

Chinese Direct Investment in the State of Washington: Strategic Considerations and Policy Implications

中国企业在华盛顿州投资: 管理战略和有关系的政策问题

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Introduction

The contemporary American entrepreneurial market economy has been an attractor of foreign investment (FDI), both portfolio and direct, for a long time. However, the ability of this economy to attract investment from developing economies is a relatively new development. According to Kofi Annan's preface to UNCTAD's World Investment Report 2005:

The conventional wisdom of developed countries as capital and technology exporters and developing countries as importers is gradually giving way to a more complex set of relationships. The geography of international investment flows is changing. Developing countries are emerging as outward investors, and their importance as recipients of foreign direct investment in more knowledge-intensive activities is increasing.¹

The emergence of Chinese investors investing abroad is part of this trend. According to IMF estimates, Chinese² FDI flows increased from US\$0 to US\$6884 million per year between 1970 and 2001.³ From 2001 to 2004, official Chinese FDI stock steadily increased to a level of US\$38.8bn, comprising 2.4% of Chinese GDP.⁴ In 2004, Chinese majority-owned foreign affiliates were providing employment to some 2,900 employees in the United States. Hong Kong companies employed 14,200. PRC employment has been stable, but Hong Kong employment has actually declined by 50% since 2000.⁵ Since not all FDI entails majority control (US definitions of direct investment require 10% ownership, while the PRC defines it as 25%), these figures understate the true amount of employment generated by Chinese firms to some extent.

While the absolute levels of Chinese FDI are still relatively small in comparison to most other developed countries, among developing economies, China is emerging as a leader.⁶ In 2003, China overtook Ireland and Israel as a source of direct investment.⁷ In the same year, officially monitored Chinese overseas investment stocks outgrew South Korea's.⁸

Officially, the Chinese state has attempted to direct Chinese FDI in order to achieve its strategic developmental priorities. Tax incentives are now available for "overseas development projects that can cover the shortage of domestic resources; overseas manufacturing and infrastructure projects that can spur the export of domestic technology, products, equipment and labor; overseas R&D

¹ UNCTAD World Investment Report 2005 p "v"

² Since investment data is collected separately for Hong Kong and the mainland, I will henceforth refer to mainland PRC as "China," in accordance with the nomenclature conventions of UNCTAD reports.

³ Chan, Sarah and John Wong "China's Outward Direct Investment: Expanding Worldwide" China: An International Journal 1, 2 (SEP. 2003): 273 – 301 Online statistical appendix http://muse.jhu.edu/journals/china/v001/1.2wong_tab03.html

⁴ UNCTAD World Investment Report 2005

⁵ Zeile, William J. and Thomas Anderson "US Affiliates of Foreign Companies: Operations in 2004." US Bureau of Economic Analysis. August 2006.

⁶ Chan and Wong p273 – 301

⁷ Buckley, Peter J., Jeremy Clegg, Adam Cross, Lui Xin, and Hinrich Voss. "Host Country Determinants of Chinese Outward Foreign Direct Investment." Presented to the 33rd AIB-UK Conference 2006. Centre for International Business, Leeds University Business School. Accessed April 2006.

<<http://66.102.7.104/search?q=cache:PLHLIzzvP7IJ:www.personal.mbs.ac.uk/rsinkovics/aibukproceedings/papers/AIBUKpaper116.pdf+host+country+determinants+of+Chinese+foreign+investment&hl=en&gl=us&ct=clnk&cd=3>>

⁸ UNCTAD World Investment Report 2005

projects that will tap into advanced global technology, managerial skills and talents; and overseas acquisition and merger projects that will enhance enterprises' international competitive capacity and help them develop international markets.”⁹

However, of the factors pushing Chinese investment outwards, not all are the product of government policy; of such policies, not all were intended to encourage FDI. The transnational nature of outward investment is such that it implicitly reduces the degree to which a given government can control it. Like so much of Chinese policy in other arenas, Chinese FDI policies have developed partly according to cautious forward-looking strategy and partly in incremental reaction to external and events.

It is reasonable to expect that the Puget Sound region's response will develop according to a similar mixture of prescience and reaction. As far as prescience is concerned, the State of Washington, specifically the Community, Trade and Economic Development office (CTED), is the first in the nation to sign a memorandum of understanding with China's Ministry of Finance and Commerce (MOF) agreeing to cooperate to stimulate bilateral foreign investment. From a public relations perspective, relations between this state and the Chinese are quite strong. President Hu Jintao, on his way to visit President Bush, stopped in Seattle to visit with Bill Gates, a subtle but important signal of diplomatic priorities. There are numerous offices in place in China representing the State of Washington, the Port of Seattle, the Port of Tacoma, and a new office representing the Washington Software Alliance in Shenzhen.

This paper will describe certain considerations particular to Chinese investors that should be taken into account as policies are formed and initiatives launched. It will engage with certain questions, that while basic, must be asked and answered for the record.

1. What makes Chinese FDI different from FDI from any other country, as far as the regional interest is concerned?
2. What kind of Chinese firm is most likely to invest in Washington, and for what reasons?
3. Is a regional management strategy (including institutions designed to implement same) specific to Chinese FDI necessary or can the risks and opportunities be handled within a wider strategy encompassing all FDI?

While considering these questions, there is one more question to keep in mind. The State of Washington is particularly dependent on trade to create jobs. It is not, however, dependent on foreign direct investment to create jobs. Trade and investment are very different phenomena, requiring different levels of economic and managerial integration, and they have similarly different effects. The argument that because trade, therefore FDI does not appear to hold in the case of the Washington economy, and the question is: is this, in fact, a problem to be solved?

⁹ Ibid p7.

The downside of FDI

Despite theoretical arguments that relentlessly promote the advantages of foreign investment (in particular for developing economies), FDI has not proven a magic pill in developing countries, and its benefits are still debated today. The FDI process, which involves one firm acquiring or merging with a firm in a foreign country, or creating a foreign subsidiary from scratch a.k.a. “greenfield” investment, is fraught with risks, for all of the parties involved. It is doubly risky for developing economies to engage in outbound FDI, since such economies have relatively less capital to speculate with and less experience managers to handle overseas operations.

In addition to the normal challenges of business in a given sector, a foreign firm must expose its capital to additional risks. It faces competition from native firms that have an intrinsically greater familiarity with the market, the subtleties of local law, the vagaries of the political attitudes of local governments and popular opinion, and differences in language and managerial culture.

The local firm of must also be wary of the foreign investor. Direct investment is not free money; it entails a loss of control and a change, however subtle, in priorities. When considering a proposal to allow foreign ownership, the local management must ask, will the foreign firm help us become more profitable, or will a conflict of interests or managerial cultures destroy the firm’s profitability? And to what extent does the national origin of the acquiring firm make it more difficult to adequately assess that firm’s intentions and compatibility with existing strategy?

Local governments and federal governments must assess risks to wider economic and security concerns over a longer period of time. At the risk of stating the obvious, the interests of these various actors are rarely synchronous, and are frequently in direct opposition. A foreign acquisition of an American company or asset is almost guaranteed to serve one interest at the expense (actual or perceived) of the other.

As importantly, there are no reasons to take the macroeconomic benefits frequently ascribed to foreign direct investment for granted. At one time FDI was considered a near panacea for a wide variety of economic problems, particularly in the developing world where economies are short of capital. In China, the poster child for the benefits of FDI, FDI has been viewed as a mechanism for facilitating internal reforms, stimulating competition, producing technology “spillover” in the form of patent applications, and mitigating political tensions between the two countries involved, and so on. However, recent literature has questioned the uniformity and predictability of such benefits from country to country and sector to sector. In China, some have argued that FDI has actually weakened Chinese domestic firms and failed to produce innovation. In the US, a country rich in capital and patent applications, what purpose does FDI serve that local direct investment cannot? Why should the Puget Sound region court Chinese FDI? If the region’s firms need cash, surely there are other sources. How many regional firms need Chinese expertise, or access to Chinese markets, or any of the other putative benefits provided by international mergers and acquisitions (M&A)?

The question is, to an extent, a straw man. The region may or may not value Chinese FDI’s potential, but it is not in a position to prevent Chinese firms from investing here even if “it” wanted to. Chinese money is free to flow into the region; firm owners and voting stockholders are free to accept or reject it with their own interests in mind. And while any number of the statements and questions above can and should be debated in the community, there are many reasons to believe that Chinese investment is coming to the region, in one form or another, no matter what . . . and that therefore some sort of regional response will be necessary. Indeed, numerous leaders in the regional economic development cluster have come to this precise conclusion, and are formulating

strategies and enacting policies designed to actively solicit and manage Chinese direct investment as part of the regional FDI initiative action item.

Understanding Chinese direct investment

China is already Seattle's 3rd largest trading partner, and where there is trade, it seems logical for some sort of direct investment to follow. While China's total amount of foreign direct investment remains relatively small, its rate of increase is substantial. In 2005, outbound flows increased by 25% according to Ministry of Commerce (MOF) statistics.¹⁰

While statistics provided by the Chinese government on outbound direct investment may be suspected, most authors reviewed believe that statistics provided by the Ministry of Finance are particularly prone to understating the case. For example, in one survey MOF reported only 188 Chinese enterprises in Singapore in 2003. Singaporean officials contradicted MOF and asserted that there were, in fact, around 1,500 Chinese firms in the country!¹¹

The potential for friction

While many foreign countries invest in the United States, there are few countries of origin as controversial as that emerging from the People's Republic of China. One need merely read the coverage of the China National Offshore Oil Company (CNOOC) bid for Unocal, review the arguments surrounding the issue of China's investments in Sudanese oil, or examine the record of Huawei, the Chinese telecommunications company, in Iraq and in the US, to get an idea of the potential for friction.¹² While the absolute amount of China's investment in the US is dwarfed by funds from Europe (in 2004, Belgium alone controlled more assets in the US than China did), it nevertheless engenders the same sort of fears once associated with Japan's forays into US property and automobile markets in the 80s, or more recently with the Dubai port management controversy in New York. It is also complicated by the fact that a disproportionate number of Chinese affiliates operating in the US are owned by the Chinese government.¹³ Decision-makers insulate themselves from such ill-informed vagaries of public opinion at their peril.

In the case of the Puget Sound region, disproportionately dependent on trade compared with many other areas, PRC investment is doubly important both as an opportunity and as a potential threat. On the one hand, there is the opportunity to leverage Chinese entry to create the sort of bidding wars such as those enjoyed by Unocal and Maytag. On the other, should the PRC use direct investment in the regional aerospace sector to transfer the technology necessary compete directly with Boeing, one of the few remaining trade surpluses the US enjoys with China would be threatened, and the local jobs that go with it.

These are extreme anecdotes, and in the case of competition with Boeing, unrealistic in the short to medium term.¹⁴ Not all Chinese companies can borrow money as cheaply as China's energy giants. Nor is there reason to believe that the ability to design and assemble large modern civil aircraft is

¹⁰ <http://english.mofcom.gov.cn/aarticle/statistic/foreigninvestment/200607/20060702705397.html>

¹¹ Wu, Friedrich "The Globalization of Corporate China" *NBR Analysis* Number 3, Volume 16 National Bureau of Asian Research. December 2005 p8.

¹² See Cisco's allegations about Huawei's behavior at http://newsroom.cisco.com/dlls/corp_012303.html

¹³ Zeile, William J. and Thomas Anderson "US Affiliates of Foreign Companies: Operations in 2004." US Bureau of Economic Analysis. August 2006.

¹⁴ For my argument on this assertion, see "Aviation Development with Chinese Characteristics: Will China Build a Civil Aircraft National Champion?" at http://academics.cuberoof.com/Chinese_aviation_manufacturing_policy_short.pdf

easily done with a few strategic acquisitions. And many of the opportunities and threats presented by Chinese investment have no real relation its Chinese origin. American firms are also capable of overpaying for assets, stealing intellectual property, destroying jobs and regional economies, and leaving behind pollution and wreckage in their wake. But when they do, it is chalked up to business, not the Pacific Northwest's strategic relationship with the state in which the firm is headquartered.

The greatest risk is the information and perception gaps inherent in the differences between the Chinese and US economies, cultures, and politics. Despite optimism that China's relationship with the US will inevitably be as benign and comprehensible as that between the US and Japan, at present the differences are not superficial. After we exclude all that Chinese and US firms have in common, we are left with profound differences in regulation, management culture, legal structures, and language. And these differences vary across Chinese companies and all sectors. Some Chinese companies are still run by barely-reformed socialist behemoths. Others are run by Harvard MBAs. Some are the perpetrators of intellectual property theft. Others are its victims.

Unique facets of Chinese FDI

Of the forces pushing Chinese capital overseas, not all are driven by a quest for profitability. This does not in and of itself distinguish them from other firms. To list the foremost "conventional" reasons for investing abroad:

1. To create overseas sales/purchasing affiliates to facilitate imports and exports. Interestingly enough, Chinese affiliates in the US do a relatively small amount of importing.
2. To avoid a trade barrier through the creation of a foreign affiliate and relying on "intra-firm" trade to facilitate movement of goods, capital, and profits. Should the current trends in trade liberalization and tariff reductions by the WTO process continue, this motive will lose leverage over decisions.
3. To escape domestic factors: tax burdens, currency instability, macroeconomic problems, legal issues etc.
4. To engage in research and development (R&D) in a foreign technology cluster.
5. To facilitate the management and integration of a component-based multinational product development chain i.e. "integrative" direct investment.

While the goal of these endeavors may be net profitability, certainly an R&D affiliate is not intended to become a profit center per se, and loss-making affiliates must be considered in the context of the domestic tax burden; it may be more profitable to lose money overseas than pay taxes at home.

In addition to these conventional motivations, Chinese firms also operate under a distinct series of incentives, largely caused by the unique nature of China's political economy and the progress of its internal market forms, which I will describe below.

The macroeconomy and the investment "bubble"

China's strong macroeconomic fundamentals, combined with its currency policies and success in attracting FDI to stimulate growth have created an economy that many are concerned is overheating. Regardless, this growth has also engendered large foreign currency surpluses. Despite its fame as an attractor of foreign investment, China is a net exporter of capital. According to Sarah Chan and John Wong, "due to the positive saving-investment and export-import gaps, the [Chinese] economy has, for years, experienced a net resource outflow. Technically speaking, China's economy can

sustain significant capital outflow for investment purposes.”¹⁵ Recent news about interventions in the Chinese stock markets by the central government testifies to the fact that many Chinese have money ready to speculate with. This speculation has driven portfolio investment in stocks and bonds, and direct investment in real estate (a significant portion of the wealthiest people in China are real estate investors), both at home and abroad.

However, many of those speculating have little experience in stock markets, investment, or risk, in particular those state bureaucrats with investment responsibilities but little financial training or experience. For example, a single Chinese man named Liu Qibing employed by the quasi-public State Resources Board managed to single-handedly cripple the Chinese copper industry to the tune of \$300 million by speculating on the British copper futures exchange and getting caught short. While the Chinese government originally denied that the man existed, then that he worked for the government, it was ultimately forced to pour copper into the market to prevent more damage to its short position.

The State-Owned Enterprise (SOE) and the *danwei*

The most singular economic institution China has are the large state-owned industrial complexes that played a particular role both in Chinese communism and in Chinese capitalism. Under the Chinese communist economy, the SOE was an all-encompassing institution, and was largely interchangeable with the *danwei* (单位) in terms of definition. The *danwei* were all-encompassing units. Generally organized around a single industry or factory, not only did they provide employment, but they handled almost every other aspect of their employees' lives. Your *danwei* gave you your apartment, vetted your guests, approved your marriage, and made sure you (or your wife) stayed on her birth control. It provided your health insurance and your pension and your children's education. The *danwei* was the core of the “iron rice bowl” that guaranteed Chinese urban workers the benefits of a socialist economy.

However, these units were never designed to be responsive to market forces, but were rather engines of Stalinist industrialization by which resources were extracted from the countryside and invested in the development of heavy industry and other forms of fixed capital. They had enormous staff levels but were prodigiously wasteful in terms of resources. By the end of the Maoist period, their flaws had become obvious to everyone, and the only arguments were over how to best reform them.

The result was the separation of the *danwei* concept from the SOE concept. The state continued to run a sort of command economy within the SOEs in terms of setting production priorities and managing investment, but slowly introduced market incentives (such as the right to keep profits instead of seeing them funneled to prop up weaker units). However, the all-encompassing social environment provided by the *danwei* system began to wither away. Some (far from all) inefficient SOEs were privatized, sold, or disbanded entirely, resulting in layoffs and social disturbance.

The process of privatizing, streamlining, and reforming the SOEs is not complete. While great strides have inarguably been made, they have not been costless for Chinese society. Nevertheless, the SOEs, and the policy legacy that created them, remain the salient Chinese characteristic of the Chinese economy, and must be understood before anything else in China makes any sense.

¹⁵ Chan, Sarah and John Wong “China’s Outward Direct Investment: Expanding Worldwide” China: An International Journal 1, 2 (SEP. 2003): 273 – 301 Online statistical appendix http://muse.jhu.edu/journals/china/v001/1.2wong_tab03.html

Distortions in domestic credit markets

For the most part, the companies with the best access to capital, loans, technology, and personnel are SOEs, *regardless of their size*. Loans from China's state-controlled banking system have traditionally been assigned according to political patronage, not profitability, which explains the presence of another member of the Chinese delegation in Seattle last May: the Great Wall Asset Management Corporation. This company, according to its description in the delegation profiles provided to attendees, is charged with leveraging its "*particular legal condition* [italics mine] and professional expertise to maximize the recovery value of non-performing loans/assets."¹⁶ The bulk of these non-performing loans are held by defunct SOEs.

In *Selling China*, Yasheng Huang argues that the central government's support for money-losing SOEs, when combined with tax incentives for foreign firms, inadvertently caused the weakening of domestic firms, who could not borrow money from Chinese banks nor compete for the best local talent. The poorly managed SOEs, rich in assets, were therefore ideal acquisition targets for foreign firms. Denied local capital due to credit challenges and local protectionism (China lacks an effective equivalent to the Interstate Commerce Clause) private domestic firms also had to turn outwards for funding.¹⁷ Huawei, China's telecommunications champion, was initially ignored by the Chinese government, and was forced to borrow funds from Hong Kong loan sharks at predatory rates.

Donning the Red Hat: who owns a Chinese firm?

Thanks to the preferences granted state-owned firms, many private firms were forced to grant the state some form of ownership in order to do business. Such firms were private and capitalist in all but name, and thus were called "Red Hat" firms by the Chinese. However, these arrangements were inherently unstable. Some governments were held liable for the activities of such firms when they broke laws, went bankrupt, etc. At the same time, the private owners of such firms could never be sure that the local government would not come back in and take control once the firm became successful.

In some cases the Red Hat was donned in order to invest overseas. Therefore those who are considering a bid from a Chinese company must concern themselves with the actual ownership and management of that firm, as opposed to contenting themselves with statements of legal status.

Tax preferences, local protectionism and "round-trip" investment

The difficulties private Chinese firms have accessing capital are compounded by the disproportionate tax advantages currently granted to foreign-invested firms (FIEs) in China. At present, FIEs enjoy an effective tax rate of 11%, in comparison to 23% for domestic firms.

This phenomenon is compounded by another; China's lack of an effective "inter-state commerce clause." In fact, throughout history, Chinese provinces and localities have always been relatively powerful vis a vis the central government. The Chinese central government, despite its predilection for authoritarianism, is relatively weak in comparison to the US government. Christine Wong points out that the central government is not, in fact, able to collect as much fiscal revenue as the US

¹⁶ "China Delegation Company Information" 投资合促进团主要城关介绍 provided to participants at the Washington State Investment Seminar, Seattle, WA May 11, 2007.

¹⁷ Huang, Yasheng. *Selling China*. Cambridge University Press: New York, NY. 2003

government is, as so much is siphoned off by local and provincial governments.¹⁸ These same governments, including the local branches of the CCP, are intimately linked to local enterprises both politically and economically, and thus introduce their own distortions to the system. They cooperate with local businesses to help them evade central taxes. They protect those businesses from other firms outside the locality through protectionist regulation and passive lack of enforcement. A Chinese firm making software in one province may find its software pirated next door; when they win the patent lawsuit, they find that enforcement of the judgment is in the hands of the offending company's allies in the provincial government. Imagine if one could not drive a car made in Michigan in the State of Florida. This precise condition has prevailed previously in China between Beijing and Shanghai. One result is that there is no "Chinese market" per se. There are, instead, many markets, and it is frequently easier for a foreign firm to widen its market in China than it is for domestic firms.

In this environment, many firms have sought to don the "foreign hat," by moving money overseas and then reinvesting it in the mainland, to avoid local protectionism and gain access to the numerous tax incentives available to FIEs. This process is called "round trip FDI," and it occurs largely through entrepôts like Hong Kong and the Cayman islands. During the Asian currency crisis in 1997, such capital flight accounted for \$22bn of the Errors and Omissions column in China's balance of payments.¹⁹ As of 2004, MOF claims that some 81% of registered Chinese FDI still goes through Hong Kong and the Caymans.²⁰

Obviously a government that makes some claims to legitimacy on the basis of economic and technological nationalism is vulnerable to charges that it is selling the country to foreigners at a discount. Numerous domestic firms have quite sensibly called for a rationalized and unified tax code. In March of 2007, the National People's Congress (NPC) passed a revised uniform corporate tax code. However, it is unclear whether this will ultimately equalize the tax treatment of FIEs and domestic firms, and if the short run such incentives are explicitly maintained, in particular in high technology industries where domestic firms are not competitive, and foreign investments supporting with other strategic priorities, such as the development of China's western provinces.

Weak brands and product diversification

One of the particular failures of Chinese firms, public and private, is an inability to create powerful brand identities, both domestically and abroad. The most relevant explanation for this is the tendency of many Chinese firms, particularly SOEs with easy access to capital, to overdiversify their product lines to the point of absurdity. For example, the Doublestar Group Corporation Ltd. From Qingdao advertises itself as "one of the most valuable brands in China." This company "mainly" deals with "shoes, tires, garments, machine and thermoelectricity, but also extends its business to many other lines, including printing, embroidery, the tertiary industry . . ."

This overdiversification, repeated throughout China, causes market saturation, debilitating price wars, lack of focus on quality, and profound brand weakness. Given the emotional and reputational

¹⁸ Wong, Christine P.W. "Central--Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China" *The China Quarterly*, No. 128. (Dec., 1991), pp. 691-715.

¹⁹ Liu, Qiao, and Geng Xiao "Why Do Firms Disguise Their Profits? Theory and Evidence from China." Working paper. January 31, 2004 <http://test.ccf.org.cn/cicf2004/papers/2-3-1.pdf>

²⁰ "Foreign Investment in China" The US-China Business Council, February 2007. <http://www.uschina.org/info/forecast/2007/foreign-investment.html> viewed 5/29/2007

aspects of branding, this stains the reputation of other Chinese companies. Lenovo's acquisition of IBM's laptop business was not driven by a need to learn how to make laptops, but in order to acquire the right to sell its own laptops under IBM's brand.

For local companies who already outsource most of their production, selling the brand is a harmless way to cash out. However, for firms with significant local employment, selling the brand can mean effectively destroying the local firm in all but name. For example, Da Vinci flavored coffees was recently acquired by a British firm, which promptly laid everyone off. This is a normal aspect of business, but taxpayer-funded agencies facilitate this sort of acquisition at their public-relations peril.

SOE performance problems

Despite their performance problems at home, Chinese SOEs were also encouraged to invest abroad; in fact, prior to the late 90s, they were the only firms legally allowed to do so. This was formalized in the "Going Outwards" policy, in which the central government encouraged firms to invest abroad to for reasons of competitiveness and national pride, and this strategy was ultimately adjusted to allow for FDI from successful private firms. However, this strategy has produced inconsistent results. Inefficient SOEs, pushed abroad, performed little better there than at home. According to MOFCOM, barely a third of Chinese corporate investments overseas were profitable in 2004.²¹ The US Bureau of Economic Analysis confirm that overseas Chinese firms perform poorly in this country; in the US, the net income for Chinese invested firms has been negative for the last years. However, in 2004 this figure saw a marked reversal, and Chinese net income from the mainland leapt into the black.²² Without diminishing the significance of this fact, it must be noted that net income alone is not necessarily an indicator of success or failure of a given firm. And it should be contrasted with the declining level of employment by Hong Kong affiliates in this country.

Monitoring and regulatory challenges

Despite the Liu Qibing's of the world, and the documented problems of the SOEs at home and abroad, the Chinese central government has a great deal of trouble controlling its firms. To that end it has increasingly focused on creating and empowering an auditing agency, empowering the State Administration of Foreign Exchange (SAFE) and taking other publicized measures to control wayward or incompetent SOEs. Li Jinhua, the head of the Auditing Bureau, described the problem in the press: "wrong decision-making is more serious than embezzlement and corruption," he said, and reported that in 2005, while his auditors had discovered \$198 million illegally used funds in 10 large SOEs, they estimated the economic losses caused by "wrong decision-making and mismanagement stood as high as 14.5 billion yuan (US\$1.7 billion)."²³

Institutionally-speaking, the much vaunted auditing and regulatory agencies have proven less effective than hoped in restraining and reporting on SOEs performance. This makes analysis and assessment difficult. MOF's statistical accuracy is restrained by its inability to obtain quality firm-level information from Chinese firms operating overseas without reporting to the MOF. For example, in one survey MOF reported only 188 Chinese enterprises in Singapore in 2003.

²¹ China. Ministry of Commerce & National Bureau of Statistics. *China Outbound Investment Statistics Report 2004*, September, 2005.

²² US Bureau of Economic Statistics

²³ Xing Zhigang "Officials to be liable for bad investment" China Daily. Updated: 2006-03-10 05:57 http://www.chinadaily.com.cn/english/doc/2006-03/10/content_530653.htm

Singaporean officials contradicted MOF and asserted that there were, in fact, around 1,500 Chinese firms in the country!²⁴

To paraphrase Disraeli, there are three kinds of lies; lies, damned lies, and statistics on Chinese FDI from the MOF. The large inefficient SOEs most likely to lose money abroad are also the most likely to report to the MOF. Depending on their incentives, SOE managers also may have reason to exaggerate their losses in order to minimize taxation, or exaggerate their profits for political benefit. Indeed, this problem is not limited to overseas investments. As the US-China Business Council reports:

In February 2006, the PRC Ministry of Commerce (MOFCOM) announced that it would no longer report the value of contracted foreign investment deals. In the past, contracted FDI figures were used to estimate future commitments. In explaining why it would no longer report these figures, MOFCOM said that the figures were unreliable. Apparently, local officials had been inflating these figures because their performance was traditionally partially evaluated on the ability to attract foreign investment. By no longer publishing the numbers, MOFCOM evidently hopes that local officials will focus on bringing in actual foreign investment rather than just signing contracts.²⁵

The quest for natural resources

The first and most obvious distinction is China's well-publicized energy shopping spree. China, despite its vast size, is relatively poor in resources. Most of its energy comes from coal, which cannot run Chinese cars or airplanes. China is also short on key factors required for many of its manufactured products. The government's response has been to cultivate direct investments in nations rich in key natural resources, particularly in oil. This is not a market-oriented strategy, since energy assets are fungible commodities that can be purchased on the open market. China's "equity oil" energy strategy, which involves direct control of oil fields and companies with reserves, is not based on a trust of market mechanisms which sell fungible oil, but on an assumption that the market will fail in a crisis, and China will not be able to purchase the oil she needs at any price.²⁶ Recent actions of the US government towards oil producing countries have not eased China's concerns in this regard.

The "equity oil" strategy, which implies direct ownership of oil assets abroad from which oil is extracted directly and shipped to China, led the Chinese government to extend enormous interest-free loans to CNOOC for the Unocal bid, allowing CNOOC to outbid Chevron by US\$2bn. The Economist explains:

The only reason CNOOC can do this without ruining its financial ratios and potentially crushing its own share price is that \$7 billion of the overall \$20-billion deal costs (the \$18.5 billion bid plus the assumption of some debt and a \$500m "kill" fee to Chevron if the latter is seen off) is coming via a parent entity from its ultimate owner—the government. Another \$6 billion is a loan from one of the big four state banks. Of the \$7 billion, CNOOC has to pay no interest at all on \$2.5 billion, and just 3.5% interest on the remaining \$4.5 billion, a loan

²⁴ Wu, Friedrich "The Globalization of Corporate China" NBR Analysis Number 3, Volume 16 National Bureau of Asian Research. December 2005 p8.

²⁵ "Foreign Investment in China" The US-China Business Council, February 2007.
<http://www.uschina.org/info/forecast/2007/foreign-investment.html> viewed 5/29/2007

²⁶ Downs, Erica. "The Brookings Foreign Policy Studies Energy Security Series: China" The Brookings Institution. December 2006. <http://www.brookings.edu/fp/research/energy/2006china.pdf>

that lasts for 30 years. Since a 30-year American Treasury bond currently yields 4.2%, CNOOC is borrowing more cheaply than the American government, clearly nonsense in a world of rational economics.²⁷

This strategy has produced some very large energy giants, with staggering amounts of capital to spare and a reputation for bidding first (at a premium price) and asking regulatory permission later.²⁸ At the Chinese outbound investment seminar held in Seattle in May 2007, the first company listed is PetroChina. Whether this was due to PetroChina's interest in investment, or in the Chinese government's desire to quash the recent movement to lobby US firms to divest from PetroChina in protest of Chinese policy in the Sudan remains an open question. Certainly Washington's burgeoning clean energy cluster could serve as a target for Chinese energy investment, should such technologies show a clear applicability to the Chinese energy market.

The role of private firms in FDI

As noted previously, it is difficult to get quality firm level data on Chinese private firms operating abroad. However, while SOEs remain important in the short term, in the long term their influence in most sectors will diminish. As the internal Chinese market sheds state investment and control, so too has Chinese FDI become increasingly dominated by private firms. A report produced by the Asia Pacific Foundation of Canada and the China Council for the Promotion of International Trade (APFC-CCPIT) describes private investors increasingly moving capital overseas:

State-owned enterprises have slipped from a dominating position to be just some among the major players, as shown by the share of ODI held by SOEs dropping from 43% in 2003 to 35% in 2004. Publicly-owned companies, including limited liability companies, shareholding companies and collective companies, accounted for 45% of total investors, up from 39% in 2003. Private companies accounted for 12%, gaining two percentage points from a year earlier.²⁹

The APC-CCPIT survey investigated both firms currently engaged in ODI, those inclined to consider it, and those not so inclined. The study designers consider their survey sample indicative of the Chinese economy's industrial, regional, and ownership mix. The survey reveals the following salient facts about Chinese ODI:

- Respondents indicated that their top three motives for engaging in ODI were 1) business expansion 2) **“security of investment”** and 3) **tax regime**. Government assistance was the 8th most important motive, and followed after factors like “membership in regional free trade agreement” and importance of the target market as a motive.
- The most common field of activity for Chinese ODI firms is **trade, including import and export**, followed by manufacturing, and then resource extraction, in that order.
- The most attractive market for future Chinese ODI is **Asia, followed by the US** and then Europe.

²⁷ “The dragon tucks in” *The Economist*. Jun 30th 2005.

http://www.economist.com/business/globalexecutive/dialogue/displayStory.cfm?Story_id=4127399

²⁸ Downs

²⁹ Asia Pacific Foundation of Canada, China Council for the Promotion of International Trade (APC-CCPIT Survey). “China Goes Global: A Survey of Chinese Companies’ Outward Direct Investment Intentions.” September 2005. Annex C.

- **Regional differences** were significant. Out of 296 surveyed companies, 31 Guangdong firms provided 34.9% of the total ODI. The Shanghai-Pudong region provided another 22%.
- Most of the companies are either entirely or **predominantly owned by Chinese nationals** (27% and 60%, respectively).
- **Publicly-traded companies** are the most enthusiastic about engaging in future outbound investment. Otherwise the survey detected no correlation between ownership structure and enthusiasm for ODI. “The percentages indicating an expected increase in ODI for publicly owned companies escalate from 22% in 12-months to 62% in 2-5-years. All other types of companies, including SOEs, only increase from around the 20% range to the 35% range. Also, publicly owned companies record the largest decline of no ODI intention, and the percentages indicating no expected ODI drop from 58% to only 10%.”³⁰
- 60% of the survey respondent’s current ODI is through **joint venture**.

A preliminary presentation of findings from a more recent survey, conducted by the World Bank’s Foreign Investment Advisory Services (FIAS), roughly coordinates with APC-CCPIT’s findings. However, there are some critical differences which must be explored. First, the FIAS survey did not survey tax factors as motivation for ODI. However, while the top three motives listed for ODI were market oriented (“market seeking,” “strategic assets,” and “competitive strategy,” respectively), the fourth most important factor was “domestic government support.” In this survey, only 35% of respondents indicated an interest in natural resource endowments of the host country.

Interestingly enough, what these firms wanted from the government is not simply limited to the elimination of paperwork and cheap money. In addition to streamlining application processes, making the requirements more transparent, 49% of respondents wanted the government to organize outwards investment fairs, and 34% wanted the government to provide more information on the host countries markets and regulatory environments. Respondents also wanted the government to provide assistance negotiating with foreign governments to provide investment guarantees and engaging in bilateral trade negotiations.³¹

On the one hand, the survey provides helpful information on the intentions and needs of non-state firms, in particular the firms who belong to CCPIT, some of the most proactive and advanced in China. The State of Washington should consider conducting its own surveys of this nature to better tailor their service mixture. However, the survey also tells us that Chinese firms are less likely to invest in the US than in Asia and (recently) in Latin America.³² The liberalization of the Chinese FDI regulations is likely to point that FDI in another direction.

³⁰ APC-CCPIT p21.

³¹ Battat, Joseph “China’s Outward Foreign Direct Investment: FIAS/MIGA Firm Survey” World Bank Foreign Investment Advisory Group. viewed April 13, 2006
http://rru.worldbank.org/Documents/PSDForum/2006/joe_battat.pdf

³² According to the US-China Business Council report, Latin America recently surpassed Asia as the regional target for Chinese investment.

Formulating a regional strategy for handling Chinese FDI

Is Chinese investment really coming?

Given the issues cited above, we should ask again; how likely is it that Chinese firms are coming to invest in Washington? If the firms come, how likely are they to positively contribute to the regional economy? The short answer is, the majority of private, high-performing Chinese FDI is more likely to be made in economies more similar to the Chinese economy, in firms more closely related along the production chain. This means the most vibrant and competitive portion of Chinese FDI is going to expand into Asia and Latin America before the US. It also means that those firms most likely to invest here will likely be large SOEs operating under soft budget constraints, seeking technology transfers. However, a few points must be made.

1. All SOEs are not created equal.

Despite the relentlessly negative coverage of SOEs as a class in the above section, not all state-owned enterprises are hidebound ministries masquerading as corporations. The uncertain ownership status of many firms also extends to “red hat” SOEs which are, in fact, profit-driven private firms in all ways but legal status. Lenovo, for example, began as an SOE, but was much closer to a Red Hat firm than a state ministry. The Chinese State Shipbuilding Corporation is an SOE, and a highly profitable one.

2. Sometimes capital is all you need.

Whether SOEs meet their domestic performance targets in China is not, of course, the primary concern for Washington policy makers and private firms. Certainly Unocal shareholders were not up in arms over getting \$2bn more for their shares just because the money was Chinese. As John Steinbeck said, “the only friend money has is more money.” There are upsides to being a tax shelter, and there are advantages for being a capital transshipment center. Additionally, while the argument that Washington’s notoriously high rate of startup failure (22% in 2004)³³ is due to a lack of capital is far from proven, unquestionably some of those firms fail for lack of access to “runway” capital, which Chinese SOEs may be inclined to provide, particularly if they acquire ownership of a new technology that can be marketed domestically . . . such as clean energy.

3. The desire to transfer technology does not equal the capability to do so.

The nightmare of those who resist Chinese foreign investment is that these companies will use FDI to legally appropriate our intellectual property, spirit it to China, and lay off US workers as soon as they do so. This is a valid concern, but it is hardly unique to Chinese companies; it should concern any company considering seeking investment that involves access to their IP. In the case of China, however, US companies (and US security) has suffered far less as a result of FDI than from direct espionage. Chinese SOEs have relentlessly purchased and attempted to duplicate foreign technology in many sectors. The failure of SOEs to compete has been repeatedly addressed by investing in more and better technology. This has provided many US companies with some very lucrative purchasing contracts without producing successful Chinese competitors, because so many of these

³³ “2006-2007 Puget Sound Regional Competitiveness Indicators” Puget Sound Regional Council: Prosperity Partnership. November 2006. Available from infoctr@psrc.org

SOEs have utterly ignored the business processes and management skills necessary to make the technology work.

4. There are genuine areas for potential cooperation.

The Washington economy and the Chinese economy nevertheless have some specific complementarities in the short run and in the long run. Channeling and managing investment along these lines would provide unquestionable benefit. The logistics sector, the clean energy sector, and the high-technology startup sector are all areas in which Chinese investment could provide both stimulus, capital, and managerial cooperation without risking a substantial regional competitive advantage.

Conclusion: Is a Chinese FDI strategy required?

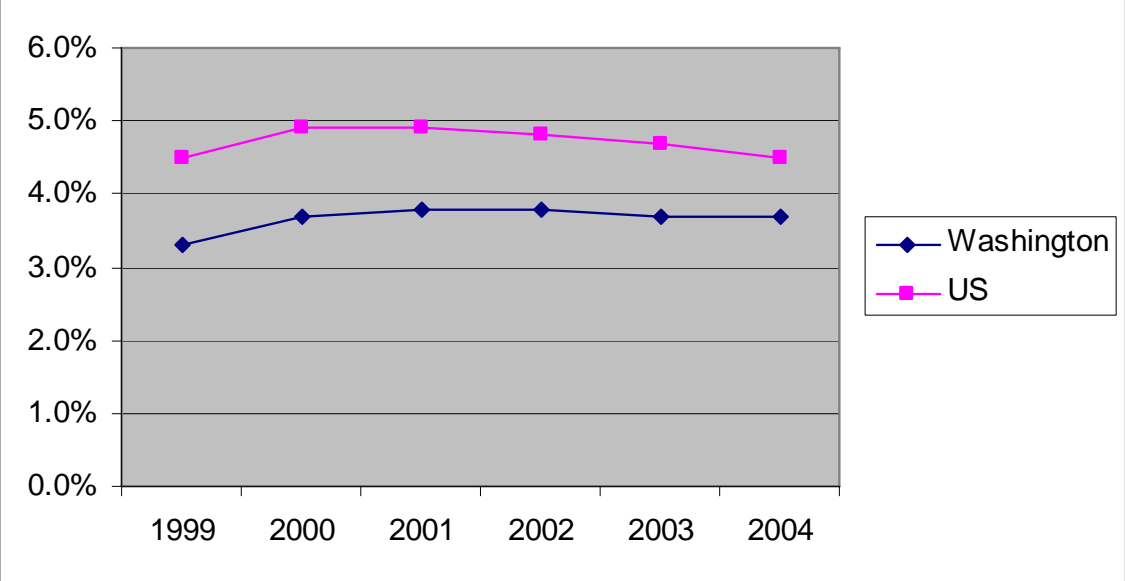
Based on the particularities of Chinese firms operating abroad, clearly there is a need to educate both incoming Chinese firms and their targets to alleviate confusions and overcome information barriers. CTED and other public agencies are already engaged in preparing the ground for these efforts, serving as clearing houses and filters for publicly available information on investment opportunities in Washington. More emphasis on language education and improved availability of information in Chinese will no doubt ease the process of investment. However, there are a few risks that should be avoided:

1. The very diversity of institutions engaged in economic development in this region (there are more than 30), distributed as they are between public and private responsibilities, may unnecessarily confuse Chinese investors. While there are no legal barriers to investment in the US, apart from those involving national security, the density of the information involved and the complexity of the information networks are daunting to organizations and individuals with one foot still in the industrial paradigm. Likewise, while I have described the complexity of ownership arrangements in the Chinese economy, the difference between public and private in the US is not necessarily more intuitive. Explaining to a Chinese investor the legal difference between the State of Washington and the Port of Seattle may take some time; indeed, it has been known to confuse Americans. It might be best to establish a simple process map- what software developers call “the happy path”- that herds the potential Chinese investor along stages of information and education, instead of turning a fire hose of data and alternatives on them when they walk in the door.
2. Given this diversity, there is a risk that the public sector services will overlap or displace services better provided by profit-driven consultancies. CTED’s services are free, true, but this is not unequivocally good. For one thing, clients tend to value what they pay for, as the popular disdain for free tax-preparation services illustrates. For another, such consultancies are in and of themselves local employers and part of the very logistics cluster Washington hopes to encourage.
3. The initiative must be conducted within the context of a wider FDI strategy. If Washington establishes that it will benefit from more FDI, as opposed to more domestic investment, it must not establish defacto preferences for one national source of FDI or another, much less privileging it over US companies. The Chinese example should warn us of the dangers of too much FDI, and we may learn from their mistakes.
4. The illusion of control must be resisted. The macroeconomic forces pushing Chinese capital abroad are far too vast to be influenced by public or private agencies. The individual firms making individual decisions cannot be evaluated according to standard templates. Chinese investment in the region will ebb and flow, succeed and fail, hire and fire, according to such a wide variety of factors that it would be arrogant to suggest that any agency be held “responsible” for its performance one way or the other. Firm-level investments are made one at a time. Therefore, from a public relations perspective, public leadership should restrain the public from suspecting that Chinese investment in the region is something done under the explicit direction of CTED or any other government agency.

In conclusion, Chinese FDI is coming, but its pace is likely to remain slow and its influence negligible in the short term. Its advent should cause neither undue excitement nor paranoia nor apathy. The regional integration with China can serve the ultimate interest of Washington residents

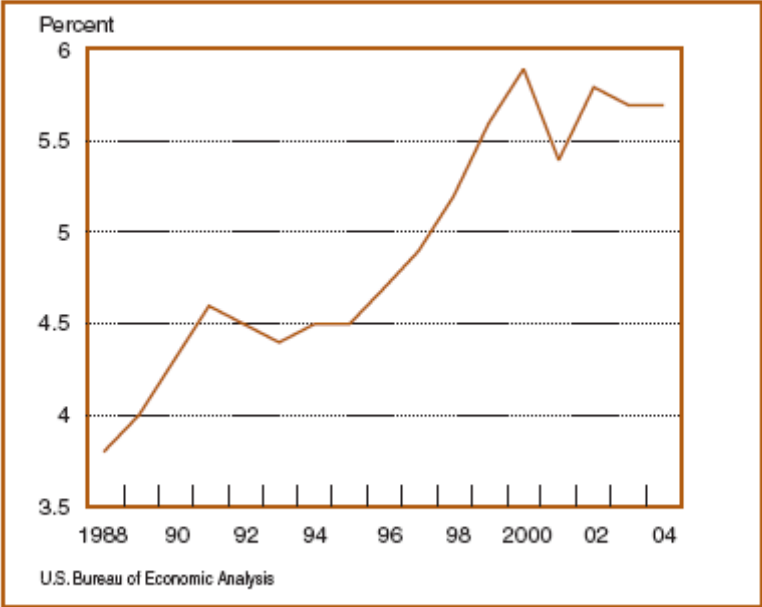
and taxpayers, and both public and private sectors can play a part in ameliorating the risks and leveraging the advantages such investment entails.

Appendix: non-bank employment created by foreign affiliates in the US and Washington State, compared



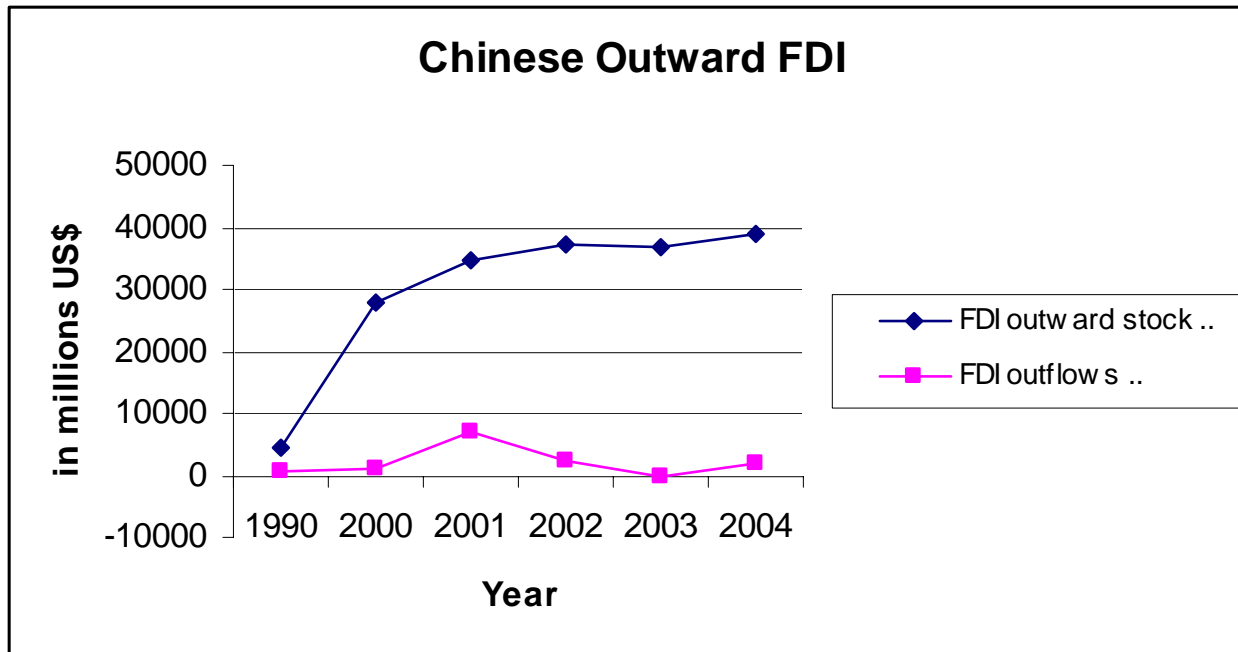
Appendix: Economic Value Added by majority-owned foreign affiliates in the US

Chart 1. Majority-Owned Nonbank U.S.-Affiliate Share of Value Added in Private Industries, 1988–2004

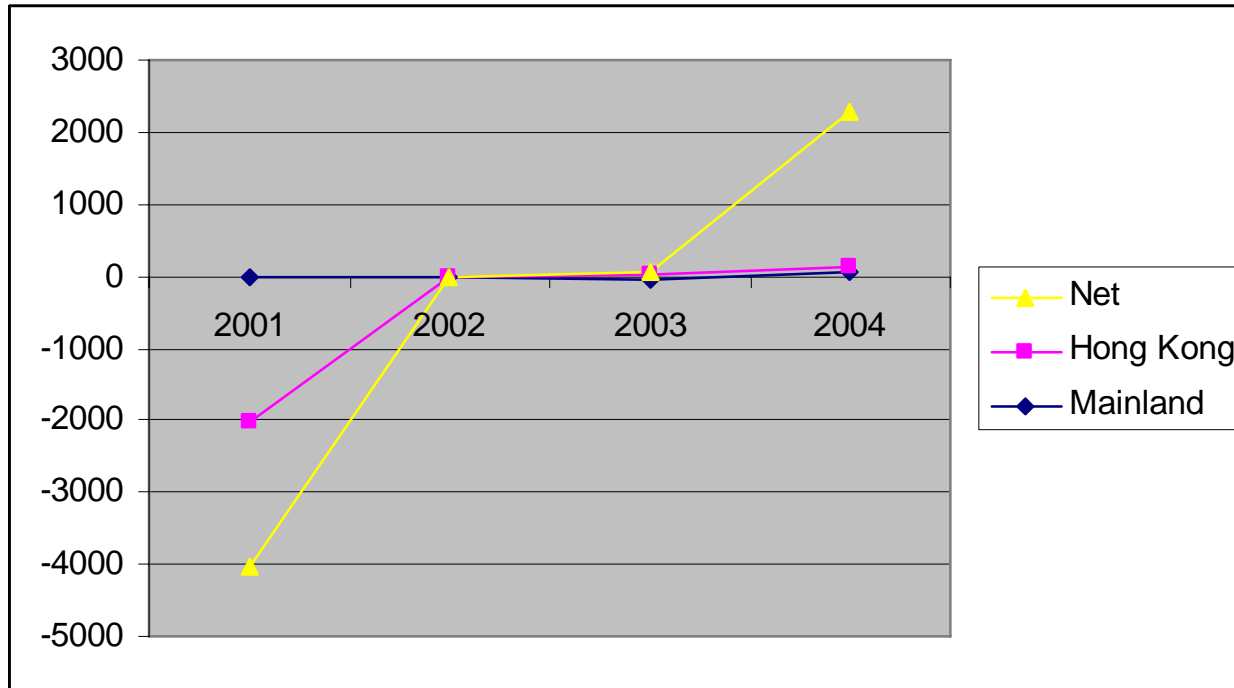


Appendix: Chinese outward FDI stocks and flows

Source: UNCTAD World Trade and Investment Report, 2005



Appendix: Net income of Chinese affiliates in the US, in \$million US



Source: US Bureau of Economic Statistics

Note: data for 2002 unavailable

Appendix: Regional targets for Chinese FDI, public and private

	In 12 months		In 2-5 years	
	Number of companies responding	Average Share of ODI (%)	Number of companies responding	Average Share of ODI (%)
Asia	58	38	99	46
Europe	35	26	59	25
North America, of which:	40	19	85	16
US	21	26	40	18
Canada	18	12	39	14
Mexico	1	10	6	9
Africa	17	13	41	15
Latin America	10	17	18	11
Oceania	4	10	12	10
Don't know	141		98	

Appendix: Ownership of Chinese FDI



Source: APC-CCPIT

Appendix: FDI as a percentage of GDP, selected economies

Selected FDI Stocks as percentage of GDP
source: UNCTAD World Investment Report 2005 Annex B3

