

**Preliminary draft – Not for quotation**

**CHINESE DIRECT INVESTMENT IN EUROPE: MOTIVES,  
STRATEGIES AND IMPLICATIONS<sup>1</sup>**

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## INTRODUCTION

China's success in attracting foreign direct investment (FDI) inflows has been well documented and the growing role of China in world trade in goods and services – driven in part by multinationals from neighbouring economies or from OECD countries – is now widely recognised. What is less apparent but with possibly greater long-term consequences for the competition faced by European firms is the growing *presence* of Chinese firms in Europe and in regions such as Africa where European firms have traditionally enjoyed a large share of the market. Although outward direct investment (ODI) is still very much a developed country phenomenon (with developing countries accounting for a mere 17 per cent of global flows), ODI from the South is gaining ground in industrial economies, with China ranking among the most active outward investors, together with India and Brazil (World Investment Report 2007).

In Europe, Chinese investors have been met on the one hand by economic nationalism (as had already been the case for Japanese and Korean firms in the past) and on the other by *ad hoc* initiatives and policies designed to attract them. This ambivalent stance suggests that the precise nature of these flows, as well as their impact, are still badly understood.

*Prima facie*, the rise of Chinese investment in Europe differs from earlier waves of investment from the United States and later from Japan. Many Chinese firms are going abroad to *become* globally competitive rather than to exploit advantages developed at home. In this respect, they may be deemed to be closer to Korean multinationals than to US or Japanese investors. Chinese ODI in Europe also differs, in terms of motives, from Chinese ODI in developing or emerging economies. While they seek to secure energy resources in Africa and Latin America, they are more likely to be market or strategic asset-seeking when they invest in Europe. This new paradigm of multinational enterprise raises the question of whether the economic impact on Europe will be deeper than that of American and Japanese investment.

The purpose of this paper is to investigate the motives and strategies behind the outward expansion of Chinese firms, with a particular focus on their direct investments into Europe. The first section provides an overview of Chinese involvement worldwide. It surveys the trends and patterns of Chinese ODI as well as the role of public policies. The next section focuses on Chinese ODI in Europe, highlighting its magnitude and empirical characteristics (in terms of sector, form of investment, etc.) as compared to Chinese ODI in other regions of the world. The emphasis is further placed on the drivers behind the expansion of Chinese firms into Europe. The third section assesses the performance of Chinese firms in Europe and suggests possible implications of the rising Chinese presence for European host countries as well as for China.

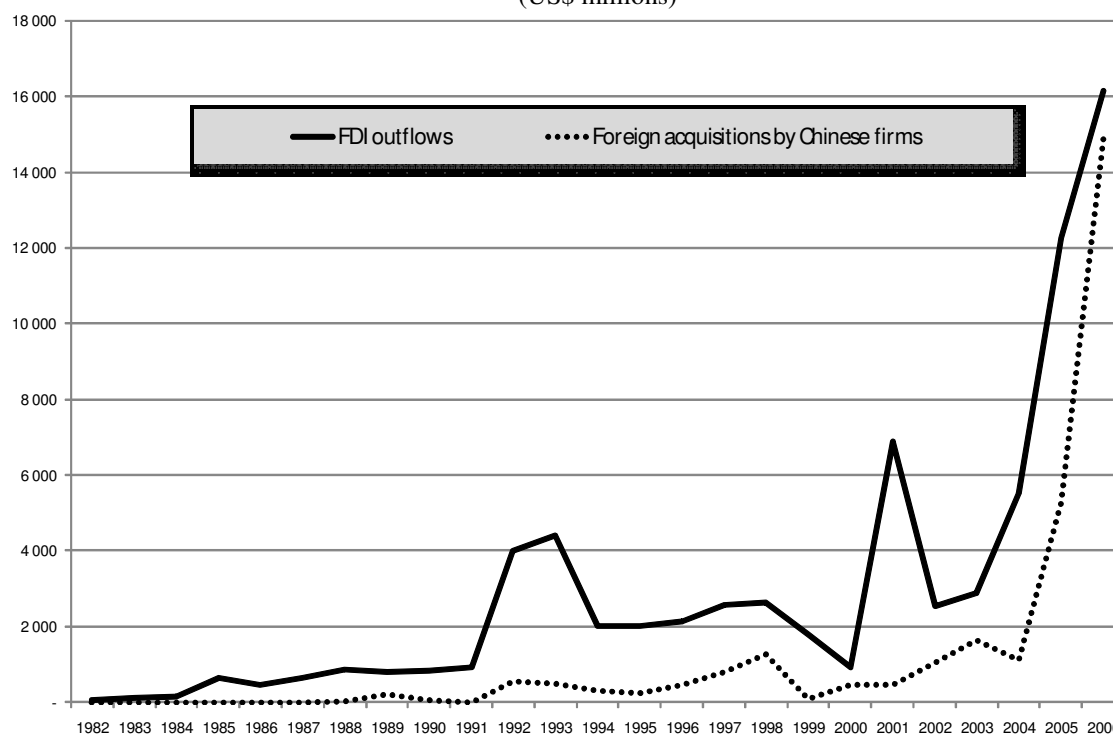
## I. AN OVERVIEW OF CHINA'S ODI

### Trends and patterns

#### *Dynamic but still modest*

Outflows of direct investment from China are growing rapidly by almost any absolute measure. Figure 1 shows both FDI outflows based on official Chinese statistics and cross-border acquisitions by Chinese firms recorded by UNCTAD. An estimate for 2007 shows Chinese FDI outflows exceeding US\$20 billion, making China one of the top 15 outward investors on an annual basis.<sup>4</sup> By the end of 2007, the cumulative ODI stock amounted to \$128 billion (\$94 billion for the non-financial sector), as more than 12,000 Chinese companies have engaged in ODI in 172 countries and regions – twice as many companies as a decade earlier.<sup>5</sup>

Figure 1. China's outward direct investment and cross-border acquisitions, 1982-2006  
(US\$ millions)



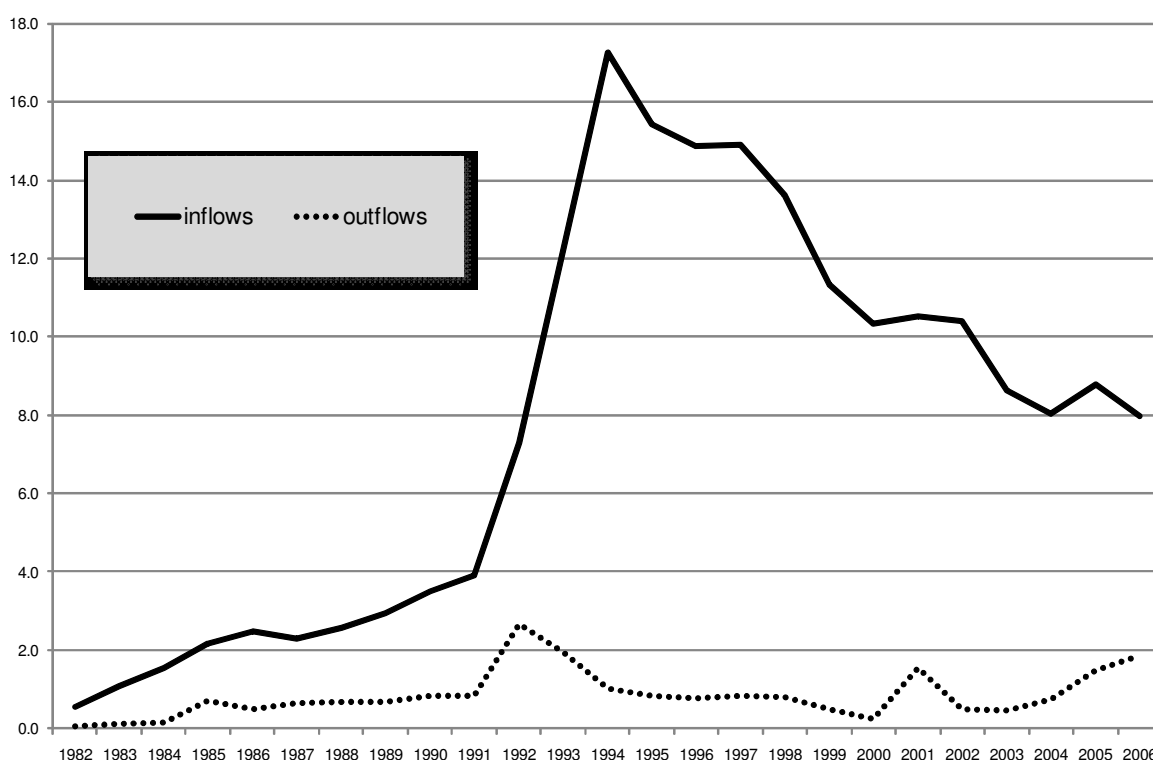
Source: UNCTAD, MOFCOM

But while direct investment abroad by Chinese firms is clearly accelerating, it is still small by any relative measure. China's direct outbound investment flows accounted for only 1.5 per cent of the world total in 2006 and lag behind not only many industrial economies but also some other emerging markets such as Russia and Brazil. Furthermore, no Chinese firm is among the 100 largest non-

financial MNEs (ranked by foreign assets)<sup>6</sup>, and only ten Chinese companies are among the 100 largest non-financial MNEs from developing countries.

Chinese ODI is also dwarfed by the amount of FDI that goes into China. Cumulative inward FDI exceeded US\$292 billion in 2006 and annual inward flows reached US\$70 billion that same year. Figure 2 shows inflows and outflows as a share of gross fixed capital formation in China. Liberalisation in the early 1990s led to a burst of ODI – as it did for inward investment – but within a decade outflows had reverted back to earlier levels as a share of domestic investment. The rapid, and largely sustained, increase in ODI as a share of total investment has arisen only since 2000 – in contrast to a steadily declining ratio of inward FDI to domestic investment as inflows have failed to keep up with the overall growth of the economy.

Figure 2. Chinese FDI inflows and outflows as a share of domestic investment



Source: UNCTAD

Compared with other home countries, China’s ODI is still extremely modest as a ratio of GDP, as reflected in the ODI performance index computed by UNCTAD<sup>7</sup>. According to this index, China invests abroad far less than what might be expected, given its economic size. With an index of 0.25, it ranked only 58<sup>th</sup> over the period 2004–2006, behind India. This suggests that there is ample scope for further growth in Chinese ODI. The Economist Intelligence Unit estimates that by 2011, China will be the ninth largest outward investor on an annual basis (US\$72 billion), roughly on a par with Switzerland and ahead of all Asian countries, including Japan.

This eagerness to invest abroad is corroborated by surveys of firms’ ODI intentions. McKinsey interviewed executives at 39 Chinese companies and found that 80 per cent claimed that globalisation was a strategic priority. Almost half of respondents wished for their companies to become true MNEs

within a decade. Over half said that M&As and alliances were at the heart of their internationalisation strategies.

### *Most Chinese ODI flows to Hong Kong and tax havens*

A clear picture of where Chinese firms are investing abroad is difficult to obtain (Box 1). Partly as a result of round-tripping and for other fiscal reasons, most Chinese ODI is officially reported to flow to Hong Kong and tax havens such as the British Virgin Islands and the Cayman Islands. As a result, Asia and Latin America rank as the largest destinations. Africa and Europe have each received a little over three per cent and North America only two per cent. By almost any measure, however, Europe does not loom large as a destination.<sup>8</sup> Among European countries, Russia looms particularly large, ahead of all other countries since 2003. Outflow data provide a similar picture, even if the share of Europe has grown slightly over time. Over one half of recent Chinese ODI to Europe has gone to Russia.

Table 1

#### **China's outward FDI stock by countries, 2003 - 2006 (non-finance part)**

<b>Country/Region</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
<b>TOTAL</b>	100,0	100,0	100,0	100,0
<b>Asia</b>	<b>80,1</b>	<b>74,8</b>	<b>71,6</b>	<b>63,9</b>
Hong Kong	74,1	67,9	63,8	56,3
Macau	1,3	1,4	1,0	0,8
Japan	0,3	0,3	0,3	0,3
South Korea	0,7	1,3	1,5	1,3
Indonesia	0,2	0,3	0,2	0,3
Malaysia	0,3	0,3	0,3	0,3
Singapore	0,5	0,5	0,6	0,6
Thailand	0,5	0,4	0,4	0,3
Vietnam	0,1	0,4	0,4	0,3
Mongolia	0,0	0,2	0,2	0,4
Iraq	1,3	1,0	0,8	0,6
<b>Africa</b>	<b>1,5</b>	<b>2,0</b>	<b>2,8</b>	<b>3,4</b>
<b>Europe</b>	<b>1,5</b>	<b>1,5</b>	<b>2,2</b>	<b>3,0</b>
Russia	0,2	0,3	0,8	1,2
<b>Latin America</b>	<b>13,9</b>	<b>18,5</b>	<b>20,0</b>	<b>26,3</b>
British Virgin Islan	1,6	2,4	3,5	6,3
Cayman Islands	11,1	14,9	15,6	18,9
<b>North America</b>	<b>1,7</b>	<b>2,0</b>	<b>2,2</b>	<b>2,1</b>
Bermuda	0,0	0,4	0,6	0,3
United States	1,5	1,5	1,4	1,6
<b>Oceania</b>	<b>1,4</b>	<b>1,2</b>	<b>1,1</b>	<b>1,3</b>

Source: MOFCOM

When Hong Kong and the tax havens are excluded from the calculations, the share of Asia drops but it is still the major destination of Chinese ODI (with over 40 per cent), ahead of Africa, Europe, North America, Oceania and Latin America (Table 2).

Table 2

**China's outward FDI stock by countries, 2003 - 2006 (non-finance part)**  
(excluding Hong Kong, British Virgin Islands and Cayman Islands)

<b>Country/Region</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Subtotal	100,0	100,0	100,0	100,0
<b>Asia</b>	<b>45,1</b>	<b>46,5</b>	<b>45,5</b>	<b>41,4</b>
Cambodia	1,4	1,4	0,8	0,8
Indonesia	1,2	1,8	1,4	1,6
Iraq	10,0	6,6	4,4	3,2
Japan	2,0	2,1	1,5	1,6
South Korea	5,4	8,5	9,0	6,9
Macau	10,2	9,4	6,1	4,4
Malaysia	2,3	1,9	1,9	1,4
Mongolia	0,3	1,1	1,3	2,3
Pakistan	0,6	0,5	1,9	1,1
Singapore	3,8	3,5	3,3	3,4
Thailand	3,5	2,7	2,2	1,7
UAE	0,7	0,7	1,5	1,0
Vietnam	0,7	2,4	2,3	1,8
<b>Africa</b>	<b>11,2</b>	<b>13,6</b>	<b>16,3</b>	<b>18,5</b>
<b>Europe</b>	<b>11,2</b>	<b>10,2</b>	<b>13,0</b>	<b>16,5</b>
Germany	1,9	1,9	2,7	3,4
Russia	1,4	1,9	4,8	6,7
United Kingdom	1,7	1,6	1,1	1,5
<b>Latin America</b>	<b>9,1</b>	<b>7,8</b>	<b>5,6</b>	<b>5,3</b>
<b>North America</b>	<b>12,6</b>	<b>13,7</b>	<b>12,9</b>	<b>11,5</b>
United States	11,5	10,0	8,4	9,0
<b>Oceania</b>	<b>10,8</b>	<b>8,2</b>	<b>6,6</b>	<b>6,8</b>

Source: MOFCOM

A similar picture emerges from a FIAS/MIGA survey of 132 Chinese firms with at least one overseas investment. The favoured destinations were East Asia (20% of total projects) and South and Southeast Asia (20%), followed by Africa (18%), North America (14%) and Western Europe (12%).<sup>9</sup> These shares are based on the number of projects rather than their value which gives greater weight to regional investments by Chinese firms which tend to be smaller but more numerous.

### Box 1. Measuring China's ODI

Idiosyncracies in the way ODI has been reported in China, together with the influence of fiscal policies on both inward and outward investment, make it difficult to measure accurately the magnitude of Chinese ODI.

On the one hand, official statistics on ODI have tended substantially to understate actual flows by including only overseas investment carried out by Chinese registered firms and not that which is channelled through entities registered offshore, such as in Hong Kong. Many large M&As undertaken by Chinese companies are financed outside China. Taking such unreported flows into account, actual Chinese ODI may be 50 per cent higher, according to a recent calculation by Deutsche Bank. In addition, investments not exceeding US\$350,000 are included in local and not in national statistics and, prior to 2003, investment financed by either debt or reinvested earnings of the subsidiary was not included in the figures for ODI. China has since adopted international standards in terms of ODI reporting.

On the other hand, some other factors point to overestimation of Chinese ODI. A fair share of Chinese ODI would qualify as portfolio investment in other economies, and part of these flows is thought to involve "round-tripping" whereby Chinese firms send capital to Hong Kong or elsewhere and then reinvest in China in order to benefit from the more favourable treatment accorded to foreign investors in China. This favourable treatment was ended recently.

### *Mostly in services and natural resources*

Chinese firms are investing in business activities, trade and mining, though the share of manufacturing has tended to rise over the past few years (Table 3). In terms of the stock of ODI by sector in 2006, 20 per cent was in mining and only 8 per cent in manufacturing. The rest was in the service sector: commercial services (22%), finance (17%), wholesale and retail (14%), transport and warehousing (8%) and other activities (8%). This suggests that a large share of Chinese ODI, outside of the natural resource sector, is currently designed to facilitate exports.

Table 3. Sectoral distribution of Chinese ODI stock, 2003–2006 (US\$ millions)

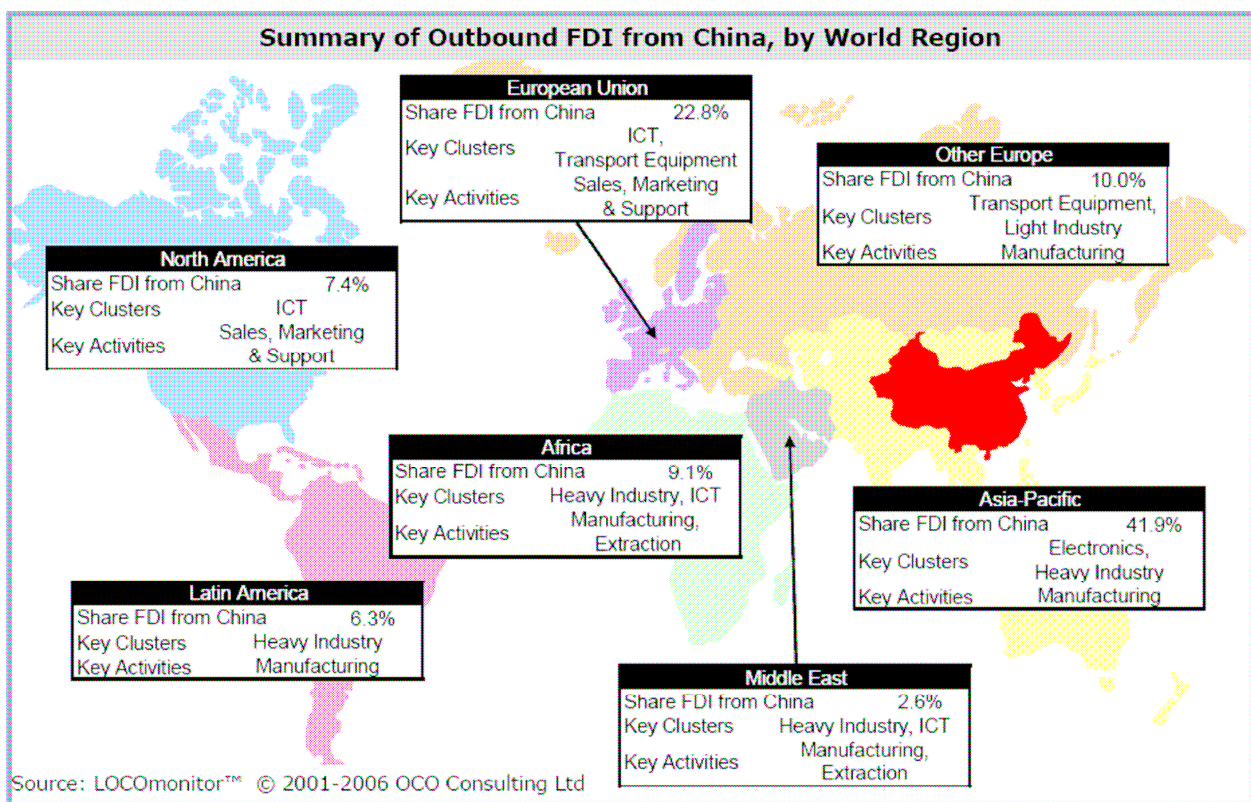
	2003		2004		2005		2006	
	Amount	%	Amount	%	Amount	%	Amount	%
<b>Primary sector</b>	<b>6 370</b>	<b>19.2</b>	<b>6 786</b>	<b>15.2</b>	<b>9 163</b>	<b>16</b>	<b>16 718</b>	<b>24.9</b>
Mining, quarrying & petroleum	5 900	17.8	5 951	13.3	8 652	15.1	17 902	23.9
<b>Secondary sector</b>	<b>2 070</b>	<b>6.2</b>	<b>4 538</b>	<b>10.1</b>	<b>5 770</b>	<b>10.1</b>	<b>7 530</b>	<b>10</b>
<b>Tertiary sector</b>	<b>24 782</b>	<b>74.6</b>	<b>33 454</b>	<b>74.7</b>	<b>42 272</b>	<b>73.9</b>	<b>48 778</b>	<b>65</b>
Lease & business services	2 070	6.2	16 428	36.7	16 554	28.9	19 464	25.9
Wholesale & retail	6 530	19.7	7 843	17.5	11 418	20	12 955	17.3
Transport & storage	2 020	6.0	4 581	10.2	7 083	12.4	7 568	10.1
<b>TOTAL</b>	<b>33 222</b>	<b>100</b>	<b>44 777</b>	<b>100</b>	<b>57 206</b>	<b>100</b>	<b>75 026</b>	<b>100</b>

Source: MOFCOM

*Different sectors are relatively more important in different regions*

The best way to understand where Chinese firms invest and in which sectors is to look at the two questions together, as there is currently a close relationship between the sectoral and geographical distribution of Chinese ODI. As can be seen in Figure 3, Chinese investments in the Middle East and Africa are primarily aimed at extractive activities, although they also include some manufacturing in heavy industry and ICT industries. Manufacturing is prevalent in Eastern Europe, in Latin America and in Asia, but the sectors of activity differ, with electronics prevailing in Asia, heavy industry in Latin America and transport equipment in Eastern Europe. Sales, marketing and support activities dominate in North America and Western Europe, but ICT is the key sector in the former while transport equipment also plays a role in the latter.

Figure 3



A recent study by McKinsey looks at all cross-border M&As over US\$10 million by Chinese companies between 1995 and 2007 (Figure 4). Once again, Asia is the first destination for Chinese firms, with 44 per cent of the total in value terms and 60 per cent in terms of the number of deals. Chinese investment in Asia is more diversified than in other regions, but the largest share is in the oil and gas sector, owing partly to recent takeovers of affiliates of western companies operating in Indonesia. Over one half of the M&As in Europe and North America are in financial services, followed by the high technology and mining sectors. Much of the acquisitions in the rest of the world are in the oil and gas sectors, except for the acquisition of 20 per cent of the Standard Bank of South Africa for US\$5.5 billion.

For the moment, any discussion of the geographical pattern of Chinese ODI must be provisional, owing to incomplete data and political reactions in some host countries which might deter Chinese



ODI into certain countries or regions. If both CNOOC and Haier had succeeded in their attempted acquisitions, North America would have been relatively far more important as a destination for Chinese ODI.

Table 4. **Outbound Chinese M&As by destination and sector, 1995-2007**  
(US\$ billion; number)

	<i>High tech</i>	<i>Financial services</i>	<i>Food &amp; beverage</i>	<i>Health care</i>	<i>Machinery</i>	<i>Metals &amp; steel</i>	<i>Mining</i>	<i>Oil &amp; gas</i>	<i>Telecom</i>	<i>Transport</i>	<i>TOTAL \$</i>	
											<i>bn.</i>	<i>no.</i>
<i>North America</i>	2	4.3			0.1	0.1	1.4	0.3	0.2	0.2	<b>8.6</b>	25
<i>Western Europe</i>		3.4	0.5		0.04	0.1	1	0.1		0.1	<b>5.3</b>	13
<i>Asia</i>	2.9	3.9	0.5	0.2	0.3	0.1	0.6	9.3	4.9	6.0	<b>28.7</b>	117
<i>Latin America</i>			0.1			0.1	0.3	3			<b>3.5</b>	11
<i>Africa</i>		5.5					0.3	3.9			<b>9.7</b>	8
<i>Others</i>		2.5				0.4	1.4	4.7			<b>9</b>	22
<b><i>TOTAL \$ billion</i></b>	<b>4.9</b>	<b>19.6</b>	<b>1.1</b>	<b>0.2</b>	<b>0.44</b>	<b>0.8</b>	<b>5</b>	<b>21.3</b>	<b>5.1</b>	<b>6.3</b>	<b>64.8</b>	<b>196</b>
<b><i>number</i></b>	<b>29</b>	<b>46</b>	<b>11</b>	<b>2</b>	<b>8</b>	<b>9</b>	<b>26</b>	<b>38</b>	<b>13</b>	<b>14</b>	<b>196</b>	

Source: McKinsey (2008)

## The role of the state

As a hybrid between a centrally-planned and market economy, the Chinese economy is still heavily influenced by the state. The ODI trends described in the previous section cannot be understood without reference to government policies. The most obvious influence is through policies towards ODI which have evolved from restrictions to encouragement. But the state can affect the overseas investment strategies of Chinese firms in many other ways, such as through the allocation of credit, the degree of competition in the Chinese market, or its role as owner of corporate assets.

## Policies

In contrast to most other countries, China's ODI is still highly regulated, even as policies have shifted from outright prohibition to gradual opening and finally to resolute and active promotion, at least for "strategic" state-owned enterprises (SOEs). Outward investment was more or less actively discouraged by the central authorities until the late 1990s, when the government made a sudden shift and embarked on the so-called 'go global' (*zou chu qu*) policy. The phases of China's ODI policy liberalisation are described below.

Chinese ODI policy can be divided into five stages:

- Stage one (1979–83): restricted ODI. Only state-owned trading companies and provincial and municipal-based corporations were allowed to invest overseas on a case-by-case basis, with the State Council as the only authority to approve ODI. During this initial phase, overseas

investment activities were tightly linked to the government's political considerations (particularly the enhancement of its political influence).

- Stage two (1984–92): gradual opening, with standardisation of approval procedures. From 1984, prohibitions against ODI were gradually lifted and a wider range of enterprises was allowed to invest overseas, including non-state firms. However the *Regulations on Examination and Approval of Project Proposal and Feasibility Report on FDI Projects*, issued by the State Planning Commission in August of 1991, tightly restricted the autonomy of Chinese enterprises' overseas investment through complex procedures and fund limitations.
- Stage three (1993–98): greater scrutiny of overseas investment projects. In response to a perceived excess of investments and to a number of financial debacles by Chinese enterprises speculating on the Hong Kong real estate and stock markets, Chinese authorities tightened regulations on ODI with a view to ensuring that capital was properly invested overseas and for “genuinely productive purposes”. However, during his Southern tour in 1992 Deng Xiaoping started to encourage Chinese firms to maintain their outward-oriented strategies and to venture abroad. In September 1992, at the Fourteenth National Congress of the Chinese Communist Party (CCP), Secretary Jiang Zemin formally stated that “we should encourage enterprises to expand their investment abroad and their transnational operations”.<sup>10</sup>
- Stage four (1999–2002): early phase of the “go global” strategy, with overseas investment in processing trade activities. In the years prior to China's entry into the WTO, the Chinese authorities started encouraging firms to engage in overseas activities that would support China's export drive, in particular through processing trade projects. Light industries such as textiles, machinery and electrical equipment were encouraged to establish manufacturing facilities abroad that would use Chinese raw materials or intermediate goods. To that end the State Council granted export tax rebates, foreign exchange assistance and financial support. Moreover the government supported the outbound investment momentum by scrapping unnecessary controls on foreign exchange reserves and simplifying administrative procedures.
- Stage five (2002–present): consolidation of the ‘go global’ strategy. The ‘go global’ policy was confirmed at the CCP's 16<sup>th</sup> Congress in 2002. The objective is to encourage domestic enterprises to participate in international capital markets and to invest directly overseas, with a view to boosting the rise of world class companies and brands<sup>11</sup>. In October 2004, *The Verification and Approval of Overseas Investment Projects Tentative Administrative Procedures* which was enacted by the National Development and Reform Commission (NDRC) makes it clear that the government is merely a guide, supporter and service provider but that the investment decisions are in the hands of the firms. More authority is also given to local governments and foreign currency controls are relaxed by the State Administration of Foreign Exchange (SAFE).<sup>12</sup>

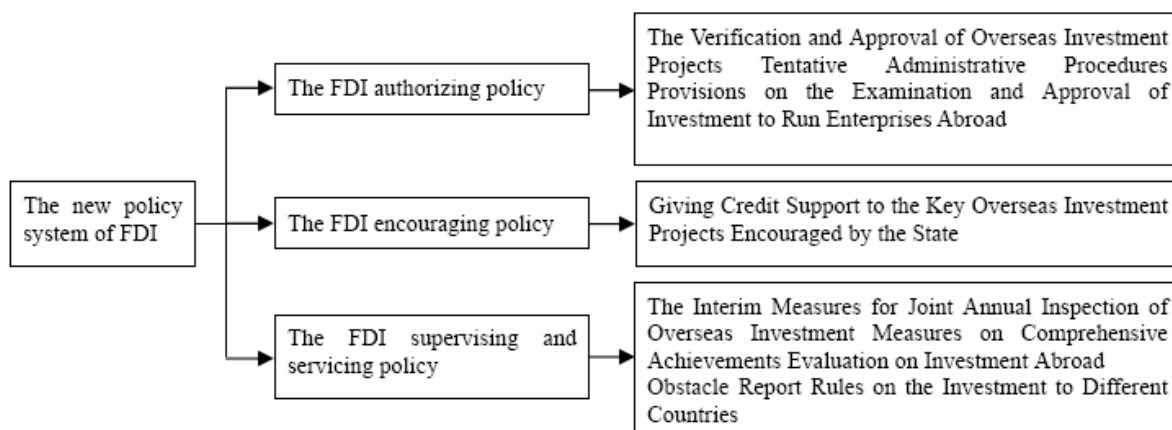


Figure 1 Current policy system of Chinese FDI

Reproduced from Cheng and Zhou (2007)

### *The major state-owned players*

State-owned enterprises are prominent in China's ODI. The first generation of Chinese MNEs were large SOEs operating in monopolised industries such as financial services, shipping, international trading or natural resources. The second generation has been active in manufacturing industries such as ICT or household appliances: Haier, TCL, Huawei, ZTE. Although these firms are also ostensibly under the control of the government, their ownership structure is more diversified than for the first generation MNEs. The nature of state ownership also varies considerably from firm to firm. Firms such as Galanx and Holly are town and village enterprises, Huawei and Haier are collective enterprises, Lenovo and TCL both have major government stakes but ownership is now shared with other investors, including foreign MNEs and private equity firms.<sup>13</sup>

By the end of 2005, 81 per cent of China's ODI stock was by SOEs directly managed by the State Assets Supervision and Administration Commission (SASAC).<sup>14</sup> According to MOFCOM, out of the 7,000 Chinese firms investing abroad, a large majority is made up of large SOEs while roughly 10 per cent are small private firms (AFII/Matthieu 2006). Out of the 15 largest Chinese TNCs ranked in Table 4 by their outward FDI stock, foreign assets and foreign revenues in 2006, Lenovo is the only one not explicitly state-controlled, although the state is a large passive investor.<sup>15</sup>

Table 5. The 15 largest Chinese MNEs by various rankings, 2006

Outward FDI stock	Foreign assets	Foreign revenue*
China Petrochemical	China Mobile Communications	China Petrochemical
China National Petroleum	China Network Communications Group	China Mobile Communications
CNOOC	China Resources	Sinochem
China Resources	CNOOC	China National Petroleum
China Mobile Communications	China National Petroleum	Lenovo
China Ocean Shipping	China Petrochemical Corporation	CNOOC
CITIC Group	China Ocean Shipping	China Resources
China National Cereals, Oils and Foodstuffs.	China Unicom	China Network Communications
China Merchants Group	Shanghai Overseas United Investment	China Ocean Shipping
Sinochem	China State Construction Engineering	Zhuhai Zhenrong
China State Construction Engineering	China Merchants Group	China National Cereals, Oils and Foodstuffs
China National Aviation Holding	China National Cereals, Oils and Foodstuffs	TCL
China Telecommunications Group	Lenovo	China Minmetals
China Shipping Company	Sinochem	China Shipping Company
China Network Communications	GDH Limited	Shanghai Baosteel Group

\*Non-financial revenue only.

Source: 2006 *Statistical Bulletin of China's Outward Foreign Direct Investment*

### ***How important is the state behind SOE strategies?***

As with the supposedly all-powerful Ministry of International Trade and Industry behind Japanese ODI in the 1980s, the importance of the Chinese government behind corporate strategies is easy to exaggerate. The 'go global' policy provides favoured firms with relatively soft budget constraints and other inducements, but administrative obstacles to ODI by Chinese firms nevertheless remain. Red tape has not disappeared in China. A FIAS survey of Chinese investors (private and public) found that 44 per cent of firms complained about the application time involved in ODI and 24 per cent were burdened by the costs involved in complying with procedures and regulations.<sup>16</sup>

Many SOEs might actually find state ownership to be a burden as they venture abroad, not least because of the hostile reaction it elicits in host countries as shown in the CNOOC bid for Unocal in the United States.

In addition, although the largest overseas investors tend to be SOEs, it is not always the favoured firms which are most aggressive or successful abroad. Some Chinese MNEs such as Huawei and Haier are setting the pace of internationalisation, although they were not selected as part of the "go global" strategy and hence did not benefit from systematic public support. They are nevertheless exceptions to the rule.

Furthermore, SOEs are increasingly managed like private enterprises according to the principle "state-owned but not government-run". Some of these firms are listed on the Shanghai and Shenzhen stock-markets or in Hong Kong, with part of their capital in private hands. Western private equity groups such as Blackstone have taken shares in Chinese SOEs.<sup>17</sup> A recent Mc Kinsey report of China's business landscape explains that a fast-emerging category of Chinese firms, while still state-owned,

function like modern private-sector concerns, compete head-to-head with MNEs in global markets and are often global themselves in operations, organization and management.<sup>18</sup> ChemChina is one such example.

Another McKinsey survey of China's SOEs argues that "public- and private-sector companies in China are not as easily differentiated by their management styles or by the challenges they face".<sup>19</sup> For example, both private and public firms must gain approval from the government for cross-border M&As. The report suggests that the most meaningful distinction among Chinese companies is not the degree of state ownership but the degree of openness of the company itself. Openness relates to their business practices and management, including transparency, best practice in governance and receptiveness to new ideas. The survey also argues that government favouritism toward SOEs is fading, partly as a result of a policy of *zhengqi fenkai* which formally separates government functions from business operations.<sup>20</sup>

Even if SOEs remain the principal players in the international arena, private sector entities have been emerging recently as a force. A survey by the Asia Pacific Foundation of Canada (Woo and Zhang 2007), suggests that many private companies are nurturing global ambitions. Some official Chinese statistics also suggest that private firms have been playing a rising role lately (Defraigne 2007), although some of this investment might be for fiscal purposes only.

### ***Chinese sovereign wealth funds***

The latest policy move which can be expected to affect China's investment outflows is the creation of a sovereign wealth fund, the Chinese Investment Corporation (CIC). The CIC, launched in October 2007 with an initial endowment of US\$ 200 billion, is placed under the direct supervision of the State Council and is mandated to invest some of China's huge foreign reserves. The CIC is reportedly modelled on the Singapore investment company, Temasek Holdings, whose portfolio spans industries as diverse as telecommunications and media, financial services, real estate, energy and resources, engineering and health care. The CIC is designed to operate domestically as well as abroad. According to the *Financial Times*, "China's \$200bn sovereign wealth fund now has as much as \$90bn to spend on assets abroad, an increase of more than 30 per cent, compared to the initial \$66bn."<sup>21</sup> Most of its early investments went to Latin America and Asia, but with increasing amounts in Africa.

Somewhat confusingly, the State Administration of Foreign Exchange (SAFE) is also beginning to take shares in foreign companies, as will be seen later in the discussion of Chinese ODI in Europe. It is not immediately clear what the ultimate division of responsibility between the CIC and SAFE will be in this area.

### ***Conclusion***

A growing number of governments, particularly in Asia, are encouraging their firms to invest abroad. Some of this investment is intended to secure supplies of raw materials and often involves state-owned enterprises, but another part is concerned with the issue of the international and even domestic competitiveness of local firms. Chinese firms are encouraged to go abroad to acquire new skills and technology because inward FDI has not delivered the expected technological spillovers. It remains to be seen whether this alternative way of technology acquisition will be more effective.

Since many firms have decided on their own account that their competitiveness is best served by investing abroad, the policy approach adopted by the government seems to be consistent with underlying corporate strategies. The risks from this policy approach are nevertheless two-fold. The first is that, by designating some firms – principally SOEs – as strategic, the government is distorting the allocation of capital within the Chinese economy by encouraging the expansion of these firms at the expense of other firms or sectors. The policy is in many ways what could be called an “outward-looking industrial policy”, although some national champions also benefit from protection at home.

The second risk concerns the distortion of capital allocation between domestic and foreign investment. By lowering the cost of capital for these firms in their international expansion, there is a risk of moral hazard by encouraging them to invest abroad beyond the level which could be commercially justified or even sustained. Direct and indirect financial support from the state<sup>22</sup>, together with favourable treatment in terms of profit retention and management autonomy, might make Chinese investors less likely to undertake proper due diligence in their overseas acquisitions. Corporate governance issues will be discussed in more detail in the final chapter.

Lastly, the rationale for Chinese ODI can be seen as the mirror image of Huang’s claim (Huang 2003) that inward FDI is to some extent the result of internal weaknesses in the Chinese financial system, rather than of an exceptional attractiveness of the Chinese market. Similarly Chinese ODI may be accounted to some extent by shortcomings in the Chinese financial system and by China’s inability to reinvest efficiently its high corporate and individual savings.

#### **Box 2: Korea’s experience with ODI**

Korea’s experience with rapid growth in ODI has many parallels with China. The Korean conglomerates (*chaebols*) received financial support from the government to expand abroad as do many Chinese SOEs do. Their ownership advantage in international markets was commonly seen to be their mastery of production techniques rather than their innovative capabilities or brand name. Also their motive for investing in developed market was part market access in response to protectionism, part technology sourcing.

In Korea, ODI was restricted to a limited number of activities until the mid-1980s, primarily because it was considered as a capital outflow. During the late-1980s, there was a change of direction in the country’s ODI policy not only as a result of a current account surplus but also in the wake of the liberalisation of foreign exchange transactions. Aggressive measures were put in place to help declining industries regain competitiveness by relocating overseas in low-wage countries or to help more high-tech industries jump over the protectionist barriers imposed by industrial countries or gain access to foreign technology. The strategic objective of this policy was to improve the competitiveness of Korean firms, in part by enhancing independent technological capabilities.

In the mid-1990s, “[Korea’s] Government grew increasingly worried about possible negative impacts of booming OFDI on the home economy. Prudential regulations were thus introduced in 1995 as an allegedly precautionary measure to induce more careful planning and healthy management of OFDI and thereby prevent any adverse side-effects arising from its liberalisation.” While the Asian financial crisis was the turning point in the case of Korea’s ODI policy, China’s accession to the WTO certainly played a key role in China’s policy shift in favour of a more resolute outward orientation.

Public policies played a strong role in Korean ODI, both indirectly through the emergence of the *chaebol* and directly through financial support for ODI. Nicolas (2003) argues that “public policies can probably account for the apparently excessive extent of some Korea [ODI]” by encouraging firms to adopt “riskier strategies than they would do in the absence of helping hands in the form of rescue loans from the Government”.

## II. CHINESE DIRECT INVESTMENT IN EUROPE

### Trends and patterns

As mentioned earlier, Chinese investment in Europe is still relatively insignificant. With the exception of 2006, official figures for Chinese ODI in Europe show very little upward movement. From China's perspective, the EU does not loom large either. According to some sources, the EU accounted for merely one per cent of Chinese outbound M&A in value terms (and six per cent in number of deals) over the period 1999–2005.<sup>23</sup>

In numerical terms, greenfield investment projects outpace acquisitions, though many of these tend to be quite small (including a large number of trade representative offices). In terms of greenfield investments, although the amount of investment in European projects funded by China has increased by 500 per cent since 2000, it started from a very low base and hence remains modest.<sup>24</sup> According to the French Agency for International Investments (AFII), Chinese firms accounted for a mere 0.5 per cent of all manufacturing projects and 0.9 per cent of jobs created in Europe over the period 2002–2005.<sup>25</sup> China accounted for 1.2 per cent of greenfield investments in Europe over the period 2004–2006, on a par with Korea but behind India (with 1.9 per cent)<sup>26</sup>. Despite its modest level, Chinese ODI into Europe has been rising lately, from only 900 jobs created in Europe in 2001–2003 to over 7,000 in 2004–2006.<sup>27</sup>

Investment in R&D is still marginal but is rapidly rising. In Europe, Chinese firms accounted for a mere 1.7 per cent of the R&D projects by foreign investors over the period 2001–2005, rising from virtually zero in 2001 to reach 2.8 per cent in 2006.<sup>28</sup> The same holds true for other activities and in particular for headquarters and shared services centres. From zero in 2002, the share of Chinese projects in these activities rose to 4.7 per cent in 2005.

### *Which European countries are preferred by Chinese investors?*

Depending on the data source, the United Kingdom or Germany is the first destination for Chinese ODI. According to private sources, the United Kingdom has been a major magnet for Chinese ODI since 2002 (Table 6), with 350 Chinese firms already present.<sup>29</sup> London has attracted 15 per cent of the Chinese investment capital flowing into Europe. Official Chinese statistics, in contrast, show Germany ahead of the United Kingdom (Table 7).

Table 6: **BRIC Investment into Europe 1997–2007**

	<i>Leading location</i>	<i>%</i>	<i>Second location</i>	<i>%</i>	<i>Third location</i>	<i>%</i>
<b>Brazil</b>	Spain	20	Portugal	20	France/UK	11
<b>Russia</b>	UK	17	Germany	13	Ukraine	10
<b>India</b>	UK	56	Germany	18	France	6
<b>China</b>	UK	41	Germany	15	France	10

Source: Ernst & Young, *European Investment Monitor* 2008.

Table 7:

<b>Chinese ODI stock into the EU, 2005 - 2006</b>		
(non finance part, millions of US\$ and percentage)		
	<b>2005</b>	<b>2006</b>
EU	768,01	1274,51
Belgium	0,3	0,2
Bulgaria	0,4	0,4
Czech Republic	0,2	1,2
Denmark	12,6	2,9
France	4,4	3,5
Germany	34,9	37,0
Hungary	0,4	4,2
Ireland	0,0	2,0
Italy	2,8	5,8
Netherlands	1,9	1,6
Poland	1,6	6,8
Romania	5,1	5,1
Spain	16,9	10,7
Sweden	2,9	1,6
United Kingdom	14,1	15,8

Source: MOFCOM

In **France**, Chinese firms are present in a wide variety of sectors, spanning chemicals, textiles, electronics and telecommunication equipment, consumer electronics, air transport and freight, as well as electrical home appliances. The ICT and chemical sectors dominate in value terms. The major Chinese firms present in France are ZTE, Huawei, COSCO, Watchdata and BlueStar (a subsidiary of ChemChina).<sup>30</sup>

Chinese M&As in **Germany** are concentrated in the electronics and machinery industries and usually involve the acquisition of troubled local firms (see table 8).

In the **United Kingdom**, major acquisitions have been undertaken in the automotive sector. British MG Rover's car making operations were purchased by Nanjing Auto in 2005. The Chinese firm plans to reopen the UK's Longbridge car plant to manufacture a range of new vehicles and conduct R&D activities. In July 1997, Wanxiang bought a 60 per cent share of the AS Company (UK), a company selling bearings in the European market, and established Wanxiang Europe Bearing Company as a beachhead in Europe. Similarly Huaxiang, one of China's largest car-parts makers, took over British Lawrence Automotive Interiors, a world class manufacturer of premium decorative trim components for luxury cars. Through the deal, Huaxiang will get access to advanced technology on making wood veneer and become an OEM supplier to GM's Cadillac and Saab and PSA Peugeot Citroën.

In another sector, China National Bluestar also acquired Fibres Worldwide (UK). Chinese investors are also present in the financial sector: teaming up with Singapore's state-owned investment vehicle, Temasek, China Development Bank (CDB) acquired a 3.1 per cent stake in Barclays in July 2007 for



over \$3 billion. One year later CDB is reported to intend to participate in Barclay's capital raising operation so as to maintain its 3.1 per cent stake.

In the **new EU member states**, Chinese firms are primarily active in the consumer electronics and white goods industries, as well as in the automotive industry (Box 2). In an ironic twist, Hisense established its factory in Hungary in a building that had been vacated by Microsoft when it moved its production to China.<sup>31</sup> In these countries, Chinese investments tend to be production-oriented and primarily efficiency-seeking. Such is the case with Hisense, Changhong, Skyworth, Haier and TCL groups, which have established overseas production bases and joint ventures in countries such as Hungary, the Czech Republic, and Poland with the aim of catering to the rest of the EU market. It remains to be seen how long such a strategy will last because of the growing need to customise production for local markets in the older EU member countries. Some signs already suggest that Chinese firms have begun to change strategies and move production to Western Europe (Hay et al. 2008).

**Box 3: Chinese ODI in the new Member States**

Consumer electronics and white goods:

*TV assembling:* SVA (Bulgaria), Hisense in collaboration with Korean Flextronics (Hungary), TCL (Poland) and Sechuan Changhong Electric (Czech Republic)

*household appliances and consumer electronics:* Haier and Lenovo (Poland)

Automotive:

*motorbikes:* Li Fan (in collaboration with DASF, Bulgaria)

*plastic products for automobile and construction industries:* Liho (in collaboration with DASF Bulgaria)

*bicycles:* Athletic Group and EIW Industrial Development (Poland)

The choice of country is partly opportunistic – such as when an acquisition target becomes available – and partly a reflection of the different strategies behind Chinese ODI in Europe. Although each country has attracted firms from several sectors, there does seem to be a tendency to invest in those sectors for which the host-country has a particular strength: machinery in Germany (Shenyang Group, Huapeng Trading, Dalian Machine among others), design in Italy and, to a lesser extent, the automobile sector in the United Kingdom (Nanjing Automotive or Huaxiang Group). This does suggest a desire on the part of investors to obtain strategic assets from their European acquisitions. In such cases, the deals result from the coincidence of a supply of know-how and financial difficulties on the one hand and financial strength and demand for technical expertise on the other.

The link between location choices and technology sourcing is even more apparent in terms of R&D centres. The location of some Chinese investments is clearly indicative of their aim to capture the externalities created by host-country technology clusters. As explained by UNCTAD (2003), “some Chinese firms are also creating R&D centres in developed economies in order to capture high tech human capital and to benefit from economies of scale of Marshallian districts.” This strategy is exemplified by Chinese telecom equipment firm Huawei investment in a R&D facility in Sweden, by

Haier investing in Germany. Similarly JAC Anhui Jianghuai established itself in Turin to benefit from the proximity to the Moncalieri Environment Park.

### *Diversified modes of entry*

Unlike direct investors from other emerging markets, Chinese MNEs tend to establish joint ventures with western multinationals within China before investing overseas, and they often use equity joint ventures and M&As as a way of directly acquiring advanced production, technology and managerial skills overseas.<sup>32</sup>

#### *Equity joint-ventures*

Chinese firms often use equity joint ventures to enter foreign markets. China's largest listed telecommunications equipment provider (ZTE) entered Europe in 2007 by forming a joint venture with Redcomm in the UK. After setting up headquarters in Newcastle, the company concentrated on pre-sales opportunities, most notably in developing a relationship with British Telecom and finding ways of working with it to support its 21st Century Network vision. The company has now moved to London, and ZTE Corporation has taken a greater stake in the UK joint venture. It is looking to expand its marketing and human resources capabilities while also supporting operations throughout Europe with more pre-sales and technical resources.<sup>33</sup>

Similarly, Huawei set up a joint venture with Siemens Mobile, France Telecom (R&D), Irdeto (tele-security), as well as Global Marine Systems (UK). Another example is Sukida, a private motorcycle manufacturer in Guangzhou, which registered three separate companies in Cardiff in November 2003. One of the companies sells motorcycle products imported from China and the other two are joint ventures with local partners. One joint venture sells spare parts for motorcycle and machinery products, and the other is a real estate agent. Sukida chose Cardiff as its first European base because of the low property and labour cost, as well as the convenient transport network.

#### *Mergers and acquisitions*

Cross-border M&As by Chinese firms are gaining in importance, accounting for a third of the total in 2007. In industrial countries, Chinese ODI took the form of M&As very early on, as a way of gaining access to brands, management talent, R&D capabilities, distribution and sales channels.<sup>34</sup>

In Europe, one can identify three main categories of firms targeted by Chinese acquirers: ailing (or financially distressed) firms (Shenyang acquiring Schiess or SGSB acquiring Dürrkopp), competitive niche producers (China Bluestar acquiring Rhodia Silicones for instance) and former partners or sub-contractors/suppliers (as in the case of Chalkis and Le Cabanon-Conserves de Provence). They can take the form of outright acquisitions or start with a strategic investment which is eventually followed by a complete takeover.

Chinese firms also sometimes engage in minority stake acquisitions simply as a way of strengthening the relationship with their European partners. These strategic investments occur both in services (with CDB and Barclays, or Ping An and Fortis for instance) and in manufacturing. For instance, with a view to strengthening its international competitive edge, Ningbo Bird, a leading Chinese mobile phone producer, chose to engage in equity partnership with France's Sagem.

#### Box 4: China Blue Star in France

In 2005, BlueStar (a subsidiary of ChemChina) acquired Drakkar, the parent company of Adisseo (a world-leading animal nutritional feed firm based in France), for US\$460 million to extend its own product line. Later in 2006, it also bought French company Rhodia's organic silicon business including its patents, manufacturing equipment and distribution channels as well as the company's sulphide business. The new entity, called BlueStar Silicones, has its worldwide operational headquarters based in Lyon. It has downstream production units throughout the world and in particular in the Rhone-Alps region, as well as leading positions on key markets such as specialty elastomers, paper and textiles coatings, dental and paramedical applications. After these M&A deals, BlueStar became the world's second and third largest producer of methionine and organic silicon, respectively, and the largest Chinese investor in France as well as in Europe. The new group will have two centres of excellence: one in Europe with a world-scale research centre in Lyon and a large number of production units and one in Asia.

Table 8: A selection of M&As by Chinese investors in Europe

Mining	Zijin Mining Group – Monterrico Metals, UK Zijin Mining Group – Ridge Mining, UK
Food	Chalkis – Le Cabanon/Conserves de Provence, France
Automotive	Nanjing Automotive – MG Rover, UK Huaxiang – Lawrence Automotive, UK Qinjiang Group – Benelli, Italy
Chemicals	China National Blue Star Group – Adisseo, France China National Blue Star Group – Rhodia silicone division, France China National BlueStar Group Corporation – Fibres Worldwide, UK Shanghai Dongbao Biopharmaceutical – Ferring's Malmö factory, Sweden
Electronics	TCL – Schneider Electronics, Germany TCL – Thomson, France Shiro – Hasselblad, Sweden Nam Tai Electronics – Stepmind, France
Household appliances	Haier – Meneghetti, Italy
Machinery and metal products	Shenyang Machine Tool Group – Schiess, Germany Shenyang Heavy Machinery Group (SHMG) – NFM Technologies, France Huapeng Trading – Welz Gas Cylinder, Germany Shanghai ZQ Tools Group – Lutz Maschinenbau, Germany SGSB Group – Dürrkopp Adler, Germany Dalian Machine – Zimmermann, Germany Dalian Machine – Rema Maschinenbau und Hendel, Germany Harbin Measuring and Cutting – Kelch GmbH, Germany China National Building Material Group – Rotortechnik, Germany Beijing No1 Machine Tool – Waldrich Coburg (Herkules), Germany
Textiles	Sail Star Shanghai – Boewe Textile Cleaning, Germany Yangtsekiang Garment Manufacture (YGM) – Sorotex, France YGM – Guy Laroche
Research	Suntar Membrane technology – Hoechst, Germany
Banking	China Development Bank – Barclays, UK
Logistics	LinkGlobal Logistics – Parchim Airport, Germany

Source: Schüller and Turner (2005), Bellabona and Spigarelli (2007), Hay et al. (2008), press releases.

Sometimes the choice of partner is dictated more by its distribution network than its proprietary technology. Teaming up with a well-established firm is seen as a way of gaining quick access to the EU market. Joint ventures negotiated by Chinese firms in the telecommunication industry are obvious examples of this strategy. Similarly, through the acquisition of French Le Cabanon/Conserves de Provence, the Chinese investor Chalkis was seeking to get access to a well-developed distribution network in the European market.

Whatever the form, the acquisition goals are access to a brand name and distribution network (with TCL's acquisitions of Schneider and Thomson as obvious examples) or to engineering know-how and customer networks (as is the case with the numerous acquisitions of German firms in the machinery and metal industries such as Welz, Lutz and Schiess).

### *Greenfield investments*

Greenfield investments focus on the establishment of headquarters, subsidiaries, trade representative offices, trading companies and R&D centres, with a view to facilitating Chinese firms' access to the European market and to help them customise their products for the local market. This strategy is common for firms having some form of competitive advantage in their home market and seeking to strengthen their market share abroad. A number of illustrations are given below.

Shenzhen China Tex Industry Co. Ltd, a sports clothing provider, set up its sales and marketing office in the UK in August 2003. The company has had a presence in the textile import and export business in the UK and European markets for more than 20 years. Britain is its biggest market in Europe and the sales volume there accounts for 60 per cent of the company's annual export turnover. China Tex chose the UK for its close proximity to existing customers and marketing channels.

Wenzhou Yuetu Electric Group (which is not a "national champion" identified and supported by the Government) established subsidiaries in Spain and the Netherlands and opened a bonded warehouse in Italy. Its strategy is to use local intermediaries in wholesaling and retailing to penetrate the European market.

Recognising a strong market for its products, Phytointl Hi Tech, one of China's biggest suppliers of nutritional ingredients, looked to the UK as a natural base for overseas investment and opened its first UK subsidiary, Nutrintl UK, in March 2006.

Greenfield investments are common in the telecommunications industry. Utstarcom (telecoms and IT services), Wenzhou Yeuhua Locks, and Beijing Huaqi Information Digital Technology and Brilliance Group (diversified distribution) set up sale units in various parts of France (AFI Matthieu 2006). China Telecom, the country's largest telecoms business, established a subsidiary in Europe in September 2006. China Netcom, the country's second largest fixed-line telephone company, followed suit one year later and opened its European headquarters in London in November 2007. China Netcom has identified an opportunity to provide communications services to the multitude of Chinese firms coming to the UK. Also China mobile, the world's leading mobile operator, established its European and African headquarters in London.

As part of its drive to diversify its market base, one of Nanchang Brothers Electronics' key strategies was to capture the overseas Chinese telephony market with the sales of broadband-based international calling cards and related products. Its plan, which focuses on providing overseas Chinese communities with reliable and reasonably priced international telephony services, met with encouraging success in Hong Kong, Canada and Singapore, where it is now the third-largest calling card company. Nanchang Brother's next goal was to set up an office in Europe to replicate the success in those markets.

Greenfield investments are also common in the service industry. CCTV recently opened its new European headquarters in London, Cosco Logistics has established a subsidiary in the UK and two subsidiaries in France and China Shipping quickly followed suit. China's Bank of Communications opened a new branch office in Frankfurt, its first branch office in Europe.

Lastly, greenfield investments are common for the establishment of R&D centres. JAC Anhui Jianghuai, one of the most important automobile firms in China, has chosen to set up a development facility within the Moncalieri Environment Park in the Italian car capital Turin. The purpose of the investment is to help the firm enter the passenger car sector.

Asimco Technologies, which is among the largest component firms in China manufacturing a wide range of products, chose to establish itself in the UK to aid its growth and have an easy access to the rest of the European market. It has a European headquarters and a R&D centre in the Motor Industry Research Association cluster (Warwickshire).

In early 2008, it was announced that China Sunergy (which is China's second largest solar-cell company) will open its European headquarters and its European R&D centre in Munich. The investment is further evidence of Germany's position as a leader in R&D and other high-tech investments.

The Chinese high-technology firm Ixento established itself in Montpellier under a cooperative agreement between Montpellier and Shanghai. In 2007, Shenyang Machine Tool established an R&D centre in Germany.

Huawei has R&D centres in France, Sweden, Germany, the Netherlands and Spain, aimed at customising goods and services for the local market. It also has technical assistance centres in the UK and in Germany, training centers in the UK, France and Hungary, as well as call centres in France and Hungary.

Starting from exports of its expanding variety of products, ZTE made its first foreign investment in 2000. ZTE's projects include overseas customer service centres, sales representative offices, factories, and several R&D centres, including in the United States, Sweden, France, India, and Pakistan. In 2005, ZTE Corporation set up a R&D unit at the Futuroscope park in western France. Today it has R&D centres in France, Sweden and projects in Rumania, as well as a training centre in Hungary.

### ***Chinese SWFs are beginning to test the waters in Europe***

Although SWFs have raised a number of concerns in host countries, at the time of writing, the China Investment Corporation has not yet been involved in any investment in Europe. Allianz SE, Europe's biggest insurer, was said to be at some point in 'intensive' negotiations with the CIC over the sale of its banking unit Dresdner Bank, but these rumours were eventually denied. Similarly, the CIC was said to be interested in buying the Swedish government's 19.9 per cent stake in Nordea AB, but there is no confirmation yet.

By contrast, the State Administration of Foreign Exchange (SAFE) has taken a 1.6 per cent stake in Total's capital, a move that is likely to heighten tensions between SAFE and CIC because, by buying equities, SAFE is encroaching on CIC territory. Similarly a Chinese investment fund took a 1 per cent stake in British oil giant BP.

## Drivers of Chinese ODI

Chinese ODI is unusual in many respects. In spite of its size and growth, China remains a relatively poor country and, as such, should not be expected to generate much outward investment. Furthermore, when firms from all over the world are rushing to produce in China, it is not immediately obvious why Chinese firms should invest in the opposite direction. In addition, Chinese firms do not possess many of the usual competitive attributes (or firm-specific assets) which would allow them to compete directly with local firms in foreign markets. Chinese ODI is also unusual in being dominated by state-owned firms, as shown in the previous section.

And yet what is surprising once one looks at the motives for Chinese ODI – including by SOEs – is how much like other countries' behaviour it is. Like their counterparts in other countries, Chinese firms are investing abroad primarily to expand their market share in host economies. In the FIAS survey of Chinese investors, market seeking is the principal motive for Chinese investment into almost all countries and regions, often by a wide margin (Table 9). This finding is corroborated in other surveys of Chinese investors. A survey of China's 50 largest "industry-leading" firms by Roland Berger found that 56 per cent of Chinese investors cited "seeking new markets" as the main motive for their investment, compared to only 16 per cent for "obtaining technology and brands". Similarly, a survey by Deloitte on emerging countries' direct investment in Germany<sup>35</sup> finds that geographical expansion is a key objective ahead of access to technology. Buckley *et al.* (2006, p. 136) also conclude, based on an econometric test of Chinese investment patterns, that "general market seeking motives underpin much of Chinese investment behaviour".

Table 9. **Motives for Chinese ODI by region** (percentage of respondents cited each motive as important)

	East Asia*	Southeast Asia	Africa	North America	Western Europe	World	State-owned	Private
Market seeking	82	92	93	89	93	<b>85</b>	86	81
Efficiency seeking	56	24	39	47	55	<b>39</b>	35	36
Resource seeking	42	33	41	36	45	<b>39</b>	31	44
Strategic assets	78	39	39	69	76	<b>51</b>	43	53
Tariff jumping	32	39	17	39	45	<b>36</b>	18	42
Reduce operational risk	40	16	28	25	41	<b>26</b>	18	24
Reduce asset risk	32	12	26	22	34	<b>20</b>	16	19
Pressure from domestic competitors investing abroad	14	4	4	17	7	<b>12</b>	10	8
Support from home government	52	43	72	44	59	<b>43</b>	47	33
Favourable FDI policies in host country	50	43	52	36	52	<b>41</b>	41	38
Make use of domestic production capacity	40	57	39	50	66	<b>41</b>	41	33
Global competitive strategy	62	55	46	56	59	<b>50</b>	49	51
Other	14	16	13	6	3	<b>10</b>	10	13

\*Hong Kong (China), Japan, South Korea, Singapore

Source: Yao and He (2005)

Market access is not the only consideration. Investors are also seeking strategic assets in the form of technologies and brand names which can improve their competitiveness both at home and abroad. As expected, the strategic asset motivation is more important in Western Europe and North America than in Africa or Latin America.

Much is made in the academic literature about how the strategic-asset seeking nature of Chinese investment sets it apart from earlier waves of ODI by American, European and Japanese firms. Ping (2007, p. 71) encapsulates this point of view when he argues “Chinese MNCs are motivated primarily by the quest for strategic resources and capabilities, and [...] the underlying rationale for such asset-seeking FDI is strategic needs”. Rugman and Li (2007, p. 341) take the opposing view: “only to a minor extent do MNEs go abroad to gain access to knowledge and technology”.

Without wishing to add to the voluminous literature which this debate has spawned, it is nevertheless useful to point out two empirical facts. Firstly, surveys of investor motives continue to give only a secondary role to strategic-asset seeking, even for Chinese investments in Europe and North America. Secondly, to the extent that strategic-asset seeking motives exist, many studies have found similar motives for earlier Asian investments in Europe and the United States (Box 5). Chinese ODI might be unusual, even surprising, but China is still on the same planet as the rest of the world.

#### **Box 5. Technology sourcing by Asian investors**

Makino et al. (2002, p. 406) reviews existing work on Japanese ODI and finds technology sourcing to be a key motive for their investments in the United States in certain sectors. Branstetter (2000, p. 11) interviewed Japanese investors in the United States and found that acquiring or absorbing US technologies is often an explicit part of the decision to invest. “By purchasing a firm in the United States, Japanese firms potentially acquire not only the proprietary knowledge assets of the acquired firm but also entrée into the informal technological networks and knowledge sharing relationships possessed by the research personnel of the acquired firm.” Similar strategies have been identified for Korean and Taiwanese firms in Europe, North America and Japan. Sachwald (2001) cites several studies finding that technological upgrading has been an important strategy for large Korean groups in their investments in other OECD countries.

Within these broad motives for Chinese ODI, there are numerous push and pull factors which help to explain why investing is preferred to exporting or Original Equipment Manufacturing (OEM) sales to foreign investors and why Chinese firms from so many sectors are deciding to invest in so many countries at the same time. These various push and pull factors are obviously inter-related.

#### ***Pull factors***

Foreign markets, technologies, factors of production and natural resources all help to pull Chinese firms overseas. On top of these, are various factors aimed either at facilitating or replacing exports.

#### ***Protectionism in export markets***

The decision to invest rather than exporting is also sometimes precipitated by actual or threatened protectionism in major markets. The record Chinese trade surplus with both the European Union and the United States has raised the sensitivity of Chinese exporters to this potential threat. In 2003, for example, the US Government imposed anti-dumping duties against four Chinese colour television

makers, up to 22.36 per cent in the case of TCL.<sup>36</sup> Haier also faced anti-dumping duties in the United States before investing. Similarly, TCL's purchase of Schneider Electronics in Germany arose partly in order to circumvent European import quotas.

#### *Support to exports and logistic development*

Many Chinese investments aim to support existing activities through trade representative offices as well as through investments in logistics. The presence of Chinese firms in maritime transports and logistics services is also indicative of their desire to keep control over the logistical chain. Moreover, Chinese investors also contemplate the development of "commercial hubs", the objective of which is to help small-and medium-sized Chinese investors to gain access to the European market. Such hubs are envisaged in Finland, Italy, Hungary, Poland, the Netherlands and the Czech Republic (Hay et al. 2008, p. 62).

#### *Taking advantage of Marshallian districts.*

The location of some Chinese investments is clearly indicative of their aim to capture the externalities created by the host-country technology clusters. As explained by UNCTAD (2003), "some Chinese firms are also creating R&D centres in developed economies in order to capture high tech human capital and to benefit from economies of scale of Marshallian districts." This strategy is exemplified by Chinese telecom equipment firm Huawei investment in a R&D facility in Sweden, by Haier investing in Germany. Similarly JAC Anhui Jianghuai established itself in Turin to benefit from the proximity to the Moncalieri Environment Park.

### ***Push factors***

#### *Government policies*

At this stage in the internationalisation of Chinese firms, government policies play an important role. The most obvious element is official encouragement of ODI by strategic firms. But two aspects of the government's liberalisation over the past few years may be equally important – if not more so – in explaining the timing of Chinese ODI.

- The first is the gradual loosening of restrictions on outward investment by the various regulatory authorities. In the FIAS survey of Chinese investors, over half of the firms complained about limitations on foreign exchange use. Other impediments to ODI included the time taken to apply, the limited sources of finance and the costs to comply with procedures and regulations. In the past, potential Chinese investors were asked to submit a feasibility study to the Government for approval and to report annually on progress. In many cases, changes in the ODI regime may have had a greater impact on ODI than any direct inducements for firms to invest.
- The second aspect of liberalisation is the commitments undertaken by China as part of its accession to the WTO in 2001. Firms in many sectors are now facing much greater competition in their domestic market, placing downward pressure on profit margins at home.

#### *Overcapacity and high market shares at home*

Overcapacity and high market shares at home both encourage Chinese firms to look abroad for future earnings growth. Cheng and Stough (2007) consider overcapacity and falling prices as the main



motive for market-seeking ODI by Chinese MNEs. As reported by the CEO of Legend Holdings, the holding company of Lenovo, “[t]he reason to go global was straightforward: with a 30% share of the Chinese PC market, Lenovo realized that its opportunity for further domestic expansion was limited”.<sup>37</sup> This share is roughly similar to that reported by Deng (2007, p. 78) for Haier in the domestic market in 2000: refrigerators (33%), freezers (42%), air conditioners (31%) and washing machines (31%).

In terms of overcapacity in the Chinese market, Wu (2005, p. 11) cites a McKinsey study estimating overcapacity at 30% in washing machines, 40% in refrigerators, 45% in microwave ovens, and 87% in televisions.

### *Competitive advantages of Chinese investors*

The academic literature on multinational enterprise asserts that for national firms to become multinational or even global enterprises, certain conditions need to be fulfilled. One key condition is the presence of some firm-specific assets or ownership advantage that will allow the investor to compete in host countries against local firms that are assumed to possess some sort of ‘home market advantage’. The academic literature is divided between those arguing that Chinese firms are competing on the basis of country-specific advantages and do not have sufficient firm-specific advantages to be able to sustain their current drive towards internationalisation (Rugman and Li 2007) and those who suggest that Chinese firms are in the midst of creating a new form of business organisation derived from the cultural emphasis on networks and connections (Box 5).

The issue is of more than passing academic interest. After all, Chinese investors in Europe are often acquiring brands and other strategic assets that existing owners could not use profitably. On what basis are relatively inexperienced Chinese investors likely to have more luck than existing owners? The answer to this question will largely determine whether Chinese takeovers and greenfield investments in Europe succeed or fail, with inevitable consequences for European investors and workers.

Perhaps the best way to explain why Chinese firms are becoming more competitive both at home and through their affiliates abroad (country- and firm-specific advantages) is to look at Chinese ODI from the vantage point of an expanded product life cycle model, after Vernon (1966). In the life cycle of a product, there will come a time when it is no longer economical to produce in the country in which the product was conceived. At this point, assembly will pass from the home country to a developing one, such as China. This might involve either Original Equipment Manufacturer (OEM) contracts with local firms or the establishment of a wholly-owned subsidiary to produce for export. In either case, the western firm retains ownership of the brand and of any proprietary technology. At some point, however, the product might become so standardised that the ownership of the brand itself passes to the developing country.

Morck et al. (2007, p. 20) describe how an ownership advantage in a certain sub-sector might shift over time from a western MNE to an emerging market firm. “In maturing industries, intensifying price competition in increasingly standardized products renders manufacturing quality more important than cutting edge R&D, and rigorous cost control more important than brand name recognition. In such circumstances, a reversal of roles becomes rational: the production unit takes over the R&D or brand-building unit because its non-contractible effort becomes more important in creating value.”

Chinese firms also derive some advantage from their proximity to, and hence greater understanding of, emerging market consumers. These consumers are becoming relatively more important in the growth of global demand and their consumption behaviour favours firms producing less sophisticated and lower price goods and services. To the extent that Chinese firms have an advantage in serving emerging markets, this too will boost their advantage vis-à-vis incumbent firms in host countries in which they invest. Buckley et al. (2008, p. 113) cite studies arguing that emerging market firms are “better able to meet the specific demand conditions and price expectations of lower income customers”. Branstetter and Lardy (2006) argue that in services, US firms have been less successful in Japan and China than might have been expected for this reason.

Several Chinese takeovers of western firms seem to fit this simple model, most notably the Lenovo takeover of IBM’s personal computer division (Box x). In many cases, the western firm sells the brand in part through the acquisition of a minority share of the ownership in the Chinese acquirer which allows it both to retain a share of the profits and provides greater potential access to the Chinese market for other goods and services remaining under its direct ownership.

In this sense, the Chinese firm does not have the traditional ownership advantage in generating technologies and brands but rather in exploiting them in sectors where the importance of brands is diminishing. Of course, if brands did not matter at all, then there would be no reason for the Chinese firm to pay a premium to acquire a western brand. Some companies have taken this route by attempting to sell under their own label.

At the level of the firm, the transaction is clearly profitable for both parties – as reflected by the fact that most takeovers involving Chinese firms have not been hostile. In the IBM-Lenovo case, it was the western firm which sought a Chinese buyer and not the other way round. In this way, the western firm is able to overcome the exit barriers which prevented it from fully divesting from a particular sector. The Chinese investor in turn overcomes entry barriers which prevented it from selling under its own name in western markets.

In this way, ODI is not so much the reward for competitiveness at home as it is a way of becoming globally competitive. This reversal of the traditional intuition concerning ODI is more a reflection of an earlier bias in traditional FDI theory than it is of a need for a new theory of FDI. Having an overseas presence, though risky for an incipient MNE, can contribute in many ways to the firm’s overall competitiveness, much as can exporting.<sup>38</sup>

#### **Box 6. Is Chinese ODI a new form of business organisation?**

Many authors have rushed to proclaim Chinese ODI as the third or fourth wave of internationalisation which differs radically from what has gone before. The idea builds partly on the popular notion that Asian society is more collectivist than the individualistic culture found in the West. As such, relationships matter most of all in deriving competitiveness. Hitt et al (2002) discuss how Chinese firms are often better endowed with social capital than their western counterparts which gives them an advantage in forming and managing alliances and networks. There are nevertheless drawbacks in terms of path dependency and opportunity costs but overall they are effective in lowering transactions costs.

Mathews (2006, p. 14) describes how latecomers are able to build competitive advantages through “global clusters of semi-autonomous businesses, interacting with each other through multiple connections, as well as with suppliers and customers”. Li (2003, p. 233-5) argues that ownership advantages for these firms are more likely to be found at the network level rather than at the level of individual firms. Mathews (2002, p. 22) supports this view, arguing that “[t]hese new firms utilize international expansion in order to tap into resources that would otherwise be unavailable. They do so quickly because they are tapping into transient advantages; they are not concerned to establish solid international structures, but rather quickly develop flexible and 'lattice-like' structures spanning diverse countries and markets”. Erdener and Shapiro (2005) discuss the advantages of the Chinese family enterprise as a new form of MNE better adapted to conditions of uncertainty.

A corollary of this idea of a network of loose and ephemeral links among firms as a way of building competitiveness is the notion that internationalisation must be undertaken rapidly rather than incrementally as in the past. Bonaglia and Goldstein (2007, p. 32) suggest that while traditional incumbent MNEs are still very much tied to a ‘home base’ and to date have demonstrated little appetite for engaging in truly ‘global’ competition, emerging market MNEs are more likely from the start to be global in their outlook, strategy and organisation. “This is giving them rapidly acquired advantages over slower-moving and less-focused incumbents – even in markets that have traditionally been viewed as global.” In contrast to traditional MNEs, Mathews (2002, p. 23) argues that what he calls “Dragon multinationals are not burdened with historical baggage in their organizational structures, strategies and mentalities that derive from a previous era”.

This view of nimble Chinese firms becoming the first truly global firms is consonant with the pervasive idea of the “Asian century”, but it sits poorly with the experience of Chinese investors in Europe.<sup>39</sup> Indeed, the most common complaint of Chinese firms, which is often echoed by management consultants, is that they do not have the necessary organisational skills to manage their rapidly expanding global operations. It is nevertheless the case that the pace of internationalisation for these latecomers is more rapid than what occurred for many other MNEs, although it remains to be seen whether this simply reflects a catch-up phase in response to the rapid opening of the Chinese economy.

### **III. THE PERFORMANCE OF CHINESE INVESTMENT IN EUROPE**

This section will focus on the performance of acquisitions by Chinese firms in Europe. Not all Chinese firms choose to enter Europe in this way, but the role of M&As is clearly growing. In addition, greenfield projects often take several years before becoming profitable and hence any assessment of their performance will have to wait given the recent nature of many of these investments.

As we saw in the previous section, Chinese firms are often acquiring European companies and brands that were generally in financial difficulties. In some sectors, such as banking, an injection of capital from China might allow the European bank to overcome a temporary crisis which otherwise might have proved fatal. Even manufacturing firms that have over-extended themselves by taking on too much debt might be resuscitated by a foreign takeover. But in many cases, the financial difficulties of acquired European firms often point to deeper problems than corporate liquidity.

Many acquisitions have arisen in so-called 'sunset' industries where Europe is rapidly losing any comparative advantage. Firms in these industries often shift production offshore and retain control of the brand name and distribution in the home region, but at some point even these activities may pass under foreign control for reasons explained in Section IV. The question of most interest for our purposes is whether Chinese firms are able to preserve these brands and whether this implies a continuation of certain activities within Europe? And if so, which activities?

#### **The profitability of Chinese ODI**

The performance of Chinese ODI in Europe can be assessed through many different indicators. The first is the profitability of the investment, whether a greenfield project or an acquisition of a local firm.

By some accounts, Chinese investors have not been particularly profitable abroad. Deng (2004, p. 10) cites a study suggesting that one third of foreign affiliates of Chinese companies were losing money a decade ago, amounting to a total loss of US\$300 million in 1997 alone. Accenture (2007, p. 7) cites a World Bank study finding that one third of Chinese enterprises had lost money on their foreign investments and two thirds of joint ventures had failed. As underlined by a Deutsche Bank survey, "while cross-border M&A can be an effective way of achieving global expansion, studies have shown that as many as 60-70% of M&A deals fail to deliver shareholder value." (Deutsche Bank 2006).

Many of the problems involved in Chinese ODI can be traced to the difficulties in integrating acquired firms often with a very different corporate culture from the Chinese one. It would be wrong to characterise Chinese investors as neophytes in the area of internationalisation since they have had close relationships with foreign firms in China for a number of years, whether as joint venture partners or through OEM contracts. But at the same time, many Chinese firms seem ill-prepared for the task of integrating foreign companies or even of operating in foreign markets. Luo & Tung (2007, p. 494-5) list post-acquisition difficulties ranging from "building effective working relationships with host country stakeholders, reconciling disparate national- and corporate-level cultures, organizing globally dispersed complex activities, to integrating home and host country operations." In particular, Chinese firms have often shown themselves unprepared for their new relationship with foreign consumers, regulators, legislators, courts, unions, employees, financial institutions.

These difficulties are corroborated by many sources including Wu (2005). The survey of 150 Chinese MNEs by Yao & He (2005, p. 34) found that the sample firms reported 'culture conflict' to be the main challenge faced in their international operations. About fifty percent of respondents said that "they have faced important or very important challenges in understanding the host country's culture, monitoring and reacting quickly to changes on the ground, and accessing project financing. With the exception of quality-price ratio, the list of advantages listed by those firms in their domestic market shrunk substantially when applied to their overseas operations. This list included brand name, technology, human resources, access to market information, knowledge of policies and distribution channels. Access to finance has been a particularly challenging exercise for those firms."

A McKinsey survey of Chinese firms cited 'a lack of managerial talent' as the biggest obstacle to their overseas expansion, well ahead of any other potential barrier. "In our interviews, 88 percent of the Chinese executives said that their globalization efforts were hindered by the scarcity of people with real cross-cultural knowledge or experience managing foreign talent."<sup>40</sup>

These problems were foreshadowed to some extent by the experience of foreign investors in China in the 1990s. As Branstetter and Lardy (2006, p. 15) argue, "many Western investors were unprepared for the cultural clashes, administrative difficulties, and operational inefficiencies created by their "forced marriages" to Chinese SOEs".

### **How does Chinese ODI fare in the EU?**

Chinese ODI in Europe is too recent to be able to assess empirically its impact both on European host countries and firms and on the performance of the Chinese investor. Anecdotal evidence points to both failures and success stories.

#### ***Failures***

When ailing enterprises were acquired, most of the time they could not be revived. This is particularly true in the electronics sector. Following the acquisition of Schneider Electronics, TCL was unable able to re-energise the brand and turn its operations around. Despite efforts to retain the company's operations in Germany, with 60 employees remaining at the firm's former headquarters, production was completely stopped in Germany in 2005. The bulk of Schneider's production was moved to China and much of the rest to Hungary. The TCL takeover of Thomson was no more successful, at least in the European market, and production ceased in Europe in 2006.<sup>41</sup> Not only was there a vast difference in management styles of the two companies, but also the acquired European firms were financially distressed and turned out to be less technologically-advanced than expected, especially in the area of flat screen technology.

Similar failures were experienced with TCL's majority stakeholding in Alcatel Mobile and with the acquisition of Euro-Auto Hose (or Tuyaux de Nevers) by China's Yangzhou Greencool in 2004. In the latter case, the French producer of rubber pipes for the auto industry, ended production in July 2007, leading to 300 job losses.

The Chalkis acquisition of Les Conserves de Provence-Le Cabanon did not bring the expected results and the group, which is currently facing financial difficulties, had to downsize its activities and lay off part of its staff. It has been suggested that the Chinese investor was only seeking access to the "made in France" label but did not have an interest in the survival of the firm as such.

Other failures occurred in the electronics sector. Novel Vision, the French subsidiary of the Chinese group Xiamen Overseas Chinese Electronics Co (Xoxeco), specialised in assembling flat screen televisions, filed for bankruptcy in March 2008 as a result of a strategic shift by Xoxeco which had acquired the firm a year earlier. Because the costs of production were deemed to be too high, Xoxeco (which was taken over by a Korean investor in the meantime) chose to move its production back to China and to import finished products from China.

Among the sources of post-acquisition problems, one may mention the lack of experience of Chinese enterprises with M&A, their lack of managerial expertise (with cultural differences as major sources of difficulty), their inexperience in brand management, as well as their weak innovative capability. As stressed by Schüller and Turner (2005), poor knowledge of the local business attitude and the specifics of the local market provide further explanations. Lastly, Chinese investors apparently under-estimated the depth of the difficulties encountered when acquiring ailing firms in sunset industries.

### ***Success Stories***

Success stories tend to be concentrated in sectors where Chinese firms possess a competitive edge (telecommunication equipment) or where the European target is a strong leader or a niche producer. One reason why acquisitions of ailing firms have turned out to be more successful in Germany than in France may be because Chinese ODI has tended to be concentrated in sunset industries (in particular television production) in France.

Some acquisitions have allowed firms previously under financial stress to expand. German machine-tool producer Zimmermann was successfully taken over by Dalian Machine, allowing the firm to expand and establish itself in the US market.<sup>42</sup> Similarly Shang-Gong Group (SGSB) has supported technological innovation at Dürkopp Adler, thereby extending the firm's activities in new and promising areas, such as environmentally-friendly technologies. At the end of 2006, it introduced its new "green line" brand label.

The investments by the two Chinese telecommunication operators, Huawei and ZTE, also proved extremely successful and both firms intend gradually to expand their involvement in the European market. Their success can be largely attributed to the support of the Chinese Government, as well as to their competitiveness in the Chinese market. Both enterprises own strong technological assets and proved able to adapt to the local market, probably owing to the experience gained in other overseas ventures, particularly in developing economies.

BlueStar's acquisition of Rhodia's silicone activities is another example of a successful venture by a Chinese investor. The strategy of external growth conducted by the firm with the strong support of the government has helped it to develop its technological capacities and led to the expansion of production units in Europe as well as in China.

R&D centres are generally successfully maintained in Europe and gradually expanding in size.

### **Implications**

#### ***For European host-countries***

Given the recentness of Chinese ODI in Europe, as well as its still modest size, any judgement on its impact on host economies can merely be tentative. The available evidence suggests that Chinese firms have not been particularly successful at turning European companies around. Successful takeovers arise mostly where there are synergies between the two partners, with the Chinese investor providing more than just cash but also competitiveness in a given area.

Concerning job creations or preservations, the impact of Chinese ODI can be expected to be limited at the aggregate level because of its size, although local implications may not be negligible. In this respect, as explained above, the picture is rather mixed with a combination of failures involving plant shutdowns and job losses where ailing firms could not be turned around and, on the other hand, success stories associated with plant expansion and job creations. Overall, however, the impact in terms of job creation or preservation is relatively modest because Chinese ODI tends to be concentrated in sectors which are not labour-intensive. As highlighted earlier, the bulk of Chinese ODI is in the tertiary sector, with trading activities as the number one and representative offices aiming to provide support for exports. Similarly, R&D centres do not tend to generate many jobs.

Secondly, when jobs were preserved in ailing industries following a takeover by Chinese investors, this positive impact did not always last long. Sometimes, the takeover might be followed by a brief recovery in the firm's fortunes, but eventually the same weaknesses re-emerge. This was the case for the takeover of Novel Vision by Xoxeco where production ceased in early 2008.

While it is not uncommon (and also not surprising) that Chinese investors choose to put an end to production in Europe and move it to China, in some cases productive activities are taken up again on European sites after a temporary interruption. Such was the case of Nanjing Automobile which started by transferring production to China and shifted it back to the UK two years later. There is thus no general rule, and industrial activities are not systematically relocated to China. In some other cases still, Chinese investors opt for the duplication of production in Europe and China since having a presence in Europe is a way for Chinese investors to acquire expertise that can be exploited eventually in the fast expanding Chinese market. Such has been the case of China BlueStar.

Turning now to the impact of Chinese ODI on host countries' industrial structure, the major lesson is that the chances for the revival of sunset industries are rather bleak, as exemplified by the repeated failures in the acquisition of television production units (Thomson, Schneider, Novel Vision). According to Hay, Milelli and Shi (2008), the impact of Chinese ODI differs across countries, with German industries emerging stronger thanks to Chinese investment, while French industrial weaknesses are in contrast deepened. As explained earlier, this state of play has to do with the different sectoral specialisation of Chinese investments in these two countries.

More generally, the impact of Chinese ODI tends to differ across sectors. An example of a positive impact is the British automotive sector where, thanks to Chinese investments, a number of automotive equipment manufacturers could be kept alive and even sometimes expand. Similarly, the arrival of Chinese operators in the telecommunication equipment industry has undoubtedly exerted a positive impact on the European sector, by intensifying competition and stimulating local producers.

Any effect on the acquired firm must also be assessed against an appropriate counterfactual: what would have happened to production in Europe in the absence of the acquisition? In many cases, the acquired firm was either bankrupt or facing severe financial difficulties. The broader question of the economic implications of Chinese ODI goes well beyond the question of whether the acquired firm retains any production in Europe.

In terms of corporate strategy, one lesson of the rise of ODI from China and other emerging markets is perhaps that, for European firms, the strategy of shifting basic production to China while retaining control of the brand and distribution network might no longer be sufficient to maintain

competitiveness in the long term. Without a steady stream of innovations, the justification for retaining ownership of the means of production becomes obsolete.

### *For China*

To understand the implications of Chinese ODI in Europe for China itself, it is first necessary to understand why Chinese firms are seeking to acquire strategic assets abroad. It stems both from the poor performance of national innovation in China and from the weak technological spillovers from inward investment.

Branstetter and Lardy (2006) argue forcefully that the appearance of ever-rising high-technology exports from China is largely a mirage. “China does not...in any real sense manufacture these goods. Rather it assembles them from imported parts and components. For example, domestic value-added accounts for only 15 percent of the value of exported electronic and information technology products.”<sup>43</sup> This explains why, although China exported US\$142 billion of electronic and information technology products in 2003, net exports were only US\$15 billion. China’s domestic production of semiconductors and microprocessors is still modest. Furthermore, most of these exports are by foreign-owned firms producing in China. These firms represent over one half of Chinese manufactured exports, 92 per cent of exports of computers, components and peripherals and 74 per cent of exports of electronics and telecommunications equipment.

From this review of China’s trade in electronics, the authors conclude that “the rapidly changing commodity composition of China’s exports does not appear to constitute evidence that Chinese firms are leapfrogging ahead technologically, because these exports are not primarily driven by the expanding ‘knowledge stock’ or innovative capabilities of domestic firms. Indeed, there may be a growing technology gap between foreign firms operating in China and domestic Chinese companies.”<sup>44</sup> This gap results both from the low level of spending on R&D by Chinese firms to develop new technologies on their own and from the low rate of technology transfer from wholly foreign-owned firms in China to Chinese companies.

It remains to be seen whether technology absorption will improve simply because Chinese firms have started to acquire foreign firms with proprietary technologies.

There may also be a risk of compromising continued economic growth by deflecting capital away from more efficient private sector ventures.

Lastly, an interesting potential benefit pertains to the complementarity between ODI and inward direct investment. Globerman and Shapiro (2007, p. 229) argue that:

[ODI] is associated with net productivity benefits to the home country that are manifested in higher per capita real income levels. The evidence suggests that the productivity benefits of [ODI] are achieved primarily through efficiency gains tied to the specialization and scale advantages of firms competing in international markets, and the indirect importation of knowledge and technology through imports and internal spillovers. In this sense, [ODI] benefits are ultimately linked to international economic integration, which, in turn, has resulted in rising per capita incomes in developed home economies. In short, [ODI] in developed economies is part of a tightly coupled system of complementary relationships that includes inward FDI...and trade flows, and the benefits to [ODI] are best understood in the context of these complementary relationships.

This view of the complementarity of inward direct investment and ODI in terms of economic effects; which we share, is likely to be equally valid in the context of Chinese inward and outward investment.



Inflows and outflows of FDI, like international trade, are important elements in global economic integration. The same attributes are likely to determine whether or how an economy benefits as a host to IDI and as a home to ODI. There are thus good reasons to believe that disappointment in China with the benefits of inward direct investment in terms of spillovers and technology transfer may be matched by disappointment with the results of ODI.

## CONCLUSION

1. Strategic acquisitions of well-known European companies account for the perception of China becoming an aggressive buyer of European assets and a global threat. In reality, however, besides the limited magnitude of Chinese ODI, the other reason for downplaying the alleged “China threat” pertains to the low success rate of Chinese M&As so far. Moreover, China is not seeking to buy up European firms, acquisitions may be an important form of investment, but again they are marginal, and more often than not they target European firms under financial stress.
2. Chinese ODI is still very much at the trial and error stage. Targeted firms are not necessarily well-selected or Chinese firms are not in a position to handle the difficulties associated with cultural differences as well as with the challenge of turning them around.
3. Also, as argued by McKinsey, EU firms should probably prepare for competitive pressure from Chinese investors, but they should also take the opportunity to discharge underperforming assets.
4. From a theoretical perspective, Chinese ODI does not reflect a new ODI paradigm. Although motives are varied, it has much in common with other Asian investors which have preceded it: Japanese and Korean FDI were also strategic asset seeking, R&D listening posts and tariff-jumping. The difference probably lies in the weighting of the different motives but not in their range.
5. An important difference between Chinese ODI and Japanese or Korean ODI is that the home country (China) still has a strong comparative advantage in basic manufacturing. It remains to be seen whether it will accelerate the structural transformation of the world economy already under way through trade (as more and more basic manufacturing shifts to China while R&D expands in Europe). While the overall welfare gains from this enhanced international division of labour may be profound, low-skilled employment, sometimes in already depressed regions, might suffer. On the other hand, jobs are sometimes preserved.
6. From China’s perspective, a number of questions remain unanswered. While Chinese ODI is expected to help upgrade some of China’s industries, for the time being, the persistence of China’s comparative advantage in basic manufacturing and the reinforcement of the traditional division of labour with R&D centres in the EU and manufacturing facilities in China do not point in this direction. In addition, there may be a risk of compromising continued economic growth by deflecting capital away from more efficient private sector ventures.
7. Chinese ODI is as much a sign of weakness as of strength. In this respect it differs in one important way from earlier waves by US or Japanese MNEs. Chinese firms have still not developed adequate technological strengths to compete on their own in western markets. One half of Chinese manufacturing exports are by foreign-owned firms in China, or over 80 per cent of exports of technologically sophisticated goods. In a sense, ODI is a manifestation of the limitations of export-led development when, as other countries such as Malaysia have discovered, export-oriented FDI does not always result in the transfer of significant amounts of technology to local firms. The acquisition of existing brands may provide a short cut to competitiveness in some cases but it may also turn out to be a dead end.

8. Lastly, the complementarity of inward and outward direct investment in terms of economic effects is likely to be equally valid in the context of Chinese inward and outward investment. In particular, disappointment in China with the benefits of inward direct investment in terms of spillovers and technology transfer are likely to be matched by disappointment with the results of ODI. It is not immediately clear why there would be an asymmetric response to the two forms of integration, even if ODI has arisen partly to compensate for the poor results of inward direct investment.
9. Of course, the past is not necessarily a good guide to the future and Chinese investments can be expected to gain ground further. This is all the more likely because Chinese investors are so far “under-performing” in Europe. As a result they can no longer be neglected. Keeping an eye on the evolution of Chinese ventures in Europe should thus rank high on the priority list of European researchers as well as policy-makers.

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## Notes

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<sup>4</sup> Non-financial sector ODI, including business services, mining and wholesale and retail sectors, reached \$18.7 billion in 2007, while financial ODI (reported by SAFE) was \$3.53 billion in 2006.

<sup>5</sup> MOFCOM (2008).

<sup>6</sup> There are nevertheless two diversified firms from Hong Kong (China).

<sup>7</sup> The Outward FDI Performance Index is calculated as the share of a country’s outward FDI in world FDI as a ratio of its share in world GDP.

<sup>8</sup> The modest share of Europe is a major difference with the distribution of Indian ODI (see Hay, Milelli and Shi 2008).

<sup>9</sup> Yao and He (2005).

<sup>10</sup> Cheng and Stough (2007).

<sup>11</sup> China’s ‘go global’ policy aims at complementing the country’s inward FDI policy regime by enhancing local firms’ competitiveness. According to UNCTAD (2005), quoted in Peng 2007, China is the only Asian government which explicitly encourages investment in R&D. At the macroeconomic level, the policy is also seen partly as a way of alleviating some of the pressure on the currency to appreciate, as it was with Germany and Japan in earlier decades. The balance of payments situation has helped to determine government policies towards both inward and outward investment at various times in many countries.

<sup>12</sup> The NDRC replaced the State Planning Commission in 2003. It is a macroeconomic management agency under the State Council, which studies and formulates policies for economic and social development, maintains a balance of economic aggregates and guides overall economic system restructuring. The SAFE drafts rules and regulations governing foreign exchange market activities and manages foreign exchange reserves.

<sup>13</sup> Child and Rodrigues (2005), p. 401.

<sup>14</sup> SASAC was established in 2003, with a mandate to turn the country’s top SOEs under its control into 50 global MNEs, all featuring on the global Fortune 500 list (Pamlin and Baijin 2007, p. 19).

<sup>15</sup> The parent company of Lenovo, Legend Holdings Limited, holds a 42.2% controlling stake in Lenovo. Legend, in turn, is controlled by the Chinese Academy of Natural Sciences.

<sup>16</sup> Yao and He (2005).

<sup>17</sup> To complicate further the ownership picture, the state investment vehicle, the CIC, has taken a 9.9 per cent stake in Blackstone.

<sup>18</sup> Grant (2008), p. 3.

<sup>19</sup> Woetzel (2008), p. 1.

<sup>20</sup> *Ibid*, p. 2.

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- <sup>21</sup> *Financial Times*, April 25, 2008.
- <sup>22</sup> Government support for ODI projects generally takes the form of access to below-market rate loans, direct capital contributions, and subsidies associated with the official aid programs. The government has also established special funds to back up China's ODI projects. Lastly, Chinese enterprises operating overseas may benefit from corporate income tax exemption for the first five years of their operations[0].
- <sup>23</sup> Dealogic, quoted in Schüller and Turner (2005).
- <sup>24</sup> European Investment Monitor (2008)
- <sup>25</sup> Hatem (2005).
- <sup>26</sup> The figures presented do not include acquisition of businesses with sound finances or minority interests, although this is the preferred method for BRIC investors to set up in Europe. They thus tend to understate the presence of these firms in Europe.
- <sup>27</sup> AFII Matthieu (2006).
- <sup>28</sup> Hatem 2005 – AFII fonctions
- <sup>29</sup> OCO (2007), Ernst and Young (2008).
- <sup>30</sup> Invest in France, May 2007.
- <sup>31</sup> Accenture (2007), p. 10.
- <sup>32</sup> Wong and Chan (2003), quoted by Hong and Sun (2004).
- <sup>33</sup> ZTE is engaged in strategic agreements with a number of other European firms such as France Telecom, Portugal Telecom, Alcatel, Ericsson and Nortel.
- <sup>34</sup> Danish Investment Center 2008.
- <sup>35</sup> *East meets West – Inbound M&A Germany: Emerging Market Perspectives*, September 2007.
- <sup>36</sup> Hong and Sun (2006), p. 626.
- <sup>37</sup> Liu (2007), p. 574.
- <sup>38</sup> The notion of 'learning by exporting' was developed to explain how exporting can help firms to "improve the quality of their products and production processes through contact with more advanced foreign competitors in global export markets" (Branstetter 2000, p. 2).
- <sup>39</sup> One can detect a certain amount of hubris in the titles of recent business books on Chinese capitalism, such as *Made in Galanz: A Miracle Story* or *Made in China: What Western Managers Can Learn from China's Trailblazing Entrepreneur*.
- <sup>40</sup> "How Chinese companies can succeed abroad", *The McKinsey Quarterly*, May 2008, p. 4.
- <sup>41</sup> Since October 2007, Haier has resumed production of television sets in the former TCL site in Angers.
- <sup>42</sup> Hay *et al.* 2008, p. 23.
- <sup>43</sup> Branstetter and Lardy (2006), p. 38.
- <sup>44</sup> *Ibid.* p. 40.