Tabled Documents -
Senate Economics References Committee
Wednesday 1 July 2009
Professor Peter Drysdale

China as a new foreign investor

Peter Drysdale[1]

The surge of Chinese investment into the Australian resource sector focused attention worldwide on the issue of China as a new investor abroad. Three particular investment projects have excited controversy in the Australian and international press—Chinalco's investment in Rio Tinto; Sinosteel's takeover of Midwest and its bid for Murchison; and Minmetal's purchase of OZ Minerals[2]. This controversy was catalysed by the issue of Chinese investment more generally. Had it succeeded the Chinalco deal, involving an 18 per cent (US$19billion) stake in Rio Tinto would have been the largest single Chinese corporate acquisition overseas to date.

The motivation for Chinese foreign direct investment (FDI) is twofold. Firstly, Chinese investors in the resources sector aim to secure stakes in projects that are linked to supplying rapidly growing markets in China. Secondly, Chinese investors perceive going into FDI as an investment in their future, as the Australian (or other foreign) projects and firms in which they invest bring management know-how and technology, and have a positive impact on Chinese firm operational efficiency and corporate standing. The 'going out' strategy for Chinese enterprise promoted by the Chinese government over the last few years has encouraged this. On the other side, FDI in the resource sector offers various advantages to host countries including the provision of capital, technology, know-how and access to markets. These benefits are substantial to Australia, for example, given the scale, longevity and technological complexity that typify resources investments.

So what, if anything, is different about Chinese investment abroad?

---

[1] Peter Drysdale is Emeritus Professor of Economics in the Crawford School of Economics and Government at the Australian National University. He is indebted to Edward Kus for research assistance in putting this paper together. Some of the material in this essay is treated at more length in a paper by Peter Drysdale and Christopher Findlay, 'Chinese Foreign Direct Investment in Australia: Policy Issues for the Resource Sector', *China Economic Journal*, June 2009 and the China Economy and Business Program, *China Update*, The Australian National University, Canberra, July 2009 (forthcoming).

[2] Findlay and Drysdale, 'Chinese Foreign Direct Investment', pp. 13 ff.

The new face of Chinese FDI

Four years ago, a report for the World Bank on Chinese investment abroad by Yang and He at Peking University[3], excited very little attention. At that time, despite a few high profile acquisitions in developed countries encouraged by the new 'going out' policy, most Chinese investment was from small or medium sized private firms and not dissimilar to other ethnic Chinese investment throughout Asia. As Yang and He observed, 'implementing the 'going out' policy has not been without its difficulties'[4]. While some Chinese firms have been successful in their investment abroad, 'impediments to outward investment in both China and host countries are not uncommon'[5], and the record was not entirely good.

What is different about the new wave of Chinese investment is that it now emanates largely from state owned enterprises (SOEs). China is a partially reformed economy. The character of SOEs in China is evolving very rapidly. For example, when China invested in the Channar iron ore mine in the 1980s[6], it did so through the Ministry of Minerals and Metallurgical Industry. Steel and other enterprises under that umbrella have now been fragmented into several competing entities and corporatized, with some listed on both the Chinese and international stock exchanges. Changes in corporate governance include the establishment of non-executive boards and executive independence in the day-to-day operations of most state owned enterprises. Some SOEs, however, are more independent in their operations than others.

Since 2003, the State-Owned Assets Supervision and Administration Commission (SASAC) has been responsible for exercising the ownership of SOEs on behalf of the Chinese government. SASAC has two roles. It supervises the key state enterprises and their management. It also carries forward the reform of SOEs, their governance, consolidation and privatization[7]. This is an active and ongoing process aimed at making SOEs conform to normal commercial market disciplines. Still, many believe that ownership of enterprise by the state and the presence of

[3] Yao Yang and Yin He, 'Chinese Investment Overseas', *Report to the World Bank*, August 2005.
[4] *Ibid*, p.1
[5] *Ibid* p. 1
[6] Findlay and Drysdale, 'Chinese Foreign Direct Investment', p.7.
[7] SASAC (website) and interviews with Shao Ning, and senior officials, SASAC, 5 June 2009.

political cadres[8] in the senior management of these enterprises in China should disqualify them from being subject to the normal rules and regulations applied to other foreign investors in host countries like Australia and elsewhere. This is not only a matter of public comment. It has been a policy consideration in Canada for some time, and is also now a matter of explicit policy consideration in Australia[9].

Other distinctions are also made in respect of Chinese foreign investors. The political system in their home country, political or strategic motives that are putatively attributed to them and the ethnicity of their principals play a role. These are not high order issues although, at the margins, they do colour the political process surrounding the management of policy towards Chinese FDI.

The scale of Chinese FDI growth

China's FDI outflows took off rapidly in the 2000s, catalysed by the 'going out', policy aimed at establishing the country's national corporate champions as international players. Chinese investment abroad averaged only US$453 million a year in the period 1982 to 1989 and US$2.3 billion from 1990 to 1999. It rose to US$5.5 billion in 2004, US$12.3 billion in 2005, US$17.6 billion in 2006 and US$24.8 billion in 2007. Preliminary figures for 2008, Davies also reports[10], show a rise to US$40.7 billion. He says that if 'financial FDI (not counted before 2006) is included, the 2008 total was US$52.2 billion, nearly double the US$26.5 billion in 2007'[11]. The evidence suggests that China's outward FDI growth continued to accelerate in the first half of 2009. Whereas global FDI fell by at least 20 per cent last year, Chinese FDI doubled. Much of the new Chinese investment activity abroad has been directed at resources. [12]

There has been nervousness and an investment protectionist reaction in the past to every new surge of foreign investment activity in the past (from the United States in the 1950s and 1960s

[8] It is not necessary to be a party member to rise to a senior management position in a SOE, although many are. 'It has the same sort of advantages and disadvantages as being a member of the Melbourne Club (in Australia)'
[9] Wayne Swan, *Australia, China and This Asian Century,* Speech to the Australia-China Business Council, Melbourne, 4 July 2008

[10] Ken Davies, 'While global FDI falls, China's outward FDI doubles', *Columbia FDI Perspectives,* No 5, 26 May 2009, (http://www.vcc.columbia.edu/www.vcc.columbia.edu), p. 1

[11] *Ibid*
[12] Drysdale and Findlay, 'Chinese Foreign Direct Investment' p. 2

and Japan in the 1970s and 1980s) so the response to the surge of Chinese investment growth is not unusual.

Keeping the scale of Chinese FDI in perspective

The growth of Chinese investment abroad is remarkable but it needs to be kept in perspective.

The recent growth of Chinese FDI activity in Australia is perhaps more intense than in any other developed economy. Yet Foreign Investment Review Board (FIRB)-approved Chinese FDI amounted only to $A10 billion in 2005-06 and 2006-07, of which about $A8 billion or 80 per cent was in minerals and resources. The Australian Treasurer reported in his speech of 4 July 2008 that, since November 2007, however, he had received applications to the value of $A30 billion for investment projects from China.[13] Had these investments materialised, it would represent a large jump in China's foreign investment presence in Australia, but it would still leave China a much less important investor than United States, or the United Kingdom, both of which now have smaller trade relationships with Australia than does China. Davies suggests that the Chinese investment in Australia alone rose from US$1.4billion in the first quarter of 2008 to US$13billion in the same period this year, although these data appear to exaggerate the actual growth considerably.

Japan is a much larger investor than China (with inflow of direct and portfolio investment of A$26 billion last year)[14]. Foreign investment approvals through FIRB are commonly higher than investments actually realised as measured by the Australian Bureau of Statistics (ABS).
As measured by the ABS, Chinese investment inflow into Australia averaged only $A180 million annually over the past decade. By 2006, the accumulated stock of Chinese investment in Australia stood at $A3.5 billion, on par with that of Taiwan. Currently, China's FDI in Australia represents less than one quarter of one per cent of the total stock of FDI in Australia. Its concentration in the resources sector gives China a higher share of resource investments, but still

[13] *Australian Financial Review*, 5 July 2009.

[14] Greg Earl, 'Pssst...Guess who's the biggest foreign investor of all' *Australian Financial Review*, 25 June 2009. The official data for the fiscal year to 2008 have not yet been published (as of June 2009).

its total share is not much over one per cent of FDI in that sector[15]. However, investment in the resource sector by Chinese enterprises has remained active through the crisis (arguably it has become more active) as bank finance and other investors have retreated from the market.

Unless it is deliberately constrained, China's share in Australian trade and in global trade and capital markets is destined to continue to grow—for good commercial reasons—and China's share in the direct and indirect ownership of Australian and global assets is likely to grow commensurately. Relative to the scale of its trade relationships and economic size, China is underinvested in Australia and other countries. It is unlikely to remain so.

The question of consumer monopoly power in the resource trade

Anxiety over the growth of foreign investment in resources by China is as unfounded as it was over the earlier growth in foreign investment by Japan. Australia has perhaps the most efficient mining sector in the world. This is due to its openness to foreign investor competition and participation, because that brings with it, and fosters, the technology, management know-how and market links that are essential ingredients in the development of a world class, internationally competitive industry. Australia, therefore, has a strong policy regime, characterised by openness towards foreign investment in its resource industries, despite the fact that, by one measure, Australia is ranked among the most restrictive among OECD countries in its treatment of FDI more generally (Stoeckel, 2008; Kearney, 2007)[16].

FDI is often part of an integrated set of mining and industrial activities. [17] Vertical integration is not the only way to manage project risks. Other options include the use of long term contracts between independent firms, complemented by portfolio capital flows. The result is that buyers and sellers in these markets operate portfolios of bilateral trade or sales and procurement links.

---

[15] Drysdale and Findlay, Chinese Direct Foreign Investment', pp. 11-12.

[16] These indexes measure the formal requirements for investment approval, and these requirements will have an effect in deterring investment, although not necessarily in investment approval outcomes. On this latter measure Australia might rank as a less restrictive regime.

[17] Ben Smith, 'Long Term Contract Arrangements and Financing Arrangements for Minerals Developments', *Research Paper, Australia Japan Research Centre*, No. 72, Canberra, September 1980.

Provision of equity capital to the project or the mining company by the buyers of the output demonstrates another form of commitment by them. Control is not required, but may be sought depending on the nature of the project, though even an investment to a level which is less than required for control may still meet the definition of FDI. If that investment by the buyer also reduces the cost of finance to the mining company (by allowing that company to ease what otherwise would be restrictions on its capacity to raise debt) then it adds to the surplus available for distribution.

These circumstances are those likely to dominate Chinese investment interest in the Australian resource sector. Chinese investors are overwhelmingly prefer a stake in projects that provides a link to markets in China and offers an additional source of capital, and to want to invest in partnership with Australian or other foreign firms that bring management know-how and technology as well as capital to mining projects.

What about the question of state ownership?[18]

In the case of Chinese foreign direct investment, there is the additional question of whether government or state-ownership should matter in the treatment of applications to invest. Chinese FDI is not the only FDI in which government ownership may be important, but growth in the number of projects in which interest is being expressed by Chinese entities with some measure of government ownership has been a policy factor. This includes both SOEs and sovereign wealth funds (SWFs).

The Australian government has responded with an elaboration of policy on screening foreign investments. In February 2008 it announced a set of guidelines covering investment applications by SOEs which are applied in relation to Chinese and other FDI proposals[19].

Some might argue that investment by an SOE is likely, of its nature, to be inefficient and resource-wasting. Government-owned enterprises have their origins in bureaucratic systems and have governance structures not subject to the disciplines of the market. Would Singtel, the

[18] The material in this section draws directly from Drysdale and Findlay, 'Chinese Foreign Direct Investment'.pp.32-39

[19] Drysdale and Findlay, 'Chinese Foreign Direct Investment'. Appendix 1.

Singapore government-owned telecommunications provider and investor in Optus, have qualified for scrutiny merely on that ground? Whatever the firm-specific advantage a government-owned foreign investor in the resource industry brings to a project (commonly a marketing link involving integration of operations along a production chain or access to additional capital), the value it puts on the asset will be ultimately tested in the market.

In fact, the empirical evidence suggests that state-owned foreign investors have performed well (Young and Lu, 1998). Multinational state-owned enterprises from Eastern Europe perform similarly to other foreign firms. Nor is there any evidence of the use of state power or privileged information in their business abroad. The goals of these ventures appear to be simply to operate successfully within the confines of the market. The investment proposals in Australia are with a Chinese investor strategy that is commercially motivated.

It is strategically important that Australia and other developed market economies welcome participation of Chinese state-owned firms rather than remain cautious about it. Domestically, SOEs in China are increasingly subject to the disciplines of the market. They enjoy preferred access to domestic credit through the state-owned banking system but on terms that are increasingly commercially based[20]. The prevalence of SOEs is wider in China than was the prevalence of state-ownership in the resource-consuming and resource investing industries in Japan thirty or forty years ago, but their entrenchment in the market is not so different. Chinese companies in which the state has a stake are publicly listed at home and, increasingly, in Hong Kong and abroad. Corporate organisation and governance in China is in a state of transition and is evolving towards a system increasingly governed by market institutions.

As Woetzel says[21]:

> An out-of-date impression of state-owned companies distorts the picture of China's competitive landscape and masks both opportunities and threats facing multinationals. A more current view would, for example, have them consider more favourably the value that certain state-owned companies might bring to a global partnership. A realistic

---

[20] Their access to funds from that source for foreign investment is constrained by commercial discipline, as recent experience with investment in the Indonesian power sector appears to attest.

[21] Jonathan R Woetzel, 'Reassessing China's State-Owned Enterprises', The *McKinsey Quarterly*, August 2008.

> multinational must also recognize that they will become more attractive to top talent and, probably, more innovative. Both developments will ratchet up the level of competition.

Thornton , a director on the board of large Chinese state-owned firms, observes[22]:

> ...officials at the highest levels (in China) recognize the need to put in place what might be called a modern system of corporate governance. They know that they'll be required to meet certain standards when they list their major companies in public markets in Hong Kong, London, or New York. They're also increasingly convinced that better corporate governance leads to better business results, greater efficiencies, wealth creation—all of those things that are good for companies, people, and the country. They have seen that even non-traded corporations like Saudi Arabia's Aramco have adopted leading corporate-governance practices.

China's SOEs are being restructured with a focus on profitability and maintaining market reform momentum. *China's Guidelines for Reform in 2009,* released recently by the State Council details a strategy to deepen the reforms in monopolistic sectors, and open the sectors and channels for private investors[23].

Many countries spanning different economic and political systems have implicit and explicit state involvement in enterprises (for good or ill) and the state is often actively engaged in representations on behalf of its national enterprises (especially but not only in developing economies).. When Japanese investors took a stake in Australian resources some were state owned and most made decisions and received significant subsidised funding within a framework closely constrained by the state. Most large financial institutions in developed market economies (including Australia) are now bound to the state in various ways. State ownership is a fuzzy issue, and it would seem unwise to stereotype state ownership in China when it is in fact changing rapidly and has fewer and fewer of the negative characteristics popularly attributed to it.

---

[22] John Thorton, 'Governing China's Boards: An Interview with John Thornton', *The McKinsey Quarterly*, August 2008.

[23] Yongsheng Zhang, 'Does Australia really benefit from the rejection of the Rio-Chinalco deal?' http://www.eastasiaforum.org/2009/06/16/does-australia-really-benefit-from-the-rejection-of-the-rio-chinalco-deal/

Conclusion

Practical engagement recommends welcoming investments from Chinese SOEs because through their fuller participation in the Australian market and other developed markets abroad they subject themselves to the disciplines of robust and well-governed market institutions. Applying special conditions for these investments would reinforce the perception of the primacy of regulatory solutions over market solutions, and help sustain the dominance of the bureaucracy over the market in China.

The rapid rise of China caught many by surprise including policymakers in Australia, although Australia has been on the leading edge of the wave. The intensification of Chinese investment activity in the Australian resource sector and right around the world has also come swiftly. These developments alone do not explain the recent elevation of policy interest in Chinese investment in the Australian resource sector or the discomfit of governments in developed countries in dealing with the issue, as suggested above.

There is a complex of political economy issues that will have to be resolved both within China, and in cooperation between China and her major economic partners. In aiming to guarantee for itself the resources and technology it needs as a developing nation and to transform its industrial giants into truly globally competitive players, China has fallen victim to misapprehension about the dangers that Chinese SOEs may pose to other states' national sovereignty. It is important to avoid investment protectionism and establish a cooperative framework—bilaterally, regionally and globally—where these issues can be resolved.

Increased international cooperation on them will bring benefits to both the investor and the host-nation alike, especially because granting FDI market access to a transitional market economy like China has scope to influence positively the dynamics of institutional change beyond the mere matrix of pecuniary and fiscal opportunity.

1 July 2009