry and Information Technology, China's dependence on imported crude oil reached 55.2% in the first half of 2011, and the figure could well exceed 60% by 2020.¹³ Many Chinese researchers have warned that the high dependence on imported crude oil

⁹ Daniel Rosen and Thilo Hanemann, "An American Open Door? -- Maximizing the Benefits of Chinese Foreign Direct Investment," *Asia Society*, May 2011, (p 42), http://asiasociety.org/files/pdf/AnAmericanOpenDoor_FINAL.pdf.

¹⁰ Ibid, (p 36).

¹¹ "China Launches Two-Way Investment Strategy," *People's Daily*, September 21, 2001, http://english.peopledaily.com.cn/english/200109/12/eng20010912_80006.html.

¹² Daniel Rosen and Thilo Hanemann, "An American Open Door? -- Maximizing the Benefits of Chinese Foreign Direct Investment," *Asia Society*, May 2011, (p 20), http://asiasociety.org/files/pdf/AnAmericanOpenDoor_FINAL.pdf.

¹³ Tan Haojun, "Tan Haojun: Yuanyou Duiwai Yicundu Guogao Yingxiang Woguo Jingji Anquan"(A High Dependence on Crude Oil will Affect the Economic Security of China), www.ce.cn, August 16, 2011, http://views.ce.cn/main/yc/201108/16/t20110816_22621677.shtml.

and other natural resources could undermine China's economic security. For instance, Tan Haojun, a researcher from the State-Owned Asset Supervision Institute, stated that the United States could take advantage of China's dependence on foreign natural resources to contain China.¹⁴ Huang Xiaoyong, Director of the Center of International Energy and Security Studies, warned that China's current dependence ratio on imported crude oil has exceeded the internationally accepted alarm level of 50%. Meanwhile, Huang argued that as a resource-importing nation, China has little price-setting power over crude oil. Against this backdrop, if the political relationship between China and the exporting countries deteriorates, or the price of crude oil fluctuates due to any political or economic reason, it will in turn pose a threat to China's national security.¹⁵ With a strong sensitivity to national security concerns, the Chinese government is pushing several state-owned oil giants to increase their overseas M&A activities.

From the government's perspective, there are a number of reasons China is increasing its OFDI in the service sector, particularly in technological M&A. With an increasingly imbalanced economy, mounting inflationary pressure and growing criticism from the US and other countries over an undervalued renminbi (RMB), the Chinese government has initiated a comprehensive campaign to rebalance its economy. China's twelfth five-year plan—released in March 2011—focuses on upgrading the country's industrial structure and promoting indigenous innovation. In this plan, the transformation of the economic model is one of the most important tasks for the Chinese government in the next five years. The plan encourages the shipping, automotive, electronics, and other important industries to focus on technological innovation, and declares that the government will propel the development of strategic emerging sectors, such as information technology, biotechnology, and alternative energy.¹⁶ Under these circumstances, the Chinese government will likely be providing strong supportive mechanisms for Chinese firms to increase their technological acquisition overseas to acquire higher margin assets. On the other hand, from the perspective of Chinese firms, with a continued appreciation of the RMB and a growing production overcapacity, Chinese private technological firms in particular, are driven to capture greater profits per unit, rather than simply churning out more units at an increasingly slimmer marginal profit.¹⁷

Though the Chinese Government has a strong motivation to push the state-owned oil giants and technology companies to increase their OFDI, it is worth noting that the government also faces

¹⁴ Ibid.

¹⁵ Huang Xiaoyong, "Nengyuan Fengxian Jiang Chengwei Woguo Jingji Anquan De Zuida Fengxian Zhiyi" (Energy Risk will Become One of the Biggest Risks for China's Economic Security"), *China.org.cn.*, May 10, 2011 http://www.china.com.cn/economic/txt/2011-05/10/content_22533096.htm.

¹⁶ "Woguo Guomin Jingji He Shehui Fazhan Shi'er Wu Guihua Gangyao (Quanwen)," (The Guideline of China's Twelfth Five-Year Plan on National Economic and Social Development), *Sina*, March 17, 2011, <http://news.sina.com.cn/c/2011-03-17/055622129864.shtml>.

¹⁷ Daniel Rosen and Thilo Hanemann, "An American Open Door? -- Maximizing the Benefits of Chinese Foreign Direct Investment," *Asia Society*, May 2011, (p 30), http://asiasociety.org/files/pdf/AnAmericanOpenDoor_FINAL.pdf.

severe constraints in pushing its initiative by fiat. First, with an increasingly vibrant Chinese news media and the quick spread of information in China today, these oil giants and other state-owned enterprises face constant scrutiny from the Chinese general public when making investment decisions. For instance, due to the global financial crisis in 2008, the market value of CIC's investment in Blackstone and Morgan Stanley plummeted, arousing doubt and criticism among the Chinese general public. In late 2008 the Chinese News media reported that CIC had sharply curtailed its overseas investment activities, particularly in the overseas capital market. Moreover, in 2010, an article was circulated on Kaixin001.com, a Chinese version of facebook, stating that 71% of China's OFDI is from state-controlled enterprises and 65% of them suffered losses. The article attracted more than 17,000 comments from Chinese netizens, denouncing the Chinese government's OFDI initiative, arguing that the government should not allow the taxpayers to "pay for the investment failures of state-controlled enterprises."¹⁸ Most recently, CNOOC, PetroChina and Sinopec all came under attack in China's news media for the huge losses they have recorded on their overseas investments. According to a report by the 21st Century Economic Report, a China-based news outlet, as of the end of 2010, CNOOC, PetroChina and Sinopec had implemented 144 investment projects around the world. In dollar terms, these projects amounted to US\$70 billion. However, the report cited an anonymous senior manager in one of the above state-owned oil giants, stating that the massive overseas investments of the three oil giants did not bring in any significant returns. For example, these companies shipped back only a disproportionate 5 million tons of crude oil from abroad in 2010.¹⁹ In addition, a separate report by China Petroleum University said that two thirds of the three companies' overseas investment projects suffered losses. Sinopec's experience reflects this difficulty: in 2009 the company sustained US\$15 million in losses on its three overseas oil fields.²⁰ The exposure of these losses by the Chinese news media has aroused the public's doubts of the state-owned investment vehicles' ability to make money in international strategic assets markets, and in turn will limit CNOOC, PetroChina, and Sinopec's investment choices in the foreseeable future.

External impacts will also exert a substantial influence on the Chinese Government's OFDI initiative. For instance, the recent political crisis in Egypt and Libya has led to severe losses for China's OFDI projects in the Arab world. According to an estimate from the Chinese Ministry of Commerce, China has 50 large-scale infrastructure project contracts in Libya and the overall

¹⁸ "Zhongguo Yangqi Zai Shate Qukui 41.5Yi, Shei Jiang Wei Sunshi Maidan" (Chinese State-Owned Enterprises Suffer Huge Losses of 4.15 Billion in Saudi Arabia – Who will be Responsible for the Losses?), *KaiXin Wang*, October 31, 2010, <http://www.kaixin001.com/lrepaste/detail.php?uid=2937385&urpid=3342294860>.

¹⁹ Yin Yijie, "Shiyou San Jutou Haiwai Touzi Chao 4000 Yi Sanfen zhier Xiangmu Kuisun" (Overseas Investment of Three Oil Giants Exceed 400 Billion while Two-Thirds of the Projects Suffer Losses"), *21st Century Economic Report*, August 2, 2011, <http://www.daonong.com/green/policy/20110802/31491.html>.

²⁰ Huang Hsin, "China's three oil giants come under fire for accidents and losses," *Want ChinaTimes*, July 21, 2011, <http://www.wantchinatimes.com/news-subclass-cnt.aspx?cid=1102&MainCatID=&id=20110721000004>.

contractual amount equals approximately US \$18.8 billion.²¹ Though the stance of an emerging, post-Gaddafi government towards China's OFDI in Libya remains unclear, "there is sure to be a cacophony of voices among opposition groups," said Yin Gang, a Middle East expert at the Chinese Academy of Social Sciences.²² With the continued political instability in the Middle East, the Chinese government has begun to pay increasing attention to protecting the security of its OFDI assets. On May 28, 2011, the State Council issued a notice titled "Forwarding the Opinions of the National Development and Reform Commission on the Key Work of Deepening the Economic System Reform." In this notice, the State Council ordered the NDRC and the Ministry of Commerce to "facilitate the establishment of an OFDI law and regulation system, as well as to propel the establishment of an OFDI risk pre-warning system and emergency processing mechanism" to ensure the security of China's OFDI assets.²³ Hence, potential political risks might dampen China's pace of OFDI in third-party developing countries.

China's Increasing Outward FDI in Energy and Natural Resources Sectors: Facts and Implications

With the support from the Chinese Government, major Chinese state-owned oil giants, such as CNOOC, PetroChina and Sinopec, continued to accelerate the pace and scale of their overseas M&A process. According to the data from the China Petroleum and Chemical Industry Association, the three major oil giants have invested US\$70 billion in projects across 50 countries by the end of 2010. Among them, US\$30 billion was spent in 2010 alone.²⁴ Meanwhile, CIC also shifted its investment interests from the overseas capital market to the natural resources industry. Starting in 2009, CIC started major investments overseas in several different companies, with a clear focus on energy and natural resources companies. For instance, in October, 2009, CIC completed the settlement for its phase I investment in 45% of the equity in Nobel Oil Group ("Nobel") based in Russia; in November, 2009, CIC made an investment through a wholly-owned subsidiary in the amount of US\$1.58 billion in AES Corporation, one of the world's leading power companies, headquartered in the US, which generates and distributes

²¹ Leng Xinyu, "Libiya Weiji: Zhongguo Sunshi Zenme Ban," (The Crisis in Libya: How to Cope with the Chinese Losses?), *Xinhua News*, May 24, 2011, http://news.xinhuanet.com/fortune/2011-05/24/c_121452193.htm.

²² Michael Martina and Chris Buckley, "China urges Libya to protect investments," *Reuters*, August 23, 2011, <http://www.reuters.com/article/2011/08/23/us-china-libya-oil-idUSTRE77MOPD20110823>.

²³ The State Council, "Guo Wuyuan Zhuanpi Fazhan Gaige Wei Guanyu 2011Nian Shenhua Jingji Tizhi Gaige Zhongdian Gongzuo Yijian De Tongzhi," (Forwarding the Opinions of the National Development and Reform Commission on the Key Work of Deepening the Economic System Reform), May 28, 2011, http://www.gov.cn/zwggk/2011-06/03/content_1876807.htm.

²⁴ Yin Yijie, "Gaochu Diru: Zhongzi Shiyong Gongsu 400Yi Haiwai Touzi Shouyi Tupu" (High Expenditure with Low Revenue: An Overview of the Revenue of the 400 Billion OFDI of Chinese Oil Giants), *Sina Finance*, July 19, 2011, <http://msn.finance.sina.com.cn/gdxw/20110719/0411180469.html>.

electric power. CIC acquired 125.5 million shares of AES stock for US\$12.6 per share, representing approximately 15% equity interest in the company.²⁵

However, the rapid expansion of China's OFDI in the energy and natural resources sector has also brought criticism concerning the profitability and effectiveness of the OFDI, which might in turn limit the capacity of the large petrochemical concerns and CIC to continue increasing their overseas investment. With China Petroleum University warning that as much as two thirds of the petrochemical giants' overseas investments are losing money, not only the Chinese general public, but also some central government officials and intellectuals who serve as advisers to the central leadership, have begun to condemn the companies' mismanagement of their OFDI. "Not only the three companies, but many centrally-administered SOEs have suffered shocking losses," an anonymous researcher from the State Council told the China Daily. The researcher put the setbacks down to "wrong decisions", "investment failure" and "arrogance."²⁶

Moreover, an official from the Chinese State-Owned Assets Supervision and Administration Commission also suggested that, "The phenomenon of Chinese oil companies blindly building scale overseas should be taken seriously. Supervision of state-owned assets overseas should be strengthened."²⁷ On June 14, 2011, the aforementioned Commission issued a regulation named "Interim Measures for the Administration of the Overseas State-owned Property Rights of Central State-owned Enterprises", stating clearly that "Central state-owned Enterprises shall be the subject of responsibility for the administration of their overseas state-owned assets, shall improve the governance structure of overseas enterprises, strengthen the administration of overseas enterprises' articles of incorporation...and ensure the security of overseas state-owned property rights". Moreover, article 18 of the regulation notes that "if relevant responsible persons in the central state-owned enterprises and their subsidiaries fail to fulfill the responsibility of supervising the property rights of their overseas assets and lead to losses of state-owned assets overseas, relevant departments could impose certain disciplinary actions²⁸ on them based on relevant laws and regulations. If the case involves a suspected crime, responsible persons should be sent to the judicial department."²⁹ The recent guidance from the Chinese Government will probably result in the three oil giants slowing down their pace of conducting

²⁵ China Investment Corporation, "Annual Report 2009", December 2009, http://www.china-inv.cn/cicen/include/resources/CIC_2009_annualreport_en.pdf.

²⁶ Week in China, "Not strategic or profitable-- new report suggests Chinese oil firms are losing money on foreign buys," July 29, 2011, <http://www.weekinchina.com/2011/07/not-strategic-or-profitable/?t=yale>.

²⁷ Ibid.

²⁸ Since responsible persons in the state-owned enterprises are usually Chinese Communist Party Members, disciplinary actions towards them usually include expelling the person from the party membership, discharging the person from the position, placing the person on probation within the party, etc.

²⁹ The Central People's Government of the People's Republic of China, "Guo WuYuan Guoyou Zichan Jiandu Guanli Weiyuanhui Lin," (Interim Measures for the Administration of the Overseas State-owned Property Rights of Central State-owned Enterprises), June 27, 2011, http://www.gov.cn/filfg/2011-06/27/content_1893993.htm.

overseas M&A and it is widely anticipated that state-owned enterprises, particularly the oil giants, will focus on comprehensive risk assessments before making any overseas investment decisions.

Since the major oil monopolies' overseas investments have not proven that successful, the companies have an increasingly strong focus on boosting profits in their overseas projects, making the top management team of the three firms even more market-oriented. An anonymous senior-level manager from one of the three told 21st Century Economic Report that currently, only around 8% of the foreign oil produced outside China is shipped back to the Mainland, and most of the oil from China's overseas assets is sold directly on the international market, not to China. Taking the logistical costs into consideration, it is indeed more profitable for the oil giants to sell the oil directly on the international market at the spot price, rather than shipping it back to China.³⁰

However, the oil giants' market-oriented positions provoked harsh criticism within the Chinese policy circle. For instance, Wang Yong, former head of China's Petroleum Chamber of Commerce, stated that, "Since they are state-owned oil companies, they should contribute to the country's strategic oil supply first. Compared to the advanced economies, the proportion of oil shipped back from China's overseas market is too small and could not compensate for the hefty costs of these companies expanding to the overseas market."³¹

Zeng Xingqiu, a Petroleum expert from the Sinochem Group, noted that there is a fierce debate on how to deal with the oil produced from China's overseas market. "Some in the policy circle argue that the proportion shipped back to China is too small and others opine that it would be more profitable to sell the oil directly on the international market," he explained.³² The contrasting views from the Chinese policy circle of whether the oil giants should place emphasis on profitability or on China's energy security concerns when making overseas investment decisions will probably inhibit the three companies' ability to forge a clear and independent investment strategy.

China's Technological Acquisition in the US

When it comes to China's technological acquisitions in the US, though the Chinese government indeed mounted a national campaign to encourage large private technological companies in particular to acquire higher margin assets overseas, there is plenty of evidence demonstrating that from the Chinese firms' perspective, the senior level managers in these firms tend to approach investment more from a corporate perspective rather than from a nationalist mindset.

³⁰ Yin Yijie, "Gaochu Diru: Zhongzi Shiyou Gongsi 4000Yi Haiwai Touzi Shouyi Tupu"(High Expenditure with Low Revenue: An Overview of the Revenue of the 400 Billion OFDI of Chinese Oil Giants), *Sina Finance*, July 19, 2011, <http://msn.finance.sina.com.cn/gdxw/20110719/0411180469.html>.

³¹ Ibid.

³² Ibid.

Lenovo's successful acquisition of IBM's PC sector in 2005 is one such example: By 2004, Lenovo was still the undisputed leader in the China PC market with a 27% market share, and a gross margin of 13.3%.³³ However, in Lenovo's traditional Chinese market, the company faced competition from newly emerging low-cost producers, including Haier, TCL, and Hasee, and ran the risk of being trapped in vicious price competition if it did not fundamentally alter its business strategies at that time.³⁴ With this in mind, the senior-level managers in Lenovo had a strong desire to broaden its market base and try to establish itself in the international market. In order to achieve this goal, Lenovo needed to catch up with other multinationals in the PC market by purchasing brands, technology, and other assets that would bring the firm closer to the international market and allow the firm to better compete with peers at home and abroad. According to Yang Yuanqing, Lenovo's vice chairman, president and chief executive officer in 2004, through acquiring IBM's global PC business and forming a strategic alliance with IBM, Lenovo would "absorb and integrate the skills from both sides, acquire global brand recognition as well as an international and diversified customer base, gain a world-class distribution network with global reach...and leading-edge technology."³⁵ Liu Chuanzhi, Chairman of the Lenovo group, also noted that the reason Lenovo decided to "go global" and acquired IBM's PC sector was that IBM's technology team was attractive, and IBM's PC business included "commercial channels, management teams, and an internationalized management mode."³⁶

Another example is the recent marriage of Zhejiang Geely Holding Group and Volvo Car Corporation. In August 2010, Geely Holding Group, one of the fastest-growing car manufacturers in China, announced that it had completed the acquisition of 100 percent of Volvo Car Corporation from Ford Motor Company. According to Li Shufu, Chairman of the Geely Holding Group, Geely gained not only the total control of Volvo, but also "the trademark, intellectual property rights, 10,963 patents, more than 10 series of sustainable products and product platforms, two whole companies with a production capacity of 500,000 vehicles a year, an engine company and three auto parts companies." Moreover, Geely also received "more than 3,800 R&D engineers, the entire talent-training and innovation system and 2,325 branches in over 100 countries including social service institutions and 4S stores."³⁷ From Li's point of view, only through cultivating the capability of developing technology could Geely improve its product

³³ John Ackerly and Måns Larsson, "The Emergence of a Global PC Giant: Lenovo's Acquisition of IBM's PC Division," *Harvard Business School*, December 2005,

<http://people.hbs.edu/mdesai/IFM05/AckerlyLarsson.pdf>.

³⁴ Ding Feng, Zhang Peng and Wang Bin, "Cong Lianxiang Binggou IBM PC Kan ShetunXiang De Wuda Fengxian," "Five Big Risks of Lenovo Acquiring IBM PC," *Xinhua Wang*, February 18, 2005, http://news.xinhuanet.com/it/2005-02/18/content_2590719.htm.

³⁵ "Lenovo acquires IBM's PC business," *Sina English*, December 8, 2004, <http://english.sina.com/business/p/1/2004/1208/13028.html>.

³⁶ Sinocast, "Liu Chuanzhi: Acquisition of IBM PC Is Successful," September 8, 2011, <http://www.sinocast.com/readbeatarticle.do?id=63670>.

³⁷ Li Shufu, "Geely's Li: What does Geely gain from the Volvo deal?" *People's Daily*, July 8, 2010, <http://english.peopledaily.com.cn/90001/90778/90860/7058090.html>.

quality and establish a highly respected, world-renowned brand to compete with peers both at home and abroad.

In a nutshell, Chinese private technological companies' OFDI decisions are mainly market-driven. However, Chinese private technological firms face a huge obstacle in investing overseas in the US. The process of M&A requires a significant amount of financial resources. Since many state-owned enterprises have had long relationships with their banks, there is a deep, mutual trust between the two. By stark contrast, China's nascent credit evaluation system makes it hard for banks to scrutinize the creditworthiness of private companies. Therefore, it is very difficult for private firms to borrow enough capital from Chinese banks to finance the M&A process. Hence, a middleman – the Chinese Ministry of Industry and Information Technology – steps into the process.

According to a recent interview with a Shanghai economist, Chinese private firms' merger and acquisition activities must be approved by this Ministry first before the firm can initiate the process.³⁸ “Since the Ministry has the ultimate authority to approve or reject the M&A activities, the officials in the Ministry do possess the rent-seeking power to choose which cases to approve,” noted the economist, “hence, only big private enterprises such as Lenovo or Geely Holding Group could have enough resources to lobby the Ministry to get the M&A activity approved. After the approval, the Ministry will serve as the middleman between the enterprises and the state-owned banks to ensure that the enterprises could receive enough bank loans to finish the M&A process.”³⁹

Therefore, in order to successfully lobby the Ministry and receive adequate financial resources, the private enterprises have to link corporate goals with national government initiatives, otherwise the Ministry will be reluctant to endorse the companies' OFDI initiatives. For instance, when mounting Geely Holding Group's “go global” initiative, Li Shufu openly stated that “the transformation of a country's economic development mode should start with the transformation of the country's national economic development strategy. To enterprises, the transformation of the economic development model is the transformation of their core competitiveness model or, in essence, the transformation of their concept of core values.”⁴⁰ Li also repeatedly emphasized the importance of technology and the capability of developing technology to an automotive company,⁴¹ integrating Geely's OFDI initiative into China's national strategy of propelling indigenous innovation and upgrading the whole industrial structure. By linking the company's

³⁸ Telephone Interview with leading Chinese university Economist, August 19, 2011.

³⁹ Ibid.

⁴⁰ Li Shufu, “Geely's Li: What does Geely gain from the Volvo deal?” *People's Daily*, July 8, 2010, <http://english.peopledaily.com.cn/90001/90778/90860/7058090.html>.

⁴¹ Bill Russo, Tao Ke and Edward Tse, “An Inorganic Approach to Globalization: The Marriage of Geely and Volvo,” Booz & Company, 2009, http://www.booz.com/media/file/An_Inorganic_Approach_to_Globalization_en.pdf.

global strategy with the national goal, it became much easier for Geely to receive government support for its OFDI initiative.

The aforementioned Shanghai-based economist interviewed for this briefing also added that bank loans to a private Chinese enterprise to support its overseas technological acquisition process generally implies that central and local governments will act as guarantors if there are investment losses after the acquisition. Hence, there is a possibility that the private enterprise will transform into hybrid ownership after the overseas acquisition, since the bank loans borrowed from Chinese state-owned banks may very well transform eventually into a government share in the enterprise. Take Geely's case for example: Geely revealed information recently indicating that the group's total liabilities climbed rapidly after its acquisition of Volvo Cars, from RMB 4.78 billion to RMB 71.07 billion in 2010. Its current debt ratio is 73.4%, arousing concerns that its capital chain might be at short-term risk without government support.⁴² To solve the financing problem, Geely Group recently announced the launch of a 10 million bond financing plan to repay bank loans to supplement working capital.⁴³ However, if the company cannot solve its financing problem effectively, Geely will have to turn to state-owned banks for further support, and the loans extended to the company may eventually result in a partial government ownership of the enterprise.

Chinese Private Companies' OFDI through Offshore Financial Centers

The Chinese Government's effort in rebalancing the economy has resulted in a diminishing profit margin for many small Chinese private enterprises. Many of them are looking for alternatives such as OFDI. However, it is difficult, if not impossible, for small private enterprises to mobilize resources to lobby the Ministry of Industry and Information Technology to offer them approval of "going out." Hence, small private enterprises have to resort to offshore financial centers to invest their capital overseas.

"Offshore financial centers," also called an "offshore center," refers to financial markets aimed at foreign currency transactions with non-residents as their major clients. Some offshore financial centers offer "benefits" such as loose monitoring systems, low transparency, and serve as tax havens and money laundering paradises. There are several well-known offshore centers including, the British Virgin Islands, Cayman Islands, Samoa, and Bermuda, among others, which are located in the Caribbean or in the Pacific Ocean. In these areas, there are no relevant monitoring systems on capital flow. Their doors are also open to those who intend to establish "shell companies", "letter-box companies" and other anonymous companies. Therefore, small Chinese private enterprises usually establish various kinds of anonymous companies at these

⁴² Gao Tianyu, "Jili Zijin Lian Gaoshao Beihou," (Behind the Problem of Geely's Capital Chain), *zhongjinzaixian*, September 21, 2011,

<http://gegu.stock.cnfol.com/110921/125,1332,10753951,00.shtml>.

⁴³ Li Jianzong, "Geely liabilities rose to 71 billion after the capital-hungry Tunxiang," July 26, 2011,

<http://www.f-paper.com/?i642867-Geely-liabilities-rose-to-71-billion-after-the-capital-hungry-Tunxiang>.

offshore financial centers, and then inject capital into these companies through China's underground banking system or even through cash smuggling, in order to conduct overseas foreign direct investment. Meanwhile, with the difficulty of financing through Chinese state-owned banks, some large private enterprises, such as Sina.com and Wahaha, have also registered their branch companies in offshore financial centers, in order to make it easier for them obtain financing and potentially save large amounts of taxes during any upcoming overseas M&A process.⁴⁴

The Strategic Implications for the United States

From the U.S. perspective, many Americans assume that with China's one-party political system, the country is still operating under an authoritarian political regime, and therefore, enterprises come to the United States with specific political intentions rather than purely commercial ones. However, the analysis in this briefing has illustrated that Chinese state-owned enterprises, such as China's oil giants, often take profit motives into primary consideration when making decisions. The notion that Chinese private companies are mainly profit-driven on OFDI decisions is even clearer: private companies often articulate their OFDI strategy in a way which is consistent with the national initiative because companies have to link their corporate goals with the rhetoric of statism so as to receive enough financial support to "go global." Hence, it is important for policy makers in the U.S. to understand that behind the national initiative, Chinese firms typically put their goal of profit maximization ahead of any national strategy.⁴⁵ It is becoming increasingly clear that profit motive is the primary driver for both state-owned and private enterprises when they make OFDI decisions.

The Beijing government's state strategy is also constrained by the influence of public opinion. With an increasingly commercialized news media, it is becoming more and more difficult for the government to control the spread of information. In recent years, social media such as Kaixin.com, Renren.com, Sina Weibo, and others, whose functions are similar to Facebook and Twitter, have grown in popularity among the Chinese general public. Therefore, even if the Beijing authority tries to push non-market driven OFDI initiatives by fiat, the news of overseas investment failures will reach the public, potentially arousing criticism from the public of the state's "going out" strategy. Now, with an increasingly severe inequality problem within China, the country faces growing anger, conflict and tension. Against this backdrop, the Beijing authority is ascribing more political weight to public opinion since the leaders at Zhongnanhai have realized that any misstep might escalate tensions and in turn threaten the stability of the

⁴⁴ Puli International, "Li'an Jingrong Zhongxin Huocheng Zhongguo Qiye Haiwai Chaodi Tiaoban", "Offshore Financial Centers might Become the Middlemen for Chinese Enterprises' OFDI Businesses," April 27, 2010, <http://www.poklee.com/newsDes.aspx?id=181&cate=1>.

⁴⁵ Daniel Rosen and Thilo Hanemann, "An American Open Door? -- Maximizing the Benefits of Chinese Foreign Direct Investment," Asia Society, May, 2011, (p 10), http://asiasociety.org/files/pdf/AnAmericanOpenDoor_FINAL.pdf.

country. Therefore, it is important to bear in mind that public opinion plays a role in framing state strategy. Meanwhile, though it is not easy to alter the Chinese general public's perceptions of China's OFDI initiatives, it is still possible and worthwhile for U.S. stakeholders in business and the government to reach out to Chinese constituents with convincing messages. For instance, public outreach activities to inform China's scholars and opinion leaders to make China's OFDI in the US more transparent for the Chinese general public through China's news media channels, would be helpful in shaping China's public opinion. Bringing attention to successful cases of private Chinese investment would do wonders for both US and Chinese sensibilities with respect to Chinese OFDI in the United States.

About the Authors

Charles W. Freeman III is a nonresident senior adviser for economic and trade affairs at CSIS. Previously, he held the CSIS Freeman Chair in China Studies. A second-generation “China hand,” he has lived and worked between Asia and the United States his entire life. Prior to joining CSIS, he served as assistant U.S. trade representative (USTR) for China affairs and was the United States’ chief China trade negotiator, playing a primary role in shaping overall trade policy with respect to China, Taiwan, Hong Kong, Macao, and Mongolia. During his tenure as assistant USTR, he oversaw U.S. efforts to integrate China into the global trading architecture of the World Trade Organization. Earlier in his government career, he served as legislative counsel for international affairs in the Senate. Outside of government, as a lawyer and business adviser, he has counseled corporations and financial institutions on strategic planning, government relations, market access, mergers and acquisitions, corporate communication, and political and economic risk management in China. He currently is a senior adviser to McLarty Associates, the global strategic advisory firm based in Washington, D.C., and serves on the boards of directors of the National Committee of U.S.-China Relations and the Harding Loevner Funds mutual fund complex. Freeman received his J.D. from Boston University School of Law, where he was an editor of the Law Review and graduated with honors. He earned a B.A. from Tufts University in Asian studies, concentrating in economics, also with honors. He also studied Chinese economic policymaking at Fudan University in Shanghai and Mandarin Chinese at the Taipei Language Institute, where he received highest honors in language fluency exams.

Wen Jin Yuan is a researcher with the Freeman Chair in China Studies at CSIS, where she specializes in China’s economics and financial issues as well as economic integration in East Asia. She is the coauthor of *China’s Exchange Rate Politics* (CSIS, 2010), *Regional Monetary Cooperation in East Asia* (CSIS, 2010), and *Is China Ready to Challenge the Dollar?* (CSIS, 2009), and she is a special contributor to Knowledge@Wharton, the online journal of the Wharton School, University of Pennsylvania. During her undergraduate studies, Ms. Yuan worked as a research assistant for several professors at the School of Economics, Fudan University, focusing on China’s economic development issues. Ms. Yuan, who is from China, received a B.A. in economics from Fudan University and an M.P.P. from the School of Public Policy at the University of Maryland. She is currently a Ph.D. student in policy studies at the University of Maryland, concentrating on international security and economic policy.