Reversing the Flow: China's Recent and Future Cross-Border Investments and Acquisitions

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Reversing the Flow: China's Recent and Future Cross-Border Investments and Acquisitions[1]

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I---Preamble, Background, and Objectives

Economists are often embarrassed by their forecasting errors, or by their failure to forecast critical matters presumed to be within their professional domain. Commenting on the frequency of such errors, a former Nobel Prize winning economist observed several decades ago that economists "have successfully predicted nine of the last five recessions"![3]

A striking example of failure to make accurate forecasts is provided by the Great Recession of 2007-2009. Hundreds of distinguished economists shared in this error, including such notables as Alan Greenspan, Ben Bernanke, Jean-Claude Trichet, and Larry Summers.

In development economics, we have for decades instructed our students and advised policymakers that developing economies should be expected to incur large current account deficits and to require compensating capital imports. These presumptions have been proven erroneous by the phenomenon of China's emergence in recent years as one of the richest sources of global capital exports, and an increasingly prominent player in international capital markets and especially in mergers-and-acquisitions markets.

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1 Prepared for the 34th Pacific Trade and Development Conference (PAFTAD), on "China's Role in the World Economy", organized by the China Centre for Economic Research (CCER), and the Australian National University, in Beijing, December 6-9, 2010.

This paper carries with it a warm but sad remembrance of the late Dr. Hadi Soesastro, with whom I discussed many of the paper's ideas in the course of extended conversations in Bali, in November 2009. Over the past 35 years, I have known Dr. Soesastro, first as a doctoral student in the RAND Graduate School, and thereafter as a respected colleague and personal friend. His passing is a profound and woefully premature loss to this community, and to all who were privileged to know him.

2 The author is senior economic advisor at the RAND Corporation, and holds RAND's corporate chair in international economics.

3 Paul Samuelson, *Newsweek*, November 18.1966

The objective of this paper is briefly to describe the scale and patterns of China's foreign investments and corporate acquisitions in recent years, and to suggest how they may evolve in the coming decade.

One of the few propositions on which nearly all China experts— inside as well as outside China—agree is that foreign investment ***in*** China has been a major contributor to the Chinese economy's remarkable growth over the past several decades. Between 1992 and 2007, annual foreign investment in China increased six-fold, from $11 billion to $70 billion—a growth that reflected both investment opportunities in China and their anticipated benefits.[4] In addition to the direct benefits realized from the invested capital itself—whether through joint ventures or equity investment—significant additional benefits accrued indirectly from the technology, management, and marketing associated with these investments.[5]

From China's perspective, these large capital inflows entailed risks, which China's policymakers addressed through various means. Their risk-mitigation measures included restricting foreign equity investment to nonvoting "B" stock, constraining the proportion of ownership that foreign investors could acquire in Chinese companies, and limiting the number and size of foreign firms' financial platforms in China's capital markets.

In the coming decade, investments abroad ***by*** China will be a significant factor in global capital markets, a major factor in mergers and- acquisitions markets, and an important contributor to growth in other parts of the world, as well as a source of indirect benefits linked to these investments. As a consequence of such investments, China's diverse 37 provinces and administrative regions may be able to improve business conditions and practices in their domestic markets.

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4 The sixfold increase refers to foreign direct investment (FDI), sometimes contrasted with portfolio investment. The former is cross-border investment that involves control or influence over a company and can take place through a variety of means; the latter involves cross-border positions in equity or debt securities not intended to give the investor control or influence over the foreign company. A common feature of FDI is that the foreign investor directly owns equity that entitles it to 10 percent or more of the voting power in the foreign company. Much recent and prospective foreign investment by China involves acquisition of all or majority shares of entire companies; hence, it is FDI.

5 See Charles Wolf, Jr., K. C. Yeh, Benhamim Zycher, Nick Eberstadt, and Sung-Ho Lee, *Fault Lines in China's Economic Terrain*, Santa Monica, Calif.: RAND Corporation, MR- 1686-NA/SRF, Chapter Eight, 2003; Shuxun Chen and Charles Wolf, *China, the United States, and the Global Economy*, Santa Monica, Calif.: RAND Corporation, MR-1300-RC, Chapter Seven, 2001; Yasheng Huang, *Selling China: Foreign Direct Investment During the Reform Era,* Cambridge, UK: Cambridge University Press, 2003.

From the perspectives of potential recipients, China's foreign investments may also entail risks. Hence, recipient countries are likely to limit such risks through various means analogous to the measures applied by China to limit the risks it associated with foreign investments in China. Doubtless, too, China's foreign investments will be associated with a general expansion of Chinese influence in the global economy during the coming decade. Section II of the paper provides a brief account of the current international economic and financial environment as context for the later discussion.

This paper aims to improve understanding of China's foreign investment patterns and policies. Toward this end, Section III summarizes global data on investments and acquisitions of companies in the U.S., Europe, and the rest of the world, by Chinese corporations, banks, and government institutions, during the period 2007 through 2009. Section III also includes a brief comparison between China's investments in the United States and the investments of five major global private equity firms. The aim of this comparison is to highlight both similarities and differences between China's investments and those of the PE firms in their respective investment patterns and priorities.

It can be presumed that China's foreign investments are and will be heavily influenced by China's domestic economic interests as well as its other national interests. If and as these shift, along with cyclical and structural domestic and international conditions and perhaps domestic political conditions as well, the pattern and priorities of foreign investments are likely also to change. Section IV concludes with observations about how such changes may affect patterns and priorities of China's foreign investments in the future.

II---China, the United States, and the Global Economy

I turn next to discuss briefly several aspects and sources of China's increased prominence in the evolving global economy; its bilateral economic relations with the United States; the effects of the global financial crisis on these relations, including the respective fiscal stimulus programs in both China and the United States; and the consequences of these matters for China's recent and prospective investments in companies in Europe, the U.S., Asia, Australia, and the rest of the world. The discussion summarizes some of the principal aspects of the global financial environment in which China's foreign investments will take place and in which the prospective recipient countries and companies will permit, encourage, resist, or otherwise react to China's expanding foreign investment activity.

In the evolving global economy, China's large and growing financial resources will strengthen its ability to invest and to acquire companies and natural resources abroad. This leverage will predictably encounter resistance for a combination of political, economic, and security reasons. The resulting challenge for both China and the rest of the world is how to nurture the opportunities for and potential benefits from efficient allocation of Chinese foreign investments, while avoiding or minimizing possible risks to the national security and other interests of recipient countries. The implicit aim should be to develop policies and procedures that will promote "win-win" outcomes while minimizing outcomes that involve losses.

China's economy has maintained annual gross domestic product (GDP) growth in the neighborhood of 9 to 10 percent during the past decade through 2009.[6] Principal drivers behind this remarkable record have included, besides the foreign direct investment mentioned earlier, a large, low-cost labor supply and a growing component of skilled labor; massive domestic investment constituting more than 35 percent of GDP; an extraordinarily high domestic savings rates of 45 percent of GDP; continued growth of factor productivity (i.e., productivity of both labor and capital); and open and expanding

[6] Neighborhood" is intended to cover a variety of questions concerning the reliability of data pertaining to China's economic growth and more particularly the comparability of time series data, which, for example, may include in later years components not equivalently covered in earlier years. See for example, Thomas G. Rawski, "What's Happening to China's GDP Statistics?" *China Economic Review,* Vol. 12, No. 4, December 2001.

markets for China's exports, especially in the United States, until mid-2008 when economic decline struck the United States and the global economy.

The drivers have also included, in addition to these quantitative indicators, important qualitative, institutional changes, for example: pervasive privatization of state-owned enterprises that formerly dominated and burdened the Chinese economy; vigorously competitive domestic markets, including sometimes excessively volatile and speculative asset markets; emergent attention to more effective corporate governance; and serious if imperfectly effective efforts to combat corruption.[7]

These multiple drivers have made China the world's second-largest economy in 2010, ahead of Japan. This place change is based on current market-exchange rates. China's GDP had already exceeded that of Japan in 2009 according to purchasing-power-parity (PPP) rates.[8]

As its economy has grown, China has accumulated the world's largest holdings of foreign exchange reserves, currently more than $2.1 trillion, one-third larger than those of Japan.[9] Held jointly by China's central bank (the People's Bank of China), the State Administration for Foreign Exchange (SAFE), and the State Assets Board (SAB), these resources enable China to expand its foreign investments by acquiring companies and other assets abroad.

China's past and continuing accumulation of foreign exchange reserves reflects perennial surpluses on its global current accounts, including its bilateral surpluses with the United States; the latter constitute about two-thirds of the former. Until recently, these current account surpluses have consisted mainly of China's trade surpluses: the excess of China's exports of goods and services over its imports. However, the composition of China's large current account surpluses has been changing. In the first five years of the 21st century, China's global trade surpluses constituted 85–90 percent of its total current account surpluses. In 2008 and 2009, the trade component has shrunk to less than 65 percent of China's global current account surplus, with the remainder consisting mainly of earnings from its accumulated foreign investments in Europe, Asia, Australia, and the

7 See, for example, William H. Overholt, *The Rise of China: How Economic Reform Is Creating a New Superpower,* London and New York: W. W. Norton & Company, Inc., 1993; Huang, op.cit., 2003.

8 World Bank, *World Bank Indicators Database,* September 15, 2009a; World Bank, *World Bank Indicators Database,* October 7, 2009b.

9 To see how the author arrived at these estimates, see footnote 18 below.

U.S. as described in section IV below, as well as remittances from Chinese residents abroad.

The significance of this change lies in the fact that China has come to rely more on net earnings from its foreign investments (over and above earnings accruing to foreign investors in China) and somewhat less on its trade balance. In turn, increasing reliance on the returns from its foreign investments is likely to focus the attention of China's investors on acquiring assets whose particular attractiveness lies in their current and expected rates of return. This focus is likely to continue in the future and to grow as China devotes more resources and more policy attention to its foreign investments. In turn, the earnings from its continued cross-border acquisitions are likely to provide a principal source of funding for further investments. This recent and prospective synergy is an important facet of emergent global finance.

In bilateral transactions with the United States, as distinct from its global transactions, China's trade surplus has decreased since 2008, mainly as a consequence of the sharp U.S. recession. But the bilateral trade balance still represents about one-third of the reduced U.S. annual trade deficit of about $550 billion (down by more than 20 percent from pre-recession levels), and a somewhat larger fraction of the U.S. annual current account deficit of about $400 billion. The difference in China's shares of the respective balances reflects China's increased earnings from its prior foreign investments, including its large holdings of U.S. Treasury bonds and other government obligations. These holdings, amounting to approximately $1.5 trillion, generate earnings between $45 billion and $50 billion annually, comprising a large component of China's bilateral current account surplus with the United States.[10]

The increased importance in China's international accounts of its net earnings from foreign investments—including investments in U.S. government obligations—has been somewhat obscured by misinformed criticism of China's alleged "manipulation" of the yuan's exchange peg to the U.S. dollar. The criticism is based on a mistaken premise that China's trade and current account imbalances with the United States result from China's failure to let the yuan appreciate relative to the dollar. According to this argument, instead of the prevailing rate of about 6.7 yuan per dollar, the "true" exchange

[10] "Trade, Exchange Rates, Budget Balances, and Interest Rates," *The Economist,* April 17, 2010, p. 106.

value of the yuan would be considerably higher, perhaps 4 or 5 yuan per dollar (that is, 1 yuan would be worth 20–25 U.S. cents, rather than 15 cents at its current pegged rate to the dollar), thereby tending to increase China's imports from and reduce its exports to the United States.

The criticism is mistaken. As long as China's aggregate, unprecedentedly-high domestic savings rate substantially exceeds its domestic investment rate (recall my earlier discussion of the drivers of China's economic growth), China will maintain a surplus in its global accounts. Regardless of the short-term, transitory effects of changes in the yuan-dollar exchange rate, China's bilateral accounts with the United States will continue to show surpluses reflecting well-established bilateral trade connections between U.S. and Chinese firms, as well as joint ventures between them.[11]

Appreciation of the yuan would, in the short-run, lower the RMB prices of U.S. exports to China, and raise the dollar prices of U.S. imports from China, thereby tending to boost U.S. exports to China, and lower U.S. imports from China. But, as long as the roughly 10% gap between China's huge domestic savings rate and its domestic investment rate remains, these price adjustments will be transitory. They will be quickly offset by subsequent upward adjustments in Chinese prices of its imports from the U.S., and downward adjustments in U.S. prices of imports from China.[12] For the respective imbalances to change in a durable way, China has to reduce its savings (i.e., boost domestic consumption), and the U.S. has to increase its savings. Exchange rate tinkering doesn't accomplish this!

Another facet of the international economic and financial environment that affects China's foreign investments is the recent and perhaps growing controversy over possible diminution, or even replacement of the U.S. dollar's role as the principal global medium of exchange. Were this to happen, global demand for dollars would shrink, the dollar's exchange value would erode, and the value of China's holdings of dollar assets, including U.S. companies, would fall.

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[11] In theory, it would be possible for China to have surpluses in its global current accounts and deficits bilaterally with the United States. In practice, this is unlikely. Established trade linkages between China's exporting and importing firms and those in the United States— at least in the short to medium term—make it most likely that bilateral surpluses with the United States will continue to be a major component of China's continuing global current account surpluses.

[12] See Charles Wolf, Jr., "Chinese Fire Drill", International Economy, Summer, pp.34, 35. 2010

Numerous factors associated with the global financial crisis have contributed to this controversy. These include the $700 billion Troubled Assets Recovery Program, established to relieve the stressed balance sheets of major U.S. banks, and the large U.S. economic stimulus package in 2009.[13] The U.S. economy has received a much larger injection of liquidity through large U.S. budget deficits to finance domestic programs, bailouts of the automobile industry and the troubled U.S. banking system, and the "conservatorships" of near-bankrupted, government sponsored enterprises (i.e., Fannie Mae and Freddie Mac).

The resulting surge of U.S. federal debt and the expansion of the U.S. money supply have heightened international concerns about the future stability of the dollar and its reliability as the principal medium of international exchange. This in turn has led China and some other countries to argue that currencies other than the dollar, or a mixed basket of currencies, or the SDR used as an accounting standard by the IMF, or the Chinese yuan itself should be considered as replacements for the dollar.

Such reforms in the international financial environment are unlikely in the foreseeable future. The yuan's prospects as a medium of international exchange are remote as long as the yuan remains incompletely convertible. Although China has indicated some willingness to allow the RMB's dollar peg to fluctuate within a narrow band, policymakers have repeatedly stipulated that capital transactions are unlikely to be fully convertible for the indefinite future. As concerns SDRs, they are likely to remain limited to their function as an accounting device rather than an international medium of exchange. Even in this role, SDRs are subject to periodic changes in the weighting of the component currencies (i.e., dollars, yen, euros, sterling) as their respective shares of international trade change.

Nevertheless, in the medium to longer term, maintenance of the dollar's central role in international finance may be open to question and challenge. How the challenge is met will depend on various factors, including, especially, the maintenance of open rather than protectionist U.S. trade policies, effective management of the swollen U.S. federal

[13] At $787 billion, the U.S. stimulus package was, in relative terms, less than half the share of U.S. GDP that China's own stimulus package was of its GDP: 6 percent and 14 percent, of the respective GDPs.

debt, and whether this management averts serious inflation and serious depreciation of the U.S. dollar during the next few years.

III---China's Recent and Prospective Foreign Investments

China's foreign investment strategy is distinctive, selective, and flexible.

It is **distinctive** in that it reflects both the salient needs of the Chinese economy, as well as the government's policy priorities. The central government's distinctive role is a consequence of the fact that major capital transactions require the approval of SAB and SAFE, which are accountable to the State Council.

That China's strategy is **selective** is evident from the conspicuous differences between China's investments in different regions and countries, for example, in its investments in Europe, Asia, Australia, the U.S., and the rest of the world, during the 2007–2009 period.[14]

The strategy's **flexibility** is suggested by recent policy pronouncements of Prime Minister Wen Jiabao and Minister of Commerce Chen Deming. Both leaders expressed their encouragement for expanded investment abroad, especially by China's most "capable" companies. A notable outlier in the flexibility domain is a recent expression of Chinese interest in acquiring a substantial ownership portion of the Cleveland Cavaliers basketball team.[15]

Global Distribution of China's Cross-Border Investments

In recent years, a modest but expanding share of China's annual current account surpluses have been devoted to acquisitions of companies in Europe, Asia, the rest of the world (ROW), and in the U.S.. These investments have usually sought and achieved full ownership of the targeted companies. In some instances, China's investments have instead taken the form of acquiring minority equity holdings in foreign companies, rather than ownership. From China's perspective, the latter appears to be distinctly preferable whenever the option is available.

Before turning to the details of China's global investments, a brief comment is in order concerning data sources. The data used in this paper are drawn from two different sources, one of which is more reliable and the other more comprehensive and complete.

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[14] This period is of particular interest because China's foreign investments rose substantially above the levels in earlier years and did so notwithstanding the financial crisis that struck most severely in 2008. China's global investments in 2007 and 2008 increased threefold above their levels in 2005 and 2006.

[15] Chen Deming, *Wall Street Journal,* April 27, 2009; *Business Daily,* update, December 16, 2009.

The more reliable data come from a single, publicly available source, the Mergerstat data base. The more comprehensive data are drawn from several different component sources, including press reports in China, the U.S., and Japan, in addition to Mergerstat. The sources used are cited in each of the Tables 3.1-3.5. In some instances, the data I've used cover the 2007- 2009 period, in others they extend through 2010.

Between 2007 and the first-half of 2010, China's global acquisitions included ownership or equity stakes in more than 386 companies.[16] Its acquisitions in this period amounted to $83.7 billion, principally located in Europe ($28.4 B.), Asia, excluding mainland China ($24.4 B), North America excluding U.S. ($12.2 B), Africa ($4.6 B, Australia ($10.4 B), and the U.S. ($1.4). The largest discrepancy between these regional figures derived from the Mergerstat data base, and the disaggregated data shown in the later tables occurs for China's acquisitions in the U.S. the more complete inventory of U.S. acquisitions shown in Table 3.2 shows a figure of $25.9 billion.

Table 3.1 shows the regional distribution of China's annual acquisitions for the 2007-2010 period.

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[16] Of the 383 companies acquired, several are pending, but not yet been concluded. The Mergerstat data base provides detailed information on mergers, acquisitions and divestitures that are publicly announced. The data are compiled from reliable sources, but do not include deals made that are not matters of public record. For example, according to a credible Japanese report: "Two investment funds, believed to be Chinese, have become major shareholders…in at least 34 Japanese companies", with a total investment of $6.2 billion. These holdings are not reported in the Mergerstat data base. (See *Asahi Shimbun*, August 23, 2010). Several likely and recently concluded Chinese acquisitions in gas exploration and mining in Iran are also omitted from this data base, (citation TBA).

Table 3.1

Regional Distribution of China's Acquisitions of Foreign Companies

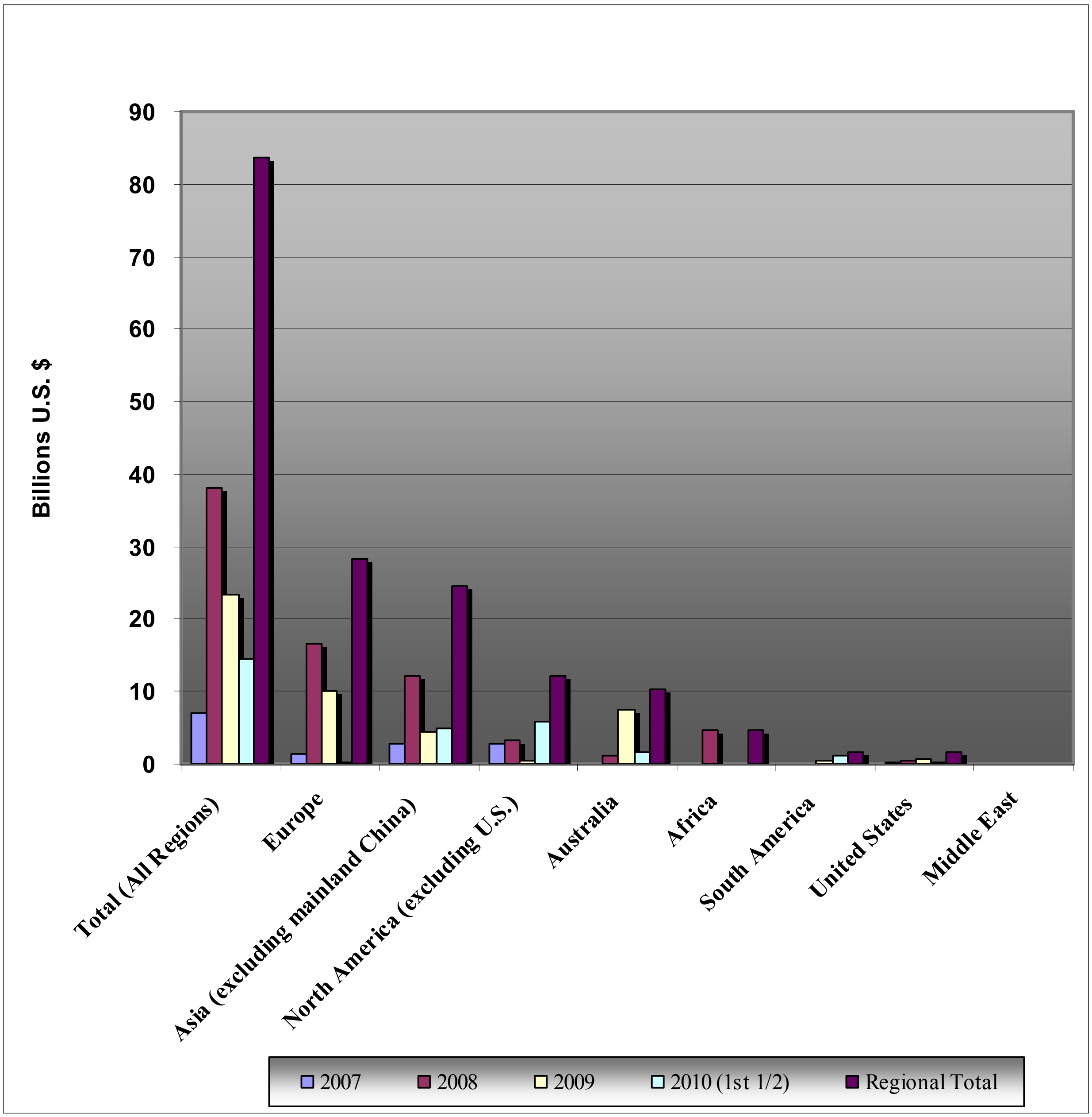
In Billions U.S. $

	2007	2008	2009	2010 (1st ½)	Regional Total
Africa		**$4.6**	**$0.01**		**$4.61**
Asia (excluding mainland China)	**$2.7**	**$12.2**	**$4.5**	**$5.0**	**$24.43**
Australia	**$0.03**	**$1.1**	**$7.5**	**$1.7**	**$10.37**
Europe	**$1.4**	**$16.7**	**$10.0**	**$0.31**	**$28.4**
Middle East				**$0.11**	**$0.11**
North America (excluding United States)	**$2.74**	**$3.16**	**$0.39**	**$5.9**	**$12.19**
South America			**$0.40**	**$1.20**	**$1.6**
United States	**$0.20**	**$0.43**	**$0.60**	**$0.34**	**$1.57**
Total (All Regions)	**$7.08**	**$38.19**	**$23.40**	**$14.56**	**$83.68**

Source: FactSet Mergerstat, 2010.

Figure 3.1 displays the same data as in Table 3.1 on the premise that a picture is more transparent than a table with many numbers.

Figure 3.1 Regional Distribution of China's Acquisitions of Foreign Companies



China's Investments in the United States, 2007–2009

Notwithstanding frequent Chinese criticism of mounting U.S. budget deficits and the jeopardy this creates for the stability of the U.S. dollar in international markets,[17] China's investments in the United States have continued to be predominantly in U.S. Treasury notes and bills and other U.S. government obligations. China's accumulation of these U.S. government assets by the middle of 2009 reached more than $1.5 trillion. Nearly one-third of these holdings—about $450 billion—were accumulated from 2007 through the middle of 2009.[18] China's concerns about the stability of the dollar are understandable in light of the size of these dollar holdings and of prospective additions to them.

China's new investments in U.S.-based companies during the 2007–2009 period reached $25.8 billion, about 5.7 percent of China's investments in U.S. government obligations during the same period. The largest share of investments in U.S. companies was in banking and financial services (78 percent), with the remainder divided among refineries, semiconductors, telecommunications, laboratory testing equipment, auto parts, and miscellaneous other industries.

Table 3.2 summarizes China's investments in the United States by buyer, seller, and industrial sector. As the table shows, investments by Chinese companies, as well as by China's sovereign wealth fund—the China Investment Corporation—and other quasi-governmental organizations, such as SAFE and the China International Trust and Development Corporation (CITIC), were concentrated in U.S. financial and business services industries. Although the scale of these investments ($25.8 billion over the 2007–2009 period) is small relative to China's investments in U.S. government obligations over the same period, the reasons for concentration in the financial and business sector

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17 See Xinhua Economic News Service, July 22, 2009.

18 Author's estimates based on the following parameters: China's annualized current account surplus in 2007–2009 (first two quarters) = $300 billion/year; 60 percent of this surplus is assumed to be invested in U.S. government obligations = $180 billion/year (although the actual proportion is probably 70 percent, we assume 60 percent in preference for erring on the low side). Hence, for the 2007–2009 period: $180 billion/year × 2.5 years = $450 billion (China's estimated investments in U.S. government obligations); $120 billion/year × 2.5 years) = $300 billion (China's estimated investments in other assets in the United States, Europe, Asia, and the rest of the world). Assuming that its holdings of U.S. government obligations represent 60 percent of China's total foreign exchange reserves, the latter is estimated as $2.1 trillion ($1.5 (1.4)).

investments seem compelling from China's point of view. These reasons included the following: (1) A reasonable, although mistaken, expectation of high rates of return on investments in these sectors; (2) the dismissive legacy of the CNOOC case in 2005, which tended to discourage investments in high-technology companies that China might otherwise have been interested in acquiring; and (3) the plausible expectation by China's policymakers that acquisitions in finance and business services would provide a unique opportunity for Chinese companies to learn about and to access a broad range of companies throughout the U.S. economy.

That such broad policy considerations are important both in affecting and in analyzing the strategies motivating China's foreign investments in the United States and elsewhere follows from certain special circumstances relating to foreign investment by China. Salient among them is the fact that, since the Chinese yuan is not freely convertible in capital transactions, investment by corporate or individual Chinese investors requires approval by SAB and SAFE. Inasmuch as these bodies are accountable to the State Council, the latter's imprimatur is essential, even if often tacit, for foreign investments to be accomplished by any Chinese entity.

Table 3.2
China's Investments in U.S. Companies, 2007-2009: Buyers, Sellers, and Industries

Year	Buyer	Seller	Industry	Investment ($ billions)
2007	Husky Industries	Lima Refinery	Oil and gas field services	1.9
	CITIC	Delta Tech Controls	Electronic components	.01
	CIC	Blackstone (12.5%)	Miscellaneous investment	4.0
	CIC	Morgan Stanley (7.6%)	Miscellaneous business services	5.6
Total				11.5
2008	Husky Inc.	Toledo Refinery	Oil and gas services	2.5
	Mindray Medical	Datascope Corporation	Electromedical equipment	.2
	Grace Semiconductors	STM Microelectronics	Electronic components	Not disclosed[a]
	CITIC	CMTEL	Telecommunications equipment	0.3
	Wuxi Pharmatech	AppTec Lab Services	Testing laboratories	.15
	Spreadtrum Communications	Quorum Systems	Semiconductors	.01
	CIC	Visa (<1%)	Business services	.1
	China Life	Visa (1%)	Business services	.3
	CIC	JC Flowers	Miscellaneous investment	4.0
	SAFE	Texas pacific Fund	Miscellaneous investment	5.6
Total				12.9
2009	Beijing West Ind.	Delphi Auto Parts	Motor vehicles and parts	.1
	Airtime DSL	TAG Industries	Lighting equipment	.03
	Qiaoxing Group	Freescale Semiconductors	Communications equipment	.1
	CIC	Morgan Stanley (2%)	Business services	1.2
Total				1.43

SOURCES: Mergerstat; various reports in Xinhua, *Financial Times,* Reuters, *Wall Street Journal,* and other Chinese and U.S. press releases.
NOTES: Percentages shown in parentheses under the column labeled "Seller" indicate the ownership stake acquired by the buyer. The absence of percentages implies 100 percent acquisition.
[a] The value of the Grace investment is omitted from the accessible data sources.

Table 3.2 also shows that China's investments in U.S. companies in 2009 declined sharply from those in the two preceding years. This is a consequence of both the deep recession in the U.S. economy as well as the large losses experienced in the market values of China's U.S. investments that were made in 2007 and 2008.

I expect the scale of China's investments in U.S. companies to rise again in the next few years and the prior pattern of investment concentration in the financial and business services sectors to shift.

The reasons for this expectation include China's continuing current account surpluses, emergent opportunities for acquiring a wide range of U.S. companies as a result of their depressed valuations, a growing and probably warranted belief that the CNOOC legacy of U.S. rejection of Chinese investment in 2005 has attenuated since then. Consequently, receptivity in the United States to acquisitions by financially capable Chinese investors may be higher than in prior years.

These reasons are reflected in a recent pronouncement by China's Minister of Commerce and member of the State Council, Chen Deming, of a new policy of encouraging "capable" Chinese companies to invest in the United States and other countries.[19] In this context, the term "capable" encompasses the resources, experience, economic, and political connections of Chinese investors presumed to be capable and whose transit through the SAB and SAFE channels is therefore likely to be relatively smooth and quick. Prime Minister Wen Jiabao recently endorsed and amplified this stance, stating his general expectation that China's investments in foreign enterprises will grow in coming years.[20]

To further highlight the distinctiveness of China's investments, Table 3.3 uses as a very rough standard for comparison the pooled investments of five of the largest and most experienced private equity firms: Carlyle Group, Blackstone, Cerberus, KKR, and Berkshire Hathaway.[21] Using the PE firms as a standard is admittedly a stretch because

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[19] Chen Deming, 2009

[20] *Financial Times,* "We should hasten the implementation of our 'Going Out' Strategy and combine the utilization of foreign exchange reserves with the 'Going Out' of our enterprises," July 22, 2009c. In the context of Premier Wen's remarks, "going out" essentially means that an undisclosed but substantial amount of additional foreign exchange will be available for Chinese companies to use in pursuing foreign acquisitions.

[21] Berkshire Hathaway is a public company, but its major investment activities, using funds from its insurance business as well as from Berkshire shareholders, are close counterparts to those of the private equity companies in the pooled data set.

the business models guiding the investments of these firms differ from those that can be presumed to influence China's investments. PE firms generally have a short- to medium-term investment horizon with a view to a profit-yielding exit within two to five years, whereas Chinese investors may have a longer-term horizon with no obligation to exit in a defined period. Also, PE firms typically have (or believe they have) expert knowledge of the markets in which they are investing, whereas Chinese investors may have more limited market knowledge. Moreover, the objectives of Chinese investors---including those that are state-owned or formerly state-owned---encompass broader considerations and a wider set of national interests, including national security interests, that extend beyond ROI. Consequently, for these and other reasons, we would expect the investment patterns and portfolios of Chinese and PE investment to differ.

Nevertheless, the comparison is of interest for two reasons; first because the top quality PE firms are usually considered to have smart, flexible, and adroit investment managers, and hence perhaps to be a good example to follow, and second because the comparison serves to highlight the composition and magnitude of the differences between China's investments and those of PE firms.

Table 3.3 shows the top eight Standard Industrial Code (SIC) sectors of the pooled five PE firms constituting almost all (99 percent) of their total investments in U.S. companies ($102.2 billion) during the 2007–2009 period.

Table 3.3
Private Equity Investments in U.S. Companies, 2007-2009:
Industries and Investments of Five PE Firms

Industry	SIC	Investment ($ billions)
Hotels and motels	701	$39.9
Real estate investment trusts	670	$19.3
Construction materials	171-177	$10.3
Motor vehicles and car bodies	371	$7.4
Packaged frozen foods	519	$7.2
Management consulting services	874	$7.0
Motor vehicle parts and accessories	501	$5.6
Skilled nursing care facilities	805	$4.9
Total		$101.6

SOURCES: Mergerstat; company and trade association reports.
NOTE : Data are pooled for Carlyle, Blackstone, Kohlberg-Kravis-Roberts (KKR), Cerberus, and Berkshire Hathaway, covering the combined 2007– 2009 period.

The contrasts with China's investments shown in the preceding Table 3.2 are evident.

1. China's U.S. investments are dominated by acquisitions in finance and business services, whereas the PE firms' investments in these sectors are negligible—indeed, as indicated in Table 4.1, several of China's largest U.S. investments were in the financial services firms themselves (e.g., Blackstone, Morgan Stanley).
2. China's U.S. investments also show interest in selective high technology companies, such as laboratories and testing facilities, telecommunications, and semiconductors; whereas the PE firms main investments avoid these sectors.
3. The PE firms' U.S. investments in the 2007–2009 period concentrated on hotels and motels, real estate, construction, and motor vehicles—none of which figure prominently among China's U.S. investments (see Table 3.2).

That the portfolio of China's investments in U.S. companies differs from those of private equity firms is unsurprising in light of their differing objectives and business models, as noted earlier. The industry and sectoral differences are both informative and not easily inferable from the prior discussion of their presumptively differing objectives.

However, to test the extent of the differences, I use a simple statistical comparison between the industrial sectors encompassed by China's acquisitions shown in Table 3.2, and those encompassed by the PE firms' acquisitions shown in Table 3.3. Using the SIC numerical designations of the respective acquisitions, the null hypothesis is that China's acquisitions do **not** differ from those of the PE firms. Based on a simple χ-square test, the hypothesis cannot be rejected. [22] Granted that the data are sparse and the test is

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[22] The test uses the SIC numbers of the specific sectoral acquisitions in Tables 3.1 and 3.2. Two among the 18 SIC categories covered in the tables are shared by the pooled PE firms' and Chinese portfolios shown in the tables, whereas the total number of SIC 3-digit sectors is more than 400. Using the χ-square test for the independence of the two sets of acquisitions, the hypothesis that the two sets do not differ cannot be rejected; the result is statistically significant at a 1-percent level. Stated another way, if one thinks of the universe of possible 3-digit SICs that either China or the PE firms could invest in, then the existence of a PE acquisition in any single SIC category is a statistically significant predictor of a category that would be likely to receive investment by China. In other words, while most of the 400 SIC 3-digit

unduly simplified (e.g., the respective acquisitions haven't been weighted by their corresponding values; also, use of 4-digit SIC designations might well alter the outcome), the result is at least of passing interest.

China's Investments in Europe, 2007–2009

In the 2007-2009 period, China's acquisitions in Europe (Table 3.4) were concentrated in two sectors: financial and banking services, and oil and gas. Investments in the oil and gas sector have mainly involved acquiring minority shares in some of the world's largest multinational oil and gas producers, specifically BP and Total.[23] In 2009 and the 1st half of 2010, China's acquisitions in Europe began to shift, moving toward more diversified and technical services: notably, communication services, information retrieval, engineering services, semi-conductors, and internal combustion engines.[24]

China's acquisitions of companies in Asia, Australia, and the rest of the world in this period show a distinctly different pattern from its acquisitions in Europe and the United States. In the Asian and ROW areas, the focus has been on resource industries, notably oil, gas, copper, iron, lead, zinc, and rare earths.[25] It's also worth noting that the reported acquisitions do not include large scale lending (i.e., $35 billion) by Chinese financial institutions to resource industries in Brazil and Singapore, as well as long-term procurement contracts in Iran ad Libya for oil and gas and other resources. Some of these loan and procurement transactions may lead to or be converted into equity acquisitions in the coming years.[26]

The data on China's company acquisitions in Europe during 2007-2009 are summarized in Table 3.4.

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categories have zero investments by both Chinese and PE investors, the fact that PE and Chinese investors chose two of the same SICs for their investments is greater than would be expected by chance.

23 See below, Table 3.5. Also, see Wolf, Chow, et al, *China's Foreign Investments: Costs and Risks, Benefits and Opportunities, MG-968, (forthcoming, 2010, Chapter Three.)*

24 The SIC numbers associated with these acquisitions are: communication services—(489); informational retrieval—(737); engineering services—(871); semi-conductors—(381); internal combustion engines—(501).

25 The SIC numbers associated with these acquisitions are: oil and gas---(131); copper(102,iron (101), lead (103), and zinc (103).

26 In 2008, PetroBraz borrowed $10 billion from China Development Bank and Sinopec. In 2009, a consortium of Chinese lenders (including CDB, China's Export-Import Bank, Sinopec, and CNPC) made loans of $25 billion to Russia and Central Asia for oil and gas development. Some of these loans may lead to or be converted to equity holdings in the future, again reflecting the high priority China accords to resource acquisitions.

Table 3.4
China's Investments in European Companies, 2007-2009: Buyers, Sellers, Industries

Year	Buyer	Seller	Industry	Investment ($ billions)
2007	**China Development Bank**	**Barclays (3%)**	**Miscellaneous investments**	**3.0**
	Ping'an Bank	**Fortis (4.2%)**	**Commercial banks and life insurance**	**2.7**
	ICBC	**ICBC Asia (8.2%)**	**Foreign bank and branches**	**.25**
Total				**5.9**
2008	**SAFE**	**Total (1.6%)**	**Crude oil and gas**	**2.8**
	SAFE	**BP (1%)**	**Crude oil and gas**	**2.0**
	CNOOC	**Norwegian Awilco**	**Oil and gas services**	**2.5**
	Bank of China	**Swiss Heritage Fund**	**Miscellaneous investments**	**8.7**
Total				**16.0**
2009	**SAFE**	**Total (1.6%)**	**Crude oil and gas**	**.7**

SOURCES: Chinese and European press releases, Mergerstat.

NOTES: The figures in parentheses are the shares of ownership acquired by China's investments. The absence of percentages implies 100 percent acquisition. The estimate of 2009 SAFE additional investment in the Total is the authors' estimate based on prorating small addition to ownership share according to the cost/share ratio of acquisition in 2008. Investment totals may not sum exactly because of rounding.

As Table 3.4 indicates, China's investments in Europe have been concentrated in two sectors: oil and gas, and financial and banking services. The focus on oil and gas reflects the priority accorded to resource security by China's policymakers—a theme that predominates in China's investments in Asia and the rest of the world, and will be discussed later.

In the European context, the oil and gas priority takes the form of acquiring minority shares in some of the world's largest global multinational producers—specifically, BP and Total. For China's investments in Asia and the rest of the world, this priority leads to investments aimed at acquiring either full ownership or at least a substantial equity share.

The factors explaining China's European investments in financial and banking services are similar to the ones mentioned above as motivating China's investments in the same sectors in the United States. These factors include learning about and gaining access to a wide spectrum of European companies and industrial sectors through the lending and securities transactions of financial and banking services companies. That said, there are reasons for expecting both the magnitude and the sectoral acquisitions of China's future investments in European companies to expand and to widen, respectively.

Expanded investments in Europe are a likely consequence of the continuing large current account surpluses of the Chinese economy, as discussed earlier. The broadened scope of investments may be affected as well by China's anticipation that acquisitions aiming at high technology companies and sectors may encounter less sensitivity and resistance in Europe than similarly targeted acquisitions would encounter in the United States. Quite apart from the sensitivity issue, China's bids and efforts in Europe may have a galvanizing competitive effect on possible mergers and acquisitions in the United States, and the converse may also be true. European and U.S. companies in similar fields may seek, as well as be sought by, infusions of capital from China.

Evidence of a prospectively broadened span of China's sectoral investments in Europe is provided by recent European visits of several large, financially well-equipped Chinese commercial delegations.[27] The delegations' explicit and linked purposes were to identify opportunities for both procurement and investment in telecommunications equipment, electronics, energy-saving technology, pharmaceuticals, automobiles, trains, and machinery. In the midst of depressed economic conditions in Europe, linking procurement contracts in the short run with investment acquisitions thereafter may be a particularly effective stratagem for China.

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[27] Joe McDonald, "Chinese Go to Europe with $15 Billion to Spend," PharmPro.com, February 24, 2009; "China, Germany Sign $14 B in Trade Deals," *China Daily*, February 26, 2009; and "2nd Chinese Shopping Delegation Leaves for Europe," *China Daily*, March 8, 2009.

China's Investments in Asia and the Rest of the World (ROW)

China's principal investments in Asia and the (ROW) are summarized in Table 3.5.

Table 3.5
China's Investments in Asia and the Rest of World, 2007–2009: Buyers, Sellers, and Industries

Year	Buyer	Seller	Industry	Investment ($ billions)
2007	China Mobile	Paktel	Telecommunications	.46
	Chinalco	Peru Copper	Copper ores	.79
	Sinopec	Iranian National	Oil and gas	2.0
	Haier	Thailand Refrigerator	Appliances	.02
	Haier	India Refrigerator.	Appliances	Not disclosed
	ICBC	Seng Heng Bank (Macao) (80%)	Foreign banks	.59
	ICBC	South Africa Standard (20%)	Foreign banks	5.0
	ICBC	Thai ACL Bank (19%)	Foreign banks	.03
	China Development Bank	PakChina Investment Corporation	Miscellaneous investments	.1
Total				$10.0
2008	Chinalco	Toromach Copper Mine	Copper ores	2.16
	Xinxing and China Metal	Indian JV	Metal mining services	1.2
	Suntech Power	Japan MSK Solar (33%)	Miscellaneous electricity machinery	.1
	China Aluminum International Engineering	Vietnam bauxite mine	Miscellaneous metal ores	.47
	Shanghai Automotive	Sangyong Automotive (2.1%)	Motor vehicles	.05
	China Merchant Bank	HK Wing Lung Bank (53.1%)	Foreign banking services	2.5
Total				$6.5
2009	China MinMetals	OZ Metals (Australia)	Copper, led, zinc, other ores	1.2
	CNPC	Singapore Petroleum Corporation (45.5%)	Oil and gas	1.0
	Hunan Valin	Fortescue (17%)	Iron ores	.46
	Haier	Prachin Buri Refrigerator.Thailand	Appliances	.01
Total				2.67

NOTES: Percentages in parentheses refer to equity share acquired by China. The absence of percentages implies 100 percent acquisition. Data for 2009 cover only the first four months of the year. ICBC = Industrial and Commercial Bank of China. CNPC = China National Petroleum Corporation.
Data sources include company and press reports as well as Mergerstat.

As Table 3.5 indicates, these investments in Asia show a pattern that is markedly different from China's investments in the United States and Europe shown in Tables 3.2 and 3.4. In the 2007–2009 period, China focused its ROW investments on resource industries: oil, gas, copper, iron, lead, zinc, gold, and rare earths. Moreover, the resource focus reflected in Table 3.5 omits substantial (i.e., $35 billion) lending by Chinese financial institutions to resource industries in Brazil and Singapore, as well as additional long-term procurement contracts in Iran and Libya for oil and gas and other resources that might subsequently lead to or be converted into equity holdings.[28]

After engaging in numerous conversations with officials and scholars both in China and in the United States, I expect that China's emphasis in recent years on resource investments in the rest of the world is likely to continue. The obvious reason is China's continuing and growing demands for basic resources as a consequence of and contributor to sustaining high rates of GDP growth. As the global markets' second-largest importer of crude oil (after the United States and ahead of Japan), and the largest importer of copper, iron, and other ores, China's policymakers accord high priority to economic growth, which underlies their emphasis on investment acquisitions in these sectors.

It is not evident whether this policy is wise or optimal. Indeed, to reach a conclusion on this matter would require a combined assessment of economic, security, and political considerations that would require more time than can be devoted to it here. Several observations suggest the complexity that would be involved in reaching a conclusion about whether this policy is wise.

Whether investing in foreign resources is sensible policy for China depends on whether the future prices of those resources rise or fall relative to the prices of the product mix of other sectors in which China might invest. For example, whether downstream energy prices and, more specifically, the prices of oil and gas rise or fall relative to a broad market basket of goods and services will determine whether current investments in oil and gas production are optimal when compared with alternative investments that are forgone. On the one hand, rising global GDP will lead to increased

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28 In 2008, PetroBraz borrowed $10 billion from China Development Bank (CDB) and Sinopec. In 2009, a consortium of Chinese lenders—including CDB, China's Export-Import Bank, Sinopec, and CNPC—extended loans totaling $25 billion to Transneft and Rosneft (in Russia and Central Asia) for oil and gas development. China may well convert these loans into equity investments in the coming years.

demand for energy and hence to expected increases in the relative prices of energy-related resources. On the other hand, major efforts under way to develop alternative energy sources (e.g., not only through wind, solar, biomass, and nuclear sources, but perhaps through such advanced technologies as nanotechnology), as well as efforts to conserve energy and reduce carbon emissions, will tend to lower the same relative prices.

The security dimension of this assessment is no less complex. Whether ownership of resource-producing companies located abroad would place China in a more secure or more vulnerable position is also open to debate. Products that are homogeneous—such as oil, gas, and metal ores—command a single price in international markets, apart from differing transportation costs between points of origin and destination. If China draws on supplies from foreign companies it owns, other consuming countries can draw on remaining global supplies, with the diminished demand from China having less effect on prices than if China were a competing buyer.

The political dimension further complicates the assessment, as amply demonstrated by Chinalco's unsuccessful attempt to acquire a 20 percent ownership stake in Australia's Rio Tinto mining corporation.[29] Usually, a foreign investment transaction conducted with reasonable transparency, and voluntarily accepted by both parties to the transaction, can be presumed to redound to their mutual benefit. However, where national sensitivities are engaged, as in the Rio Tinto case, and in CNOOC's attempted acquisition of California's UNOCAL in 2005, the presumed mutual benefit can be replaced by mutual recriminations.[30]

In sum, it is arguable whether aggressive pursuit of what are intended by China to be resource-security acquisitions is a sensible or a misplaced part of China's foreign investment policy. In pursuing the argument, it's well to remember both my opening remarks about the frequency and gravity of economists' forecasting errors. At the same time, it's appropriate to acknowledge that, from China's point of view, taking

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[29] For an interesting comparative analysis of the contrasting policies of China's and Japan's concerns and policies relating to resource security, see Samuel Thawley, "Resource Security Policies of China and Japan: A Case Study of the Iron and Steel Sector," Santa Monica, Calif.: RAND Corporation, unpublished research.

[30] Although no less concerned with and dependent on imported sources of energy and metal ores, Japan's policies focus more on procurement contracts and project financing and less on foreign corporate acquisitions than do China's policies. Although no less concerned with and dependent on imported sources of energy and metal ores, Japan's policies focus more on procurement contracts and project financing and less on foreign corporate acquisitions than do China's policies, ibid.

precautionary measures relating to possibly higher relative commodity prices in the future and being subsequently proven wrong about this assumption, may be a lesser concern than being wrong about the possibility that future commodity prices will turn out to be lower than expected.

IV---Conclusion and Implications

In his opening remarks to launch the first U.S.-China strategic and economic dialogue on July 27, 2009, President Obama observed:

> The relationship between the United States and China will shape the 21st Century. . . . The United States and China share mutual interests. If we advance those interests through cooperation, our people will benefit. And the world will be better off, because our ability to partner with each other is a pre-requisite for progress on many of the most pressing global challenges.

In the evolving global economy, China's large and growing financial resources are propelled by having the world's largest trade balance and the largest current account balance—trends that are likely to continue, although they might diminish somewhat as well as fluctuate during the next half-dozen years. The result will increase China's influence in the global economy and strengthen its bargaining power in its quest for companies and resources abroad, including those in the United States. In commenting on the U.S.-China strategic and economic dialogue, two U.S. commentators not usually known for being particularly friendly toward China observed:

> a subtle shift in power between China and the United States, one in which the Chinese are showing a new assertiveness as they seek to protect their huge investment [in U.S. Government securities].[31]

As both a consequence of and a contributor to these trends, China's attempts to make additional investments in U.S., European, Asian, and Australian companies are likely to grow substantially in the coming years. Many, and indeed most, of these acquisitions will be mutually beneficial. Where they are not so construed, recipient countries can and should be able to undertake appropriate precautionary or mitigation efforts to avoid worrisome consequences.

From discussions I have had with government officials and scholars both in China and in the United States, it seems particularly worthwhile to recall and to invoke the principle of reciprocity in devising remedial or mitigation measures that will induce win-

31 See Mark Landler and David Sanger, "China Seeks Assurances That U.S. Will Cut Its Deficit," New York Times, July 29, 2009.

win outcomes while avoiding losses to either party. During the past two decades, China has acquired considerable experience in both encouraging and circumscribing foreign investment within China, including by U.S. investors. China's experience and practice has included restricting foreign equity investment to nonvoting "B" stock, constraining the proportion of ownership that foreign investors could acquire in Chinese companies, and limiting the number and size of foreign firms' financial platforms in China's capital markets. Reciprocity provides ample grounds for expecting cooperative and compliant response by China to U.S. formulation of creative mitigation plans to deal with any proposed acquisition of U.S. companies that may entail security risks.

I expect the number and scale of Chinese investments in U.S. companies, as well as companies in other regions, to rise in the next few years. I also expect the pattern of these expanded investments—while still including further investment in the financial and business services sectors—to shift toward other sectors. The reasons for this expected shift include the losses Chinese investors have thus far sustained from concentrating investments in the financial and business sectors, the newly emerging opportunities for acquiring a wide range of U.S. companies as a result of their depressed valuations, and a probably warranted belief by China's policymakers that U.S. receptivity to acquisitions by financially well-endowed Chinese investors may be somewhat higher than in prior years.

Turning to China's investments in Europe, the discussion in Section III of the paper shows that the pattern of these investments in 2007– 2009 exhibits concentration in two sectors: namely, oil and gas, and financial and business services. I expect that China's investments in Europe will continue in these two broad sectors, while expanding to certain other sectors as well. Expanded investments in Europe are a likely consequence of China's continued large current account surpluses, as discussed in Sections II and III. At the same time, I expect these expanded investments to aim at acquiring high-technology companies in Europe whose acquisition may encounter (or may be expected by China to encounter) less sensitivity and resistance than might similarly targeted acquisitions encounter in the United States. China's opportunity to benefit from market-based competition among companies located in Europe and the United States will be a prominent part of this process.

For this reason, it will be important for scholars, analysts and the international community writ large to try to be fully informed about emerging trends in China's foreign investments. Such awareness will be useful as an aid to better understanding of the compelling needs of China's domestic economy, as well as its expanding role in the international economic system.

A similar conclusion is warranted concerning China's investments in Asia and the rest of the world. As discussed in Section IV, China's investment focus in Asia and the rest of the world has been in resource industries—oil, gas, copper, iron, lead, zinc, gold, and rare earths. In turn, this focus on resource security is viewed within China as deriving from the high priority that China's policymakers accord to economic growth and its presumed requirement for secure supplies of critical materials. The validity of this policy is open to question, as is the issue of whether China's efforts to expand such investments in Asia and the rest of the world may indirectly benefit the United States and other major importers of these commodities.

In any event, more complete and current data and other information are clearly important from the standpoint of knowing whether and when a series of Chinese investments might lead to China's acquisition of quasi-monopoly power in controlling these resources. Such power might be exercised over valuable ores and other resources, which in turn might create vulnerabilities for other economies. The wider view recommended above suggest may help to anticipate and forestall such circumstances.

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