Executive Summary

We are entering a new era of Chinese capital: China's policy liberalization and adjustments to its growth model will turn the country from a nobody to a driving force in global cross-border investment in the coming decade. Projections see China tripling its global assets from currently $6.4 trillion to almost $20 trillion by 2020 – a catch-up process that will have significant implications for host economies and global markets. This shift in China's global investment position will require political leaders around the globe to adjust their economic policy configuration towards China both to reap the benefits of this next stage of global integration as well as minimizing potential new risks. This is particularly true for the countries of the European Union, whose economies are now intimately linked up with China following three decades of trade integration and significant investment of European businesses in China.

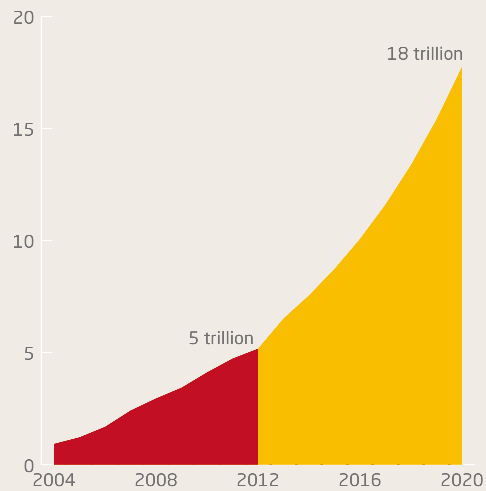


Figure 1:
China's Global Investments Projected to Triple by 2020
Assets in China's international investment position based on assumption of fully convertible capital account by 2020

USD trillion

Source: SAFE; He et al. (2012).

The first wave of Chinese capital has arrived in Europe

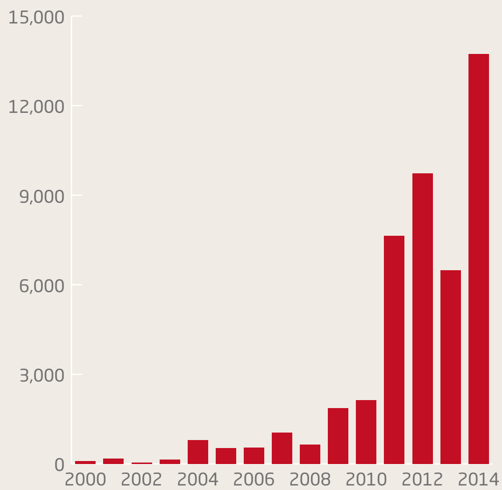
The first wave of this new era of Chinese capital has already begun and it is increasingly impacting Europe: Outbound Foreign Direct Investment (OFDI) by Chinese companies now exceeds $100 billion per year and has shifted from natural resources in developing countries to technology, brands, real estate and other assets in advanced economies. This report presents a comprehensive and timely snapshot of the direct investments by Chinese companies in the European Union based on a novel dataset that aggregates individual transactions and thus avoids the distortions and significant time lag in official statistics.

Annual investment by Chinese companies in **EU member states** soared from virtually zero in the mid-2000s to €14 billion in 2014. For the period 2000 to 2014 we count over 1,000 Chinese greenfield projects and acquisitions in the EU together worth more than €46 billion. The sectors that attracted the most Chinese capital are energy, automotive, food and real estate. State-owned companies play an important role in China's investments in Europe, but growth in recent years is mostly driven by private companies and financial investors from the most advanced eastern coastal provinces.

Germany is the second largest recipient of Chinese OFDI in Europe, with investments in the period 2000 to 2014 adding up to €6.9 billion. Since 2011, annual investment levels have jumped up and stayed stable at €1-2 billion per year, which differs from the volatile patterns found in other economies. Germany's advanced manufacturing capabilities were the biggest attraction for Chinese investors with automotive and industrial equipment accounting for more than 65% of total Chinese investment since 2000. In recent years, the industry mix has broadened with IT equipment, finance and business services as well as consumer products gathering interest. Instead of mega mergers, most deals in Germany

Figure 2:
Chinese FDI in Europe Grows Exponentially
Value of greenfield projects and acquisitions with stake of 10% or more by Chinese companies in EU-28 economies

EUR million

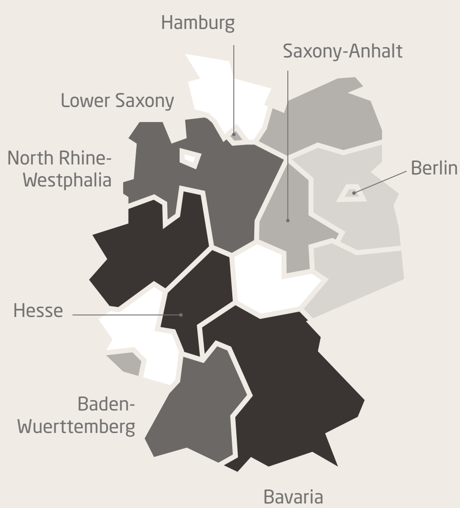


Source: Rhodium Group.

Figure 3:
Germany is a Top Destination for Chinese Investors
Cumulative value of FDI projects by Chinese companies in Germany 2000–2014

Shading indicates cumulative value (EUR) in the respective federal states

< 50 mn
50 – 100 mn
100 – 500 mn
500 mn – 1 bn
> 1 bn



Source: Rhodium Group.

were small and medium sized takeovers, with state-owned companies accounting for a higher share of investment than in the European average.

China's OFDI boom: Europe's test case for a new era of Chinese capital

This OFDI boom will be the first test case for EU leaders' ability to respond to the new era of Chinese capital. We show that China is clearly different from other countries with significant OFDI assets in Europe. Characteristics such as the size, growth and complementarity of the Chinese economy create unique opportunities for Europe. At the same time, some specific concerns that are related to the nature of China's political and economic system, for example subsidies, China's authoritarian political system and lack of openness to FDI in China, create particular challenges. China's uniqueness does not question the existing paradigm that FDI is beneficial on net for recipient economies, but it highlights that new approaches are needed to maximize the benefits and hedge against risks related to these new flows to avoid hasty knee-jerk reactions that would poison the outlook for deeper EU-China investment relations. This report catalogues the special opportunities and risks related to growing Chinese OFDI and makes recommendations for policy priorities on different governance levels.

China's OFDI catch-up: a huge opportunity for attracting much needed capital

First and foremost China's changing global OFDI footprint presents a once in a lifetime opportunity for attracting capital to Europe and helping re-start investment and economic growth. Other benefits include innovation spill overs and backward linkages to the Chinese consumer market, while fears that Chinese investment negatively impacts local employment and innovative capacity is not supported by our review of more than 1,000 deals. We see several priorities for securing and maximizing those benefits in the future: **First,** Europe needs to implement the necessary structural reforms to ensure it is well positioned to compete with other advanced economies for Chinese FDI that increases growth, innovation and productivity. **Second,** the emergence of China as a significant source of capital requires a re-thinking of existing approaches to investment promotion and investor support, including an increase in capacities on the ground in China. Third, policymakers need to be prepared to defend the principle of investment openness against populist and local backlashes.

China's unique political and economic system elicits special concerns related to foreign investment

At the same time, there are legitimate concerns related to China's specific nature, which, if unaddressed, could threaten European economic and security interests and undermine public support for investment openness. Given the particularities of the rise of China as a global investor, a hedged welcoming needs to work with risk scenarios in order to be prepared should problems arise. We identify the following priorities. The highest priority is to conclude a robust bilateral investment agreement (BIA) that addresses the existing asymmetries in market access through pre-establishment rights for European companies and a short negative list for sectors restricted to foreign investment. A robust BIA is also important to ensure that the principle of investment openness towards China continues to have the support of EU citizens and parliaments. Second, European leaders need to grapple with the question of how to react if the structural economic reforms promised by Beijing to address subsidies and other non-market elements that distort global competition happen slower than required by the reality of growing outbound FDI. Existing competition policy instruments including the state aid regime would be the best starting point from which to think about potential options on the European level. Nation states have a range of instruments that could potentially be used to address these problems in the future, including competition policy, mandatory disclosures, government procurement and others. Third, there is an urgent need to initiate a debate about greater coordination of security review processes within Europe to increase the efficiency and coherence of such reviews from a security point of view, but also to increase the confidence of European citizens that there is a functioning solution in place to monitor and mitigate potential security risks.

A reality check for global investment governance

The rise of China as an investor and the commensurate shift in Chinese preferences also opens up a unique window of opportunity to improve investment governance in Europe and globally.

In Europe, nation states will have to re-think their strategy as the EU has taken over the mandate to negotiate investment agreements. In our view it is critical that Germany and other large EU member states stand behind current EU efforts to conclude an effective bilateral investment agreement with China. Europe must speak with one voice instead of following national agendas. Nation states must also explore new channels for pursuing their interests outside of bilateral investment treaties. In the case of China, governments will be critical for reminding their Chinese counterparts of their promise of implementing a new regulatory regime that levels the playing field between domestic and foreign firms. This includes flagging delays and unsatisfactory progress as well as grappling with policy options that set an incentive to accelerate convergence with market economy standards.

The emergence of China as a global investor also opens up the opportunity to revive plurilateral and multilateral initiatives related to global investment flows. As opposed to trade, the existing institutional frameworks for governing global investment flows and resolving disputes are underdeveloped because the dominance of developed economies in global FDI flows did not create urgency for global rules and institutions. The rise of emerging markets as significant global investors is challenging this status quo, and China's growing global investments will be an important indication of the path forward. A joint high-level working group on investment governance between the three poles of the global economic order which together account for more than 67% of the world's outbound FDI stock – the EU, the US and China – would be a good starting point.