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## **A NEW CONTEXT FOR MANAGING OVERSEAS DIRECT INVESTMENT BY CHINESE STATE-OWNED ENTERPRISES**

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**A New Context for Managing Overseas Direct Investment by Chinese State  
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**ABSTRACT:** Chinese state-owned enterprises (SOEs) and their overseas direct investment (ODI) have played an important role in China's economic development. But the rapid expansion of SOE-dominated ODI has also raised concerns, including about state capitalism and the need for competitive neutrality. This paper considers China's strategy for managing ODI by its SOEs given a changing context. On the one hand, the Chinese economy is rapidly growing and will soon become the largest economy in the world. China's role in the world, as well as its global responsibility, is therefore changing. China needs to establish a win-win and harmonious relationship with the rest of the world, and ODI has a role to play in this. On the other hand, China's growth model is shifting to become greener, more balanced, and innovation-driven. China's changing international role and the changing growth model have created new imperatives for, and constraints on, ODI by SOEs and reforms to SOEs. This paper aims to examine ODI by Chinese SOEs from the two dimensions of China's changing role and growth model. It discusses strategies for better managing ODI by Chinese SOEs in the new context that is emerging.

**Keywords:** China's overseas investment; state-owned enterprises; SOEs; strategic adjustment, changing role, green growth.

**JEL Codes:** F21, L21, O53.

## **1. Introduction**

Chinese enterprises have accelerated the pace of their overseas investment since the 1990s . After the global financial crisis began in 2008, the Chinese government set out to accelerate the implementation of the ‘going global’ strategy and Chinese overseas investment started to boom as developed countries like the US and European nations experienced an economic downturn and rushed to withdraw their capital from overseas. After the crisis, by contrast, Chinese companies – especially large state-owned enterprises (SOEs) – rapidly expanded their overseas investment using various means including greenfield investment and mergers and acquisitions (M&As).

According to the Chinese Ministry of Commerce, China's stock of foreign direct investment (FDI) reached US\$317.21 billion by the end of 2010 (MOFCOM 2011, 2). 13,000 Chinese companies had also established branches in 178 countries or regions, covering all sectors (MOFCOM 2011, 2). In 2010 China's FDI flows reached US\$68.81 billion, for the first time surpassing Japan (US\$56.26 billion), the UK (US\$11.02 billion) and other traditional overseas investors, and China ranked fifth in the world among foreign investors (MOFCOM 2011, 5). Among China’s FDI flows for 2010, investment through M&As reached US\$29.7 billion (MOFCOM 2011, 5). This accounted for 43% of that year’s FDI flows, and became the fastest means of growth for overseas investment by Chinese enterprises. A striking feature of this picture is that

FDI flows by Chinese SOEs reached US\$42.39 billion, which accounted for 61.6% of China's total flow in 2010.<sup>1</sup>

The rapid expansion of overseas investment by Chinese SOEs has also raised concerns both overseas and at home. In some Western countries, China's so-called 'state capitalism' has been raised as an issue, and some commercially based M&A attempts by Chinese SOEs have been rejected on various pretexts. Public opinion in various countries host to Chinese FDI has sometimes seen the investment activities of SOEs as a front for the Chinese government. These sections of the public appear concerned that perceived 'state capitalism' could create unfair global competition.<sup>2</sup> As a result, the call for competitive neutrality has emerged in some Western countries. Some proposed overseas M&As by Chinese SOEs were also refused on the basis of a variety of other pretexts including national security. Whether or not these concerns can be supported by evidence, as China will soon become the largest economy in the world

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<sup>1</sup> Calculated by the authors according MOFCOM (2011, 18).

<sup>2</sup> See, for example, The Economist (2012). 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'. The OECD has also framed the issue by identifying three reasons why SOEs may create an uneven playing field. These are that: (1) SOEs receive support from their government owners; (2) the incentives provided to managers of SOEs give them advantages not enjoyed by private companies, which are governed by cost constraints and profit goals; and (3) the incentives provided to managers of SOEs are not corrected by corporate governance arrangements (Hormats 2011).

it must establish a win-win and harmonious relationship with the rest of the world in order to secure its rise. China therefore needs to deal with these concerns seriously.

At home, China needs to achieve the transformation of its development mode – from an unsustainable model with high pollution, high resources use, high carbon emissions, export-dependence, and labour intensiveness – to a greener, more balanced, and innovation-driven growth model. The transformation has proved difficult, since the structural reforms (e.g., fiscal, financial, land, and price reform) necessary to achieve it have encountered enormous obstacles from China's vested interests. Partly because of their privileged position that enables access to lucrative resources, Chinese SOEs have aggressively expanded in both domestic and overseas markets. In contrast, China's private companies have encountered some institutional bottlenecks that have affected their development. These problems have raised concerns about China's market-oriented reforms and prosperity in the long-run.

In the new context of China's changing role and growth model, China needs to rethink its overseas investment strategy. One question is to what extent does ODI that is dominated by Chinese SOEs serve the needs of domestic reform and the transformation of China's development pathway? A second question is whether ODI dominated by SOEs helps to build a win-win and harmonious relationship between 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 for SOEs in the new emerging context. Section 2 will investigate why SOEs have dominated China's

overseas investment, and will also look at the new characteristics of that investment. Section 3 analyses the challenges that China faces in overseas investment at home and abroad given the new context. Section 4 reviews China's overseas investment that has been dominated by SOEs given the existing challenges. Section 5 discusses state capitalism and competitive neutrality. The last section concludes by arguing that China's strategy for managing ODI by its SOEs must be adjusted so that it is consistent with the country's future role on the world stage as the largest economy as well as China's need to transform its development model.

## **2. Why SOEs have Dominated China's ODI, and the New Characteristics of that Investment**

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

### ***2.1. Why SOEs Have Dominated China's Overseas Investment***

In the 'going global' process, China's large SOEs have always been dominant. The vast majority of enterprises that have participated in the 'going global' strategy are small and medium sized. But large SOEs, especially those controlled by the central government, have dominated in terms of the scale of overseas investment and the

volume of financing deployed. The vast majority of the top 50 Chinese non-financial enterprises in terms of FDI stock and overseas asset size 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% of national stock (see Figure 1).

Table 1. Top 50 Chinese Non-Financial Companies According to Stock of FDI at the end of 2010.

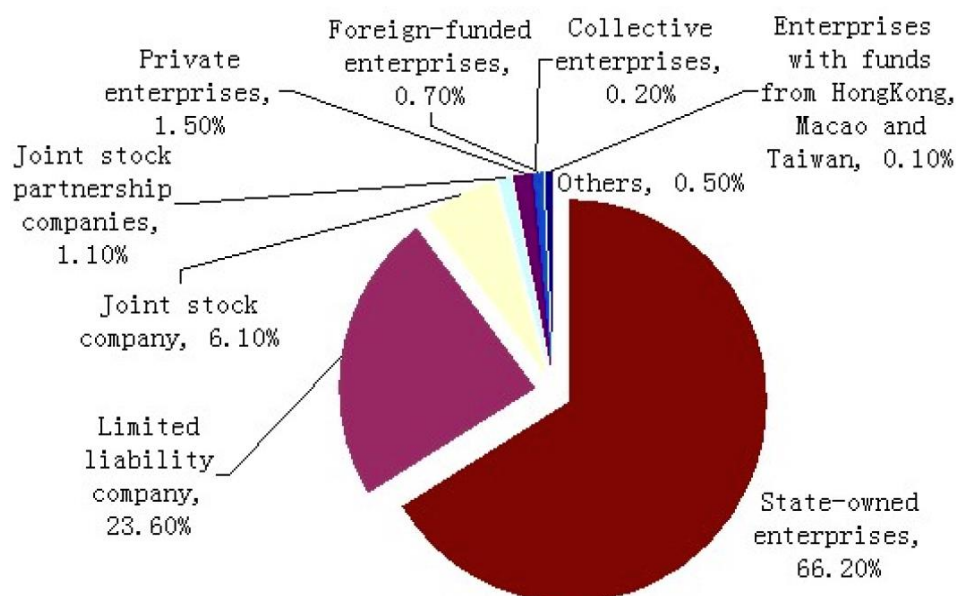
1	China Petrochemical Corporation (SINOPEC)	26	Legend Holdings Ltd.
2	China National Petroleum Corporation (CNPC)	27	Shumyip Holdings Company Limited
3	China National Offshore Oil Corporation (CNOOC)	28	China Nonferrous Metal Mining (Group) Co., Ltd. (CNMC)
4	Huarun (Group) Corporation	29	China Communications 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	SINOCEM 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 Telecommunications 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 (Guangzhou) Group
25	Zhejiang Geely Holding Group Company Limited	50	Jinchuan Group Co., Ltd.

Note: Only three of the 50 enterprises (Zhejiang Geely Holding Group Company Limited, Legend Holdings Ltd., and Huawei Technologies Co. Ltd.) are not SASAC-controlled SOEs.



Data source: the Ministry of Commerce of the PRC (MOFCOM 2011, 58).

Figure 1. Share of FDI Stock Held by China's Non-Financial Companies in 2010 (by Registration Categories of Domestic Investors).



Data source: the Ministry of Commerce of the PRC (MOFCOM 2011, 18).

Despite the significant role that SOEs have played, China's major policies aimed at encouraging overseas investment since 2000 do not show a particular policy bias or obvious government support for overseas investment by SOEs. Furthermore, there is no explicit discrimination against overseas investment by private enterprises. The Chinese government historically applied an approval system (审批制) to enterprises seeking to make investments abroad. After the 'going global' strategy was proposed, the Chinese Ministry of Commerce gradually simplified and loosened its approval procedures. Overseas direct investment started to be transitioned to a system of 'report and record' (核准备案制). In July 2004, the State Council released a document entitled the *Decision of the State Council on Reform of the Investment*

*System.* This clearly articulated the State Council's aims to reform the project approval system and ensure autonomy in the making of business investments. For projects that do not involve government investment, the approval system is no longer applied – the 'report' and 'record' system now applies to these situations. The National Development and Reform Commission (NDRC) now administers resource-oriented overseas investment projects worth US\$30 million and above. It also administers non-resource based overseas investment projects with an investment value of US\$10 million and above.<sup>3</sup> In addition to the projects noted above, all proposed investments by central-government SOEs should be reported to the NDRC and the Chinese Ministry of Commerce. All other proposed investment projects are subject to the administration of local governments in accordance with relevant laws and regulations. All overseas investment by SOEs – including those that are not centrally controlled, but excluding financial enterprises – must 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 Ministry of Commerce and the NDRC both established rules further encouraging all domestic enterprises to invest overseas and streamlining foreign investment procedures.<sup>4</sup>

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<sup>3</sup>According to the 2011 notice of the National Development and Reform Commission on *Devolving Approval Authority for Overseas Investment Projects*, these threshold limits have increased and are currently RMB 300 million (US\$47 million) and RMB 100 million (US\$15.8 million) respectively.

<sup>4</sup> See MOFCOM (2004) and NDRC (2004).

This shows that the current domination of Chinese ODI by SOEs is not because they have received extra regulatory support for their ODI from the Chinese government. Rather, it is a reflection of China's domestic economic and institutional reality. There are a number of specific reasons why SOEs dominate China's ODI.

First, most SOEs are so-called 'national champions' and have strong financial capability that allows them to go global. After previous reforms to SOEs in China, many small and medium-sized SOEs were privatized leaving mainly large-scale SOEs. These SOEs are among the most profitable enterprises in the world. For example, the profits of 10 SOEs reached 866.84 billion yuan (US\$139.8 billion) in 2011, which accounted for 40% of the total profits for China's top 500 enterprises (China Business News 2011).<sup>5</sup> Meanwhile, the total profits of China's 10 largest private enterprises in 2011 equated to less than half of the profits of these same 10 SOEs (China Business News 2011).

Secondly, at this stage most of China's ODI is resources-oriented. SOEs play a dominant role in the resources sector at home, and consequently they play a dominant role in China's ODI. This is particularly the case for investments in resource-rich countries like Australia.

Thirdly, although the position is changing quickly, because of an historical legacy SOEs still have a privileged position in terms of finance, taxation, employment, regulation, and investment approval. This helps them access quality resources that may not be so readily accessible to private enterprises.

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<sup>5</sup> These top 10 SOEs included CNPC, CNOOC, China Mobile and Sinopec.

Fourthly, although the choice by SOEs to ‘go global’ is mainly a commercial decision, it is inevitable that some managers of SOEs will make irrational overseas investments for reasons of political opportunism. Because of soft budgetary constraints, the managers of SOEs do not always have to fully bear the consequences of their investments, meaning that private enterprises are much more risk averse than their SOE counterparts.

Lastly, as far as the government is concerned, it is easier to influence SOEs than it is to influence private enterprises. Hence the government may sometimes use SOEs as an instrument to achieve immediate policy objectives. For instance, SOEs can quickly respond to government’s call to ‘go global’ (since the government is their ultimate owner), while private enterprises must still prioritize risk evaluation.

## ***2.2. New Characteristics of Overseas Investment by SOEs***

First, with the rapid expansion of China’s ODI since 2008, the relative importance of SOEs is inevitably declining. Since the ‘going global’ strategy was first proposed in the year 2000, the Chinese government has imposed a series of encouraging policy measures on Chinese enterprises including in areas such as finance and taxation, credit, insurance, and foreign exchange. In 2008, China's ODI flows totalled US\$55.91 billion, with a year-on-year increase of 111 per cent (MOFCOM 2011, 5). This amount is in itself 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 (Ministry of Commerce 2011, 2). This is about 2.7 times and

2.6 times the 2008 figures respectively. With the rapid expansion of China's economy, its overseas investment will continue to rapidly expand as well. According to Rosen and Hanemann (2011), China's overseas investment is beginning an anticipated huge upward surge, and by 2020 China can expect to see its overseas investment hit US\$2 trillion (16).

According to Huang (2012) and Wang (2013), ODI by enterprises that are not SOEs is also increasing very quickly (Table 2) and those enterprises will eventually overtake SOEs as the dominant player in China's ODI. For instance, between 2003 and 2010, the share of ODI projects by SOEs declined by roughly 33% and the share of projects by limited liability companies increased by about the same percentage.

Table 2. Share of Chinese ODI by SOEs and Other (Non-SOE) Investors

Year	Share of ODI Projects			Share of ODI Stock	
	2003	2007	2010	2007	2010
SOEs	43.0%	19.7%	10.2%	71.0%	66.2%
Limited Liability Companies	22.0%	43.3%	57.1%	20.3%	24.0%
Private Enterprises	10.0%	11.0%	8.2%	1.2%	1.5%
Companies Limited By Shares	11.0%	10.2%	7.0%	5.1%	6.1%
Foreign Owned Companies	7.0%	4.4%	5.2%	--	0.8%

Source: Wang (2013, 61 [Table 5.1]). Permission to reproduce this table kindly supplied by the author.

Secondly, as far as motivations are concerned, the focus of China's ODI has shifted from simply obtaining raw materials to also expanding market share. Since SOEs are mainly dominant in the resources sector, the shift of focus means that their dominance in China's ODI will reduce over time. In terms of ODI, Chinese enterprises can largely be divided into three categories. Category 1 includes the state-owned energy and resources enterprises. Their main objective for overseas investment is to stabilize their domestic supply of resources and to avoid the risk of price volatility in raw materials by integrating the assets of upstream resources. Category 2 includes high-tech enterprises mainly in the communications and IT industries. Their purpose in 'going global' is to acquire access to new technology. Category 3 refers to those enterprises with a comparative advantage in labor, including those that produce textiles, garments, and household appliances. Their purpose in 'going global' is to be closer to their target markets and to mitigate foreign trade friction and the potential for protectionism.

A survey of 365 Chinese enterprises<sup>6</sup> showed that many see rising domestic costs, domestic competition, and difficulty in acquiring talent, as restrictions on their domestic development (China Council for the Promotion of International Trade 2012). It also showed that the key motivation behind an enterprise's decision to 'go global'

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<sup>6</sup> Among these 365 enterprises, 57.7% were private enterprises, 22.7% were SOEs, 10.7% were joint stock companies, 5.8% were foreign-funded enterprises, and 3.1% were collective enterprises.

was its desire to seek market opportunities rather than to gain access to overseas resources. This suggests that the main objective of Chinese enterprises investing abroad is to find new markets rather than to gain access to resources.

Thirdly, since China's manufacturing industry is facing mounting pressure from its domestic transformation and the move up the value chain, the time is ripe for the (mainly private) enterprises involved in Chinese manufacturing to enter new markets by pursuing emerging opportunities through overseas M&A. M&As undertaken by Chinese companies have begun to shift towards a focus on technology and access to brands and distribution channels, and away from the traditional focus on energy and raw materials.

In sum, new features of China's overseas investment are emerging as it rapidly expands. The investment is increasingly diverse, and is targeting a wider range of areas. These developments signify that SOEs are confronting an unprecedented level of competition in overseas markets, and that the relative importance of SOEs in China's ODI will inevitably continue to decline. To cope with the changing situation, Chinese SOEs must rely on their own competency, instead of support from the government, to succeed in international markets.

### **3. New Context for, and Challenges to, China's Overseas Investment**

In addition to these new features of China's overseas investment, the profound changes in both domestic and international conditions also pose new challenges for China's pattern of ODI where SOEs play the dominant role.

### ***3.1. New Challenges in China's Overseas Investment: the Changing International Role of Chinese ODI***

On the one hand, the evolution of China's identity into that of a developed country imposes new constraints on Chinese ODI. With its rapidly increasing income, China's identity as a developing country will eventually change, at which point its rights and responsibilities in the global public domain will change accordingly.

From the early 1500s until the early 1800s, China's economy was the world's largest. By 1820, China's economy was 20% 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. Then, starting in 1978, China underwent another meteoric rise (Maddison 2001). Today, China is once again among the largest economies in the world. Even if China grows one third more slowly in the future compared to the past,<sup>7</sup> it will become a high-income country some time before 2030 and will outstrip the United States in economic size. China's per capita income, however, will still be a fraction of that in advanced countries (DRC/World Bank 2012, Chapter 1).

The difference is that when China served as the premier global economic entity hundreds of years ago, there was no globalization like there is today. Consequently, there was no need for China to assume the responsibility of providing global public goods. This means that when China becomes the largest developed economy in the world, it will have greater responsibility to provide global public goods and maintain a

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<sup>7</sup> That is, an average of 6.6% per year compared to 9.9% over the past 30 years.



fair level of competition in global markets than it did hundreds of years ago and (more recently) as a under-developed country. China's overseas investment strategy should therefore be changed accordingly.

With the advance of globalization, the demand for new global public goods is expanding. Existing international governance is not sufficiently effective at managing a range of increasingly complicated global public issues. The world is facing financial crises, a climate crisis, a crisis of natural resources and energy, an ecological crisis, and so on. This requires the establishment of effective mechanisms for international governance. Overseas FDI has a direct impact on the reconstruction of the international economic order and on international governance, and hence there is a strong rationale for re-thinking the way in which China makes its overseas investments.

On the other hand, the global trend towards green development has led to new constraints on overseas investment. Because of climate change, excessive resource consumption, ecological deterioration and the like, green development has become the only solution for sustainable global prosperity. Responding to this, many countries including China have developed a strategy to promote green development. Green development represents the future and is replete with excellent investment opportunities. At the same time, green development also depends on global cooperation. This means that foreign investment needs to facilitate global green growth, but serious technological innovation and risk aversion are also needed. Obviously, SOEs have their limitations in adapting to these new circumstances.

### ***3.2. New Challenges in China's Overseas Investment: the Changing Growth Model***

The changing growth model introduces new requirements for China's reforms to SOEs, as well as to ODI by SOEs. China's traditional imbalanced growth model, characterized by high resource consumption and severe environmental degradation, is an unsustainable way of successfully accomplishing the country's modernization. China must therefore achieve the following two significant transformations.

China must first rebalance its development model to adjust the relative importance assigned to: economic and social undertakings; internal and external demands; urban and rural areas; spatial imbalance; and the upgrading of Chinese industries. In this regard, China can draw on best practices from developed countries. China's second task is to take a green growth path that reflects future trends. The first transition is to a large extent an internal issue within China, while the second transition is a common challenge shared by all nations of the world.

China needs to make the two transitions simultaneously, as it is no longer feasible for China to reach its modernization target by simply continuing along the historical pathways taken by industrialized countries. China should jump over the current unsustainable development model, and instead move directly to modernizing its economy in a green way so that it is a leader in international competition as it joins the club of high-income nations.

The new growth model represented by green growth has two prominent features that challenge China's current development model in an unprecedented fashion (Zhang

2013, 275). The first important point to note is that the new growth model challenges the traditional government-led development model in China. Green growth that is based on information and communications technology (ICT), big data, and renewable resources is highly decentralized. Whereas the conventional model is driven by large and medium-sized companies, green growth tends to be largely driven by small and medium enterprises (SMEs) connected to one another via networks. This means that the previous government-led model in China is not viable if green growth is to be pursued.

The second point to make is that the new growth model challenges the imitative model of China. As a 'catching-up' economy, China has been copying Western economic models that are not innovative enough. In the past, all the models of economic organization, industrial structure, and business that were formulated by industrialized countries have been copied in China. Now, all of a sudden, green growth has become a global trend that is unfamiliar to everyone, including developed countries. Indeed China is now at the same frontier of green growth as the US and Europe.

China must conduct in-depth reforms to meet the two challenges of rebalancing its development model and ensuring that growth is environmentally sustainable, and the reform of SOEs is an essential part of this. In essence, green growth is a form of institutional competition in which only those with creativity can stand out. Green standards will have to be integrated into ODI, and SOEs will need to strictly implement these standards. The overseas expansion of SOEs has played a relatively important role in China's development. But this expansion may also strengthen distortions in the

domestic system and consolidate vested interests, which is likely to obstruct in-depth market-oriented reforms and thus affect the transformation of China's development model. This is not in the interests of China's long-term prosperity. China's overseas investment should therefore be more consistent with the core goal of transforming the development model towards green development.

#### **4. A Review of the Dominance of SOEs in China's ODI**

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

##### ***4.1. China's ODI and its Domestic Goals***

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 transformation should be taken into account when judging the effects of China's overseas investment. At present, the biggest task for China's economic development is to transform its development model through structural reform. There is then a question as to what implications China's current pattern of ODI (that is dominated by SOEs) has for its domestic goals.

In general, overseas investment by both SOEs and private enterprises is conducive to China's economic transformation and rebalancing. However, as Song, Yang, and Zhang (2011) have pointed out, the pattern of over-relying on SOEs for

overseas investment has also brought about a number of problems and is a double-edged sword (38-53).

One problem is that the aggressive overseas expansion of SOEs increases inertia in reforming state-owned companies. The overseas expansion of SOEs is a reflection of the distorted domestic economic system. This distortion stems largely from inadequate reform of SOEs, and hence reform of these entities must be expedited to eliminate such distortion. However, the aggressive expansion of SOEs has already created a dependence on them for future economic growth thus aggravating the difficulty of reforming SOEs.

Another problem is that the rapid overseas expansion of SOEs is not required for the progression of domestic market-oriented reforms, and indeed may make those reforms more difficult to carry out. China's successful development over the past three decades can largely be attributed to advancing the reform of SOEs and to 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 further reforms to SOEs. The domestic phenomenon that sees 'SOEs advance and private enterprises retreat' (*Guo Jin Min Tui*)<sup>8</sup> is uncondusive to market-oriented reforms. Similarly, the aggressive expansion of SOEs in overseas markets is not conducive to domestic market-oriented reforms

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<sup>8</sup> This phrase refers to the phenomenon whereby the expansion of SOEs has crowded out private investors.

either, and thus it is difficult to establish a self-enforcing mechanism for the transformation of China's development model (Song, Yang, and Zhang 2011, 38-53).

A further problem is that if the competitiveness of SOEs is seen by the government as an indicator of the state's own ability to compete, the government is likely to strengthen its institutional inclination towards SOEs (including through distorting the domestic financial system)<sup>9</sup> so as to enhance their monopoly and competitiveness. This institutional bias towards SOEs would not only squeeze the market space for SMEs, but would also cause path-dependence in domestic macroeconomic policy on state-owned investment. At present, overseas investment funds for domestic enterprises are mainly administered by the China Development Bank, the Export-Import Bank of China and other policy-oriented financial institutions, as well as some industry funds. The access of SMEs to financial resources administered by these bodies is quite limited, and hence the majority of SMEs that 'go global' have limited choices and must rely on their own funds to a large extent.

In short, considering that historical conditions have fundamentally changed, to ensure China's long-term prosperity it is necessary to make adjustments to the dominant pattern of overseas investment led by SOEs. This requires a re-conceptualization of the role that SOEs play in the domestic and international markets and the government's historical reliance on, and institutional bias, towards SOEs.

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<sup>9</sup> For instance, it is relatively easy for SOEs to get bank credit compared to their private counterparts.

#### ***4.2. China's ODI, International Economic Competition, and Cultivating a Win-Win and Harmonious Relationship with the Rest of the World***

The great economic success that China has achieved over the past three decades proves that economic globalization and an international order based on fair competition are conducive to both a strong global economy and a strong Chinese economy. China's overseas investment strategy should serve as an important safeguard of fair competition in the international market.

China is one of the largest beneficiaries of the World Trade Organization's (WTO) 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 and imports have increased 6.2 times. The contribution of exports to China's national GDP is continuing to increase.<sup>10</sup> In 2009, China surpassed Germany as the world's largest exporter, and in 2010 it outstripped Japan by becoming the world's second-largest economic entity.

Because China's overseas investment is dominated by large SOEs, some countries believe that Chinese ODI is driven by state intervention and that it is a threat to fair global competition. Consequently, China's overseas investment is continually subjected to questions about 'state capitalism'.

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<sup>10</sup> FDI in China plays an essential role in the expansion of exports. FDI also contributes to imbalances in the Chinese economy. In these circumstances, ODI plays a role in rebalancing China's payments.

A number of questions have tended to be asked about ODI by Chinese SOEs, such as:

- what is the relationship between the government and Chinese SOEs?;
- how can the fairness of transactions by SOEs be ensured?; and
- how can other countries ensure that Chinese SOEs do not become a tool for achieving government objectives?

Concerns over these issues have often led to the exercise of a higher degree of caution by host countries, which has in turn led to both trade protectionism and fraught politics. Various restrictions have been imposed on overseas investment by large Chinese SOEs and their investments have been subject to greater scrutiny. Concerns may be greater during periods of economic downturn, leading to stronger trade protectionism and access restrictions. These measures ultimately not only harm the interests of Chinese enterprises, but also cause a 'lose-lose' situation. There are continual frictions in China's overseas investment activities. 'National security', the so-called 'China threat', and the 'loss of employment' have all become frequent explanations for the hindrance of China's overseas investment by Western countries. These concerns help explain Haier's abandoned merger with Maytag, China National Offshore Oil Corporation's failed acquisition of Unocal, and the denial of Huawei's attempt to acquire 3 Leaf Systems. Doubts surrounding state capitalism, which affect other countries through SOE-led overseas investment, have also tainted overseas



investment by China's private enterprises.<sup>11</sup> 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.

While accusations about state capitalism are not necessarily fair, China cannot simply turn a blind eye or consider them an inevitable outcome of other countries' prejudices against China. It is also important that China does not look for a way to take revenge. Western society is generally concerned about the expansion of state capitalism, and this has an historical background. In the past, the world economic order was deeply influenced by state intervention exemplified by the former Soviet Union and its state capitalism. Though free market competition is the fundamental force for economic development today, its worldwide dominance is the result of a successful long-standing battle against state intervention and state capitalism. Hence the international community's concern over the loss of fair competition has an important historical background. China's tremendous economic success over the past three decades should be attributed to the growth of market forces and the reform of SOEs, rather than the expansion of its SOEs.

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<sup>11</sup> Bremmer (2009) has argued that '[t]hese 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'.

China therefore needs to properly respond to the concern from Western countries, both through better communication with them and through reforming its own SOEs. It is important that as a future economic powerhouse, China establishes a win-win and harmonious relationship with the rest of the world.

## **5. Discussion**

### ***5.1. Is China's Economy a Case of 'State Capitalism'?***

As a catching-up economy, China's model has been a government-led market economy over the past three decades. This model has been labeled 'state capitalism' by some to distinguish it from the Western model of development that is based on a decentralized market. According to Hormats (2011):

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'.

The suggestion that China's growth is a consequence of state capitalism may be a misreading of the causes of China's economic success. That evaluation will not be helpful for Western countries looking to alter their own economic models by incorporating a measure of government intervention. This is because simply attributing China's economic growth to so-called state capitalism ignores the merits of China's overall economic model.

There is no doubt that the operation of China's government needs to be completely transformed so that it is service-oriented and there are checks and balances on government power so that the market can function well. And yet the situation is not so simple. With increasing division of labor and the continuous expansion of the public domain, the government's role is changing as well. Both China and the Western world need to redefine the role of the government, so as to avoid so-called government failure.

Despite the perceived shortcomings of state capitalism, certain aspects of the Chinese government's behavior (for example, pervasive administrative measures) have some merit that has not been fully recognized. One advantage is that government action can significantly reduce the coordination costs to society. Such 'government action' is actually engaged in in order to provide a new kind of public good that helps the market function well. Especially in catching-up economies, the government's role in economic development is essential as it operates mainly to duplicate economic practices that exist in developed economies but that have not yet been established in developing economies. This kind of government coordination is actually a new public good for society, and is consistent with the principles that govern market economies. Hence some aspects of Chinese government behavior that differ from the actions of Western governments are necessary for modern economic development. It is important to bear this in mind when it comes to considering (and perhaps redefining) what we see as the appropriate role for government. On the other hand, weak or non-interventionist governments traditionally favored by Western societies are perhaps a manifestation of government failure and an absence of the government's public functions. A resolutely

non-interventionist government may ultimately increase the operation costs of society and reduce market efficiency.

Ultimately, while China needs to make changes to the overseas investment of its SOEs, it is not appropriate to label China's overseas investment as state capitalism. Moreover, this investment certainly does not violate market principles simply because it originates in China or because it has arisen in response to the government's 'going global' strategy and receives government support.

## ***5.2. 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. According to Hormats (2011), '[c]ompetitive 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'. A framework of competitive neutrality must include mutually reinforcing policies on trade, investment, and competition.<sup>12</sup>

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<sup>12</sup> Robert Hormats, the US Under Secretary of State for Economic Growth, Energy, and the Environment has said on the subject: '[o]ur 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 '[o]ne aspect of a solution to

Adopting a policy of competitive neutrality often appears to be a punitive approach taken by some countries in response to China's model of government-led economic development and ODI that is dominated by SOEs. 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.

Shaping China's overseas investment strategy is not a one-way process, but an interaction between China and the world. China's rapid economic rise is changing the patterns of global economic activity and interests. And because 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 prejudice in the course of their overseas investment. To some extent this problem stems from the West rather than just from China. China and the West should therefore learn to adapt to one another.

In the meantime, with the current level of global economic integration, China's economy is simply too big to fail. China's success is not only its own success, but the world's success too. On the other hand, China's economic crisis will also be a global crisis – failings in the Chinese economy would undoubtedly drag down the global

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these problems would be a political commitment to “competitive neutrality” (Hormats 2011).

economy as well. Thus the West should not make containing China its goal. It should be committed to creating a win-win situation with China by adopting an open and cooperative attitude when it comes to approaching the rapidly expanding overseas investment from China.

## **6. Conclusion and Policy Implications**

China's strategy for managing ODI by its SOEs must be consistent with its future role on the world stage as the largest economy. China should further commit itself to establishing and maintaining an international order based on fair competition in order to create a win-win and harmonious relationship with the rest of the world. China must conduct strategic restructuring and reform its SOEs internally so as to promote the transition of its domestic development model. These are choices that must be made to safeguard China's long-term interests, and they also provide a clear direction for the strategic adjustment of overseas investment by SOEs.

One of the most pressing issues that needs to be addressed is the further commercialization of SOE behavior. The corporate governance of SOEs needs to be further improved, and the channels through which SOEs potentially get extra support from the government should be cut-off. Introducing such a buffer between enterprises and the government could help distinguish enterprise behavior from that of the government, and thereby provide a stable operating environment for all enterprises. The debate on the reform of SOEs should also go beyond the issue of whether or not to privatize and focus more on the reform of the state assets system. In order to achieve the

government's public goals, state assets should be able to float freely through capital markets and between all enterprises (including SOEs and non-SOEs alike) and the public sector (including the pension system).

The government also needs to consider its overseas investment strategy from the perspective of China's future role in the world as the largest high-income economy. China is bound to become a developed country in the foreseeable future. Hence strengthening cooperation with other countries, maintaining a competitive trade environment, promoting the liberalization of international investment, and pursuing green development are all in line with China's interests and are also part of the increasing responsibility that China should assume as a major power.

Strict green standards should be introduced as a requirement for Chinese ODI, especially ODI by SOEs. Achieving green growth at home is not just in China's own interests, but is also a significant contribution to society as a whole. As the future largest economy in the world, China needs to go beyond traditional notions of the 'national interest' that (as observed in many countries) regard fewer reductions in emissions as a sort of national interest while simultaneously expecting other countries to raise the levels of their emissions reductions. Green growth through deep emissions cuts actually represents an enormous opportunity and could ultimately become a source of economic growth. Green growth is needed for global prosperity and sustainability in the long-run, and its success depends on decisive government action on environmental protection and carbon mitigation.

It is important that the major participants in overseas investment gradually shift from being SOEs to private enterprises. The Chinese government should make an effort to encourage private overseas investment through deepening China's structural reforms. Necessary reforms include: (1) further deregulation and liberalization (such as in finance, medicine, education and infrastructure); (2) elimination of the intangible barriers that are cropping up as the private economy develops; and (3) the introduction of more supportive policies that will help create a better environment for the development of China's private economy.



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