China's Economic Transition and Overseas Direct Investments

by

Lawrence J. Lau

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Lau Chor Tak Institute of Global Economics and Finance
The Chinese University of Hong Kong
13/F, Cheng Yu Tung Building, 12 Chak Cheung Street, Shatin, Hong Kong

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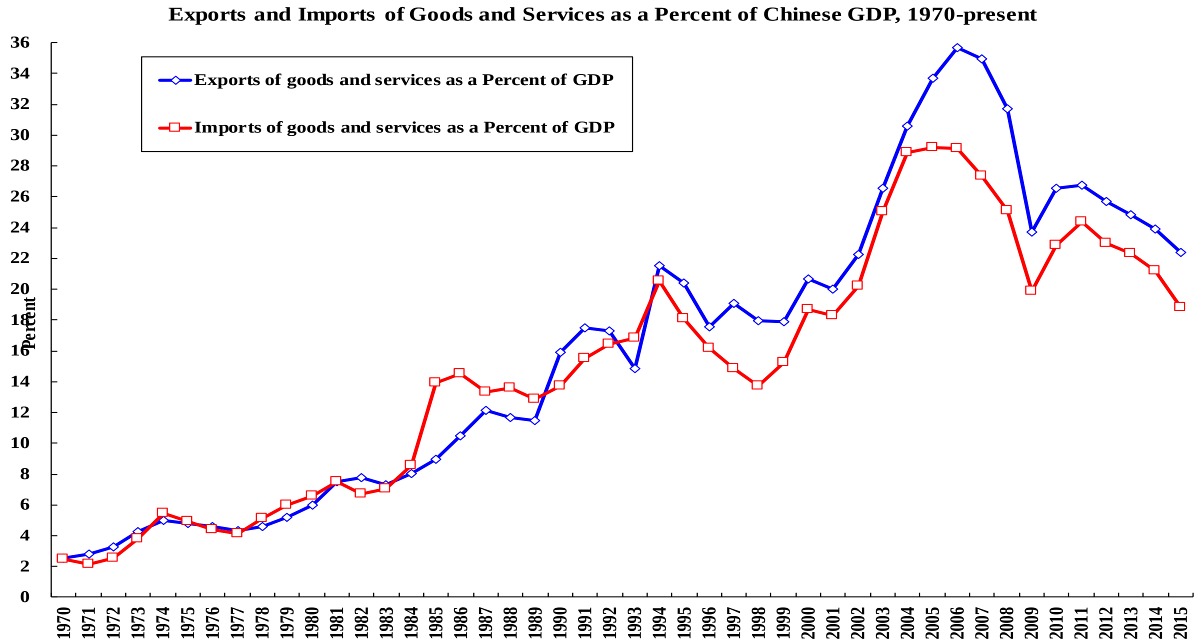
1. Introduction

China is the fastest growing economy in the world, averaging 9.6% per annum since 1978. No other economy has ever grown as fast for over as long a period as the Chinese economy. However, Chinese economic growth has begun to slow down, to an average annual rate of around 6.5%, in a process of transition to a "New Normal". In 2016, the Chinese economy grew 6.7% in real terms. Chinese total international trade in goods and services also grew rapidly, from US$20.3 billion in 1978 to US$4.67 trillion in 2015, making China the second largest trading nation in the world, just after the U.S. with its total international trade of US$4.99 trillion. However, Chinese international trade has also begun to slow down recently. Both U.S. and Chinese total international trade fell absolutely and as a percent of GDP in 2015 and 2016 (see Chart 1). Nevertheless, China continues to have a trade surplus on the order of 3% of GDP.

[1] Lawrence J. Lau is Ralph and Claire Landau Professor of Economics, The Chinese University of Hong Kong and Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University. All opinions expressed herein are the author's own and do not necessarily reflect the views of any of the organizations with which the author is affiliated.

Chart 1: Chinese Exports and Imports of Goods and Services as a Percent of GDP, 1970–2015



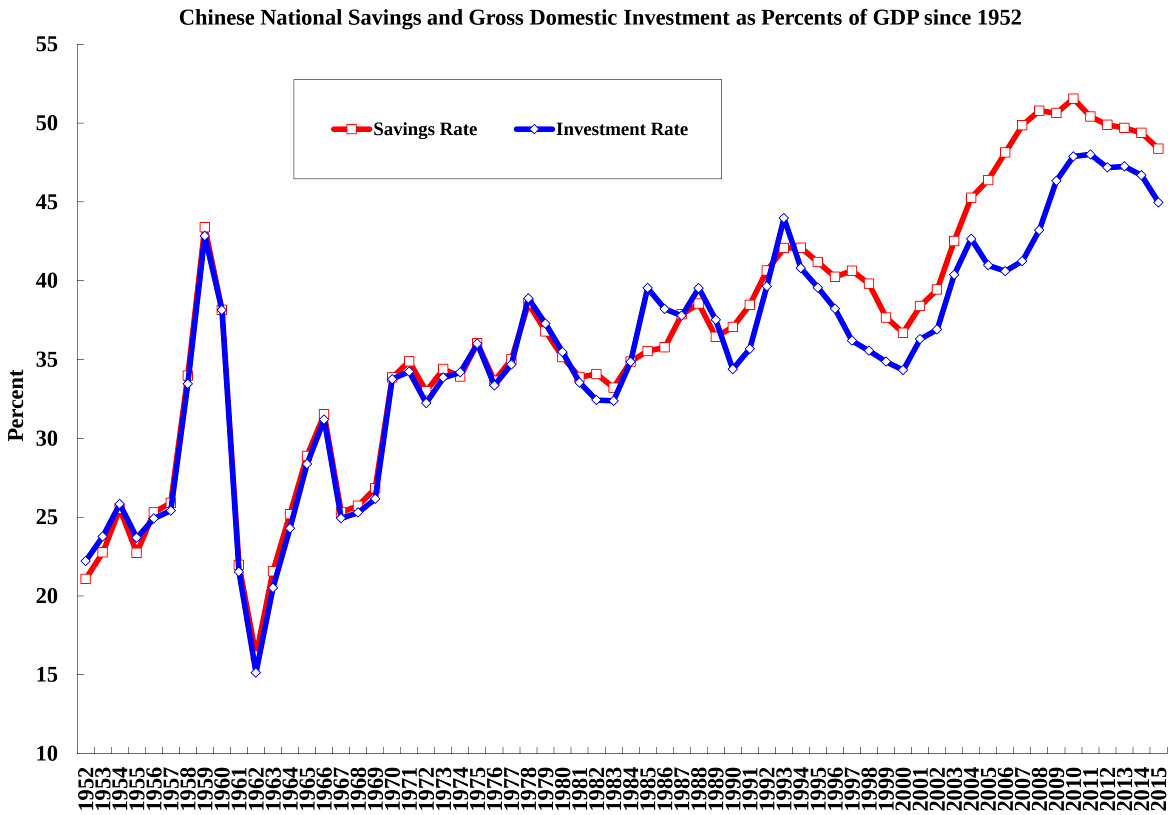
What does the "New Normal" imply? On the demand side, the "New Normal" is characterized by first, a reduced reliance on exports. Chinese exports of goods and services declined absolutely and as a percent of Chinese GDP and are not expected to grow at the same rapid rates as in the first decade of this century. Second, it is also characterized by reduced investment in fixed assets in the manufacturing sector and in residential real estate, as there are huge excess production capacities in almost every traditional industry: coal, steel, cement, plate glass, solar panels, shipbuilding, aluminum smelting and even electric power, and excess supplies of residential housing in all except the first-tier cities of Beijing, Shanghai, Guangzhou and Shenzhen. And even in the latter cities, there are risks of housing price bubbles. Third, it is also characterized by a greater emphasis on household consumption and a better environment, for example, clean air, clean water and clean soil.

On the supply side, the Chinese economy will continue to have strong economic fundamentals—a high domestic saving rate, abundant surplus labor and a huge domestic market—going forward. However, the "New Normal" implies that Chinese economic growth will be increasingly driven by innovation and technical progress, in addition to the growth in tangible inputs. Supply-side structural reform, which is intended to increase the efficiency in the use of capital through reducing wasteful and duplicative investment, is a continuing long-term effort. However, increases in tangible inputs will continue to play a role in Chinese economic growth as the tangible capital per unit labor in China still lags far behind those of the U.S. and other developed economies.

One important unique feature of the Chinese economy is its very high national saving rate. Except for the early 1950s, China has always had a high saving rate. During the past decade, the average national saving rate was almost 50%, the highest in the world. In contrast, the average national saving rate around the world is probably around 25%. This high national saving rate has enabled a rapid accumulation of tangible capital in China—structure, equipment and basic infrastructure—without relying on foreign capital, including foreign direct investment, foreign portfolio investment, foreign loans and foreign aid. The growth of the tangible capital stock in China has been the source of the bulk of the Chinese economic growth since China began its economic reform and opened to the world in 1978.

However, this high national saving rate has also caused a serious savings-investment imbalance. Since 1994, the Chinese national saving rate has always been higher than the Chinese investment rate (see Chart 2), which means that as much as China has been investing in structure, equipment and basic infrastructure, it is unable to fully utilize all of its national savings. At its peak (2007), the excess of Chinese savings over investment is almost 9% of GDP. It has since declined to around 3% of GDP, but China must seek better and more productive uses for its savings. As investment opportunities in China have become quite limited because of the existing excess capacities in many manufacturing industries and in residential real estate, Chinese enterprises (and households) must look for investment opportunities outside of China. This is where overseas direct investment comes in. Of course, it is also possible for China to invest more in research and development (R&D), which supports innovation. However, R&D expenditures are projected to reach 2.5% of GDP only by 2020 from its 2.1% in 2015 and cannot productively absorb more resources. Another possibility is to increase investment in the provision of domestic public goods such as clean air, clean water, clean soil, education, health care and elderly care. To do so will require government commitment and leadership.

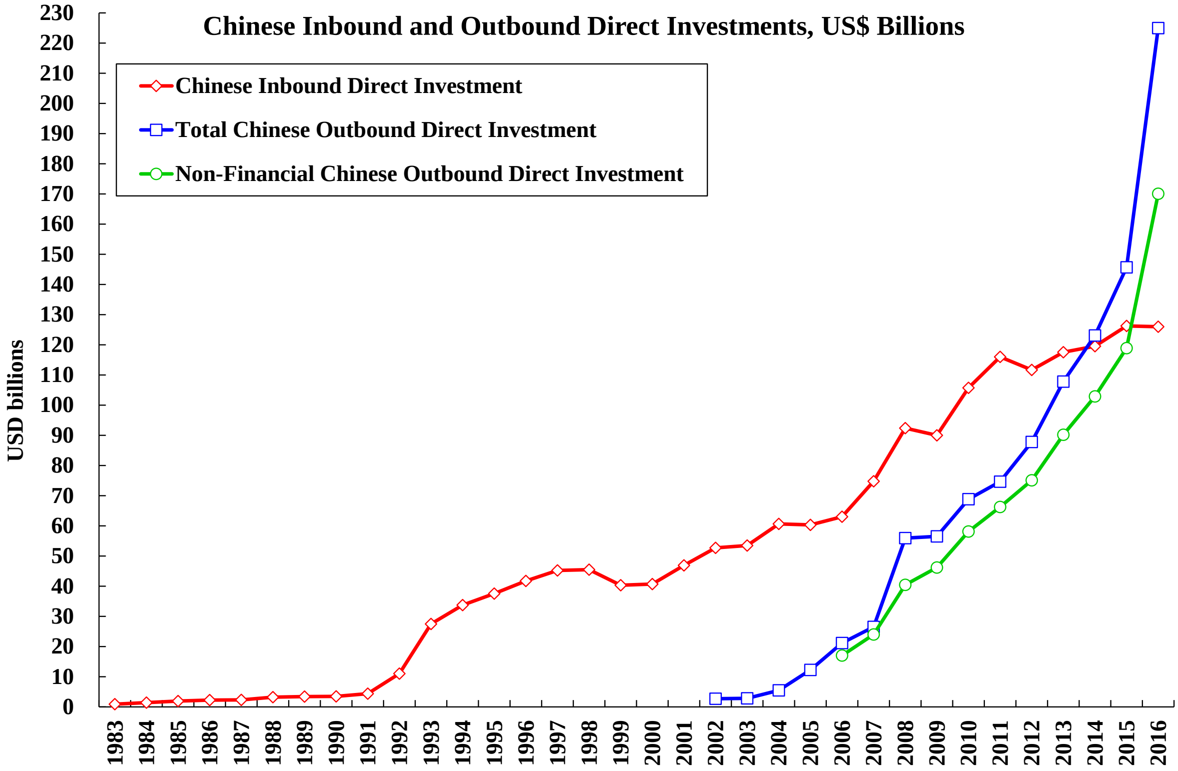
Chart 2: Chinese National Savings and Gross Domestic Investment as Percents of GDP since 1952



In Chart 3, we present inbound and outbound (including total outbound and non-financial outbound) direct investment of China. Inbound foreign direct investment began to take off in 1992, soon after the famous "Southern Tour" of the late Chinese paramount leader Mr. DENG Xiaoping, and reached 126 billion in 2016. Outbound direct investment (including both financial and non-financial direct investment) started much later, in 2003, with less than US$3 billion. However, it grew rapidly and surpassed inbound foreign direct investment in 2014 and reached US$225 billion in 2016. Even excluding financial investments, outbound direct investment amounted to US$170 billion in 2016, substantially exceeding the inbound direct investment. In the last couple of years, financial outbound investment grew much faster than non-financial outbound direct investment. Net total direct investment currently runs at the rate of approximately minus US$100 billion per year. This is still a relatively small number relative to the trade surplus in goods and services, which is of the order of US$400 billion a year.[2]

[2] There is, however, an unofficial forecast of an outbound direct investment of US$750 billion five years from now.

Chart 3: Chinese Inbound and Outbound Direct Investments, US$ Billions



Note:
Sources: Ministry of Commerce, National Bureau of Statistics, and State Administration of Foreign Exchange, 2014 Niandu Zhongguo Duiwai Zhijie Touzi Tongji Gongbao (2014 Statistical Bulletin of China's Outward Foreign Direct Investment), as adjusted by the author; National Development and Reform Commission, Work Report for 2016, p. 56, Chart 13. Data on total outbound direct investment for 2016 are according to Dealogic.

While the excess domestic savings in China provide a strong motivation for outbound direct investment, the aging demographics also support outbound direct investment at this time, with the expectation of capital repatriation years later. The rate of return to capital has been falling in China, in part because of rising wages, in part because of the decline in the working-age population and in part because of over-investment in many industries, all of which shift the terms of trade between capital and labor against capital. In addition, since capital is already relatively abundant in China but relatively scarce in the rest of the world, it can earn a higher rate of return elsewhere. China Investment Corporation, the sovereign wealth fund of China, was specifically set up to make investments overseas. Similarly, the Silk Road Fund was set up to invest in countries and regions along the new Silk Roads linking East Asia and Western Europe through Russia, Central Asia, and South and Southeast Asia and the Middle East.

The outlook for inbound foreign direct investment is not as promising as it used to be. China remains a huge market for both consumer goods and producer goods. Its middle class has been expanding rapidly and has been projected to be as high as 700 million. Even 300 million is already an extremely attractive potential market. However, today, China no longer lacks money. If all that a foreign direct investor can bring to China is money, it should not come. There is no shortage of money for investment in China. In addition, China has also become technologically more sophisticated and can produce many goods that it was unable to produce before. Only a foreign direct investor with innovative technologies, superior designs, new business models, protected by patents, trademarks and copyrights, or unique access to markets, can have a good chance to prosper in China.

2. Reasons for Outbound Direct Investment

Why do Chinese enterprises invest overseas? As explained above, Chinese national savings far exceed Chinese national investment. So, there are excess savings to be productively deployed elsewhere. Chinese domestic household consumption currently constitutes less than 50 percent of GDP, compared to the more typical 65–70 percent for a developed economy. Even though it has been increasing at approximately one and a half time the rate of growth of GDP, because of its low base, it will be a long time before Chinese household consumption as a percent of GDP approaches the level of developed economies. So the Chinese national saving rate will remain high for a long time. Moreover, the lack of good opportunities for investment in fixed assets (and for portfolio investment) in China also means that excess savings will continue to exist and enterprises (and households) must look to invest overseas.

Seeking Lower Costs

One important reason for investing overseas is to seek lower production costs. During the last decade, Chinese wage rates have gone up substantially and the renminbi has appreciated by approximately 25 percent. In addition, land costs and energy costs are no longer low in China. Setting up manufacturing facilities in overseas markets, despite higher labor costs, can make sense as land and energy costs are much lower, transportation costs can be greatly reduced, and labor costs can be saved through automation and robotics. More recently, since the election of Mr. Donald Trump as the President of the United States, there is, in addition, the consideration of the possible implementation of a border adjustment tax, which makes it even more favorable to the setting up of manufacturing facilities in the United States.

Increasing Market Share and Market Power

Another important reason for investing overseas is to protect as well as increase market share and market power. Proximity to market makes it much easier to respond to the preferences and needs of the customers in a timely manner and to achieve deeper and more durable market penetration. Acquiring a local enterprise in the same line of business can increase both market share and market power instantly. The acquirer can also leverage on the existing customer base and distribution system of the acquisition target. Examples of such overseas investment include the US$5.4 billion acquisition of General Electric's appliance unit by the Haier Group and the $3.4 billion unsuccessful offer for the U.S. crane maker Terex Corporation by Chinese manufacturer Zoomlion Heavy Industry Science & Technology Co., Ltd.

Acquisition of Natural Resources and Raw Materials

An yet another important reason for investing overseas is to ensure the security of supply of indispensable imported natural resources such as oil and iron ore, and potentially the supply of agricultural commodities through the acquisition of agricultural land. Past examples include the $15.1 billion acquisition of Canada's Nexen Inc. in 2013 by China's CNOOC Ltd. as well as the failed bid by state-owned Aluminum Corp. of China for a significant stake in the Anglo-Australian miner Rio Tinto in 2009. Not all such overseas investment deals were consummated, and not all of the completed transactions turned out to be profitable for the acquirers.

Acquisition of Technology

The Chinese Government actively promotes innovation and entrepreneurship. In order to support domestic innovation, many Chinese enterprises scour the world to find technologies and high technology companies that can contribute to innovation in China. For example, China National Chemical Corporation, also known as ChemChina, made an offer to acquire Swiss pesticides and seeds group maker Syngenta AG, for US$43 billion in 2015.[3] Another example is the acquisition of Kuka, a German robotics company, by the Midea Group for US$5 billion more recently.

Upgrading the Quality of Domestically Produced Consumer Goods

The rapidly expanding Chinese middle class has become a major source of consumer demand in China. As the disposable incomes of the middle-class households rise, their tastes have shifted towards consumer goods of higher quality and greater variety. Foreign brands and labels are often preferred because they serve as a form of quality assurance. As Chinese manufacturers of consumer goods gradually abandon the low ends of their markets and move up to produce higher-quality goods, the acquisition of foreign brands, labels and designs becomes important to them as a way of facilitating their own transformation. An example is the acquisition of Swedish automobile manufacturer Volvo Cars by Geely in 2010, even though in this case technology transfer was also an important consideration.

Trade Follows Investment

It has been well established that trade follows investment. For example, the German automobile makers that set up manufacturing operations in the U.S. import critical components and parts from Germany. Similarly, Japanese automobile makers in China also import critical components and parts from Japan. Thus, Chinese overseas investments can help to expand exports from the outbound direct investors to their investee countries and regions. However, it is not clear how this would work if the border adjustment tax of U.S. President Donald Trump becomes a reality.

Diversification

Of course, diversification must also have been an important motivation of outbound direct investment. Even though the Chinese economy continues to grow faster than almost all other economies in the world, with the possible exception of India, it is only prudent for any successful enterprise to diversify its sources of revenue and profit. It is simply too risky

[3] This acquisition is still in progress. It will be largely financed by loans from a consortium of banks including the HSBC Group. It still awaits final clearance by the various governments concerned.

to rely on a single market or a single location of production given all the uncertainty in the world. That is why most successful enterprises try to diversity by investing overseas.

Moreover, one important fact that should be borne in mind is that most owners and managers of enterprises prefer to stay in the same business but operate in a different location rather than to go into another business and operate in the same location. This is because the industry-specific expertise that they have accumulated over the years is much more valuable than a general knowledge of the local situation. Thus, as labor cost rises and the renminbi appreciates, enterprises making garments and toys in China would rather move to Bangladesh, Cambodia and Vietnam to continue in the same line of business rather than enter another business in China.

Diversification is also relevant to portfolio investment. Almost all Chinese wealth is currently invested in Chinese assets of various kinds. It is also prudent for households to diversify their investment portfolios. There is, of course, still capital control in China at the present time. If and when capital control is lifted in China, there is likely to be a one-off outflow of portfolio investment as a result of the stock adjustment of the existing wealth portfolio, which may take several years. This is likely to be followed by a stable annual outflow of portfolio investment, perhaps amounting to 10 percent of the annual increase in the wealth of Chinese households. However, for the rest of the world, there is also a one-off stock adjustment in its wealth portfolio, resulting in a one-off inflow of capital into China, also followed by a steady annual inflow of foreign portfolio investment into China. Thus, the Chinese capital accounts may still remain in reasonable balance even after capital control is lifted.

Irrational Investments

Of course there are Chinese outbound investment projects that do not appear to make much economic sense. Some Chinese Government officials, such as Governor ZHOU Xiaochuan of the People’s Bank of China and Minister ZHONG Shan of the Ministry of Commerce, have even made references to the so-called irrational investments. These are investment projects with low expected returns. They can be motivated by a desire to move money out of China, never mind the rate of return. They can also be the results of deliberate overpayments for the projects, benefitting the agents and brokers and perhaps ultimately the principals themselves. They can also simply be trophy properties such as football clubs, for which returns do not matter. But capital control still exists in China (even though in principle, outbound investment of less than US$1 billion does not require prior approval from the State Administration of Foreign Exchange). Recently, enforcement of the capital control regulations has been tightened up considerably. It is hoped that these "irrational investments" will be appropriately discouraged.

3. Is it Necessary to Wholly Own?

A subject of considerable controversy is whether Chinese enterprises investing overseas should always insist on 100 percent ownership or a controlling ownership. The same controversy also applies to foreign enterprises investing in China. Currently there are restrictions in many industries that have upper limits of permissible foreign ownership in China. There are also explicit or implicit restrictions on foreign and/or Chinese ownership in certain industries in other countries. For example, foreign ownership in U.S. Airlines is limited to 25 percent. Some foreign, including Chinese, direct investments into the U.S. are also subject to the approval of the Committee on Foreign Investment in the United States (CFIUS).

However, there are times when 100 percent ownership or controlling ownership may not be the best arrangement for a foreign direct investor. Sometimes one may need a local partner to help with the distribution. Sometimes one may need to local partner to be a guide to local preferences and tastes. Sometimes one may need a local partner to help navigate local politics. Greenfield investments overseas will typically benefit from having a local joint venture partner. However, partial ownership for the local partner may be needed to provide the right incentive for the local partner so that the interests of the local partner can be more aligned with those of the foreign direct investor.

It may also be useful to consider alternative business models that may operate well without 100 percent or even partial ownership. The important consideration is to make sure that any arrangement is win-win and incentive-compatible. Suppose a Chinese enterprise (it does not matter whether it is state-owned or non-state-owned) is interested in investing in an oilfield in a Central Asian country with rich oil reserves, with the objective of assuring the supply of this critical commodity in the future. However, the oil is in the ground and the oilfield has to be developed. Moreover, once lifted, the oil has to be transported to China by pipeline. Both the development of the oilfield and the construction of the pipeline require a very substantial investment. Of course, the Chinese enterprise can simply make a large direct investment to develop the oilfield and to build the pipeline. However, ownership of both the oilfield and the pipeline does not in itself assure security of the supply of oil, as the government of the Central Asian country may decide to do something else once oil starts to flow and a better customer than China can be found, or it may decide to levy an export tax on the oil or an additional transit fee for the use of the pipeline. If any of this happens, the Chinese enterprise will need to write off or write down its investments in both the oilfield and the pipeline.

Instead of investing directly in the oilfield and the pipeline, a more prudent alternative for the Chinese enterprise is to sign a long-term (say, 30 years) supply contract with the state oil company of the Central Asian country, committing to purchase a fixed quantity of crude oil from it every year, to be delivered to the Chinese border, at a pre-agreed price formula (for example, it can be cost-plus, subject to auditing, or it can be pegged to the price of Brent crude), backed by an irrevocable letter of credit issued by a Chinese state-owned bank. With such a contract, backed by the letter of credit, the Central Asian state oil company as well as the Central Asian government should be able to obtain financing for the development of the oilfield and the construction of the pipeline from both public and private investors, lenders and even multilateral financial institutions. In fact, the pipeline may well be partially financeable by the Asian Development Bank or the Asian Infrastructure Investment Bank. The Central Asian state oil company will then have every incentive to develop the oilfield, construct the pipeline to the Chinese border and start the oil flowing to China, because it will need the revenue to service the debts related to the project. And as long as the oil is delivered to the Chinese border, the Chinese enterprise is required to take the oil at the pre-agreed price. So this arrangement is completely incentive-compatible. The Central Asian state oil company needs the revenue and the Chinese enterprise needs the oil. If no oil is delivered, the Chinese enterprise does not need to make any payment. The Central Asian country may still have concerns that the Chinese enterprise may renege even with the letter of credit. But it is the responsibility of the Chinese enterprise to arrange to have the pipeline on the Chinese side built. As long as it has been built, the Chinese enterprise also has every incentive to accept and pay for the oil; otherwise the Chinese portion of the pipeline would become worthless. A further consideration is that the Chinese enterprise may encounter much greater difficulties than the Central Asian state oil company in trying to build the pipeline in the Central Asian country.

Similarly, in order to assure the supply of grains such as maize or wheat from overseas, it is not necessary to own the underlying agricultural land or to organize and manage the production directly in the foreign country. In fact, the massive purchase of land by a foreign investor often arouses significant local opposition, but it is totally unnecessary. Moreover, it is generally more difficult for a foreign investor to manage farms and farm labor. Again, a long-term supply contract with a local producer or consortium of producers, providing for the delivery at Chinese ports at an agreed price formula and backed up by an irrevocable letter of credit from a well-established bank can do just as well. A long-term contract is essential in order to provide the incentive for the producer in the overseas country to develop new supply. New agricultural land will have to be put into production, and this can occur only if there is sufficient assurance that the export demand is continuing and long-term. A long-term supply contract backed by a bank letter of credit can also enable the financing of new agricultural production in the overseas country.[4]

Another feasible approach to foreign direct investment is some form of joint ownership. For example, instead of a Chinese enterprise acquiring a company in Europe, the Chinese enterprise can arrange to inject new capital into the European company in return for a significant percentage of the company, and in so doing enable the European company to launch an operation in China and elsewhere. The European company receives much needed capital for expansion and acquires a Chinese partner that can help it expand in China. The Chinese enterprise can share in the worldwide profits of the European company and can also learn about what is going on in the company, in the industry and in Europe generally through its representatives on the board of directors. So the net result is win-win for both the Chinese investor and the European investee, which is not necessarily achievable with a 100 percent Chinese ownership.

[4] There is of course the risk that the foreign government may decide to impose export control. In order to ensure security of supply, the long-term supply contract can specify that one year's worth of supply has to be put into storage facilities in China as a "bond". If export control is imposed, the Chinese importer can take the grains stored in China and the long-term supply contract will be terminated. This provision removes the incentive for the foreign government to impose export control.

Another possible approach is the model of Royal Dutch Shell and Unilever. These two companies are joint Anglo-Dutch companies and are always identified as such. There is no reason why there cannot be similar Chinese-German enterprises, registered in both China and Germany and owned predominantly by the nationals of the two countries.[5] It can be listed on both the Frankfurt and Shanghai stock exchanges.[6] For example, Volkswagen AG, by converting its joint-venture subsidiary with Chinese partners in Shanghai into its wholly-owned subsidiary through the issuance of new shares in the parent company to its Chinese partners, can become such a company overnight. After completing such a transaction, Volkswagen AG can then obtain a secondary listing of its shares on the Shanghai Stock Exchange so that Chinese as well as other shareholders can trade their shares in Shanghai as well.[7]

Thus, it may be advantageous for Chinese direct investors to consider alternative ways to achieve the same objectives as they venture forth overseas.

4. Bilateral Investment Treaties (BIT)

China and the U.S. as well as China and the European Union have been engaged in negotiations on their respective bilateral investment treaties for quite a few years. Apparently, the negotiations of the China-U.S. Bilateral Investment Treaty are about 90 percent complete. It is based on the principles of national treatment and reciprocity, subject to respective negative lists (which forbid investments in certain industries as well as provide maximum foreign ownership percentages in certain other industries). The negative lists in principle do not have to be the same in both countries. Nevertheless, the negative lists are still regarded as too long. There is also no consensus on the appropriate treatment of state-owned enterprises.

First, it is mutually beneficial for China and the U.S. (and for China and the European Union) to have negative lists because then direct investors from all of these countries know for sure what can or cannot be acquired, which saves them a great deal of time and money. The negative lists do not have to be the same for both parties to a bilateral investment treaty.

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[5] Of course, Anglo-Chinese, Chinese-French, and other combinations of companies are also possible.
[6] One of the listings can be a secondary listing.
[7] There are feasible arrangements that can be made to provide for arbitraging between the two stock markets so that the prices of the same shares on the two separate stock exchanges can be equalized. The lack of space does not permit a detailed discussion here.

Instead of waiting until the negative lists can be pared sufficiently by both parties, one way to proceed is to accept the current negative lists for now but for both parties to commit to a gradual but steady reduction of each side's negative list, say, by ten percent a year for the next ten years. For example, if China has 50 industries on its negative list and the U.S. has 30 industries on its negative list, China will have to delete 5 industries from its negative list in each of the first two years, and then 4 industries for the next two years, followed by 3 industries each for the next 3 years, and 2 industries each for the final three years. At the end of ten years, the Chinese negative list will be down to 21 industries. Similarly, for the U.S., in ten years, its negative list will be down to 11 industries. At the end of ten years, both countries can agree on further reductions over time, subject to the provision that each side can maintain up to ten (or some other number of) industries on the negative list. In this way, over time, the number of industries on the two negative lists will become broadly equal. I believe some variation of such a proposed scheme may allow the bilateral investment treaty to go forward, with firm commitments from both countries to reduce gradually the sizes of their respective negative lists. This should greatly reduce the uncertainty facing both Chinese and U.S. direct investors and make it faster as well as more likely for deals to be completed. It also helps to reduce friction between the two countries.

Second, it may also be useful to make a distinction between state-owned enterprises and sovereign government entities in the bilateral investment treaty. Essentially, direct investors which are state-owned enterprises should be treated like any other direct investor from that country from the point of view of complying with the laws of the investee country. State-owned enterprises should not be allowed to claim sovereign immunity and other sovereign privileges unless they are truly sovereign entities such as a sovereign wealth fund or a central bank or monetary authority.

5. Local Currency Financing as a Natural Hedge

In fact, for outbound direct investment, especially an investment that involves an acquisition and merger of an existing ongoing business, it is actually better for the outbound investor to make the investment in the currency of the investee country or region as much as possible. This minimizes the amount of foreign exchange that the outbound investor needs to purchase from the State Administration of Foreign Exchange. Moreover, it also provides a "natural hedge" for the outbound investor against future exchange rate risks for the life of the outbound direct investment.

How does this work? Let us consider a concrete example. Suppose a Chinese enterprise wishes to make a direct investment in Malaysia, it is possible for it to purchase U.S. dollars from the State Administration of Foreign Exchange with renminbi first and then acquire the assets in Malaysia with the U.S. dollars. The Malaysian seller will then exchange the U.S. dollars into Malaysian ringgits. Alternatively, the Chinese direct investor can try to borrow, say, 80 percent of the purchase price, in the form of a Malaysian ringgit-denominated loan, secured by the assets that it plans to purchase. This can be readily done because the target of acquisition is a going concern, with revenue and profit and a track record. This would reduce the foreign exchange required by the Chinese investor to, say, only 20 percent of the purchase price. (Moreover, it can also try to pay the Malaysian seller the remaining 20 percent in its own currency, the renminbi, if it is agreeable to the seller). Furthermore, by borrowing in Malaysian ringgits to purchase the assets, the Chinese direct investor has also acquired a "natural hedge" against the exchange rate risk for the lifetime of its investment. When the renminbi appreciates with respect to the ringgit, the value of the Malaysian assets of the direct investor will decline in terms of renminbi; however, this is largely offset by the decline in the value of the liabilities of the investor (recall that a ringgit-denominated loan has been taken out to finance the direct investment). When the renminbi devalues with respect to the ringgit, the value of the Malaysian assets of the direct investor will appreciate in value in terms of renminbi, offset by the rise in value of its liabilities in terms of renminbi. Moreover, the revenue from the Malaysian investment, which is likely to be in Malaysian ringgit, can be used to service the ringgit-denominated loan. Thus, the Chinese direct investor will be largely immune to the effects of exchange rate fluctuations between the renminbi and the ringgit for the life of the investment.

Such an arrangement can reduce both the transaction costs and exchange rate risks for the direct investor. The amount of foreign exchange that is needed to support the transaction is also significantly reduced. The direct investor also benefits from the "natural hedge" because after all, it is not an expert on exchange rates, and no one can successfully predict exchange rate movements more than a couple of years out. In any case, it is almost impossible to buy currency hedges of more than two years into the future, and even if they are available they will be very expensive and are still subject to significant counter-party risk.

The seller of the currency hedge may not be able to honor its commitment to exchange the Malaysian ringgit for either the U.S. dollar or the renminbi when it is needed.

One question that arises is whether commercial banks are willing to lend to Chinese enterprises on their overseas direct investment. Past experience suggests that both Chinese and foreign banks have proved to be eager lenders. For example, J.P. Morgan Chase & Co. provided a US$7.4 billion bridge loan for the Pirelli purchase by ChemChina for US$7.7 billion. Local banks are probably even more eager to provide local-currency loans to Chinese enterprises, especially if they are secured against local assets.

One possible application of this method of financing outbound direct investment is to the infrastructural projects in the China-Pakistan Economic Corridor. Most of the capital expenditures of these projects will be in Pakistani rupees (for example, all labor costs). Any future revenues upon completion of these projects will also be in Pakistani rupees. Thus, it is possible to finance these projects in Pakistani rupees.

6. Concluding Remarks

Chinese outbound direct investment is likely to increase rapidly during the next five to ten years for many of the reasons discussed above. If and when capital control is lifted, there will be significant one-time stock adjustments in order to rebalance the wealth portfolios. There will also be continuing outflows of portfolio investment driven by the annual increases in the total national wealth. At the same time, one can also expect a portfolio investment inflow into China from the rest of the world that also includes a one-time stock adjustment of the world's wealth portfolio and a continuing annual flow, motivated by diversification considerations. It is too early to tell, in steady state, whether the outflows or the inflows will be higher. However, if the rate of growth of the Chinese economy continues to be higher than those of the other developed economies, the probability is that the inflows are likely to exceed the outflows as investments seek higher returns.

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