

EABER WORKING PAPER SERIES

PAPER NO. 109

CHINA'S RISING OUTBOUND INVESTMENT: TRENDS AND ISSUES

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Abstract:

This paper aims to facilitate China's globalisation process and to enable destination countries to benefit from Chinese ODI potential by having a clear understanding of the institutional background against which Chinese SOEs have participated in ODI. It reviews the current and emerging trends in China's direct investment abroad. It also looks at the issues arising from the predominance of state-ownership of China's companies investing overseas along with the impact of the reforms state-owned companies have undergone and are currently undertaking.

Keywords: Foreign direct investment; China; investment data; policy reform; investment trends

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1 Introduction

The rapid rise of China's outbound direct investment (ODI) in the past decade is a significant economic phenomenon. According to China's Ministry of Commerce, in 2014 Chinese companies invested US\$116 billion in 156 countries—about 45 times more than in 2002. If new investments by Chinese companies with an existing foreign presence abroad were included, China's ODI in 2014 would have exceeded inbound FDI by about US\$20 billion—that is, China became a net capital exporting country in 2014 (Ministry of Commerce 2015).

The surge in China's ODI has encountered a lot of resistance in several host countries. Questions arise about Chinese companies' investment motivations and strategies. Some hosts consider Chinese investment a threat to their national interests. For example, former Minister of Commerce Deming Chen suggests that only one-third of China's intended investments in the United States receive approval from authorities (Hornby 2013). In other words, there is a large share of potential Chinese ODI that has failed to go abroad.

There is the potential of significant benefit, for China and host countries, in better understanding China's ODI.

The aim of this paper is to facilitate China's globalisation process and to enable destination countries to benefit from Chinese ODI potential by having a clear understanding of the institutional background against which Chinese state-owned enterprises (SOEs) have participated in ODI. To achieve the research goals, this paper addresses selective concerns about Chinese companies and the resistance they have encountered in their ODI experiences. It particularly focuses on the fact that a significant share of China's outbound investment is by state-owned firms. The background to China's SOE reform process explains why and how SOEs have behaved in making ODI. The paper also discusses the new round of SOE reforms and the implications for the future development of China's ODI.

The paper is structured as follows: section two analyses trends and discusses issues in Chinese ODI focusing on SOEs' motivations and political connections in determining ODI; section three discusses the new round of SOE reform and the implications for Chinese ODI; we then discuss and conclude in section four.

2 Trends in China's ODI

Since the period of opening up and reform, China's outbound FDI has developed over four distinct phases, shown in Figure 1. The first, early in the reform period, from 1980 to 1990, was when ODI was negligible at around US\$400 million. China's goal at that time was solely to attract inbound investment. During the next phase, from 1991 to 2000, ODI was similarly limited, reaching just US\$2.3 billion in the period (Figure 1).

Figure 1 Four stages of China's ODI

Source: Foreign direct investment data set compiled by United Nations Conference on Trade and Development (UNCTAD).

In 2001, China's economy shifted from being 'open' to also being outbound. First, China became a member of the World Trade Organization (WTO). Second, the Chinese government launched its 'going out' policy, which encouraged ODI via selective incentives. This marks the third phase of China's ODI development. Specifically, from 2001 to 2007, China's ODI rose to US\$10.6 billion. This is 4.6 times the level of ODI in 1991–2000. In the years since the global financial crisis (GFC), however, China's ODI has grown at an extraordinary rate (Figure 1).

Figure 2 China's ODI flows, 1980–2013

Source: UNCTAD.

Figure 2 illustrates the dramatic rise in China's ODI flows, from 2002 to 2013 it grew at a compound rate of some 40 per cent.¹ Average annual ODI since the GFC has reached US\$74 billion—seven times the level of ODI in 2001–07. Research has shown that a good share of China's ODI passes through Hong Kong and other tax havens or is otherwise excluded from national statistics, meaning these levels could be far higher than officially reported.

¹ Because the flow was unusually low in 2000 and unusually high in 2001, the flow in 2002 was used.

By the end of 2013, China's ODI flow and stock were US\$101 billion and US\$614 billion, respectively, ranking China at number three and number 12 in the world, respectively. China ranks first among developing countries in both categories.

2.1 Future prospects²

China's ODI has developed rapidly in the past decade and there is vast potential for additional ODI growth.

The 'investment development path' theory is based on an empirical analysis of 67 countries in the period 1967–78 (Dunning 1981), found a tendency for net ODI to be cyclical around the level of economic development. Between a gross national product (GNP) per capita range of US\$5,000 and US\$10,000, ODI tends to reach a transition point where it surpasses the level of inbound investment—that is, the net outward investment (NOI) becomes positive, and the country becomes a net direct investment exporter.

In China's case, GNP per capita reached US\$5,680 in 2012, at which point China's outbound investment was still less than its inbound FDI by US\$27.5 billion. It was not until 2014, when China's gross domestic product (GDP) per capita reached \$7,485,³ that China's NOI become positive. In line with the per capita range identified by Dunning (1981), China's ODI surge is in the mid-range of the theory's predictions.

Figure 3 Estimated annual flow of Chinese ODI, 2013–22 (US\$ billion)

Source: Wang (2014).

² The work is based on Professor Fan Gang's advice.

³ Data on GNP per capita in 2014 is not available yet, should be around \$7000. In 2013, China's GNP per capita was \$6560, GDP per capita \$6807.4.

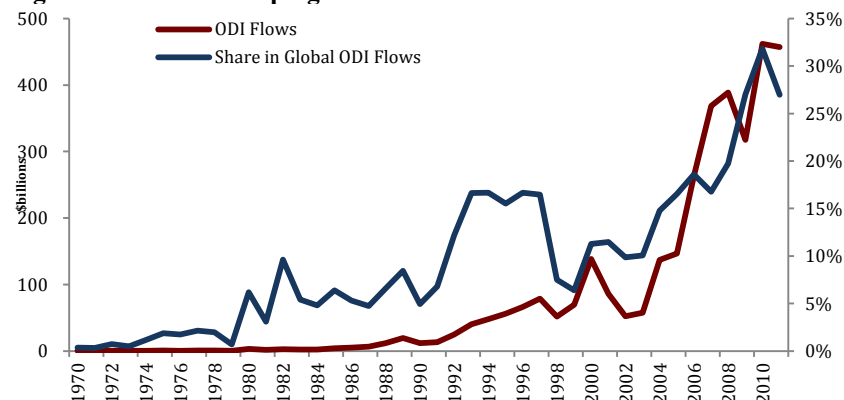
Figure 4 Comparison of China’s future ODI estimations, 2013–22 (US\$ trillion)

NERI = National Economic Research Institute Note: Estimation by Rhodium and HKIMR is for the period 2011–20. Sources: Rhodium from Rosen and Hanemann (2011); Hong Kong Institute for Monetary Research (HKIMR) from He et al. (2012).

Looking forward, it is estimated that China’s ODI will increase at the annual compound growth rate of 19–22 per cent in the decade from 2013 (Wang 2014).⁴ This would make the total increased volume of China’s ODI during 2013–20 between US\$2.5 trillion and US\$3.6 trillion (Figure 3). The estimates of Wang (2014) are higher than Rhodium Group’s estimate of US\$1–2 trillion, but lower than that of the Hong Kong Institute for Monetary Research (HKIMR), which puts the figure at US\$4.6 trillion (Figure 4).⁵

Whatever the precise level, China’s ODI is expected to keep growing rapidly in the next decade.

Figure 5 ODI of developing countries



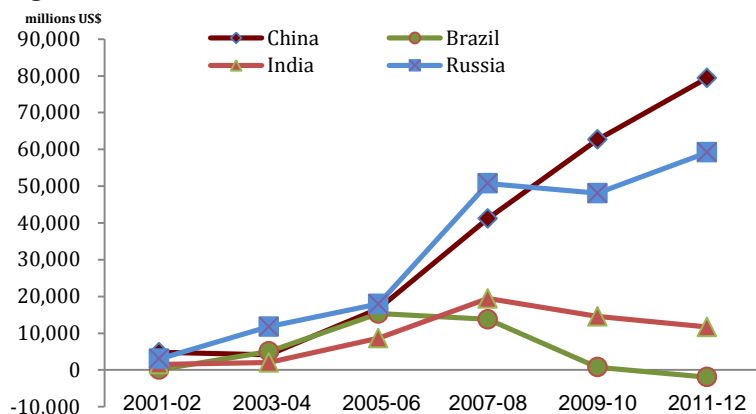
Source: UNCTAD.

China is not the only developing country with surging ODI levels. As the share of global GDP of developing economies has grown and per capita incomes have risen into the US\$5,000–10,000 range identified by Dunning (1981), so too has their collective ODI. Figure 14.5 charts developing-country ODI across 40 years—from almost nothing to more than one-third of total global ODI.

⁴ See detailed analysis in Wang (2014).

⁵ HKIMR’s estimation is based on very optimistic assumptions. For example, they assume that China’s average GDP growth rate is 8.4 per cent during 2012–15 and 7 per cent during 2016–20. The authors’ assumption is 7 per cent during 2013–17 and 6.5 per cent during 2018–22.

Figure 6 BRIC ODI



BRIC = Brazil, Russia, India and China
Source: UNCTAD.

Figure 6 illustrates ODI trends among several of the largest emerging market economies, the BRIC countries (Brazil, Russia, India and China), in particular after the GFC. About the time of the GFC, China's ODI surpassed Russia's to become number one amongst these four countries.

Traditional ODI theories were developed primarily around developed-country ODI as, until the turn of the century, these ODI flows dominated global ODI. There is an insufficient comparative body of research on ODI between developing countries to understand whether these earlier theories still provide an ideal framework for analysis in this new, more varied global ODI landscape. Indeed, in this new landscape, there are cases where developing countries have become the largest investors in developed economies—for example, the case of Chinese ODI into Australia.

3 Issues in China's ODI

As noted earlier, the rapid growth of China's ODI has led to concern in some host destinations. These concerns come from not only the media and the general public, but also governments, scholars and other analysts.

A leading concern is the high share of China's ODI by Chinese SOEs.

The ODI of China is dominated by SOEs, even though it is not easy to confirm this using official data. Specifically, China's official ODI data list numerous state-owned or state-controlled corporations under the broader classification of 'corporation', from

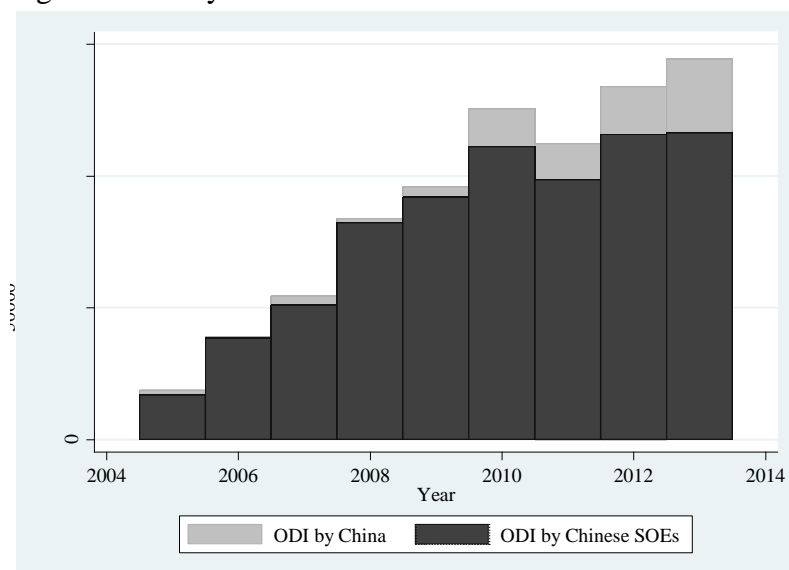
which it is not possible to distinguish whether these corporations are state or privately owned.

Our attempt to explore SOE ODI relies on data compiled by the US-based Heritage Foundation's *China global investment tracker* (HF 2015), which has recorded Chinese ODI and contracts of more than US\$100 million since 2005. That this series from the HF tracks only transactions of more than US\$100 million suggests that non-SOEs' investment—mostly smaller transactions—is under-represented. On the other hand, as an unofficial tracker, it could also miss some SOE investments. We assume the HF data are representative.

By the end of 2013, according to the foreign direct investment data set compiled by United Nations Conference on Trade and Development (UNCTAD), China's ODI stock was US\$614 billion, while HF records China's ODI (excluding the contracts) as US\$476 billion between 2005 and 2013. This suggests the HF data capture some 78 per cent of China's ODI, even though its record starts only from 2005. It is not known whether the difference relates to large investments that were not included in the HF dataset or whether the difference is made up of ODI transactions below the US\$100 million limit of the tracker.

Based on the HF dataset, we identify companies one-by-one and categorise them as SOEs and non-SOEs. The dominance of SOEs within Chinese ODI is obvious, especially before 2009 (Figure 7). According to our calculations, between 2005 and 2013, 89.4 per cent of the US\$807.5 billion of Chinese ODI and contracts were linked to SOEs.

Figure 7 ODI by China and Chinese SOEs above US\$100 million



Note: The value here includes both investments and contracts, so the value here is larger than the UNCTAD data. On average, 59 per cent is investments and the rest are contracts.

Source: Heritage Foundation (2015); and authors' calculations.

With an estimated 90 per cent of China's ODI from SOEs, demystifying SOEs is the key to understanding Chinese ODI. Among the concerns of ODI recipient countries is that SOE ODI is driven by the Chinese government, and in turn motivated by political and state-based strategic considerations, not commercial ones. That generates fear that SOE investment is potentially harmful to the national interest of destination countries.

These concerns are understandable. China's rising ODI is new. Traditionally, ODI has moved between Organisation for Economic Cooperation and Development (OECD) countries, and from OECD countries to developing countries. In the case of China's ODI, China is not only a developing country but also a transitional economy. It is not a member of the OECD. This means that China's ODI comes from an economy with a unique system that is not easy to understand. Understanding it demands energy, time and interest in learning about it. Of course, some concerns could be protectionism in disguise.

3.1 *Regulatory environment confronting China's ODI*

In response to such concerns, the overseas regulatory environment confronting China's ODI is getting tougher, especially towards SOEs. For example, following the

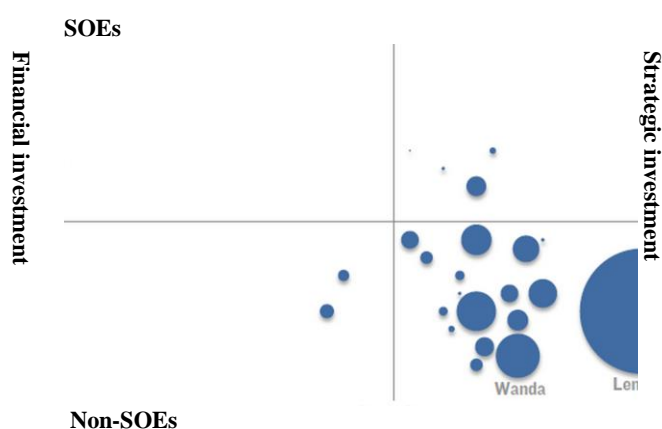
passage of the US *Foreign Investment and National Security Act of 2007*, Australia also issued new foreign investment guidelines, in 2008, while Canada introduced an amendment to the *Investment Canada Act* in 2009. All have made SOEs' investments in their domestic markets more difficult.

Figure 8 Chinese transactions covered by the Committee on Foreign Investment in the United States

Sources: US Treasury Department; Rhodium Group; authors' calculations.

In the United States, 2012 marked a shift in the apparent scrutiny of Chinese investment in that country. That year, the number of Chinese transactions reviewed by the Committee on Foreign Investment in the United States (CFIUS) jumped 109 per cent—from 11 transactions in 2011 to 23 in 2012 (CFIUS 2012). China accounted for 20 per cent of the total transactions covered by CFIUS (Figure 8) (CFIUS 2012). In comparison, China's investment in the United States comprised only 2.5 per cent of total FDI in the United States that year (UNCTAD).

Figure 9 Typology of Chinese entities investing in the United States, Q3 2014



Source: Hanemann and Gao (2014).

Figure 9 illustrates the characteristics of Chinese ODI in the United States in the third quarter of 2014, which is after the investment review process was tightened. In this quarter, SOEs' investment in the United States almost disappeared (Hanemann and Gao 2014).

In addition to investments reviewed by CFIUS, many proposed transactions were withdrawn by Chinese companies before the review stage, after informal exchanges with regulatory agencies or their legal advisors. These abandoned bids are unknown to the public. Deming Chen, former Chinese minister of commerce, said in March 2013, 'roughly one dollar of every three dollars we want to invest in the U.S. gets approved' (Hornby 2013).

Let us take an example of how process affects Chinese investment attempts in the United States. In July 2012, CITIC Securities, the biggest securities house in China, announced that it had approved its subsidiary, CITIC Securities International, to purchase 100 per cent of equity in Credit Lyonnais Securities Asia (CLSA),⁶ for US\$1.25 billion. The transaction was closed a year later, in late July 2013. One of the main causes of the delay was that the US government was against the transaction—because CITIC Securities' biggest shareholder was CITIC Group (which owns 20 per cent of CITIC Securities) and CITIC Group is owned by China's Ministry of Finance. The US government does not want a US company—CLSA Americas LLC—to be controlled by the Chinese government. The deal was only approved when China's Vice Premier Wang Yang personally raised the issue during the fifth round of the US–China Strategic and Economic Dialogue, held in early July 2013.

In 2012, a US\$15 billion acquisition of Canadian company Nexen by China's third-largest oil company, China National Offshore Oil Corporation (CNOOC), was considered by many as a breakthrough for China's overseas investment. Canadian Prime Minister Stephen Harper, when announcing approval of the deal in December 2012, said that the government had been making efforts to reduce state ownership in economic sectors, but the energy sector had been made an exception in being bought and controlled by foreign governments instead. Although China's CNOOC, as an SOE, has received approval for the Nexen deal, it was followed by the Canadian government indicating that it intends to impose stricter rules in future for foreign state-owned companies acquiring Canadian companies. CFIUS has also barred CNOOC from operating Nexen's Gulf of Mexico oilfields.

⁶ CLSA is a brokerage firm that used to be owned by Credit Lyonnais, a French company.

In 2013, Lenovo, a leading private computer company in China, which some consider a state-supported enterprise (The Economist 2012), attempted to acquire Blackberry, but the deal was rejected by the Canadian government.

There is new uncertainty about trade and investment policies. The United States is leading the formation of Asia's biggest trade and investment agreement, the Trans-Pacific Partnership (TPP), without the inclusion of China—the region's largest economy. An article in *The Economist* considers this initiative nonsensical (The Economist 2014). A former US Under Secretary of State Robert Hormats has linked the TPP to restrictions on investments by SOEs and state-supported enterprises (SSEs) that, he says, may have an unfair competitive advantage in the US or in third countries, through anti-competitive practices which require 'a robust and effective policy response'. The TPP, in his view, is a significant opportunity to move the SOE issue forward (Hormats 2011).

In order to clarify SOEs' motivations in ODI, it is necessary to investigate SOE reform and the principal-agent problem.

4 The evolving role of SOEs

At the end of 2013, there were 156,000 SOEs (incorporated enterprises, not corporation groups) in China. Among them, 52,000 were central SOEs (some of them are subsidiaries of 112 central SOE groups, which are under the supervision of the State-Owned Assets Supervision and Administration Commission; some were SOEs affiliated with central ministries, such as the Ministry of Finance), and 104,000 were provincial or other local SOEs. The total number of SOE employees was about 37 million, 18 million of whom were employed by central SOEs, and 19 million by local SOEs (Ministry of Finance 2014).

At the end of 2013, the combined assets of SOEs stood at RMB104 trillion (US\$17 trillion)—up 16.3 per cent year-on-year (YOY); and the total outstanding debt was RMB67.1 trillion (US\$10.9 trillion)—up 16.7 per cent YOY. In 2013, SOEs' operating revenue rose 10.8 percent to RMB47.1 trillion (US\$7.7 trillion), and profits increased 5.3 per cent to RMB2.6 trillion (US\$400 billion). The companies paid a total of RMB3.8 trillion (US\$620 billion) in taxes in 2013—up 5.4 per cent YOY (Ministry of Finance 2014).

In the past 30 years, Chinese SOEs have undergone a series of reforms, including on bankruptcy, mergers and acquisitions. From the first SOE bankruptcy, of Shenyang Explosion in 1986, to the first SOE listing, of China Communications Construction Company, on the Hong Kong Stock Exchange in 2006, and the first SOE (CITIC)

moving its headquarters to Hong Kong in 2014, the Chinese SOEs have undergone profound changes.

At the core of this is change to the management system and operating modality. At the beginning of the 1980s, Chinese SOEs were directly attached to the government bodies that in turn were deeply involved in SOE operations. During the 1980s and 1990s, initial reforms were carried out to separate the government's ownership from management's operating role.

Early last decade, nine government bodies engaged in managing SOEs were abolished. The resistance to these reforms was immense. Then Premier Zhu Rongji declared 'I am willing to risk my life to carry this reform through'. From 1998 to 2006, the number of SOEs decreased by 59 per cent, from more than 60,000 to less than 30,000. The number of people employed by SOEs fell from about 37 million to about 18 million (Shao 2007). Many small and medium SOEs have been privatised.

In 2003, the Chinese government established the State-Owned Assets Supervision and Administration Commission (SASAC). SASAC is empowered to execute regulatory authority over and determine the rights of SOEs. Unlike former regulators, SASAC enjoys consolidated powers over SOE regulation—there has been a massive shift from fragmented to concentrated regulatory power. This new regulatory regime exerts a subtle influence on SOEs' behaviour, the detailed mechanism for which will be discussed in the section exploring SOEs' motivations.

In 2006, SASAC issued the 'Guiding Opinions on Pushing Forward the Adjustment of State-Owned Capital and Merger and Acquisition of State-Owned Enterprises'. The document made it clear that if central SOEs did not rank among the top three of their industry, they would be merged and acquired. The goal then was to reduce the number of central SOEs from 155 to between 80 and 100.

Eight years later, in 2014, there were 112 central SOE groups. In the intervening years, the SOE performance evaluation criteria set up by SASAC was revised several times, with profit-making at its core. By 2013, there were about 260 SOEs listed overseas, and 953 SOEs listed on the domestic stock market (People's Daily 2013).

The major reforms of SOEs listed in this section are a small sample of the reforms agenda undertaken to ensure the long-run sustainability of China's SOEs. It is clear that China's SOEs and their administration is evolving and SOEs' motivations and political connections have been, and continue to be, reshaped.

5 Is SOE ODI commercially motivated?

Many scholars have undertaken comprehensive analyses of whether SOEs are commercially motivated (for example, Cornish 2012; Downs 2007; Drysdale 2011; Drysdale and Findlay 2009; Hanemann and Rosen 2012; Rosen and Hanemann 2011). These scholars have concluded that SOEs are generally commercially motivated, but concerns remain. There is a spectrum of SOE behaviours, and this leads to a spectrum of different views. The following case studies provide examples of the competition between China's SOEs and between China's SOEs and private enterprises.

5.1 Central SOEs: China CNR versus China CSR

China CNR and China CSR are both leading companies in the rail rolling stock industry in China. Both are centrally owned SOEs and both are listed on the Hong Kong and Shanghai stock exchanges.

In the second half of 2012, Argentina announced a decision to purchase a fleet of city rail cars. China CNR, Alstom and several other companies participated in the bid. China CNR's bid price was US\$2.3 million per car, and other companies' bid prices were about US\$2 million per car. This prompted China CSR to approach Argentina with a lower bid, of US\$1.27 million per car. Ignoring the Chinese government's request that it should first register at the China Chamber of Commerce for the Import and Export of Machinery and Electronic Products (CCCME), China CSR ultimately won the contract to supply 409 cars to Argentina for a total of US\$514 million.

The reason for China CSR's bid being much lower was that its car design was for an older model and its car parts would be made in China, while China CNR's bid was for a newer car model and the car parts would be imported. As a result, China CSR was able to make a profit at its low bid price. Furthermore, China CSR was at the time short of orders and facing operating difficulties.⁷

5.2 SOE versus a privately owned enterprise: Zoomlion and Sany

Zoomlion and Sany are both leading public companies in the construction machinery industry in China. Zoomlion is listed on both the Hong Kong and the Shanghai stock exchanges. Sany is listed only on the Shanghai Stock Exchange.

⁷ The two companies were merged by the end of 2014. One of the purposes was to avoid the harmful cut-throat competition between them.

Zoomlion is a provincial government company, operating under the auspices of the Hunan Assets Supervision and Administration Commission. Zoomlion was established in 1992. It had been growing at a compound annual rate of 65 per cent for 20 years.

Sany is a privately owned enterprise (POE)—that is, founded and owned by private individuals, with chairman Liang Wengen as its controlling shareholder. Sany was established in 1994 and has been growing at about 50 per cent annually. It was selected by the *Financial Times* as one of the FT Global 500 in July 2011, becoming the only Chinese machinery company on the list.

In November 2007, the Italian company CIFA, the world's third-largest concrete machinery company, launched a public auction for its shares. Zoomlion and Sany both submitted bids, in January 2008. Zoomlion partnered with Goldman Sachs and won the bid. Afterwards, the chairman of Zoomlion said that even though the timing of the bid was not good (on the eve of the GFC), it could not let CIFA fall into the hands of competitors.

Another example from Europe is from late 2011 when German company Putzmeister, the world's number one brand in concrete machinery, was looking for a buyer. Zoomlion and Sany both received invitations to bid. Even though Zoomlion was the only company with approval from the National Development and Reform Commission (NDRC) to participate in the bid, Sany partnered with CITIC PE and succeeded in acquiring Putzmeister in a record 33 days.

These two cases are examples of Chinese SOEs competing fiercely with each other and with POEs. They also illustrate how SOEs and POEs do not necessarily follow the coordinating efforts of the Chinese government to enhance their own business as independent commercial entities.

6 How do political elements influence SOEs' ODI?

Being state-owned, SOEs are clearly connected closely with the government and politics. However, this does not necessarily mean that SOEs' behaviour reflects their owners' policy purposes. Twisted by the complicated principal–agent problem, SOEs tend to pursue their own rather than their owners' objectives.

It is essential to understand SOEs' principal–agent problem. There are three tiers to the SOE principal–agent system: the nation or all people as principal are located on the top. As agents, the SOEs' managers are at the bottom of the three tiers; the regulators,

who exercise SOE owners' authority and rights on behalf of the principal, are in the middle.

Within this system, regulators play multiple and significant roles. On behalf of the whole nation, they scrutinise SOE investment proposals, select and assign SOE managers, inspect SOE productivity, examine SOE restructuring plans, and evaluate senior managers' performances, as well as other performance or proposals. In other words, the regulators are involved in and exert subtle influence on SOEs' operation.

As the bridge connecting the SOE owners with SOE managers, regulators have dual characters: economic and political. By changing the regulatory structure and political environment, the nation or government can exert influence on regulators' incentives and also constrain their behaviour. The changed behaviour of regulators in turn affects the SOEs' behaviour and performance.

6.1 *Regulatory regime change*

We divide the regulatory regime into 'separated regime' and 'integrated regime' according to the degree of concentration of regulatory power. The regulatory regime is integrated where fewer regulators enjoy a higher concentration of power. The regime is separated where there are more regulators and a lower concentration of power. Since the market-oriented reforms introduced in 1978, Chinese SOEs' regulatory regime has been changing dramatically. The main trend since the reforms began in 1978 is towards consolidating what were decentralised regulatory powers. There has been incremental transition from a separated regime to an integrated regime.

The regulatory regime transition since 1982 can be divided into two periods that pivot around 2003, the year in which the creation of SACAC led to greater concentration of regulatory power. From 1982 to 2003, there were for the most part four SOE regulators: the State Economic and Trade Commission for examining SOEs' reform and reconstruction; the Ministry of Finance for asset management and financial supervision; the Ministry of Organisation for selecting and assigning SOE managers; and the Central Work Committee for Large Enterprises, ensuring the implementation of the party's policies. There were also 10 specialised industrial ministries depending on the year, including the Ministry of Textiles, Ministry of Coal and Ministry of Mechanical Engineering Industry. These took responsibility for their corresponding industry's planning, coordination and supervision. Generally, before 2003, the regulatory power was distributed among various regulators—a separated regulatory regime.

In 2003, SASAC was established, consolidating all the powers of the State Economic and Trade Commission, Ministry of Finance, Central Work Committee for Large Enterprises, Ministry of Organization, and so on. This in turn means that SASAC monopolises all regulatory powers over SOEs. Consequently, the period after 2003 can be viewed as an integrated regulatory regime, taking the concentration of regulatory power into consideration.

According to Qi et al. (2015), there is a trade-off in these regime choices. A more decentralised, separated regime has comparative advantage in reducing the risks of collusion between regulators and SOEs. An integrated and more centralised regime has comparative advantage in effective use of regulatory powers.

There is a free-riding problem in the separated regulatory regime. When regulatory powers are shared by several regulators, responsibility for success and failure is diffused amongst all players. In the separated or decentralised regulatory regime, Chinese SOEs repeatedly complained that all the regulators would claim success when their SOEs outperformed expectations, but avoid responsibility when SOEs underperformed. Regulators in the separated regime do not have sufficient incentive to promote good performance in the SOE, including when that would involve expanding domestically or internationally.

The establishment of SASAC resolved the problem of free-riding, because reward or punishment for good or bad performance goes to the sole regulator. Regulators' reputations for competence are enhanced by successful expansion into more mature and competitive foreign markets. Promoting ODI is also a way for regulators to respond to the national strategy of 'going out', and by so doing, to accumulate credits for future promotion.

The Chinese national strategy of 'going out' was initiated in the late 1990s, but was not implemented effectively until a decade later. According to the mechanism described above, only if the related government departments' incentive problems were solved properly could the 'going out' strategy be implemented effectively. The establishment of SASAC solved the incentive problems, assisting the acceleration of SOEs' ODI after the mid 2000s.

Another concern of SOE regulation is the need for mechanisms to prevent collusion between regulators and SOEs. The state delegates to regulators so that they can supervise SOE behaviour. This in turn mitigates the SOE principal-agent problem, although it does not completely remove it. In the process of regulation, the regulators can potentially collude with the SOEs they regulate for their own benefit and at the

expense of the state. For regulators, collusion has at least two faces: bribery and the ‘revolving door’.

Corruption related to a regulator’s abuse of power is not uncommon in the Chinese state sector. This can be indirectly demonstrated by the dozens of SOE officials who have been investigated and charged during the national anti-corruption campaign that was instigated in 2013.

The revolving-door phenomenon is also a salient problem in the Chinese state sector. According to the Unirule Institute of Economics (2011), among 19 ministries and commissions, 30.6 per cent of the 183 leaders with at least the rank of Vice Minister ranked have at some point been employed by an SOE. Zhou (2010) shows that among the SOEs listed on the Chinese A Share Market, 1,142 senior corporate executives—some 50 per cent—used to serve as government officials.

The revolving door gives regulatory officials an incentive to collude with SOEs. They can, for example, avoid strictly imposing regulation to keep a friendly relationship with their potential SOE’s colleagues.

While the integrated regulator has a stronger incentive to perform well and is less constrained than separated regulators in using regulatory powers, the separated regime regulators can check and balance one another. The checks and balances reduce the risk of collusion (Qi 2015).

Collusion causes losses to the SOE owners—for example, through approval of inefficient investments. However, extra costs are incurred when owners try to police this kind of collusion.

As the Chinese regulatory regime changed from a separated to an integrated regime, SOE regulators had stronger incentives to promote SOEs’ ODI. SOEs’ investments have increased dramatically since the establishment of SASAC in 2003. However, collusion between the regulator and SOE under the SASAC regime can lead to lower quality ODI. Low-quality ODI could contribute to SOE ODI growth, but lower the efficiency of Chinese ODI as a whole.

6.2 *Political environment*

The second factor that influences regulator incentives and constraints is the political environment. Currently, the biggest factors that influence government officials' inventiveness and constraint are the breadth and depth of the ongoing national anti-corruption effort.

China's corruption problem is severe. In 2014, China ranked one hundredth among 175 countries on Transparency International's Corruption Perceptions Index—on par with Algeria and Suriname.

Corruption can lead to low-quality investment—domestically and internationally—and so impose a cost on the SOE owner and the Chinese economy.

Since 2013, Chinese President Xi Jinping has overseen a high-profile anti-corruption campaign. This has targeted hundreds of thousands of officials at all levels of government and in the state-owned sector. As of 2015, it had executed cases involving 100 high-level officials, including several very senior executives of SOEs, and punished more than 70,000 officials for violations of the eight-point anti-graft rules. More than 200,000 petty officials have also been targeted. Considering the number of officials punished and the scale of scrutiny, this anti-corruption campaign is considered the toughest in China for 30 years.⁸

The scale of this anti-corruption action has had several consequences for China's SOE ODI. It slows SOE ODI growth, but ultimately enhances its efficiency. According to the analysis framework we have applied here, the regulator's incentive for promoting ODI partially comes from benefits from collusion. In an environment with intense anti-corruption efforts, regulators' and SOEs' collusive behaviour is easier to investigate—that is, incentives for regulators to collude with SOEs have been compressed by anti-corruption actions. Reduction of the expected benefits from collusion discourages regulators and SOEs from colluding, and reduces inefficient investments.

⁸ On June 5 2015, the Central Party's Leading Group on Comprehensive and Deepening Reforms issued a new SOE reform document, "Opinions on Maintaining Party's Leadership and Strengthening the Party's Organization in Deepening Reform of State-Owned Enterprises". While how the document will be implemented is still under discussion, it is considered as a new measure to address prevalent corruption problems of SOEs.

Our analysis shows that SOE behaviour is affected by political elements such as the regulatory regime and the political environment. The perceptions of some destination countries differ from the actual behaviour of SOEs not only because the State sees value in good commercial performance of the companies which it owns, but also because principal–agent problems means the managers do not always follow the objectives of the State.

Chinese SOEs cannot be compared with those three decades ago during the central planning era. Moreover, SOEs keep changing as the reforms grow broader and deeper over time.

7 SOE reform: Implications for China’s ODI

At the Third Plenary Session of the Eighteenth Communist Party of China Central Committee, held in November 2013, ‘The Decision on Major Issues Concerning Comprehensively Deepening Reforms’ was adopted. SOE reforms make up a key element of reforms within the decision.

The main components of this next round of SOE reforms include: developing a mixed-ownership economy, improving the state-owned asset management system, improving SOE governance and management systems, and strengthening the budget system for state-owned capital operation.

Developing a mixed-ownership economy, in particular, is central to the new round of SOE reforms. Mixed ownership refers to allowing more SOEs and enterprises of other ownership types to develop into mixed-ownership enterprises. This means allowing private capital to invest in state-owned capital investment projects, and allowing mixed-ownership enterprises to adopt employee stock ownership so as to align the interests of capital owners and workers.

Currently, the overall design of the SOE reform is being studied and developed under the leadership of a unit within the Central Leading Group for Comprehensively Deepening Reform,⁹ chaired by President Xi. Key questions of the reform being discussed and explored include how and what share private capital can take in SOEs, how senior management might be allowed to hold stocks, and how state-owned capital investment and operating companies can be established. On the final point, the question is whether to transform existing central SOEs into separate holding and

⁹ The unit’s name is Economic System and Ecological Civilization System Reform Group.

operating companies, or to divide central SOEs into different groups, with the larger and stronger ones sponsoring and establishing holding and operating companies.

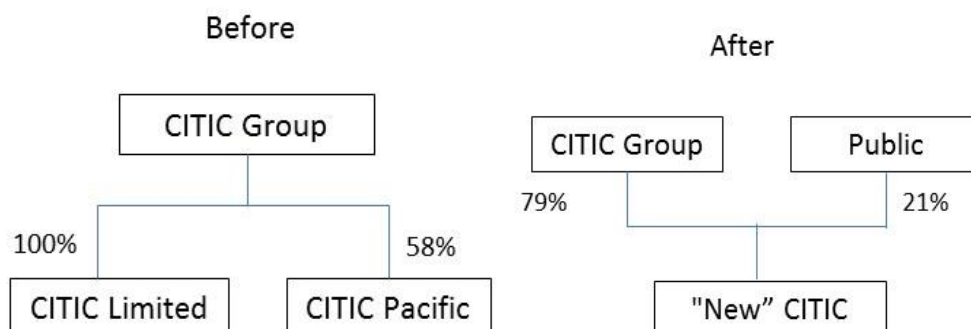
A number of central SOEs have already started reforms within the new policies. For example, the board of China Petroleum & Chemical Corporation (Sinopec)—China's largest manufacturer and supplier of petroleum products and major petrochemical products—approved a plan to restructure its fuel retail business and invite private capital to form a mixed-ownership company. The shareholding percentage allocated to private capital is up to 30 per cent (Shanghai Securities Daily 2014).

Separately, in October 2013, Sinopec announced it would look for investors for its Monteny and Duvernay shale gas projects in Canada, which Sinopec acquired in 2011. The hope is that this will lower Sinopec's own capital requirement and also speed up development of the projects. The Canadian Minister of National Resources commented that this SOE was operating just like a commercial entity, in buying, selling and bringing in investors (Reuters 2013).

A second example is from China's largest oil and gas producer and distributor, PetroChina. In March 2014, PetroChina announced it would establish six separate platforms for its undeveloped reserves, unconventional oil, gas, transmission, refinery (onshore and offshore) and financial businesses. It plans to use the production share model to bring in private capital and push for a mixed-ownership system. This reform reflects PetroChina's desire to open the entire business chain, and also to out-compete Sinopec.

In the power sector, China Power Investment Corporation (CPI Corp), one of the five largest state-owned electricity producers in China, announced in March 2013 that it would allow private capital to invest in some of its subsidiaries and projects. This would extend to up to one-third of the total share capital.

Figure 9 CITIC before and after the acquisition.



Source: CITIC.

CITIC Pacific's acquisition of CITIC Limited in March 2013 caught the market's attention. The acquisition process involved CITIC Group injecting most of its operating businesses, currently held by CITIC Limited, into its Hong Kong-listed subsidiary company, CITIC Pacific (Figure 9). The deal would be the largest asset injection into a Hong Kong-listed company from the Chinese mainland.

The 'new' CITIC headquarters will be in Hong Kong. As a Hong Kong-listed company, the new CITIC will be subject to the more mature legal system of Hong Kong and similarly to the higher supervision standards of Hong Kong regulators and media. This will help make its operations and finances more transparent, and will also improve its management system and corporate governance. Changes will include adopting an employee stock option plan, recruiting senior management from the market, lowering the government's ownership share and attracting more private and overseas capital.

On 15 July 2014, SASAC announced pilot reforms applying to six central SOEs, including State Development and Investment Corp, China National Cereals, Oils and Foodstuffs Corporation (COFCO), Sinopharm, China Construction, China Energy Conservation and Environmental Protection Group, and Xinxing Cathay International Group. The pilot projects include: 1) transforming central SOEs into state-owned capital investment companies; 2) developing central SOEs into mixed-ownership companies; and 3) giving central SOE boards the right to recruit senior management personnel from the market, and to assess their performance and determine compensation independently.

At the provincial level, almost all of the 32 provinces and municipalities have publicly announced SOE reform plans. For example, Gree Electric Appliances Inc., a

provincially owned entity in Guangdong and a leading electric appliances company in China, will transfer up to 49 per cent of its shares to investors through an open bidding process. These plans received positive reactions from capital markets.

7.1 What's new in this round of SOE reform?

Mixed ownership is not a new concept in China. It was in use more than two decades ago, in 1993. Central SOEs' mixed-ownership practices have been continuing over the years, through public listing and introducing strategic investors, and so on. More than 60 per cent of the subsidiaries of central SOEs are now structured in ways that include some level of mixed ownership.

Several differences can be identified between this new round of SOE reform and previous ones. First, the status of mixed ownership has been elevated and is now considered the basic form of the socialist economic system—and, as a result, the majority of SOEs can now become mixed-ownership entities. Second, private capital is encouraged to take controlling shares. Third, employees of mixed-ownership enterprises will be permitted to hold stocks (China Securities Daily 2014).

The SOE reforms, as difficult and complicated as they are, will bring profound changes to the Chinese economy, as well as to Chinese enterprises and their overseas investments. As the SOE reforms evolve, so should the world's views on them.

8 Concluding Remarks

China's ODI, like ODI from any other country, aims to make profits, and in doing so seeks sound investment environments with fair and transparent regulatory rules. As China's economy continues to grow at a slower, 'new normal' rate in the next decade, the rate of China's outbound FDI, by SOEs and privately owned firms, is likely to continue to be buoyant. In parallel, their economic efficiency will be enhanced by broader economic reforms, and also SOE reforms.

Through this growth process, misunderstandings, fear and protectionism will hinder the execution and success of China's ODI, while also preventing host countries from benefiting from the contributions that Chinese ODI could make to economic growth and employment. To that end, '[s]uccumbing to the nationalist response to foreign investment would, based on all the evidence, be extremely damaging economically as well as have political ramifications' (Drysedale 2011: 70). Similarly, *The Economist* has noted that 'to reject China's advances would thus be a disservice to future

generations, as well as a deeply pessimistic statement about capitalism's confidence in itself' (The Economist 2010).

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