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CHINA ANALYSIS

FACING THE RISKS OF THE "GOING OUT STRATEGY"

ABOUT

The Chinese have long been obsessed with strategic culture, power balances and geopolitical shifts. Academic institutions, think tanks, journals and web-based debate are growing in number and quality and give China's foreign policy breadth and depth.

China Analysis, which is published in both French and English, introduces European audiences to these debates inside China's expert and think-tank world and helps the European policy community understand how China's leadership thinks about domestic and foreign policy issues. While freedom of expression and information remain restricted in China's media, these published sources and debates provide an important way of understanding emerging trends within China.

Each issue of China Analysis focuses on a specific theme and draws mainly on Chinese mainland sources. However, it also monitors content in Chinese-language publications from Hong Kong and Taiwan, which occasionally include news and analysis that is not published in the mainland and reflects the diversity of Chinese thinking.

The French version of China Analysis can be accessed online at www.centreasia.eu.

Introduction
by François Godement

After two years of cautiousness, Chinese started to increase overseas investment again since 2010. Surprisingly, the main increase was in Europe (where investment increased by 102 %) and the United States (74 %) rather than in developing and emerging economies. 15 % of Chinese firms that have "gone out" have chosen Europe. More worryingly, however, the first global destination of Chinese FDI is the British Virgin Islands, and the third (after the Cayman Islands) is Luxemburg. This illustrates once again how much China's external capital flows are opaque and how important the issue of financial regulation is for Europe as a whole.

This issue of *China Analysis* describes how China sees its FDI. It is on a continuum from overseas contracts and joint projects or subsidiaries to mergers and acquisitions and ultimately purchases of equity – an area in which the Chinese have had disappointments but are still active. One main caveat about our sources is that they do not go into non-official FDI flows. That means that private investment or money invested by the subsidiaries of large state-owned enterprises or by local enterprises that are owned by provinces and cities is not counted in. Neither is hot money leaving China. That in turn leaves huge questions open: is China the next Latin America, where capital flight is the new sport of the rich, as some would have it? Or is China acquiring a much larger international footprint than statistics suggest, and how much does the Chinese state actually know about it?

Nonetheless, our sources are revealing. Worries about the lack of business skill, market experience and knowledge about the legal environment may come as a surprise to foreigners. But it is true that Chinese firms tend to move with a herd instinct and to rely on relational networks to overcome problems. That has worked fine in the developing world. But this issue of *China Analysis* also includes a revealing and precise analysis of how a major Chinese construction company botched its first major infrastructure deal in the EU – the famous "Polish motorway" story. Our source somewhat understates the degree to which China's government were involved in the deal: Chinese officials made several visits to Poland and major state financial actors backed it. Although it is true that the construction firm itself was to blame for the failure of the project, the refusal of Chinese banks to honour their guarantees is perplexing.

Another angle in this issue is the nexus between economic motivations of investment and political deals. This is due to the top-down nature of the Chinese economy, but a key problem emerges: the vulnerability of Chinese investment abroad. Our sources sometimes mix together two trends: reluctance towards Chinese investment, using the term "economic nationalism" that has been first applied to China in the past few years; and physical threats to Chinese FDI and Chinese citizens overseas. Undeniably, economic motives outweigh political considerations. And if a breakdown was done factoring local and private Chinese firms, the evidence would be even more compelling. As illustrated by the fight for contracts between CNOOC and Sinopec, or between Huawei and ZTE, Chinese investors also compete between one another.

What is the solution to China's "absentee landlord" syndrome? Does geopolitical risk suggest the need for a stronger capacity to project military force? We carry a contrarian liberal view from Guangdong province – by far China's biggest exporting region. China needs to incorporate more international norms and standards. According to this view, there is no way to protect FDI through hard power, even for the US (although, one might add, it did so in the past in its own backyard). China's economic interests are on the high seas – both on the supply and export sides – as were the interests of Victorian England. But in today's world, there are no colonial or naval solutions to the security dilemma this creates. That a key national journal on geopolitical issues carried this view suggests that that there is a real debate about in China about its FDI.

1. A road accident: the inside story of the Polish highway that wasn't built by Chinese firms

by Jade Le Van

Source:

Ni Weifang[1], Gu Yongqiang, and Yao Weitao[2], "How to wreck an industrial project abroad", *Xin Shiji – New Century*, No. 460, 25 July 2011.

In June 2011, the contract for the construction of the Polish section of the motorway from Warsaw to Berlin that had been awarded to the Chinese consortium, China Overseas Engineering Group (COVEC), was cancelled. The Chinese weekly, *Xin Shiji*, conducted a detailed enquiry into the reasons behind the astonishing failure of the first European project undertaken by COVEC and its parent company, the China Railway Engineering Corporation. The COVEC consortium was formed jointly by China Overseas, China Railway Tunnel Co., Shanghai Construction Group, and the Polish group DECOMA. Its tender for the project was accepted by the Polish government in September 2009. It took less than two years for the project to be abandoned, after COVEC fell behind in payments to local sub-contractors, costs spiralled out of control, and work hit serious delays.

The *Xin Shiji* journalists see these events as proof that the "Chinese construction model" (中国打法, *Zhongguo dafa*) is unsuitable for European markets. Industry experts agree that the Chinese model consists of winning a contract by offering an extremely low price for the job, which after a few months is revised upwards on the grounds of weather conditions, unfavourable exchange rates, or costs of raw materials. Although these methods have worked for Chinese construction companies elsewhere in the world, in Poland COVEC came up against European Union regulations on anti-competitive practices. So for *Xin Shiji*, the Chinese model is "a long way from a universal remedy" (远非万应灵药, *yuanfei wanying lingyao*).

Winning the Polish contract to build two motorway sections adding up to 49 kilometres was an example of the "Chinese construction model" in action. With its estimated cost of 1.3 billion zloty (€330 million), COVEC's price for the job was less than half the amount allocated in the Polish government's budget. At first, the Polish General Directorate of Roads (GDDKiA) was doubtful that COVEC could meet its contractual obligations at the price, but it was finally convinced by the assurances of the Chinese consortium, even as the other firms who bid for the project complained of dumping and deception. COVEC then claimed it had US$100 million dollars (€140 million) that would enable it to cover the initial stages of the project.

The project was cancelled two years after the agreement was signed with less than 20% of the work done, even though it was supposed to be completed for the European Football Championship in June 2012. The collapse of the deal was the result of a series of mistakes and misunderstandings on the part of the Chinese operator. *Xin Shiji* thinks the failure was entirely predictable.

COVEC's main mistake was its haste to win the contract. It had decided the most important thing was "to submit the tender before worrying about anything else", since the contract was seen as strategically important by the parent company, which saw it as "a first step towards the conquest of the European market". This eagerness was behind the company's failure to analyse the market properly, which in turn led to an inadequate cost assessment and an insufficient understanding of the legal, economic, and political situation in Poland.

Xin Shiji says the price proposed in the tender was based on guesswork rather than due diligence and in-depth analysis. Since the Chinese engineers had not carried out any independent geological surveys, they failed to notice that the soil quality was less favourable than expected, which would cause significant cost overruns once the work had begun. Many legal issues were also overlooked by the Chinese decision makers, beginning with the legal obligation to pay foreign workers at the hourly rate for Polish workers. Faced with spiralling labour costs, COVEC tried to regain its competitive edge by bringing in more than 500 workers from China, but that earned it a fine of 65,000 yuan per worker. But more than anything else, environmental legislation left the Chinese company mystified and feeling "indignant and powerless" (既愤怒又被动, *ji fennu you beidong*). For two weeks in late autumn, work had to be halted while seven rare species of frogs, toads, and newts were moved out of the path of the motorway, and an obligation to create tunnels for the passage of wildlife was included in the terms of the contract.

The inability of the Chinese managers to understand the rules of operation of local markets caused problems in controlling budget and cash flow. *Xin Shiji* says that the project director refused to pay in advance for guaranteed supplies of sand and bitumen from local suppliers. This decision left the consortium vulnerable to shifts in the prices of these materials, and with the economic recovery and the start-up of several new construction projects, prices more than doubled over the following year. COVEC had at first intended to bring earthmoving equipment from China, before realising it did not have the necessary permits. So, most of the equipment had to be hired locally, which meant hiring Polish workers trained to use it. Cash flow problems created by budget overruns were exacerbated by the gap between contracts with the subcontractors, who demanded weekly payment, and the contract with the General Directorate of Roads which provided only for monthly payment.

1 Ni Weifang is a special correspondent for *Xin Shiji* in Warsaw.
2 Gu Yongqiang and Yao Weitao are journalists for *Xin Shiji*.

Crucially, the contract signed in a hurry by the Chinese decision makers – who believed that it was "pointless to be too precise" – turned out to be extremely disadvantageous to the construction company. *Xin Shiji* highlights major deviations in the contract between COVEC and the General Directorate of Roads from standard contracts recommended by FIDIC.[3] Several FIDIC clauses favouring the construction company were taken out of the contract, including one that provided for price adjustments in the case of changes in commodity costs, and another that penalised late payment from the project sponsor. But anecdotal evidence suggests that COVEC had the original contract in Polish only partially translated, wilfully leaving itself open to risk.

Every effort by COVEC to review payment terms or to be reimbursed for additional costs caused by the rise in commodity prices was discounted, leading to a strong sense of injustice on the part of the Chinese operator. Chinese and Polish experts alike see COVEC's reaction as further proof of its inability to adapt to the rules of the game in Europe. The Polish General Directorate of Roads had actually spelled out in the project specifications the importance of including in the final bid all costs relevant to risk avoidance. The Directorate was determined to respect the principles of competition in awarding the bid, because it had been suspected of corruption in the past.

The Xin Shiji journalists see these events as proof that the "Chinese construction model" is unsuitable for European markets.

Along with COVEC's poor management and failure to understand the local environment, *Xin Shiji* sees a link between the failure in Poland and a "confusion between politics and business" (混淆政治与商业, *hunxiao zhengzhi yu shangye*) that is typical of Chinese enterprises abroad. This tendency has been encouraged by the increasing number of construction contracts won by Chinese companies in emerging markets, particularly in Africa. In countries where the legal system is relatively underdeveloped, political support can be a key factor in settling trade disputes. The leaders of the consortium were convinced that the Polish government was well disposed towards them, but they ended up disillusioned. Relationships forged within the Polish embassy in Beijing and the Polish Ministry of Transport could not help them with the repeated refusal of the General Directorate of Roads to revise the terms of the contract. Demonstrations by Polish sub-contractors in May 2011 drew criticism from politicians and the media, and in the same month the company failed to win the contract to build the Warsaw gymnasium. This left COVEC "completely disheartened" (心灰意冷, *xinhui yileng*). It has withdrawn from the contract without even attempting judicial proceedings and is preparing to pay compensation fees that could amount to US$390 million (€300 million)[4]. This financial penalty goes along with a ban on participating in public tenders in the country for three years. But instead of blaming the Poles for the problems of the Chinese consortium, *Xin Shiji* cites a Polish Asia specialist, who says that that "neither side won".

The project that was to mark an auspicious beginning for COVEC in Europe has ended in a major disappointment. It is not yet possible to assess the impact of this outcome on future investments between the two countries[5]. *Xin Shiji*'s position on the strategy of Chinese companies abroad can be described as constructive self-criticism. The article concludes that the costs of the Polish failure should be written off as an expensive lesson on the rules of business. It says the process of Chinese companies' international expansion will necessarily include such "tuition fees" (交学费, *jiao xuefei*). Chinese companies will continue to pay these costs as long as company directors maintain their policy of "letting politics rule" (政治挂帅, *zhengzhi guashuai*) and relegating technical and commercial considerations to second place.

3 The International Federation of Consulting Engineers, which promotes the interests of the construction industry, particularly by defining different types of building contract.

4 This huge sum is still well below the cost of completing the work within the agreed timeframe, which *Xin Shiji* puts at US$786 million (€602 million).

5 *Xin Shiji* notes that in the wake of these events, the acquisition announced in late March 2011 of the Polish machinery manufacturer HSW (Huta Stalowa Wola) by the Chinese construction company LiuGong Machinery Corporation was suspended. However the acquisition has since then been completed ("LiuGong completes acquisition of HSW", *Construction Week online,* 11 January 2012 ; http://www.constructionweekonline.in/article-7648-liugong_completes_acquisition_of_hsw/).

2. The "going out" strategy: economic moves with political consequences

by Thomas Vendryes

Sources:

Special dossier published by the journal *Xiandai guoji guanxi – Contemporary International Relations*, No. 8, 2011, based on the proceedings of a conference organised by the Chinese Institute of Contemporary International Relations on 9 August 2011 entitled "Reviewing ten years of China's "going out" strategy: successes and challenges". Articles:

Tao Jian, "From a step-by-step "going out" strategy to its accelerated implementation"[6].

Jin Canrong, "Reviewing ten years of China's "going out" strategy: successes and challenges"[7].

Mei Xinyu, "Why are the political risks in Chinese direct overseas investments so high?"[8].

Jiang Yong, "Some salient problems linked to China's 'going out'"[9].

Lin Hongyu, "An analysis of China's "going out" strategy from the standpoint of international political economy"[10].

Zhao Qingming, "Steps towards the internationalisation of the renminbi through an independent strategy"[11].

Fan Libo, "The 3L growth method for China's multinationals"[12].

Zhang Yuncheng, "The role and the functions of Hong Kong in the new phase of China's "going out" strategy"[13].

Li Yonghui, "The companies' "going out" and public diplomacy"[14].

Thirty years ago, Deng Xiaoping set the People's Republic of China on the path of "reform" and "openness" to the rest of the world. Twenty years later, under the Tenth Five-Year Plan in 2001, the Chinese government laid down a strategy for China's large companies to "go out" abroad (走出去, *zou chuqu*). This new strategy represented a real turning point in China's relations with the rest of the world, economically and politically. China's "going out" gathered speed over the first decade of the twenty-first century. By the end of 2009, the country's annual exports and exchange reserves totalled US$1,200 billion and US$2,400 billion respectively. And, as a sign that Chinese firms had arrived on the international scene, by the end of 2009 Chinese investors had already established more than 13,000 companies outside the nation's borders, in over 180 countries and other territories. Meanwhile, Chinese foreign direct investments totalled US$2,500 billion, and the number of people leaving China annually rose above 50 million, according to Jin Canrong. Jin says that while the Tenth Five-Year Plan referred to the goal of "actively and steadily going out" (积极稳妥走出去, *jiji wentuo de zouchuqu*), and the Eleventh referred to "going further outwards" (进一步走出去, *jinyibu zouchuqu*), the current Twelfth plan calls for "accelerating the implementation of the strategy for going out" (加快实施走出去的战略, *jiakuai shishi zouchuqu de zhanlüe*). So, over the last decade, China's policy of outward movement has consistently increased in economic and political significance.

But the commentators agree that outward movement has its difficulties and challenges. Mei Xinyu sums up one key problem as "the risk of violence" (暴力风险, *baoli fengxian*) faced by the companies and workers who leave China for host countries. Tao Jian and Mei Xinyu say that because Chinese firms are late arrivals (后来者, *houlaizhe*) on the international markets, they often find themselves operating in countries like Afghanistan and in sectors like natural resources where levels of violence and risk are especially high. Jin Canrong notes the risk of violence of another kind from within the international community, particularly from Western countries, who denounce the "neo-colonialism" (新殖民主义, *xin zhimin zhuyi*) of the Chinese movement abroad. All the contributors agree that these reproaches and fears are unjustified and unjust: the outward movement of Chinese companies is driven by economic motivations, not political ones. Chinese companies make deals with willing host countries, bringing about a win-win situation (双赢, *shuang ying*) for both parties. The strategy is the result of a simple and natural progression matching China's current stage of economic development. Lin Hongyu describes the stages of China's integration with the wider economic world: Chinese companies first created links overseas through direct sales abroad (直销式, *zhixiao shi*), before positioning themselves overseas through contractual arrangements (合同式, *hetong shi*), often in infrastructure projects. Now, the final stage of "going out" takes the form of direct investment abroad (投资式, *touzi shi*).

So, Western fears and reproaches are unjustified because China is simply following the path to economic development laid down by Western countries and already followed by the developed economies of Asia such as Japan and South Korea. The recriminations are particularly unfair since, Jin Canrong says, when the Western countries themselves went

6 Tao Jian is Professor and Director of the University of International Relations.

7 Jin Canrong is Professor and Vice-Director of the Faculty of International Relations at Renmin University.

8 Mei Xinyu is a researcher at the Chinese Academy of International Trade and Economic Co-operation.

9 Jiang Yong is a researcher in the Economics department at the Chinese Institute of Contemporary International Relations.

10 Lin Hongyu is Professor and Director of the Department of International Politics at the University of International Relations.

11 Zhao Qingming is a doctoral graduate and Deputy Senior Manager at the head branch of the China Construction Bank.

12 Fan Libo is Professor and Director of the Research Centre on International Companies at the International Business and Economics University.

13 Zhang Yuncheng is Researcher and Director of the Hong Kong and Macao Centre at the Chinese Institute of International Contemporary Relations.

14 Li Yonghui is Professor and Director of the School of International Relations at the Beijing Foreign Studies University.

abroad, they brought their gunboats with them (坚船利炮, *jianchuan lipao*). And when companies from other Asian countries took to the international markets, they were tightly controlled by their states and governments – unlike Chinese companies, who have autonomy. Besides, Jin says, China is today more open, especially to foreign investment, than are the majority of those who accuse it of neo-colonialism. Jin thinks these accusations arise from the fact that China is now the second leading economic world power, so it faces the same criticisms as previous challengers to American power, such as, for example, Japan. Lin Hongyu says that international fears are exacerbated by the wide cultural distance between China and its Western partners, as well as by the fact that China is a socialist country.

However, the contributors suggest that China's "going out" strategy could benefit from some adjustments. Firstly, even though the strategy is driven by economic dynamics, it has political implications and consequences. This politicisation must not be ignored and the strategy must be made more flexible to deal with it. Li Yonghui says links must be established between companies and the government's diplomatic programmes, since the companies are representatives of China abroad, while government diplomacy is adapting to support their "going out". The commentators agree that the objectives of this trade diplomacy must be to provide a peaceful environment for Chinese companies to "go out".

Because Chinese firms are late arrivals on the international markets, they often find themselves operating in countries and in sectors where levels of violence and risk are especially high.

Jiang Yong says Chinese companies and their objectives must become more transparent, and Li Yonghui says they must take an active role in local development, for example by financing development projects. Tao Jian and Li Yonghui say links between China and the host countries must be strengthened, by spreading Chinese culture and by training some Chinese people that would be able to get closer to the host countries (当地同, *dangdi tong*). Li Yonghui also says multilateral co-operation must be strengthened, particularly at the regional level, and that Chinese companies must work more closely with NGOs and organs of civil society. And despite the peaceful orientation of China's outward movement, China must still build its capacity for projecting military power (武装力量的远程投放能力, *wuzhuang liliang de yuancheng toufang nengli*). Tao Jian says this is important not to threaten the outside world but to protect Chinese nationals wherever necessary, as events in Libya demonstrated.

The commentators identified three other important elements in the Chinese "going out": the way Chinese companies operate, Hong Kong, and the internationalisation of the renminbi. The movement abroad of Chinese firms necessitates a clearly defined political strategy. But as Fan Libo argues, it also means that the companies themselves must change in order to become successful multinationals and improve their position in the global value chain (全球产业价值链,*quanqiu chanye jiazhi lian*). On Hong Kong, Zhang Yucheng believes the region must continue to fulfil its traditional role of providing an interface with the rest of the world and a place for trading on international capital markets. So, its economic capabilities must be developed and its special autonomous administrative and political status must be strengthened. This will enable it to maintain its international position and also to contribute to the improvement of China's international image.

Zhao Qingming disagrees with the majority of other Chinese experts on the renminbi, saying that its internationalisation is likely to be an outcome of rather than a precondition for the outward movement of Chinese companies. The experience of other countries shows that while companies, and the Chinese state itself, can gradually increase the use of the renminbi in their foreign transactions, it is pointless to force the pace of the internationalisation of the currency by developing off-shore centres for its use. The main obstacle to its internationalisation is something that often appears to be a major strength of contemporary China, its trade surplus. The imbalance in China's economic relations with the rest of the world means that the renminbi cannot be a stable currency, so it ends up a product of speculation rather than a fixed point of reference. If it wants to significantly expand the global use of the renminbi, China will first have to resolve the internal and external imbalances in the Chinese economy.

Chinese firms' outward movement has developed over the last decade to the point where it has now become a political phenomenon, and must be treated as such. Chinese commentators agree that the main aim of Chinese policy on overseas expansion should be to create an environment in which the country's firms can "go out" in peace.

3. Mapping out and sequencing the "going out" strategy

by Cheng Gong

Sources:

Li Zhongmin, "Chinese financial investments overseas: opportunities, challenges, and changing strategies", *Jinrong fazhan pinglun - Financial Development Review*, No. 7, 2011.

Sun Yuqin, "Comparative advantage, challenges and political options for overseas Chinese investments", *Zhongguo keji touzi - China Venture Capital,* January 2011[15].

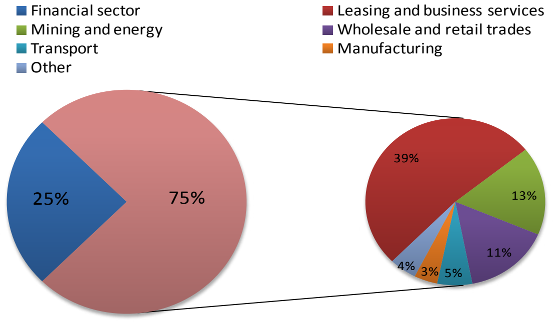
Chen Yantai, "*Chinese Enterprises Overseas Investment Situation and Layout Difference Analysis*", *Jishu jingji yu guanli yanjiu - Technoeconomics and Management Research*, No. 6, 2011[16].

Zhang Fei, "Towards becoming a major overseas investment nation: challenges and solutions", *Guoji guanxi xueyuan xuebao - Journal of the University of International Relations,* No. 4, 2011[17].

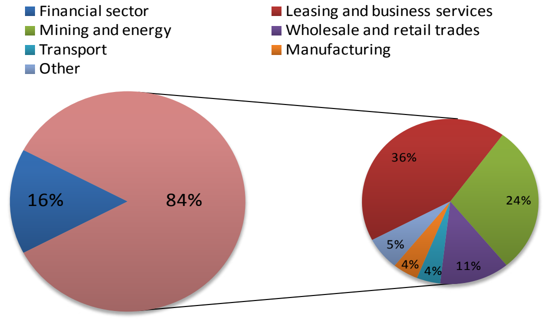
China's capacity for foreign investment has been growing for several years, driven by strong economic growth and a continuing rise in the state's foreign exchange reserves. Between 2002 and 2009 China's total foreign investment amounted to US$47 billion, placing it in the ranks of the top five leading global investors. To some observers, it seems that the country is transforming itself from a major exporter of goods into a major exporter of capital. This article will analyse China's different foreign investment strategies across the economic sectors in which it is active.

The non-financial sector accounts for more than 75% of China's foreign investment, since manufacturing, mining, and construction were the first industries to launch the strategy of "going out" (走出去, *Zou chuqu*), starting from the time of the Tenth Five-Year Plan. The financial sector, including Chinese banks and investment funds, has only recently begun to make its own overseas investments. According to a recent survey conducted by the China Council for the Promotion of International Trade (CCPIT), 40% of Chinese companies investing abroad are in manufacturing, 21% are trading companies, and 11% are in natural resource exploration.[18] Recent financial and economic crises (the sub-prime mortgage crisis, the global financial crisis of 2009, and the European sovereign debt crisis) have tarnished the macro-economic prospects of the developed economies and have destabilised financial markets in Europe and the USA. So, cross-border financial investments are down as compared to other kinds of investment. The chart below illustrates this recent movement towards non-financial sectors[19].

Proportion of investments per sector in 2008



Proportion of investments per sector in 2009



Source : National Bureau of Statistics of China

Chinese investors in both financial and non-financial sectors have tended to favour mergers and acquisitions as an investment strategy. Mergers and acquisitions often entail lower initial costs than, for example, setting up a branch in an overseas market. And merging with or buying out a company already operating in the host country can reduce the time Chinese firms need to take to adapt to the new market. The local company can help Chinese investors to familiarise themselves with the host country's legal system in terms of applicable employment laws, environmental protection regulations, and property rights legislation. Mergers and acquisitions are generally overseen by major investment banks and their legal teams, who can do just about all the work for the investor company, making the process much easier, even if their charges for facilitation are high. Chinese investors are still learning the ins and outs

15 Li Zhongmin is a researcher specialising in international investment at the Research Institute on International Politics and Economics at the Chinese Academy of Social Sciences.

16 Sun Yuqin is a Professor of Economics at the School of International Economics and Trade of the University of International Economics and Trade.

17 Chen Yantai works at the School of Economics and Management of Zhejiang Industrial University. He is also a researcher at the China Institute for Science and Technology Policy at Tsinghua University.

18 Zhang Fei is a postdoctoral research fellow at the Institute of Contemporary International Relations of Tsinghua University.

19 The statistics are taken from Chen Yantai's article (Chen, 2011, p.67), citing "Survey of the current situation and future prospects for Chinese overseas investments". This survey is conducted by the China Council for the Promotion of International Trade, between December 2008 and February 2009, covering 1,104 companies throughout China.

of the overseas investment market; doing business through mergers and acquisitions helps them to pick up knowledge quickly and increases their ability to launch large-scale investment projects. So, recent years have seen a large number of mergers and acquisitions by Chinese companies. In July 2011, a study of Chinese mergers and acquisitions by the Zero2IPO group put the value of new M&A transactions at US$14.7 billion, representing an annual growth rate of 106.8%.[20]

But in the past few years, Chinese cross-border mergers and acquisitions have suffered many setbacks, causing analysts to question the popular strategy.[21] Zhang Fei says Chinese companies do not have the necessary management skills to manage overseas subsidiaries effectively. This lack of management competence together with Chinese companies' frequently underdeveloped internal communications structures has caused problems within the new entities created in mergers or takeover bids. Zhang says 60% of buy-outs and 75% of cross-border mergers in the last five years have ended in failure. This high rate of non-completion could also be a function of the return of "economic nationalism" (经济民族主义, *jingji minzu zhuyi*), which has become widespread in Europe and other developed economies since the 2009 global financial crisis. One deal that collapsed in part due to economic nationalism was the 2009 effort by the Aluminium Corporation of China (Chinalco) to buy into Anglo-Australian company Rio Tinto's mines in Australia.

Mergers and acquisitions are Chinese investors' favourite strategy, but they also use other investment strategies. More than half of companies in the secondary sector, according to the CCPIT survey, open sales outlets in external markets to create new channels for distributing Chinese products in foreign economies. Joint ventures or investment consortiums in which one or several Chinese companies partner with one or several foreign ones are also popular. Joint ventures can be useful to Chinese firms in facilitating technology transfer or upskilling in management techniques. In infrastructure and construction, investment consortiums are favoured because of the size and complexity of the operations involved. Just 20% of Chinese companies choose to set up a completely Chinese-owned company for doing business overseas. The only companies that prefer to go it alone are the large, often publicly-owned manufacturing companies.

In the financial sector, aside from mergers and acquisitions, two other strategies are frequently used: financial participation and the opening of branch offices abroad. Ownership of shares has become a common practice since the creation and rise of sovereign wealth funds in the 2000s. At least three Chinese sovereign wealth funds regularly invest abroad: the China Investment Corporation (CIC), the National Social Security Fund (NSSF), and the China-Africa Development Fund (CADF). The State Administration of Foreign Exchange (SAFE) is not officially a sovereign fund, but it is in charge of managing the portfolio of the Central Bank of China's foreign exchange reserves, and so has many overseas branches to develop foreign investment. These Chinese sovereign wealth funds have immense resources and have formed partnerships, with and without voting rights, with foreign companies such as Tesco and financial institutions such as Blackstone and Morgan Stanley. At the same time, some large national banks, such as the Bank of China and the Industrial and Commercial Bank of China (ICBC), have since 2009 accelerated their programmes of opening subsidiary branches throughout the world. In 2011, the ICBC opened five new branches in Europe, in Paris, Brussels, Amsterdam, Milan, and Madrid. And the Bank of China has plans to expand its network of branches in countries with economies that complement China's, especially in countries that export natural resources.

Chinese companies sometimes attempt to apply in developed economies the same investment approaches that they would use at home or in an emerging market.

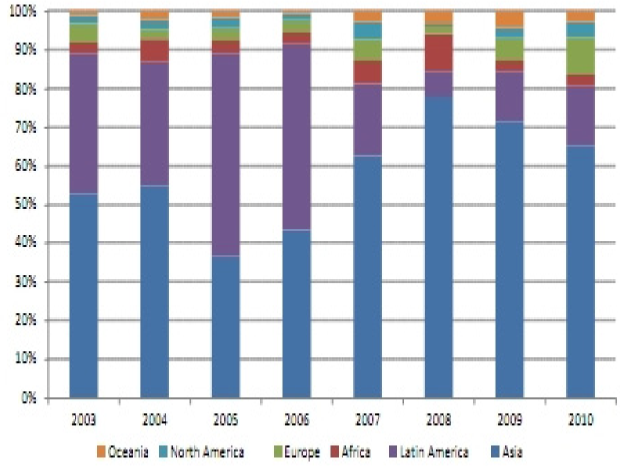
Chinese banks and investment funds are also investing in financial products, although for now, these investments remain relatively few in comparison with other modes of investment. Chinese financial institutions have already invested in financial securities issued by foreign governments or public agencies, like US Treasury bonds or the debt of Fannie Mae and Freddie Mac. This type of investment requires sophisticated financial expertise to manage pricing, studying yields, and so on. China obtained this expertise with the creation of the CIC and the recruitment of financial talent from Wall Street and the City of London. But the US sub-prime crisis and the sovereign debt crisis have destroyed the financial market's confidence in some types of financial product and the performance of Chinese financial investments has often proved unsatisfactory. So, Chinese investment in developed economies' financial securities is not likely to increase.

Chinese investment strategies need to take account of the specific conditions in the markets they enter and to evolve accordingly. So far, Chinese foreign investment has concentrated on emerging economies in Southeast Asia, Africa, and Latin America. Chinese companies and banks have only recently begun to explore the markets of developed economies. The chart below illustrates the geographical disparity in the distribution of Chinese investments between 2003 and 2010.

20 Zero2IPO Group, "Report on the Chinese mergers and acquisitions market: the first half of 2011". (Group Zero2IPO group is a financial institution specialized in IPO and venture capital). The executive summary of the report can be found here: http://www.zero2ipogroup.com/research/reportdetails.aspx?r=b14bc206-305d-42d2-be00-2b2abb430aef

21 For example, the projected buy-out of the US 3leaf Group by Huawei was abandoned in February 2011 under pressure from the Committee on Foreign Investment in the United States.

The regional distribution of Chinese investments between 2003 and 2010



Source: Datastream

Chinese companies have some experience of investing in developing countries, where the state can play a vital role in encouraging and supporting foreign investment. In these markets, Chinese investors can often apply pressure to local government to guarantee their economic interests. Chinese companies are used to working with countries that have economic organisational methods and social and legal systems similar to China's. So, they sometimes attempt to apply in developed economies the same investment approaches that they would use at home or in an emerging market. But if Chinese investors wish to develop markets in Europe or North America, they must adapt their investment strategies to the legal framework of the host country. The numerous failures of Chinese investment – such as the collapse of the contract to build a motorway in Poland – underline the need for Chinese companies to learn to adapt and assimilate to new ways of doing business abroad[22].

4. How best to avoid political risks abroad?

by François Godement

Source:

Tang Hao, "Strategic reflections on protecting China's international interests", *Xiandai guoji guanxi – Contemporary International Relations*, No. 6, November-December 2011, pp. 1-8[23].

Tang Hao is a leading Guangzhou public intellectual who writes personal opinion pieces for newspapers and journals such as Nanfang, Southern Window, and China Dialogue. His opinion on the conflict in Libya differed decisively from the official Chinese version, and he was willing to say so long before the final outcome of the operation by France, the United Kingdom and US. This stance has allowed him to promote his idea of how best to protect Chinese interests within the international system. Tang is critical of China's legacy of state-centred diplomacy and militaristic conceptions of security.

In his critique of China's Libya policy, Tang says it is a mistake to see "oil interests" as the main motivator for France, the UK and the US. European oil companies such as BP won major oil contracts as early as 2002, when Libya re-opened its market to the outside world. He says US military intervention in Iraq in 2003 did not stop Iraq from granting major oil contracts to Petrochina rather than to American companies. He believes the Libyan intervention by France and other NATO countries was "the defence of an international system of rules, including human rights, above the interests of national sovereignty, and the peaceful settlement of internal issues, non-violence, and the protection of democratic parties". These concerns, to the Western countries, were more important than mere oil interests. In any case, appropriating resources through occupying a country is no longer wise, and no country will act so openly these days. The measures taken by the Western powers were no more than a defence of the rules and proper functioning of the supply chain. China, on the other hand, lost nearly US$19 billion worth of investments channelled through 13 State enterprises. It saw its installations come under attack, and it had to conduct emergency evacuations of 30,000 of its nationals – although this operation provided it with a more striking success in terms of its international image than all its public propaganda efforts to bolster China's reputation.

Alongside his hard-headed analysis of the Libya intervention, Tang criticises some other common views in China, propagated in particular by the *Global Times* (although he never quotes from that journal), which has become a mouthpiece for some extreme strategic ideas.

22 For a detailed analysis of the Polish failure, see the article by Jade Le Van in this issue.

23 Tang Hao is an associate Professor at the South China Normal University, Guangzhou.

He rejects the idea of a military solution to the problem of protecting China's overseas interests: neither one aircraft carrier nor a fleet of ten can ensure China can protect itself. He says the US hardly ever uses its armed forces to protect its investments. He also criticises the outdated official Chinese conception of diplomacy, based on formality and propaganda. What is the point of diplomats spending only three years in their host country, if the first year is spent introducing yourself and getting to know local customs and habits, and the third year is spent packing your bags? And what is the value of the Confucius Institutes and the rigid Chinese idea of public diplomacy? Why is it that half of Chinese attempts to acquire companies abroad end in failure? What security is gained from the Chinese oil companies' massive investments in the only regions to which they have access – in 60% of cases, areas of high geopolitical risk? China has focused on forming close political ties with Libya, Sudan, and Iran, to gain access to resources for Chinese companies. But when civil unrest breaks out, these links become chains that China cannot escape.

Tang identifies different kinds of national interests that need to be protected, including private interests and what could be described as China's international reputational capital. He says a large part of the wealth of Western nations consists of international, mostly intangible assets. He is critical of the Chinese economy and its key players: the companies that, to avoid confrontation with sophisticated international competitors, focus on acquiring natural resources and on low-cost manufacturing in China using these resources. One major problem for the Chinese economy is the fact that its "two heads are located abroad" (两头在海外, *liangtou zai haiwai*); it has no control over prices either at the point of supply or the point of sale. Tang compares China's economic situation to Victorian England, which also depended on imported materials and export markets. Victorian England relied on its powerful navy and its colonies for security – an unrealistic path for China to follow in the modern world.

Tang thinks China's main weaknesses relate to the need for the country to integrate further into the international system in terms of standards and responsibilities. For example, China must be aware of the link between cultural influence and reputation – soft power – and its security interests. This kind of cultural influence depends on freedoms of various kinds, such as freedom to exchange educational, cultural, and technological knowledge, and freedom of access to international cultural goods. Tang points to the fact that, contrary to Chinese expectations, Japan was hardly censured at all by the international community for its disastrous management of the consequences of the Fukushima accident, whereas China was heavily criticised for its equally poor handling of the SARS outbreak in 2003. The reason for this lies in the difference between the two countries' international images.

Tang says an overabundance of liquidity and low domestic demand are leading to excessive growth in the acquisition of international interests, as seen in the buying spree being undertaken by Chinese companies. Gradually, these companies are encountering hostility and obstruction in their target markets due to resentment caused by low-cost Chinese competition. Public and state policy lags behind the changes in the country's economic interests, so China can provide no effective "self-defence" for its economic interests, leaving them vulnerable to hostility caused by China's poor international image. There seem to be many obstacles to Chinese interests abroad, from the attack on Chinese businesses in Italy and Spain to Russia's huge customs seizures of illicit Chinese exports. The list makes China feel friendless and without international protection. Among the examples Tang notes is that while Chinese citizens from the People's Republic have visa exemptions for only a few dozen second-string countries, people from Taiwan can freely enter more than 100 countries.

> Neither one aircraft carrier nor a fleet of ten can ensure China can protect itself.

Tang Hao recommends improvements to China's crisis management capabilities, since the foreign ministry cannot carry out the job. He sees a particular need for the construction of a control system to facilitate naval forces in protecting China's supply lines for raw materials. The Chinese presence in the waters off Somalia provides a good example of this. But any military expansion must be carried out in conjunction with diplomatic outreach so that China's neighbouring countries do not think the country is beginning an arms race.

Like the major developed economies, China must participate in drawing up the rules of the international system. And to do this, the country must be seen to change itself. Tang says China needs to show the international community that it is a country that takes care of its citizens – as it demonstrated in the evacuation of Chinese nationals from Libya. It should build on this starting point to generate positive change in the economy and society as a whole, and through political reforms it should increase democratisation and transparency (透明度, *toumingdu*, a term rarely used since 1989). Here, Tang rejoins the mainstream of a discussion that has been ongoing since 2010, before the debate about political succession began. Speaking out against militaristic enthusiasm, the priority of the State apparatus and enterprises, and a neo-realist vision of economic interests limited to the possession of material resources, he mounts a clear defence of the need for China's thorough integration into the international system – which presupposes far-reaching political changes within China itself.

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