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Chinese Westward FDI: Take it or Lose/Skip it?

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The Chinese are coming! Just as the summer winds down, announced Chinese acquisition in the US has reached $7.8bn, approaching its all-time full-year record of $8.9billion. Most recently, China National Offshore Oil Corporation (CNOOC) agreed to pay $15.1 billion in cash to acquire Canada's Nexen Inc, on the same day that Sinopec, another Chinese oil company, agreed to acquire a 49 percent stake in UK North Sea assets owned by Talisman Energy (another Canadian enterprise) for $1.5 billion. Regardless of whether these two deals are ultimately approved – the process that continues at this writing – the sheer volume and potential of Chinese foreign direct investment (FDI) will have a profound impact on the global economy, providing both enormous business potential and new challenges. The world, particularly the West (which is becoming increasingly attractive to Chinese investors) should welcome this trend, but governments must also develop strategies to take full advantage of the economic opportunities it presents.

The July 23 deals are part of China's growing interest in mergers and acquisitions (M&A), which has assumed a steadily expanding share of China's recent FDI. M&A constituted some 46 percent of Chinese FDI in 2011 up from 18 percent in 2003. Large State-Owned Enterprises (SOEs) continue to be the main driver of Chinese outward FDI, making up more than two-thirds of such deals in 2010. The average value of M&A deals is usually larger than green field projects: the 143 M&A deals in 2011 have almost the same value as the 918 green field projects (the increasing use of M&A as format by Chinese investors also reflects the growing sizes of Chinese FDI projects).

Significantly, Chinese FDI is pushing westward toward Europe and North America. While Asia remains the overwhelming favorite for Chinese investment, the share of North America and Europe in the total Chinese FDI portfolio has grown from less than 3 percent in 2008 to over 13 percent just two years later. The absolute value of that expansion is equally impressive: the $9.54 billion total in 2010 is more than quadruple the level of two years ago.

This shift of investment direction is natural after three decades of fast growth that has established China as number two among global economies. The growth has primarily been dependent on labor and resource-intensive industries. For the Chinese economy to continue to advance, it has to reform its giant industrial machine toward higher value-added production. The fact that Chinese outward FDI is moving toward matured markets such as the US and Europe is a reflection of this fundamental transition in its economic development. This shift will present China opportunities to access sophisticated technology and management, mature its large domestic consumer market, and assure a stable supply of resources, as well as skilled labor.

Experts debate whether specific FDI projects are independent, profit-driven commercial decisions or driven by the government as part of its national development strategy. Whatever the conclusion, the choices of industries fit the strategic needs of China's long-term economic development. There is growing interests in China to acquire large stakes in companies in the West that have relatively safe and established energy resources, advanced technology that can supply much needed R&D for Chinese industry, manufacturers with good market bases and potential in the West and in China, or banks that provide a pathway to Western financial markets.

The impending takeover of Nexen comes after a $19 billion bid by the same company to acquire the US oil company Unocal in 2005; that bid was blocked by strong political objections based on controversial national security concerns from the US Congress. It comes at a time when Canadian energy companies are trying to reduce dependence on the US market by building new pipelines toward Asia. The takeover of Nexen will provide the Chinese company with access to sophisticated technologies for oil/gas production, including Nexen's oil-sands, shale gas, and deep-water leases in North America. It will also provide the Chinese company significant assets in the Gulf of Mexico. CNOOC made the offer after careful preparation to satisfy the needs and political demands of Canadian authorities to avoid an experience similar that of the Unocal acquisition.

If the Nexen deal is completed, it would become another example of a company that has met with strong political resistance in the US successfully investing in projects with US allies and close partners. Many people believe that the Nexen deal enables CNOOC to park the same money from its unsuccessful bid to acquire Unocal in another country. Similarly, Chinese telecommunication giant Huawei has been blocked from making acquisitions of US-based technology companies citing national security concerns. But it has had a smooth ride in Europe setting up six R&D centers in Europe and a recent acquisition of the UK's world-leading photonics research laboratory. Unlike the US, the European Union does not have regulations that distinguish foreign investors from domestic ones.

Without judging whether national security concerns are credible in each case, a fundamental question remains: If national security concerns about Chinese FDI are credible, then should we be worried about breaches by Chinese investments in allies and partners? This is not to say that we should follow suit when others make mistakes, but we should rethink our current strategy. A detailed and forthcoming national security strategy regarding Chinese direct investment that also takes into account critical allies' activity will be key to successfully guarding US security interests and would welcome Chinese investors with clear guidance. However, if it's not about national security but other vested economic interests, then we are hurting ourselves by turning away investment capital.

It is natural that the world's two largest economies are not just important trade partners, but also investment partners. It isn't just wise but necessary for the US to take full advantage of westward Chinese FDI with appropriate strategic caution. Thus, the US must resist political pressure to oppose Chinese investment based on protectionist commercial interests; national security-related concerns over Chinese FDI should not be treated in isolation. In other words, national security concerns should not become a political tool to justify protectionist measures. At the same time, there is a need to communicate and coordinate valid concerns to US allies and close partners so that US efforts are not compromised elsewhere. These concerns could be addressed through numerous existing channels between the US and key ally countries, such as the communication lines with the Defense Department, Congressional exchanges, and Treasury.

The westward trend of Chinese FDI will continue; the West must adapt to it. The Nexen takeover will be only one of many large-scale Chinese FDI projects to come. Some investors predict an additional $800 billion in Chinese FDI from 2011 to 2016, if current growth rates and government policy hold steady. Given growing uncertainty in global financial markets and increasing risks in sovereign bond markets such as the Eurozone, the need for direct investment by China will likely increase: since January of 2008, Chinese firms have disclosed 1,414 overseas acquisitions with a value of over $235 billion. In order for the US to seize this opportunity, a number of other things must also be done: the US needs to promote further its open market, good investment environment, and business opportunities. This is particularly necessary to counter the negative image created by a few failed cases that Chinese FDI is not welcomed in the US. But a better definition of national security for US companies and potential Chinese investors will be a critical step toward a comprehensive US approach to Chinese FDI.

To hear more on this subject, you can listen to a recent discussion on Pacific Forum's Issues & Insights radio program.

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