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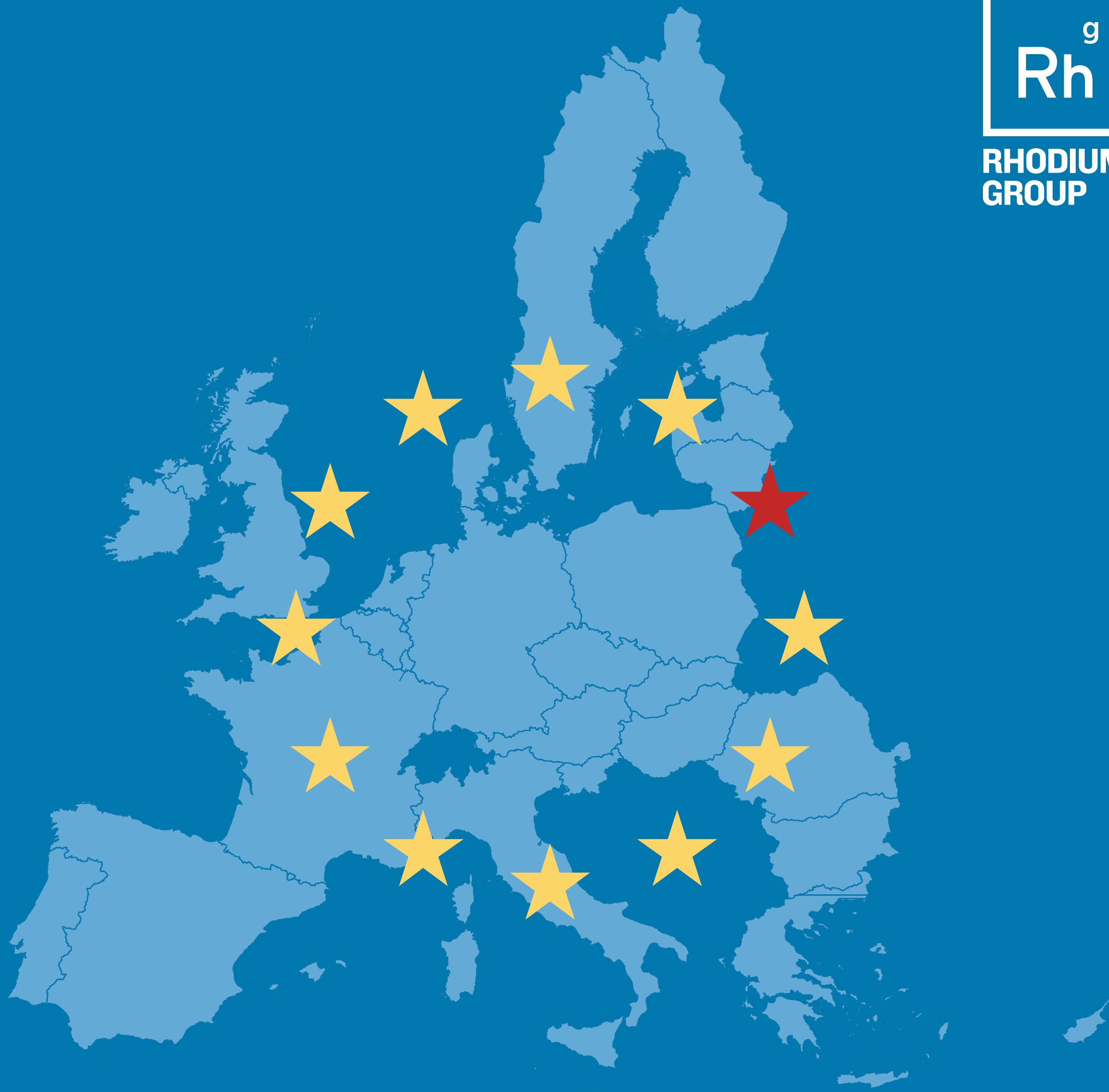

China Invests in Europe

Patterns, Impacts and Policy Implications

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Executive Summary

Europe is experiencing the start of a structural surge in outbound direct investment in advanced economies by Chinese firms. The take-off was only recent: annual inflows tripled from 2006 to 2009, and tripled again by 2011 to $10 billion (€7.4 billion) for the year. The number of deals with a value of more than $1 million doubled from less than 50 to almost 100 in 2010 and 2011.

To many business leaders and policymakers, the drivers, motives, patterns and impacts of this buying spree seem impenetrable. Neither Chinese nor European official investment data are sufficient for making sense of this new investment boom. But an alternative approach, based on the collection of data on Chinese greenfield and mergers and acquisitions (M&A) transactions in Europe since 2000, can resolve many of the mysteries surrounding this promising new channel of investment, and point the way to an effective European response to Chinese foreign direct investment (FDI).

DRIVERS AND MOTIVES

Our detailed data support the view that Chinese direct investment in Europe is driven overwhelmingly by **commercial motives**. Chinese policy is playing a role, but mostly in terms of getting government out of the way so firms can make more rational judgments about locating operations. Direct political guidance has played a very minor role in Chinese investment in Europe thus far. China's industrial policies and encouragement (via offered low-interest capital) of going abroad are impacting investment decisions, but they are not the primary reasons why firms from China are appraising opportunities in the European Union (EU). The mix of industries targeted, the high number of private enterprises making investments, and the competitive behavior of companies from the People's Republic after they arrive and set up shop in Europe all point to profit as the greatest motive in China's outward FDI story.

The profit drive of Chinese executives is colored by a broad range of considerations. For many, the acquisition of rich-world brands or a technological edge is the key element for breaking away from a fiercely competitive pack back home. Often times, it has proven cheaper and more rewarding to situate higher value-added activities in advanced regulatory locations like Europe. For other Chinese buyers, the crisis in the West presents the prospect of discounted prices, while an increasingly stronger renminbi is making European (and American) assets look more attractive. For Chinese contract manufacturers of the labor intensive products Europeans consume, defending market share increasingly means expanding market presence. As a direct investor, Chinese exporters are able to relate directly with customers and deliver more of the value that makes up profits today.

PATTERNS

The patterns of direct investment by Chinese firms provide a window into China's evolving motives and capabilities. Our dataset shows a profound post-2008 surge which the official data sources are missing: from less than $1 billion (€700 million) yearly 2004-2008, annual OFDI flows to Europe tripled to roughly $3 billion (€2.3 billion) in 2009 and 2010 before tripling again to almost $10 billion (€7.4 billion) in 2011. The absolute values remain small compared to Europe's total inward FDI stock, but the change in trend line is what matters. The number of annual investments with a value of more than $1 million grew from less than 10 a decade ago to 50 in 2007 and almost 100 in 2010 and 2011.

Geographically China's OFDI preferences look typical for Europe, with the three biggest economies—France, the United Kingdom and Germany—in the lead. This pattern supports the notion that China is investing like any other commercially motivated investor, not in some odd and idiosyncratic way. By coding the ownership patterns of Chinese deals, we also find that acquisitions are more frequent in the Western European core; the new EU member states of Eastern Europe see almost entirely greenfield investments, with a few exceptions. We see practically no evidence of declining OFDI prospects for states which run afoul of China politically over issues such as Tibet or arms sales, or rewards in the form of FDI for states which hew closer to Beijing's assumed preferences; at the end of the day, it's hard enough to make money as a Chinese firm overseas without having a volatile political agenda foisted upon management.

The **sectoral mix** of Chinese investment in Europe tells us that a shift is under way. Chinese deals are less dominated by natural resource objectives and trade facilitation and more concerned with the full range of industries and assets spread widely across Europe. Of the 30 sectors we track, 18 show over $200 million in deals; 9 show over $1 billion. Several sectors show greenfield projects at several hundreds of million dollars – unusual for a "developing country". The bottom line from our detailed analysis is there is breadth and momentum across the board, not cherry picking in a handful of strategic industries.

Another useful perspective is Chinese investment by **ownership** of the investing firm. While Europeans are somewhat less incensed about statism than many of their American cousins, it is nonetheless useful to discover that – as across the Atlantic – about two-thirds of all deals, or 359 of 573, are done by privately held or non-state publicly traded firms. Due to a handful of large-scale acquisitions in capital intensive sectors, this picture reverses when looking at ownership in terms of total deal *value*: 72% of the total $21 billion originates from state-owned enterprises. Not only is the ownership mix consistent with a benign model of China's OFDI story, but it also makes European interests compatible with the United States in this regard.

Finally, the similarity in patterns between Chinese investment in **Europe and the United States** is more than superficial. In rough value terms (stock and flow), in the breadth of the industrial mix, and in ownership patterns, the US and EU have much in common. Thus far they have responded to the advent of Chinese investment in parallel but very separate ways, with similar results—contrary to all the talk about America's higher bar for national security screening. China needs the opportunity to invest in both the US and Europe – it is not either/or – and should OECD nations decide to coordinate international investment regimes more closely, underlying interests should be fully compatible.

IMPACTS

The arrival of China's firms elicits both excitement and anxiety, as the new investors are still unknown and the impacts of their investment unclear. A good analysis of the impacts of Chinese investment on Europe is difficult because the lion's share of deal-flow is so new, and has not yet fully demonstrated its potential – either positive or negative. We present an integrated approach, combining an informed view on the evolution and status quo of the Chinese economy, historical data on foreign investment, and our database on Chinese investment projects in the EU, to discuss the impact of Chinese FDI on Europe from the perspectives of economics, politics and national security.

In the aggregate, Chinese FDI should deliver the same **economic benefits** as other direct investment flows, whether from inside or outside the EU. Foreign direct investment increases the welfare of both producers and consumers. It allows firms to explore new markets and operate more efficiently across borders, reducing production costs, increasing economies of scale and promoting specialization. It is particularly important when serving overseas markets requires an on-the-ground presence (for example, in the provision of services). Foreign direct investment also means better prices for firms looking to divest assets, thanks to a bigger and more competitive pool of bidders. For consumers, it increases the contest for buyers' attention, leading to more choices, lower prices and innovation. And in local communities, foreign investment brings new jobs, tax revenue, and knowledge spillovers from worker training, technology transfers and R&D activities.

In terms of new capital we project $1-2 trillion in global Chinese OFDI from 2010-2020. At that rate, if Europe continues to attract the same share of global FDI as in the 2000s – around 25% -- then by 2020 Europe would see $250-500 billion cumulatively in new Chinese M&A and greenfield investment. Even if Chinese outflows underperform and Europe ceases to attract as big a share, an annual average of $20-30 billion would be expected for the coming decade. Employment impacts are a common question when it comes to Chinese investment. Unlike trade, direct investment is unlikely to be associated with *negative* effects on employment: greenfield projects by definition create work that was not there before, and acquisitions are hard to move and often entail turning around a firm that might have gone under. We count around 45,000 EU jobs associated with Chinese direct investors today. Projecting job effects from Chinese FDI is a low-return game – too many variables enter the mix. However, it is helpful to consider the amount of jobs created by FDI from other major economies: American firms today cut paychecks to 4.3 *million* EU citizens. Europeans possess advanced economy workforce skills in rich abundance urgently needed in Chinese production chains (including environmental management and controls, quality assurance, design and innovation, and high technology), which should help to sustain the positive momentum.

We catalogue the *potential* for **negative economic consequences** arising from Chinese investment to the extent possible as well, bearing in mind that such concerns are tomorrow's worry more than today's. As a still minor contributor to total EU direct investment, China is unlikely to be distorting asset prices or market efficiency at present – and in fact may well be improving it. However, there are Chinese economists arguing that China's tendency to gradually converge toward market norms of macroeconomic management, pro-competitive regulatory outcomes and privatization has slowed or even reversed. The massive debate on this subject is beyond the scope of this study. But in an era of global operations by Chinese firms (state-owned or otherwise), it is vital to think through the global economic implications of a future less market-oriented China. We present four concerns that require attention in Europe in this regard: greater Chinese investment could expose Europe to macroeconomic volatility if there is a significant economic disruption in the years ahead; Chinese firms could have a preference to reorganize operations according to industrial policy directives and move high value activities back home after making acquisitions; features from China's unique economic structure could spill over through FDI and threaten market-based competition in the European marketplace; and there is potential for a race to the bottom to attract Chinese investment, which could negatively impact European welfare.

In addition to economic implications, we also consider the **political impacts** of Chinese FDI in Europe. It is natural that Chinese officials might threaten to withhold direct investment if they believed doing so could affect European politics. Based on our analysis, however, Chinese firms are less subject to Beijing's puppetry than many observers believe. As noted above, direct investment (unlike portfolio investment) cannot be easily liquidated or withdrawn to communicate short-term political signals. The selection of investment targets requires arduous work by Chinese firms, and is undertaken for commercial reasons, not at the behest of back-room political strategists. These firms are not investing in Europe out of charity or with a foreign policy goal in mind; they are trying to defend market share in the rich world, acquire technologies and brands to stave off fierce competitors back home, or achieve some other commercial imperative. That said, there is ample reason to anticipate attempts by Beijing to mix money with politics – they already have with Japan over rare earths, and Europe over support for crisis stabilization funds.

Finally, while **national security fears** related to foreign investment are not new, China presents particular concerns. For one, China will likely be the world's largest economy within two decades, lending it huge leverage and power to shape global national security. Second, China is a one-party authoritarian state with values at variance and sometimes at odds with those of OECD countries. State ownership and influence create special concerns about government-driven, non-commercial motives for investing. Third, China is not a European ally but an emerging power with a modernizing military. China and Europe have good relations but there is uncertainty about the future: China has a stated aspiration to displace the existing global power balance in favor of a greater role for itself – including a greater voting share in international organizations, most likely at Europe's expense. Fourth, China has a troubled record on export control rules, and a reputation as a major proliferator of sensitive technologies to rogue regimes including Iran, North Korea, and Pakistan. This raises the potential for discord over the obligations of China's firms in Europe. Finally, China is considered a heightened threat for economic and political espionage by the intelligence communities in Europe and North America, and not without reason.

POLICY RECOMMENDATIONS

The heady growth in Chinese investment in Europe described by this study presents an impressive picture that warrants and optimistic outlook for Chinese investment in Europe. As the United States takes the heat for imposing tighter national security reviews, in relative terms it would appear that Europe is in the fast lane – especially after 2011's stellar $10 billion inflows. However we conclude that policy attention to a number of matters is crucial at this point in time to sustain Chinese investment in Europe and maximize the benefits from these new capital flows. Several of our recommendations revolve around a central, simple equation: to support its interests, Europe needs a common approach to greeting Chinese direct investments as well as safeguarding against potential economic and political risks. Europe's current model of openness will be seriously tested in the future when inflows from China reach first-tier volumes, not all acquisitions are friendly, and EU austerity is in full swing. If a Europe-wide investment policy is to remain free from economic nationalism, it must assure healthy competition and clear and effective national security screening.

1. Keep the door open. Europe must not risk losing its hard-earned reputation for openness by imposing additional barriers to capital inflows based on economic security considerations. Several cases have already raised that specter. There may be more loopholes for veiled protection in the European framework than admitted, and the reaction to China is not yet fully tested. Europeans will embrace foreign investment if they know a thorough, EU-wide process to address concerns is in place, guided by the principles of openness and non-discrimination.

2. Address market distortions forthrightly. There are concerns about China's long-term evolution, and the prospect of China's economic model spilling out with Chinese firms' movement abroad. Our advice is to *not to burden* the investment screening process with "economic security" demands arising from legitimate worries about China's system. Nor do we think that reciprocity demands are practical or productive. Ideally, China will redress aspects of domestic distortion such as preferential capital costs for state firms, but given the potential risks if this scenario does not materialize, policy should be in place to protect EU interests via internal processes including competition policy review. A rationalized and systematized game plan for handling the concerns sure to arise over China's system without risking investment protectionism is best for Europe; it also lends itself to the prospect of better coordination internationally to manage the advent of emerging market

OFDI. By standardizing its internal approach, Europe maximizes its role in joint efforts to discuss competitive neutrality, state capitalism and other concepts.

3. Take national security seriously. Europe's current fragmented approach to screening foreign investment for security threats risks a race to the bottom, fails to address pan-European national security risks, and offers room for protectionist abuse in the name of security. A common European concept and legislative framework for investment review is needed to address these problems and hedge against a protectionist fallback in the false name of security. Greater transatlantic and international coordination is needed to reach a consensus on legitimate investment restrictions and global best practices for investment reviews.

4. Set the right priorities for investment promotion. An EU-China bilateral investment treaty will help to address market access problems on the European side, but it will do very little to promote investment flows from China. Tailored investment promotion approaches that help Chinese investors overcome the hurdles they have in entering mature market economies are important to sustain the inflow of Chinese investment. In the long run, it is critical that Europe finds a way out of its current crisis. Only a competitive EU economy can sustain foreign investment from China and other places - and in turn better cope with any challenges it raises.

These findings and policy recommendations are far from comprehensive, but we hope they will contribute to a better understanding of growing Chinese investment in Europe and help inform the policy debate. While the growth in recent years is impressive, many chapters in the story of Chinese EU investment have yet to be written. Securing the right policy response is crucial, given the potential for future investment flows and China's role as test case for a wider range of emerging market investors.

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