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STRATEGIES FOR MANAGING CHINA'S STATE-OWNED FOREIGN DIRECT INVESTMENT

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Strategies for Managing China's State-owned Foreign Direct Investment

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Abstract: China’s state-owned enterprises (SOEs) and their overseas investment have played an important role in China's economic development. Nonetheless, the rapid expansion of SOE-dominated overseas investment from China has also raised concerns about so-called state capitalism, and several Western countries have objected to some cases of overseas investment from China, proffering various excuses. Meanwhile, the urgent need for both domestic market-oriented reform and the transformation of China’s development model has also raised new challenges for China’s overseas investment pattern. Domestically, China's overseas investment should promote its economic growth and the transformation of its development model so as to best serve its national interest. Internationally, China's overseas investment should promote fair competition in the international markets, and make China's economic success a win-win situation with the rest of the world. These two objectives are internally consistent. This paper aims to examine China's overseas investment from these two perspectives, and subsequently propose recommendations on how to better manage China’s SOE overseas investment.

Key words: China’s overseas investment; state-owned enterprises; strategic adjustment

1 Introduction

Chinese enterprises have accelerated their pace of overseas investment since the 1990s, when the Chinese economy began to greatly expand. In particular, the Chinese government set out to pursue the dual concepts of “two markets” and “two resources” (i.e. overseas and domestic) and accelerate the implementation of the “going out” strategy in 2000, at which point the overseas investment of Chinese enterprises started to boom. After the financial crisis began in 2008, developed countries like the US and those throughout Europe were stuck in the economic downturn and rushed to withdraw their capital from overseas. Yet Chinese companies—especially large state-owned enterprises (SOEs)—staged their rapid overseas expansion through various means, including direct investment and mergers and acquisitions (M&A).

According to statistics from the Chinese Ministry of Commerce (2012), China's stock of foreign direct investment (FDI) hit US$317.21 billion by the end of 2010, and 13,000 Chinese companies had established branches in 178 countries (regions), covering all sectors. In 2010, China's FDI flows reached US$68.81 billion, surpassing Japan (US$56.26 billion), the UK (US$11.02 billion) and other traditional overseas investment powers for the first time, and ranking fifth in the world. Among these FDI flows, investment achieved through M&A activities hit US$29.7 billion, accounting for 43 per cent of that year's FDI flows, and becoming the fastest means of growth for overseas investment by Chinese enterprises. A striking figure is that overseas investment by SOEs reached US$42.39 billion, accounting for 61.6 per cent of China's total flow.

However, the rapid expansion of overseas investment by Chinese SOEs has also raised concerns about so-called state capitalism and provoked opposition—under various guises—in some Western countries. Some public opinion sees the investment activities of Chinese SOEs as a front for China's government, and these sectors of the public appear concerned that such "state capitalism" could bring about unfair global competition (see, for example, *The Economist* (2012)[1] and OECD[2]). As a result, the demand for so-called competitive neutrality has emerged throughout the world. Some overseas M&A cases initiated by Chinese SOEs were even refused for a variety of excuses, including national security. At home, the transformation of China's development model has proved a difficult task, since the structural reforms necessary to achieve this transformation have encountered enormous obstacles from China's vested interests. Holding a privileged position, and able to access lucrative resources, Chinese SOEs have aggressively expanded in both domestic and overseas markets. In contrast, the development of China's private companies has encountered institutional bottlenecks. All these problems have raised concerns about China's market-oriented reforms.

The emergence of these problems is not simply due to the fact that the overseas investment is from China, but that it stems from China's SOEs. In this context, China needs to rethink its overseas investment strategy. First, to what extent does China's SOE-dominated overseas investment reflect the needs of domestic reform and development? And second, is this strategy conducive to the formation of a fair global order, and does it help to build a win-win situation for China and the rest of the world? The answers to these two questions are related to how China will adjust and refine its overseas investment strategy.

This paper aims to rethink China's overseas investment strategy from these two perspectives, and thereby propose recommendations to improve China's overseas investment strategy as it relates to SOEs. Section two will investigate the reasons for the dominance of SOEs in China's overseas investment and the new characteristics of this investment. Section three analyses the challenges facing China's overseas investment at home and abroad. Section four reviews China's SOE-dominated overseas investment from these two perspectives. Section five discusses a number of issues relevant to China and state capitalism. The last section concludes the paper with several policy recommendations on how to better manage the overseas

[1] According to *The Economist*, "China is utterly convinced that it needs to use all the elements of national power-its companies and banks, its aid agencies and diplomats-to get its rightful share".

[2] The OECD has framed the issue by identifying three reasons why SOEs may create an uneven playing field. These are: (1) receipt of support from their government owners; (2) incentives provided to SOE managers that provide them with advantages not enjoyed by private companies, which are governed by cost constraints and profit goals; and (3) incentives that are not corrected by corporate governance arrangements (see Hormats, 2011).

investment of Chinese SOEs.

2. Reasons for the dominance of SOEs in China's overseas investment and the new characteristics of this investment

Prior to 2000, China's opening-up policy focused on attracting foreign investment, while outward investment was quite limited. The expansion of China's outward investment started with its "going out" strategy in 2000, but after the 2008 financial crisis in particular, the scale of China's overseas investment showed explosive growth. Large- and medium-sized SOEs have occupied a dominant position in this expansion, and some new features are emerging.

1) Why SOEs have dominated China's overseas investment

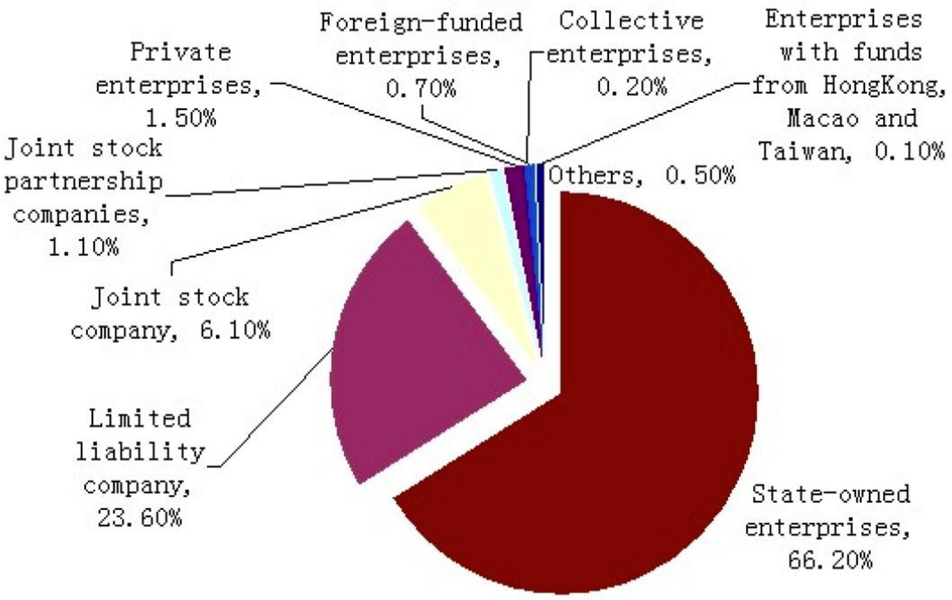
In the process of "going out", China's large SOEs have always been dominant. Although the vast majority of enterprises connected to this strategy are small and medium sized, large SOEs, especially those controlled by the central government, are dominant in the scale and volume of financing in overseas investment. Among the top 50 Chinese non-financial enterprises in terms of FDI stock and overseas asset size, the vast majority are controlled by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) (see Table 1). In 2010, the foreign investment stock of SOEs reached US$210 billion, accounting for 66.2 per cent of national stock (see Figure 1).

Table 1: Top 50 Chinese non-financial companies according to stock of FDI at the end of 2010.

1	China Petrochemical Corporation (SINOPEC)	26	Legend Holdings Ltd.
2	China National Petroleum Corporation (CNPC)	27	Shumyip Holdings Company Limited
3	China National Offshore Oil Corporation (CNOOC)	28	China Nonferrous Metal Mining (Group) Co., Ltd. (CNMC)
4	Huarun (Group) Corporation	29	China Communications Construction Company Limited (CCCC)
5	China Ocean Shipping(Group) Company	30	Guangdong Holdings Limited
6	COFCO	31	China North Industries Group Corporation (Norinco Group)
7	Aluminum Corporation of China (CHINALCO),	32	Wuhan Iron and Steel (Group) Corporation (WISCO)
8	China Merchants Group	33	Sinohydro Corporation
9	SINOCHEM GROUP	34	State Grid Corporation of China
10	China United Network Communications Limited (China Unicom)	35	Shougang Group
11	China State construction Engineering corporation (CSCEC)	36	Anshan Iron and Steel Group Corporation (Ansteel)
12	China Minmetals Corporation	37	Shenhua Group Corporation Limited
13	China National Aviation Holding Company (CNAH)	38	Baosteel Group
14	SINOTRANS&CSC Holding Co., Ltd.	39	China Guangdong Nuclear Power Holding Co., Ltd (CGNPC)
15	Sinosteel Corporation	40	China Railway Construction Corporation (CRCC) Tongguan Investment Co., Ltd.
16	CITIC Group	41	Beijing Enterprises Group Company Limited
17	China Shipping (Group) Company	42	China Telecommunicaltions Group Corporation (China Telecom)
18	China Huaneng Group	43	China Chengtong Holdings Group Company Limited
19	China Mobile Limited	44	Yanzhou Coal Mining Company Limited
20	China Metallurgical Group Corporation	45	Aviation Industry Corporation of China
21	China Power Investment Corporation (CPI)	46	China Datang Corporation
22	China National Chemical Corporation (ChemChina)	47	Huawei Technologies Co. Ltd.
23	ZTE Corporation	48	Shanghai Overseas United Investment Holding Co. Ltd
24	Hunan Valin Iron & Steel Co., Ltd. (Valin Steel)	49	Yue Xiu (Guangzhouo) Group
25	Zhejiang Geely Holding Group Company Limited	50	Jinchuan Group Co., Ltd.

Data source: the Ministry of Commerce of PRC (2010)

Figure 1: Stock of FDI of China's non-financial companies in 2010 (according to registration types of domestic investors).



Data source: the Ministry of Commerce of PRC (2010).

However, China's major policies encouraging overseas investment since 2000 show no particular policy bias or obvious government support for SOE overseas investment, and there is no explicit discrimination against the overseas investment of private enterprises. The Chinese government used to apply an approval system （审批制） on those enterprises seeking to make investments abroad. After the "going out" strategy was proposed, the Chinese Ministry of Commerce gradually simplified and loosened its approval procedures, with direct investment starting to be shifted to a system of "examine and record" (核准备案制). In July 2004, the State Council released a paper entitled 'Decision of the State Council on Reform of the Investment System' in which it made clear the council's aim to reform the project approval system and ensure the autonomy of business investment. For projects not involving government investment, the approval system is no longer applied; the "examine" and "record" system now applies to different situations. The National Development and Reform Commission (NDRC) now administers resource-oriented overseas investment projects worth US$30 million and above, and non-resource development overseas investment projects with an investment amount of US$10 million and above.[3] In addition to the projects noted above, investment projects controlled by central-government SOEs should be reported to the NDRC and the Chinese Ministry of Commerce, and other investment projects are subject to the administration of local governments in accordance with relevant laws and regulations. Further, overseas investment by SOEs (excluding financial enterprises) should be approved by the Ministry of Commerce. The government encourages and supports all enterprises conducting overseas investment, regardless of who owns them. In October 2004, the

[3] According to the Notice of National Development and Reform Commission on Devolving Approval Authority of Overseas Investment Project in 2011, limit amounts have increased to RMB 300 million (US$47 million) currently, and RMB 100 million (US$ 15.8 million), respectively.

Ministry of Commerce and the NDRC both laid down rules further encouraging all domestic enterprises to invest overseas and streamlining foreign investment procedures.

This shows that China's current pattern of SOE-dominated overseas investment is not the outcome of deliberate support by the Chinese government, but a reflection of China's domestic system. This is true for a number of reasons.

First, for historical reasons, SOEs hold a privileged position in terms of finance, taxation, employment, regulation and investment approval, which helps them to access quality resources.

Second, after previous SOE reforms, many small- and medium-sized SOEs were privatised, while the remaining SOEs are mainly large-scale monopolistic or quasi-monopolistic enterprises with access to large amounts of high-quality resources that would be difficult for private enterprises to obtain. These SOEs are among the most profitable enterprises in the world.

For example, among China's top 500 enterprises in 2011, the profits of 10 SOEs, including CNPC, CNOOC, China Mobile and Sinopec, were up to 866.84 yuan, accounting for 40 per cent of the total amount of all top 500 enterprises. Meanwhile, the total profit of China's 10 largest private enterprises is less than half that of the 10 SOEs (China Business News, 2011).

Third, though the "going out" of SOEs is mainly motivated by profits, it is inevitable that some business managers will make irrational overseas investments out of political opportunism. For example, the managers of SOEs do not always fully bear the consequences of their investments, meaning private enterprises are much more risk averse than their SOE counterparts.

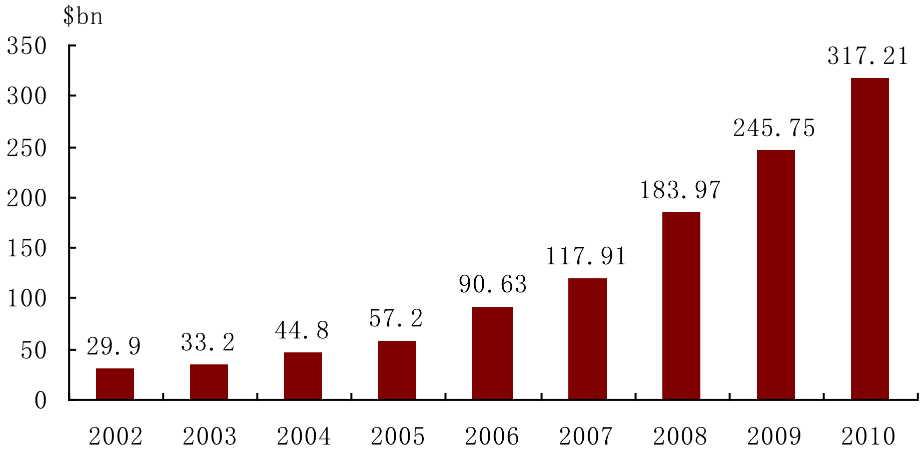
Lastly, as far as the government is concerned, it is easier for the government to control SOEs than it is to control private enterprises. Hence, the government might occasionally use SOEs as an instrument to achieve immediate policy objectives. For instance, if the government called for the expansion of foreign investment, SOEs could quickly respond to this call, while private enterprises must still prioritise risk evaluation.

2) New characteristics of SOE overseas investment

First, the scale of overseas investment has been expanding rapidly since 2008. Since the "going out" strategy was first proposed in 2000, the Chinese government has vigorously imposed on Chinese enterprises a series of policy measures, such as finance and taxation, credit, insurance, and foreign exchange, which has been a remarkable success. In 2008, China's overseas investment flows totalled US$55.91 billion, with a year-on-year increase of 111 per cent. This amount is equivalent to the sum of foreign investment flows in the previous three years. At the end of 2010, China's stock of FDI reached US$317.21 billion, and FDI flows reached US$68.81 billion, about 2.7 times and 2.6 times the 2008 figure, respectively (see Figures 2, 3 and 4).

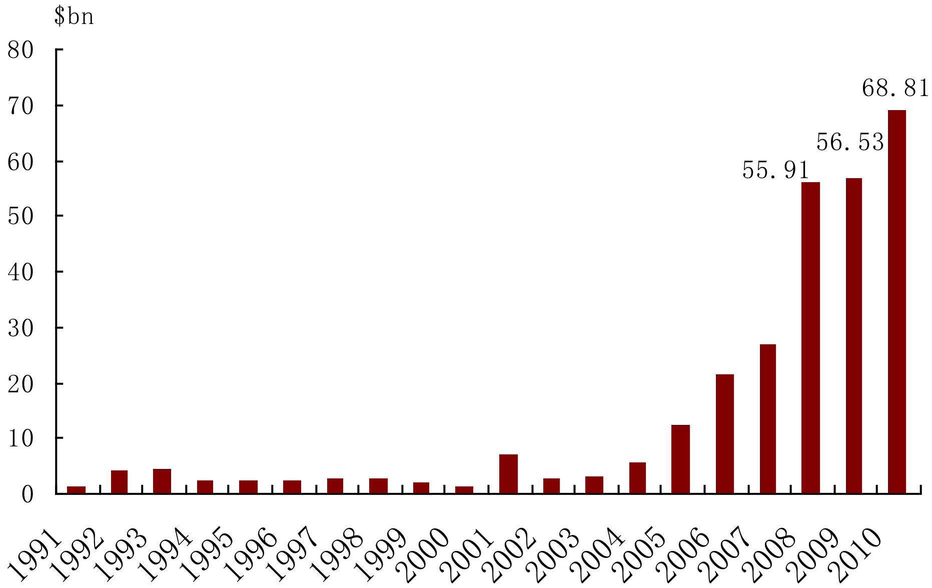
With the rapid expansion of China's economy, its overseas investment will rapidly expand as well. According to The Association of Asian Studies (2011), China's overseas investment is beginning a huge upward surge, and by 2020 China should expect to see its overseas investment hitting US$2 trillion.

Figure 2: China's stock of FDI in 2002-2010



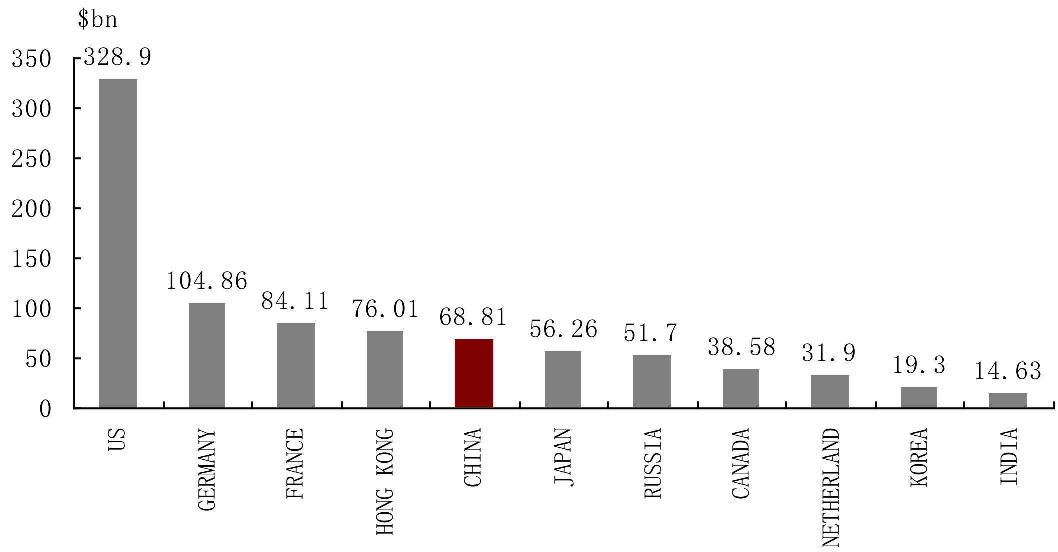
Data source: the Ministry of Commerce of PRC (2010)

Figure 3: China's FDI flow in 1991–2010



Data source: the Ministry of Commerce of PRC (2010)

Figure 4: FDI flows as compared between China and major global countries (regions) in 2010



Date sources: the Ministry of Commerce of PRC (2010)

Second, as far as motivation is concerned, the focus has shifted from simply obtaining raw materials to both obtaining raw materials and expanding market shares. More and more Chinese enterprises now aim to improve their ability to achieve the best allocation of resources worldwide and explore both international and domestic markets. Chinese enterprises showing potential in overseas investment can be mainly divided into three categories. Category I includes the state-owned energy and resource enterprises. For these enterprises, the main objective for overseas investment is to stabilise the domestic supply of resources and to benefit from increased prices in the raw materials concerned by controlling upstream resources. Category II encompasses high-tech enterprises, and mainly those in the communications and IT industries. Such enterprises generally "go out" for the purpose of acquiring access to new technology. Category III refers to those enterprises with a comparative advantage in labour, including in textiles, garments and household appliances. The purpose of "going out" for these enterprises is to be closer to the markets and mitigate foreign trade friction.

The investment motives of these three types of enterprise can be further divided between those seeking overseas market opportunities and those looking to access overseas resources. According to the *Investigation Report on Overseas Investment and Operation of Chinese Enterprises*, issued by the China Council for the Promotion of International Trade (2012), a survey of 365 Chinese enterprises showed that many enterprises see rising domestic costs, domestic market competition and difficulty in acquiring talent as restrictions to their domestic development. It also showed that the key motivation behind an enterprise’s decision to "go out" was its desire to seek market opportunities rather than gaining access to overseas resources. This suggests that the main objective of Chinese enterprises investing abroad is to find new markets rather than fight for resources.

Third, regarding the form that Chinese overseas investment has increasingly taken, growing numbers of enterprises have conducted their M&A activities via capital markets. In the context of the present European debt crisis, weak international economic situation and serious global liquidity shortages, the market value of many overseas companies is currently undervalued. Considering that China's manufacturing industry is facing mounting pressure from its domestic transformation and upgrading, the time is ripe for Chinese enterprises to pursue emerging opportunities in overseas M&A. At the same time, M&A undertaken by Chinese companies has also begun to spread towards technology, brand and marketing channels, and away from a traditional focus on energy and raw material. China is in short supply of resources and energy, and this has determined the importance of acquiring such items, but the risks should not be underestimated either.

Meanwhile, the form of M&A employed by Chinese companies has also begun to change. For instance, private equity investment funds have featured in both Zoomlion’s acquisition of Italy’s CIFA and Sany Heavy Industry’s acquisition of Putzmeister, indicating that China’s overseas M&A behaviour is more market-oriented, and that more overseas M&A activities are accomplished through capital market operations.

According to the *Report on M&A transactions in Asia (excluding Japan) and China for the first half of 2012* (Reuters, 2012), the overseas acquisitions of Chinese companies totalled US$18.1 billion, of which US$6.7 billion was invested in energy and power industries. This industry sees an increase of 16.7 per cent year on year. A study by Citibank showed that China's overseas M&A transaction were only US$5–120 billion in 2004–2005, but reached US$79 billion in 2011, more than six times the amount from 2005. And in the first eight months of 2012, China's cumulative overseas M&A transactions have reached US$54 billion, and will likely surpass US$100 billion by the end of the year.

Lastly, in terms of investment fields, financial enterprises are accelerating the pace of overseas investment. In particular, overseas investment in sovereign wealth funds has grown on a very large scale.

China's financial sector was not impacted too much during the 2008 global financial crisis; the profitability of China's banks has consistently moved up the ranks of the world's 1000 major banks. With their own strength enhanced, more banks and financial institutions are increasingly capable of investing abroad. In the meantime, financial services are also required for those enterprises investing overseas, and this provides a good opportunity for the "going out" of China's financial industry. Among these financial institutions, China Investment Corporation—a sovereign wealth fund with a strong grip on China's huge foreign exchange reserves—has carried out a profusion of overseas investment projects, occupying an important position in the overseas investments of China’s finance enterprises. Of course, the “national” colour of the sovereign wealth fund also attracts much attention when it invests overseas.

In short, the new features to be found in the rapid expansion of China's overseas investment and in the diversified forms of investment and investment fields signify that SOEs are being confronted with an unprecedented level of competition in overseas markets. To cope with the changing situation, Chinese SOEs must rely on their own competency, instead of support from the government, to succeed in the international markets because government support can only be short-lived. However, improvements in the operational capability and the management of SOEs are still restricted by the institutional problems of these enterprises. Furthermore, with the rapid expansion of China's outward investment, there is an increasing demand for Chinese companies investing overseas to provide a greater supply of public goods. The increasing demand for public services needs to be provided by the Chinese government or SOEs. This means the current dominance of SOEs in China's overseas investment will be difficult to maintain for much longer, and the role of SOEs in overseas investment also needs to change accordingly.

3. New challenges in China's overseas investment

These new features of China's overseas investment have raised new requirements for China's overseas investment strategy. At the same time, profound changes in both domestic and international conditions have also imposed new challenges on the pattern of SOE-dominated overseas investment.

1) New challenges in China's overseas investment: the changing international situation

First, the need to establish a new international economic order based on fair competition and effective international governance has led to new requirements in overseas investment. With the advance of globalisation, the demand for new global public goods is increasing. Existing international governance is not sufficiently effective at managing a range of increasingly complicated global public issues. The world is facing a financial crisis, climate crisis, natural resource and energy crisis, ecological crisis and so on, which require establishing effective international governance. Meanwhile, the existing international order is incapable of reflecting the changing world economy, a fact that highlights the importance of establishing free trade and investment that is based on fair competition. Overseas FDI has a direct impact on the reconstruction of the international economic order and international governance.

Second, global economic rebalancing has raised new requirements for overseas investment. The current division of work between developed and developing economies has brought about serious imbalances in the global economy. The outbreak of the financial crisis in 2008 is the consequence of such an imbalance, and overseas investment is directly related to the global economic rebalance. However, whether it has a positive effect on balancing the global economy depends on each country's model of development. If developed economies continue to over-rely on manufactured goods from emerging economies, then the overseas investment made under such traditional development models will exacerbate rather than alleviate global imbalances. Moreover, if a country's domestic development model does not come to evolve, then overseas FDI cannot help to balance the global economy; it will simply serve as a tool for passively balancing states' balance of payments.

Third, the global trend towards green development has also led to new requirements for overseas investment. Due to climate change, excessive resource consumption, ecological deterioration and the like, green development has become a global trend. Responding to this, many countries, including China, have developed a strategy to promote green development. Green development represents the future and abounds with great investment opportunities. At the same time, green development also depends on global cooperation. This requires not only foreign investment to act as a facilitator in promoting global green growth, but also requires serious technological innovation, and foreign investment entities must be aware of the risks. Obviously, to adapt to these requirements, SOEs have their natural limitations.

2) New challenges in China’s overseas investment: the changing domestic situation

First, the evolution of China's identity towards that of a developed country poses an important challenge. With its rapidly increasing incomes, China’s identity as a developing country will eventually change, at which point its rights and responsibilities in the global public domain will also change accordingly. A report by the Development Research Centre of the State Council and the World Bank (2012, p.3) stated that even if China grows one-third as slowly in the future compared with its past (6.6 per cent a year on average compared with 9.9 per cent over the past 30 years), it will become a high-income country some time before 2030 and outstrip the United States in economic size (China’s per capita income, however, will still be a fraction of that in advanced countries). This means that, when China becomes the largest developed economy in the world, it will have more responsibility to provide more global public goods and maintain a fair level of competition in global markets. China’s overseas investment strategy should also be changed accordingly.

Second, with the current changes to China's position on the global stage, the role of SOEs in overseas investment must also change: they must take some responsibility in providing global public goods on behalf of the government. The reason why a country should have SOEs is largely consistent with the reason why a country needs its government; that is, providing public goods to make markets function well. The fundamental reason why reform is required in China's SOE sector is that, if a large number of SOEs exist in competitive areas, fair competition is unlikely to be established and maintained in the markets. There are historical reasons for the existence of China’s SOEs, and indeed SOEs have made very important contributions to China's economic development. But with historical circumstances changing as they are, SOEs should return to their traditional public function as much as possible in both domestic and international markets, so as to create better market conditions.

Third, due to the incompleteness of a market-oriented economic system and the lack of thoroughness in China’s domestic reforms, the existing government- and export-led development model cannot be maintained, and there is an urgent need for China to change its development model—and this would require deeper reform in the SOE sector. Though the overseas expansion of SOEs has played a relatively important role in China's development, this expansion can also strengthen distortions in the domestic system and alienate vested interests, which would likely obstruct in-depth market-oriented reforms, thus affecting the transformation of China’s development model. This is not in the interest of China’s long-term prosperity. Therefore, China's overseas investment should be more consistent with the core goal of transforming its development model.

4. A review of China’s SOE-dominated overseas investment

Facing the new challenges outlined above, the pattern of overseas investment that prioritises large SOEs must be re-examined at both the domestic and international level.

1) Does Chinese overseas investment serve the country’s goal of structural reform and economic development?

It is fair to say that SOEs, as the main force in China’s overseas investment, have played an important role in facilitating access to overseas resources and in opening up new markets. But at the same time, the larger context of China’s structural reforms and economic development should be taken into account when judging the effects of China’s overseas investment. At the present stage, the biggest task for China's economic development is to transform the country’s development model through structural reform. What are the implications of China’s current pattern of SOE-dominated overseas FDI for its domestic goals?

In general, overseas investment by both SOEs and private enterprises is conducive to improving China's economic balance. Overseas investment also broadens China’s access to minerals, energy and other significant strategic resources, which make up for the scarce domestic supply of resources and energy. In this sense, the overseas investment of Chinese enterprises contributes to domestic economic development. However, the pattern of over-reliance on SOEs for overseas investment has also brought about a number of problems and is a double-edged sword, as pointed out by Song, Yang and Zhang (2011).

First, the aggressive overseas expansion of SOEs increases the inertness of reform in this sector. The overseas expansion of SOEs is a reflection of the distorted domestic economic system. This distortion stems largely from inadequate SOE reform, and hence reforms in this sector must be expedited to eliminate such distortion. However, the aggressive expansion of SOEs has already created a form of path-dependence for future economic growth, thus aggravating the difficulty of eventual SOE reform.

Second, the rapid overseas expansion of SOEs is not an inherent requirement of domestic market-oriented reforms. China's successful development over the past three decades can be largely attributed to the advancement of SOE reform and the development of the private economy, but the biggest impediment to the effective transformation of China's development model stems precisely from the fact that such in-depth reforms have not been completed. Among the most-needed reforms are the transformation of government functions and SOE reforms. The domestic phenomenon that sees “SOEs advance and private enterprises retreat” (Guo Jin Min Tui) is unconducive to market-oriented reforms, and, similarly, the aggressive expansion of SOEs in overseas markets is not conducive to domestic market-oriented reforms either, thus making it difficult to transform China’s development model through the establishment of an effective self-enforcing mechanism (Song, Yang, Zhang, 2011).

Third, if the competitiveness of SOEs is deemed as the competitiveness of the state, the government would voluntarily strengthen its institutional inclination towards

SOEs, including through the domestic financing system, so as to enhance the monopoly of SOEs and improve their competitiveness. This would not only narrow the market space for small- and medium-sized enterprises (SMEs), but it would also cause path-dependence in domestic macroeconomic policy on state-owned investment. At present, the overseas investment funds for domestic enterprises mainly stem from the China Development Bank, the Export-Import Bank of China and other policy-oriented financial institutions, as well as some related industry funds. At the same time, the access of SMEs to financial assistance is quite limited, and hence the majority of SMEs that "go out" have a limited choice and must rely on their own funds to a greater extent.

Last, but not least, the dependence on SOEs for short-term economic growth will result in a lack of vitality in long-term economic growth. Strong government support may be effective in some sectors (i.e. infrastructure) or during the early stages of economic take-off, but when an economy has entered a period of mature growth, the power of innovation becomes more important. At this point, the government should gradually deregulate, leaving the market to more innovative and efficient enterprises, namely, private enterprises. For example, an OECD (2005) study shows that the total factor productivity of private enterprises is twice that of SOEs. Indeed, the world's leading centres of innovation are often established by small start-up companies.

In short, there are historical reasons for the dominance of SOEs in China's overseas investment, and the contribution of SOEs to China's economic development cannot be ignored. But considering that historical conditions have fundamentally changed, and taking into account China's long-term prosperity, it is necessary to make adjustments to the dominant pattern of SOE-led overseas investment. Because this pattern is a reflection of China's domestic system, however, such adjustments cannot be accomplished through simplistic government intervention. Rather, it must rely on the advancement of deep-seated domestic structural reform.

2) Does China's overseas investment promote an international order based on fair competition and form a win-win partnership with the world?

The huge economic success that China has achieved over the past three decades proves that economic globalisation and an international order based on fair competition are conducive to both a strong global economy and a strong Chinese economy. Once the norm of fair competition is destroyed, however, both the world economy and China's domestic economy will be precipitated into economic loss. Therefore, China's overseas investment strategy should serve as an important force to safeguard fair competition in the international markets.

China is one of the biggest beneficiaries of the WTO's system of multilateral free trade and fair competition. Since China began its economic reforms and its "opening up", the model of government- and export-led economic growth has been a great success. In the 10 years after China's accession to the WTO, Chinese exports increased 6.3 times over and imports have increased 6.2 times over, and the contribution of exports to national GDP is continuing to increase. China surpassed Germany to become the world's largest exporter in 2009, and in 2010 it outstripped Japan, becoming the world's second-largest economic entity.

However, because China's overseas investment is dominated by large SOEs, some countries believe it is a result of state intervention and that it is a threat to the global norm of fair competition. Consequently, China's overseas investment is continually subjected to questions about "state capitalism". *The Economist* (2012) describes it this way: "The Chinese state is the biggest shareholder in the country's 150 biggest companies and guides and goads thousands more. It shapes the overall market by managing its currency, directing money to favored industries and working closely with Chinese companies abroad".

Therefore, when China's large SOEs make investments overseas, their counterparts are inevitably concerned: when Chinese enterprises obtain public support from their government, how can a fair transaction be ensured? And how can other countries ensure that Chinese enterprises will not become military or diplomatic weapons for their government? Concern over these issues often tends to evolve into a higher degree of caution, leading to both trade protectionism and fraught politics, which, in turn, lead to various restrictions on and greater examination of large Chinese SOEs in the course of their overseas investment. In particular, during periods of economic downturn, this concern may lead to stronger trade protectionism, access restrictions and discriminatory regulatory rules, or more countries granting subsidies to their domestic enterprises. These strategies ultimately harm the interests of China's enterprises, and are only conducive to the economic recovery of particular states; pursuing such tactics at the expenses of others will eventually cause a "double loss".

Frictions are continually being identified in China's overseas investment activities. From Haier's abandoned merger with Maytag and CNOOC's failed acquisition of Unocal, to Huawei being denied its acquisition of 3Leaf Systems: "national security", "China threat" and "employment loss" have all become frequently used explanations for the way in which Western countries are hindering China's overseas investment. Furthermore, due to the doubts surrounding state capitalism—which affects other countries through SOE-led overseas investment—this same sense of concern has also tainted the overseas investment of China's private enterprises. Ian Bremmer (2009) comments that: "These privately owned but government-favored national champions get breaks from the government, which sees them as a means of competing with purely commercial foreign rivals, and they are thus able to carve out a dominant role in the domestic economy and in export markets. In turn, these companies use their clout with their governments to gobble up smaller domestic rivals, reinforcing the companies' strength as pillars of state capitalism". From an overseas viewpoint, Huawei, ZTE, Lenovo, Geely, Haier and other famous Chinese private enterprises have all obtained implicit support from the government to varying degrees.

Though such accusations are unfair, China cannot simply turn a blind eye or consider them an inevitable product of other countries' prejudices against China—or look for a way to take revenge. Western society is generally concerned about the expansion of state capitalism, and this has an important historical background. In the past, the world economic order was deeply influenced by state intervention and state capitalism. Though free market competition is the fundamental force of economic development today, in effect, its dominant force worldwide is a result of its having won the long-standing battle with state intervention and state capitalism. Hence, the international community’s concern over the loss of fair competition has an important historical background, and China’s tremendous economic success over the past three decades can be attributed to the growth of market forces and SOE reform, rather than the expansion of its SOEs.

5. Discussion

1) Is China’s economy a case of “state capitalism”?

China's economic development over the past three decades has mainly depended on a government-led market economy model. Such a model is labelled "state capitalism" by some people in order to distinguish it from the Western model of development that is based on a decentralised market. "Today wealth is moving not just from West to East but is concentrating more under state control. In the wake of the 2008–2010 global financial crisis, the State's role in the economy may be gaining more appeal throughout the world. These States are not following the Western liberal model for self-development but are using a different model—‘state capitalism’"(see Hormats, 2011).

However, this interpretation may be a misreading of the causes of China’s economic success. The evaluation will also not help to facilitate the transformation of Western economic models if these countries simply attribute China's economic growth to so-called state capitalism—which is so opposed to the West’s deep-rooted tradition of free market competition—and if Western society remains anxious about China's economic expansion, reflecting its concerns in specific countermeasures against China’s overseas investment.

There is no doubt that the functioning of China’s government needs to be transformed from a reliance on unlimited government in a planned economy to a service-oriented government in a market economy that provides public goods and market order, and establishes checks and balances on government power so as to encourage market forces.

Yet, it is not so simple. With the increasingly developed division of labour and the continuous expansion of the public domain, the government's role is expanding, and it no longer plays the traditional role of "night watchman". Both China and the Western world should redefine the role of the government, so as to avoid so-called government failure.

In fact, certain aspects of the Chinese government’s behaviour (e.g. pervasive administrative measures) have some merit that is not fully recognised; that is, the government can significantly reduce the coordination costs in Chinese society. Such "government intervention" is actually conducted in order to provide a new kind of public good that helps the market function well. In developing economies especially, the government’s role in economic development is essential, and operates mainly by duplicating economic practices in developed economies. This kind of government coordination is likely to provide a new public good for society, and is consistent with the requirements of market economies.

Therefore, some elements of the Chinese government, which differ from those of

Western governments, may still fit the requirements of modern economic development when it comes to redefining the role of the government. On the other hand, the weak governments traditionally respected by Western society are perhaps a manifestation of government failure and an absence of the government's public functions. This situation may subsequently increase the operation costs of society and reduce market efficiency.

Though China needs to make changes to the overseas investment of its SOEs, it is not suitable to identify China's overseas investment as state capitalism, and this investment certainly does not destroy market rules simply because it originates from China or because it has responded to the government's "going out" strategy and receives support from the government.

2) The implications of 'competitive neutrality' for China

To address concerns over so-called state capitalism, some Western analysts have proposed 'competitive neutrality' as an alternative concept (Hormats, 2011). Robert Hormats, the US Under Secretary of State for Economic, Business, and Agricultural Affairs, has said on the subject: "Our strategy to meet the state capitalism challenge involves a re-examination and robust deployment of the policy tools available to level the playing field in the home markets of the practitioners of state capitalism, in third-country markets, and increasingly here in our own home market so that open competition is maintained for all players". He has also commented that: "One aspect of a solution to these problems would be a political commitment to 'competitive neutrality'" (Hormats, 2011).

"Competitive neutrality implies that government-supported business activities do not enjoy artificially derived competitive advantages over their private sector competitors by virtue of their links to or benefits from governments" (Hormats, 2011). A competitive neutrality framework must include mutually reinforcing policy recommendations from the fields of trade policy, investment policy and competition policy.

The concept of competitive *neutrality* appears to be a punitive measure taken by some countries in response to China's model of government-dominated economic development, and this is not conducive to China's further economic development. However, while China is seeking to prevent competitive neutrality from becoming a protectionist tool in some countries, the concept should not be written off completely. If used properly, it may eventually become a key driving force behind China's deeply needed structural reforms, such that it could fundamentally benefit China's long-term economic prosperity.

3) China and the West: pursuing mutually beneficial action

Shaping China's overseas investment strategy is not a one-way process, but an interaction between China and the world. Because China's rapid economic rise is changing the patterns of global economic activity and interests—while a discrepancy still exists between Chinese institutions and values and those of developed Western societies—it is not uncommon for Chinese enterprises (both SOEs and private companies) to suffer from prejudice in the course of their overseas investment. To a large extent, this problem stems from the West, rather than from China. Therefore, China and the West should learn to adapt to each other.

That China's economy is returning to its premier position in the world is merely a reversion to its normal status in history, and Western society does not need to wonder and worry about this. In fact, from the early 1500s until the early 1800s, China’s economy was the world’s largest. By 1820, China’s economy was 20 per cent larger than Europe’s and accounted for a third of gross world product (GDP). But the next two centuries were tumultuous for China. The country experienced catastrophic decline between 1820 and 1950 and then, starting in 1978, another meteoric rise (Maddison 2001). Today, China is once again among the largest economies in the world. Even if China grows a third as slowly in the future compared with its past, it will become a high-income country some time before 2030 and outstrip the United States in economic size (See DRC/World Bank, 2012). The difference is that, when China served as the premier global economic entity hundreds of years ago, there was no globalisation like there is today, and there was no need for it to assume the responsibility of providing global public goods. In the future, China’s share of global public goods will be largely provided by China's SOEs.

In the meantime, with the current level of global economic integration, China's economy is too big to fail. China's success is not only its own success, but the world's success; on the other hand, China's economic crisis will also be a global crisis, and the Chinese economy would undoubtedly drag down the global economy as well. Thus, the West should not make containing China their goal; they should be committed to creating a win-win situation with China by adopting an open and cooperative attitude when it comes to approaching overseas investment from China.

6. Conclusion and policy implications

According to the Development Research Centre (2012), China will likely become the world's largest economy around 2020. Around 2030 the scale of China's economy will be far greater than that of the United States, and China will be achieving its transition to a high-income society. China thus needs to ask whether its current overseas investment strategy is consistent with its future role on the world stage. China must conduct strategic restructuring and reform its SOEs internally so as to promote the transition of its domestic development model, and it should commit itself to establishing and maintaining an international order based on fair competition in order to create a win-win situation with the rest of the world. These are choices that must be made to safeguard China's long-term interests, and they also represent a clear direction for the strategic adjustment of SOE overseas investment.

First, the overseas expansion of SOEs must be considered in respect of the need for structural reform and a transformation of China’s development model. On the one hand, SOE overseas investment should promote the development of high-end chain and strategic emerging industries so as to enhance technical upgrading and structural adjustment. On the other hand, by taking the opportunity to transform China’s development model, SOE reforms should also help to promote structural reform and facilitate reforms in fiscal, financial, government and other areas.

Second, the government needs to consider its overseas investment strategies from the point of view of China’s future role in the world as the biggest high-income economy. China is bound to shift its identity to a developed country in the foreseeable future. In this sense, strengthening cooperation with other countries, maintaining a competitive trade environment, and promoting international investment liberalisation and green development are all in line with China's interests, and are also part of the responsibility that China should assume as a major power.

Third, SOEs need to gradually become an important tool for the Chinese government to provide global public goods, as well as to provide public services for overseas Chinese companies. The Chinese government should be committed to establishing effective global governance; creating an international market environment based on fair competition; and playing a more positive role in solving the global financial crisis, climate crisis, natural resource and energy crisis, ecological crisis, epidemic prevention and control, and the like. The role of SOEs in overseas investment needs to gradually change, becoming an important tool for the Chinese government to provide global public goods.

Fourth, the major subject of overseas investment should gradually shift from SOEs to private enterprises, forming a division of labour between the two. The Chinese government should make an effort in the following areas to encourage private overseas investment through the deepening of China's structural reforms: (i) further deregulation and the liberalisation of access restrictions (such as finance, medical, education, infrastructure and other fields), (ii) eliminate the "glass door" and "ceiling" barriers that are cropping up as the private economy develops, and (iii) introduce more supportive policies to create a better environment for the development of China's private economy.

Last, but not least, China should separate the role of state capital and SOEs, and step up domestic corporate governance reform to further commercialise the behaviour of SOEs. The pattern of overseas investment dominated by SOEs is not the direct result of deliberate support by the Chinese government, but a projection of China's economic system at home. Therefore, to change the existing pattern and promote China's overseas investment, efforts should be focused on domestic structural reforms, including SOE reform.

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