Chinese Economic Structure Change and Outward Direct Investment

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1. Introduction

Over the past three decades, China's export-led growth mode has obtained tremendous success in economic growth and export promotion. Now, China's GDP ranks second just next to US in the world, and it is the largest exporter and foreign reserve accumulator and the second largest foreign trader. In accordance with the fame of "World Factory", China is also the largest manufactured goods producer, fixed capital investor, energy and raw materials consumer and CO2 emitter in the world, which has engendered prolonged worldwide impacts on manufactures supply, commodities demand and environmental conservation.

However, due to the rising costs of production factors, rapid aged tendency of population, lack of advanced technology and gloomy global economy, China's current growth mode featuring with overdependence on export and investment can't be sustainable. To escape the middle income trap and realize the target of the new normal state formulated by the Chinese new administration, the most emergent and challenging task for China is to restructure the economy, charactering with the transformations of the growth mode from export-led and investment-driven to consumption and innovation driven, and the replacement of resources intensive and heavy emission manufacturing industries by service and high technology industry.

Regarding the restructure and upgrade of industrial structure, a successful experience of China in the past decades is to open-up, and attract FDI inflow and foreign technology and management skills. Through the adoption of export promotion measures and the encouragement of FDI policies, China has successful shifted from an agriculture country to an industrial state in the past three decades. In the future economic restructure and upgrade, China certainly should continue the policy of FDI encouragement and welcome the FDI inflow with high quality or technology.

It is worthy of noting that outward direct investment (ODI) can play an important role in attracting foreign technology and upgrading the economic structure, through acquiring oversea natural resources and advanced technology, establish market distributional channels and transferring domestic overcapacity industries. In the past, a mistake that China had made is to neglect the role of ODI, and China started to encourage outward direct investment activities in 2001, and even so the stock of the ODI can't compare to that of the FDI, Chinese huge foreign assets are collectively held by its monetary authority—the PBOC, and current Chinese firms have only a modest international presence. In recent years, the pace of Chinese enterprises' outward direct investment has significantly accelerated due to domestic strong demand on strategic resources and technology, and reasonable asset prices in advanced countries attributed to the global financial crisis and European sovereign debt crisis. With the implementation of the initiative of "One Belt and One Road" and the diversification of Chinese foreign reserve, it is expected that China's ODI will entered a stage of rapid growth, and there are more Chinese capital will be invested in infrastructure, high-end manufacturing industry, labor-and-resource intensive standardized technology industry and service sectors. Hence, China's ODI will play a more important role of stimulating the economic structure upgrade, through acquiring key technology and famous brands, transferring overcapacity sectors such as steels and cements, and making use of the idle labors of the host countries.

2. Facts of Chinese Economy

In this section, we undertake a comprehensive investigation on the current circumstances of Chinese economy in terms of economic growth and development, foreign trade, fixed capital investment, energy and electric power consumption, and cross-border direct investment.

2.1 China's Economic Growth and Development

Since the reform and open-up in 1978, China has experienced continuous and dramatic high economic growth, and the GDP size rose substantially from 189bn USD in 1980 to 10330bn USD in 2014 in current term. Featuring with high savings, heavy investment and export stimulation, China's export-led growth mode has achieved great success over the past thirty-five years, with average annual growth of 9.8%, the highest economic growth rate in the world (see Figure 1). In 2010, China's GDP reached 5930bn USD in current price, overtook Japan's GDP scale of 5474bn USD and became the second largest economy in the world. If China's strong growth momentum maintains, it will overtake USA as the largest economy in the near future. According to a prediction of OECD, if calculated in constant PPP international dollar, China economy size has surpassed that of eurozone and will become the largest economy in 2016.

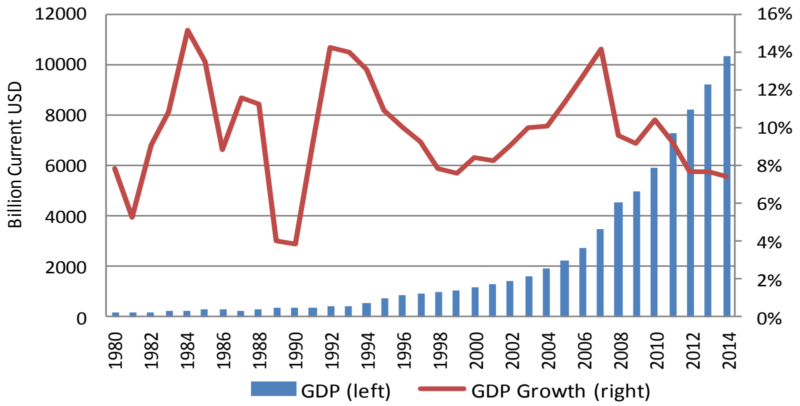

Figure 1. China's Economic Growth Rate and GDP Size
Source: World Bank and CEIC

As a result of persistently strong economic growth, the share of Chinese economy in the world aggregate output has risen steadily. Figure 2 shows China's GDP share in the world in terms of current USD, constant 2005 USD and PPP constant 2011 international dollar over the period from 1980 to 2013. In 2013, China's GDP share in the world aggregate GDP reached 8.6% in constant 2005 USD, 12.2% in current USD and 15.7% in PPP constant 2011 international dollar respectively, and which was 10.6, 6.9 and 12.1 percent higher than the level of 1990 correspondingly.

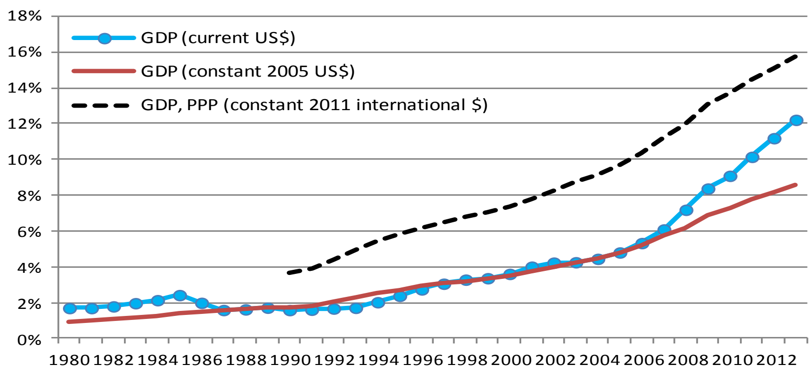

Figure 2. China's Share in World Aggregate GDP
Source: World Bank

In the past decades, although China has obtained substantial progress in economic development and poverty alleviation, it is still a relative poor developing country. As shown by Figure 3, the level of China's GDP per capita reached 6807 in current USD or 3583 in constant USD in 2013, and which was 35.3 times or 16.3 times as much as that of 1980. However, China's GDP per capita is still far lower than world average level, meaning that current China is a relatively poor country. In 2013, the ratio of China's GDP per capita to world average level equaled to 0.64 in current US dollars and 0.45 in constant 2005 USD respectively.

2.2 China's Foreign Trade

In the past three decades particularly since the entrance into WTO in 2001, China's export-led strategy has achieved unbelievable success and became the world factory. China sequentially overtook Japan as the third largest foreign trader in 2004, Germany as second largest trader in 2010 and USA as the largest exporter in 2011. As seen in Figure 4, the amount of China's import and export of goods in 2014 reached 1960bn USD and 2343bn USD respectively, and which is correspondingly 8.0 times and 8.8 times as much as those of 2001. In accordance with the strong growth in absolute term, the share of China's export and import in the world has also increased steadily in the past decades, considerably rising from 1.43% and 1.21% in 1990, then to 4.30% and 3.40% in 2001, and finally to 8.49% and 8.05% in 2013 respectively.

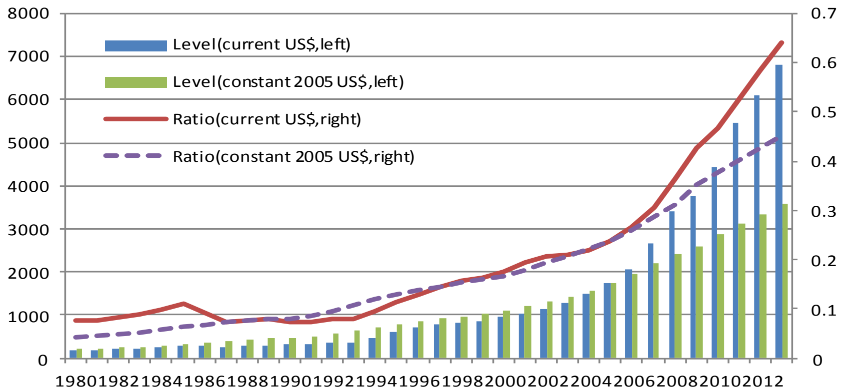

Figure 3. China's GDP Per Capita and Its Ratio to World Average GDP
Source: World Bank

China's trade surplus has increased sharply and become an excessive exporter since 2005. As Figure 5 displays, the share of trade surplus of GDP in China was moderate over the period between 1994 and 2004, increased dramatically in 2005 and maintained strong growth trend till 2008, and then declined steadily due to the global financial crisis and China's economic structure adjustment. The share of China's trade surplus of GDP has experienced large fluctuation in the past decade, first rising dramatically from 1.66% in 2004 to 7.57% in 2008, and then steadily falling to 2.02% in 2014.

It is rather difficult to explain the sharp expansion of trade surplus in the perspective of China's structural changes like drastic enhancement of enterprises' competitive capabilities. Although the rapid expansion in trade surplus should be highly related to the establishment of China's status as "world factory" and the flourish of export processing industries in recent years, the arbitraged capital inflows to obtain potential profits may be another important factor under the background of strong anticipation of RMB revaluation. Anecdotal evidences show that a frequent way for unwanted capital to evade capital movement restrictions is over-invoicing exports and under-invoicing imports. Thus, the one-way anticipation of RMB revaluation and strict controls on capital inflows provide much incentive for multinational firms in China to circumvent capital mobility restrictions through international transfer prices.

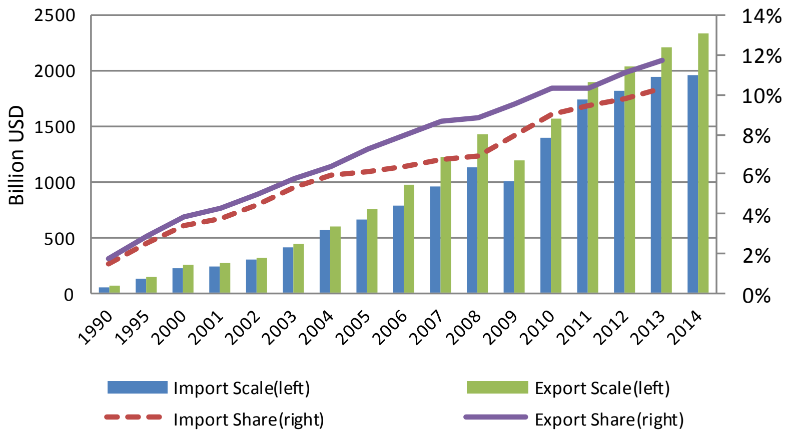

Figure 4. The Scale and Share of China's Import and Export of Goods
Source: UNCTAD and CEIC

2.3 China's Investment, Energy Consumption and CO2 Emission

A typical feature of China's economic growth mode is heavy investment. As Figure 6 displays, the scale of Chinese fixed capital investment has experienced persistent and substantial growth in the past decades, rising sharply from 55bn USD in 1980 to 4370bn USD in 2013, with an average annual growth rate of 14.6%. China surpassed USA in 2009 and became the largest nation in fixed capital investment. Over the period of between 1990 and 2013, the average share of China's fixed capital investment in GDP attains 37.7%, and which is much higher than the world average level of 22.8%. Furthermore, the share of China's investment in GDP has shown an obvious trend of increase, rising from 34.1% in 2001 to 47.3% in 2013. Considering into Chinese features of high savings and investment, it is sure that China will maintain the status of largest investment economy in the foreseeable future. This means that it is a tough task for China to adjust its economic structure by reducing overdependence on investment.

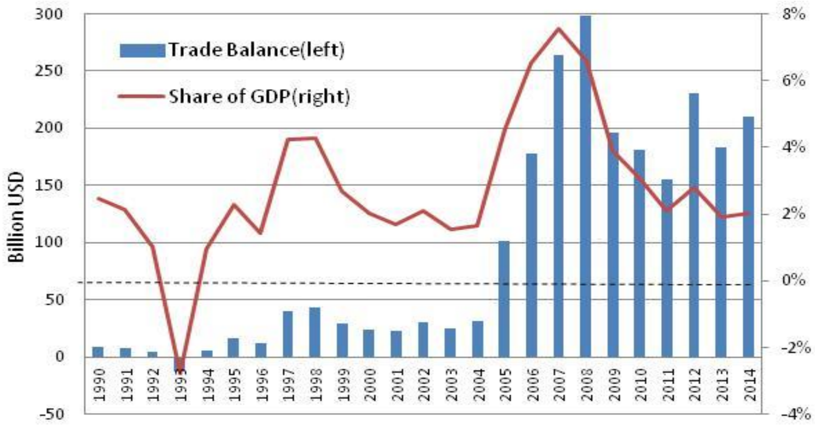

Figure 5. China's Trade Balance and Its Share of GDP
Source: CEIC

Highly relevant to heavy investment, China is also a main energy user and electric power consumer in the world. In the past decades, China's energy use and electric power consumption has increased steadily. The amount of energy use substantially rises from 0.6bn tons of oil equivalents in 1980 to 2.7 tons of oil equivalents in 2011, and that of electric power consumption increases from 276bn KWH to 4.43tn KWH correspondingly.

As Figure 7 displays, the share of China's energy use and electric power consumption in the world has risen dramatically in the past decade, increasing from 8.9% and 11.9% in 2000 to 21.8% and 21.5% respectively. China overtook USA and became the largest energy consumption country in the world in 2009, and it now ranks second only to USA as the second largest nation in electric power consumption. Due to the strong and persistent growth in energy consumption and fixed capital investment, the gap between energy consumption and energy production has enlarged significantly since 2001, and hence China needs to import around 10% of energy consumption to meet its strong demand originated from heavy investment.

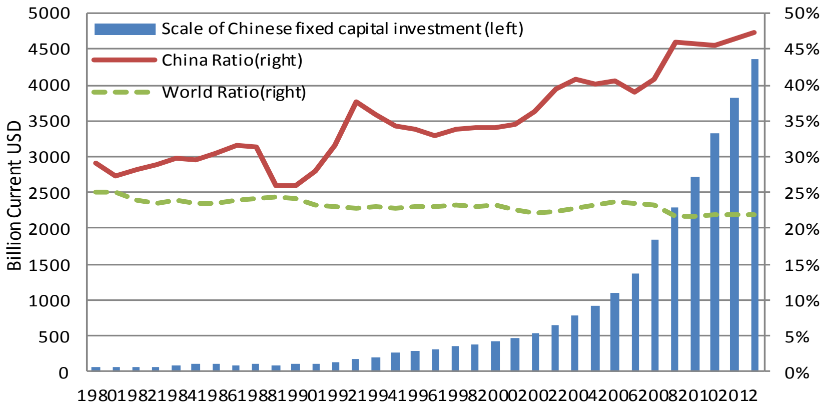

Figure 6. Value and Share of China's Gross Fixed Capital Investment
Source: World Bank

A natural consequence of China's overdependence on investment and massive energy consumption is heavy CO2 emission. As manifested by Figure 8, the scale of China's CO2 emission has experienced rapid growth in the past decades, rising substantially from 1.47bn tons in 1980 to 8.29bn tons in 2010, and the share of China's CO2 emission in the world aggregate emission correspondingly climbed from 7.6% in 1980 to 24.7% in 2010. China surpassed USA as the biggest emitter in 2006 and the emission margin between China and USA has continually enlarged since then, which partly explains China's worsening air pollution in recent years.

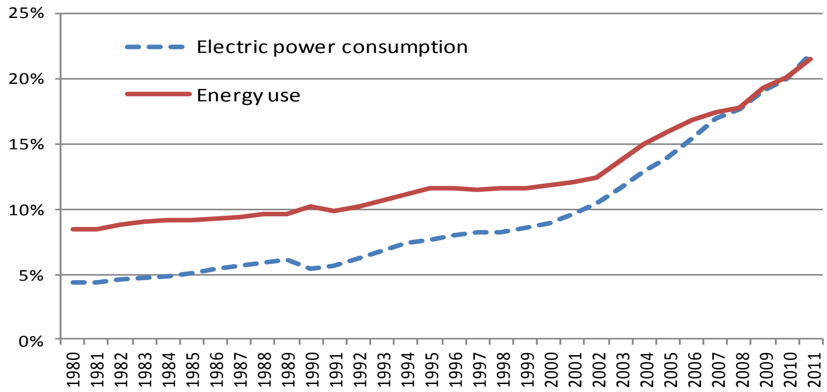

Figure 7. The Share of China's Energy Use and Electric Power Consumption in the World
Source: World Bank

2.4 China's Inward and Outward Foreign Direct Investment

China's regulatory system discriminates among different kind of cross-border capital movements. Encouraging foreign direct investment (FDI) is China's long-held policy. With features of relative stability and associated with benefits such as transfers of technological and managerial expertise, FDI has generally been the dominant form of China's capital inflows under the background of capital transactions restrictions.

As seen in Figure 9, with the establishment of China's status as "world factory" after entry into WTO and the revaluation pressure of the RMB gradually accumulated, China's FDI inflow has expanded steadily since 2001, with an average annual growth rate of 8.1%. The flow and stock of China's inflow FDI in 2014 was 119.6bn USD and 2677.9bn USD respectively, which is 2.6 times and 13.2 times as much as those of 2001. The share of China's inward FDI stock in the world FDI stock has risen steadily since 2007, increasing from 1.80% in 2007 to 3.76% in 2013. The share of China's FDI flow is much higher than that of FDI stock, with an average annual level of 7.24% over the period between 2001 and 2013.

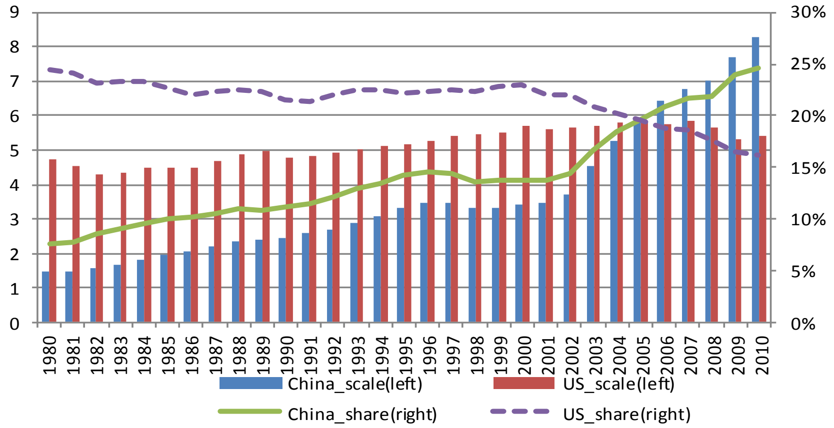

Figure 8. The Scale and Share of China and US's CO2 Emissions
Source: World Bank

Recently, the growth speed of China's FDI inflow has substantially declined due to foreign investors' tight fiscal constraints originating from the global financial crisis, and China's enhancing requirements on the quality of foreign capitals, average annual growth rate falling from 13.1% over the period between 2001 and 2008 to 2.2% during the period from 2009 to 2014. However, the share of FDI stock of China in the world is much lower than that of GDP means that China still has large potential to attract foreign capital. Hence, China is a main and popular destination for foreign direct investment capital.

With strong pressure of growing foreign exchange reserves, China has changed fundamentally the outward direct investment policy and began to implement the policy of encouraging Chinese companies to "Go Globally" in 2001. This policy shift intends to increase capital outflows to reduce external surplus, acquire oversea natural resources and advanced technology, establish market distributional channels for Chinese products, and enhance investment revenues of China's huge foreign assets. The approval procedures of Chinese firms' conducting outward investment have been simplified substantially, and this will provide scope for cross-border capital movements in the future.

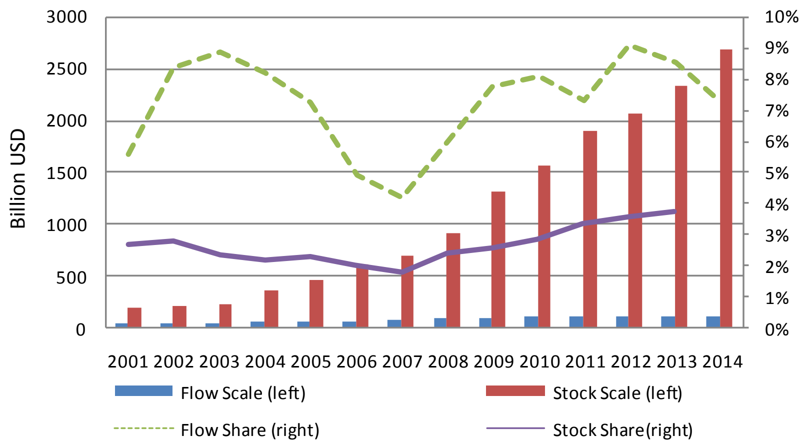

Figure 9. The Value and Share of China's Inward FDI
Source: UNCTAD and SAFE

As displayed by Figure 10, China's outward investment has accelerated substantially since 2003, due to large and persistent trade surplus and FDI inflow, rapid accumulation of foreign exchange reserves, and strong demand on natural resources, energy and high technology. The flow and stock of China's outward direct investment rose from 2.9bn USD and 33.2bn USD in 2003 to 116.0bn USD and 744.3bn USD in 2014 respectively, and the average annual growth rate is up to 42.4% and 31.5% correspondingly over the period between 2003 and 2014. The share of China's ODI flow and stock in the world aggregate has also experienced dramatic growth in the past decade, sharply rising from 0.49% and 0.33% in 2003 to 7.16% and 2.33% in 2013 respectively. The share of ODI flow substantially higher than that of stock reflects China's late comer status in the field of ODI. Also, China's share of ODI in the world is much lower than that of GDP means that China has a large potential to expand abroad direct investment activities. It is expected that China's investment in Asian infrastructure will increase substantially in next several years with the implementation of the strategy of “One Belt, One Road”.

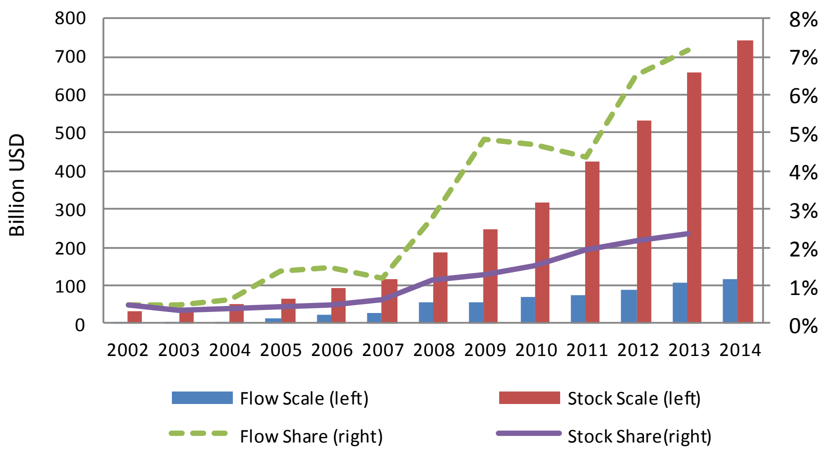

Figure 10. The Value and Share of China’s Outward FDI
Source: UNCTAD and SAFE(China)

3. Chinese Economy: Challenges and Prospect

The most comprehensive and complicate challenges of Chinese economy is middle income trap. The new normal state is a vitally important target for Chinese economic development in the coming decade.

3.1 The Challenges of Chinese Economy

Due to limitations in politics, society, endowment and environment, it is impossible that the development process of Chinese economy will be gone smoothly without a setback. China will encounter some serious challenges in the coming years. These challenges are as follows:

First, the most comprehensive and complicated challenge that China has faced is middle income trap. Owing to the rising costs of production factors, rapid aged tendency of population, lack of advanced technology and slow growth of global demand, China's high speed growth mode featuring with overdependence on export and investment can't be sustainable. The challenging task for China is to restructure its economy and replace the resources intensive and heavy emission manufacturing industries with service and high technology industry. According to the international experience particularly the lessons of Latin America, this restructure process is quite difficult, and only several countries have walked out the middle income trap and become developed states.

Second, China's current economic growth mode has faced increasingly serious constraints in labor, land, resources, energy and environment. China has faced the potential threats of social instability, such as, disparity in urban and rural areas, income gaps in different stratums, social emergent incidents, corruption, environment pollution, real estate bubble, and unjust in education, health care and endowment insurance.

Third, The global financial crisis and European sovereign debt crisis and the resultant gloomy world economy could dampen hopes for moderate world growth over the next several years, and which has caused the resurgence of trade and investment protectionism in the world so that some countries have set up many non-tariff barriers against Chinese firms, such as, anti-subsidy, anti-dumping and product standards. This has constituted a serious obstacle to the sustainability of China's export-led growth mode.

Fourth, Chinese enterprises have faced fierce competition and political obstacles in international market. This can be reflected in three aspects: (1) Due to low entrance barriers, standardized technology and low value-added ability, Chinese firms have undergone fierce competitions in the world and their temporary competitive advantages in international production chains can easily lose. (2) The reindustrialization plan of US will constitute a serious threat to the competitive capability of Chinese firms. Comparing to Chinese firms, US manufacturing enterprises have substantial advantages in capital financing cost, energy cost and technology. With an intention to enhance the competitive and export capabilities of manufacturing goods, reduce trade deficits and make the core economy return back to manufacturing industries, the US government plans to provide tax subsidy and R&D fund support to high end core industries like new energy and new equipment. (3) The application of the principle of competitive neutrality will make Chinese firms particularly SOEs experience many obstacles in carrying out outward direct investments, such as, investment motives investigation, state security examine, market monopoly investigation, and industrial entrance barriers.

To copy with the above four main challenges, China should firmly push forward economic reform and structural rebalance. First, China economic growth mode should shift from over-reliance on exports to consumption driven, with a balance between consumption and investment, the latter is critical industrial upgrading, raising incomes, and developing "green economy" sectors. Second, China should give new impetus to accelerate structural transformation to reduce income disparities, with alarming income inequality approaching the level of Latin American countries. Third, China should improve its market economy framework, equally treating to private firms and SOEs, and establish institutional environment favorable for technology innovation. Fourth, China should seek balance between environmental protection and economic growth, shifting its stance towards short-term growth and long-term environmental sustainability.

3.2 The New Normal State of Chinese Economy

Currently, the "new normal" is a popular term in China. Before the new normal state, Chinese economy was overwhelmingly relied on investment and export. The new normal means that Chinese economy has entered a new phase that features more sustainable, mid-to-high-speed growth with higher efficiency and lower costs, and environmentally friendly. To deal with the tough problems and risks of Chinese economy, such as sharply rising costs of labor and land, excess production capacity, and worsening environment pollution, the Chinese new administration put forward the new target or strategy of the new normal. The new normal state has four key characteristics: the GDP growth will shift from high-speed growth of around 9 to 10 percent to now mid-to-high rate growth of about 7 percent (and even lower); the economic structure will undergo comprehensive and fundamental changes, the service industry will gradually play a dominant role in the Chinese economy; consumption will gradually replace investment as the dominant source of demand, the income disparity will be shrink, and people's income will account for a larger share of the economy; the engine of Chinese economy will gradually transform from the investment-driven model into an innovation-driven model.

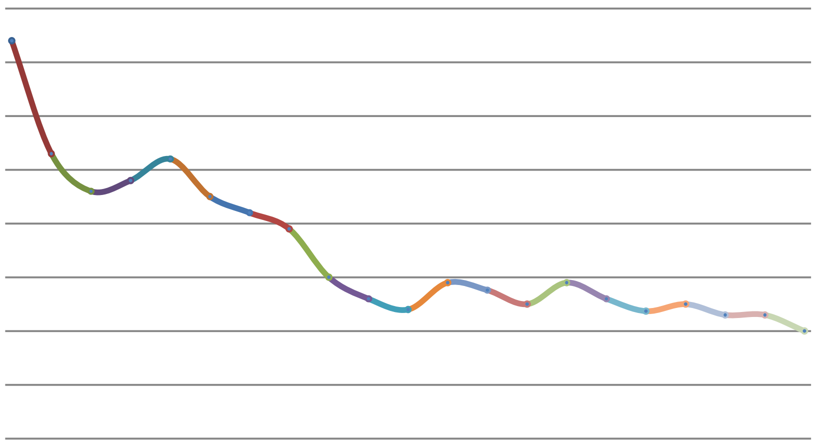

Figure 13. China's Quarterly GDP Growth Rate (previous year=100)
Source: CEIC

To realize the target of the new normal, Chinese new government has adopted some concrete measures since it took office in late 2012 and early 2013, such as, reducing overdependence on investment, deepening the economic reform, substantially loosening regulation on economic activities, and accelerating open-up. These new attempts has produced some elementary achievements:1)quarterly GDP growth rate significantly falls from 7.9% in the fourth quarter of 2012 to 7.0% in the first quarter of 2015 (Figure 13); 2)the share of service industry in Chinese economy amazingly rises from 45.5% in the fourth quarter of 2012 to 51.6% in the first quarter of 2015, while that of manufacturing industry significantly declines from 45.0% to 42.9% (Figure 14); 3) the growth rate of high technology industry and equipment manufacturing industry is obviously higher than that of manufacturing industry, meaning that Chinese economy is gradually more driven by innovation; 4)the service sectors have provided more new jobs than the manufacturing industries; 5)the income gap between rural and urban areas is gradually narrowed, and if the trend maintains, consumption will play a more important demand source of Chinese economy; 6) the environment protection law and relevant regulations have been revised, features with strengthening supervision on enterprises' environment related activities.

However, in the transition to the new normal state, the Chinese economy has some uncertainties and challenges, such as, middle income trap, large fluctuation in economy, real estate bubbles, local government debt and financial uncertainties. The largest challenge for Chinese economy is middle income trap. Under the environment of the declining potential growth rate and increasing environmental pressure, if China can't improve growth quality and efficiency, restructure the economy and boost the economy by innovation, the sharp slowdown of Chinese economy will weaken investors' confidence in investment, real estate market and local government debt, and trigger a chain reaction and even economic crisis.

If China's strong growth momentum continued and economic restructuring gone smoothly in the next ten years, China will become a critical important economy and can make manifold contribution to global economy. For advanced countries, China will become an actual main market for their capital goods, intermediate goods and high end consumption goods. For countries rich in agricultural and natural resources, China's huge demand on commodities will continue to support commodity prices and theirs export sectors. In addition, China's capital control measures will be loosed substantially, and China will become a main capital exporter in portfolio and direct investments in the world. It is sure that Chinese firms will be actively involved in international production and management, not only investing in advanced countries for marketing channels, technology and product brands, but also providing funds for natural resource and infrastructure investment in emerging markets and low-income countries. This is already happening, and it will continue in increasingly larger scales.

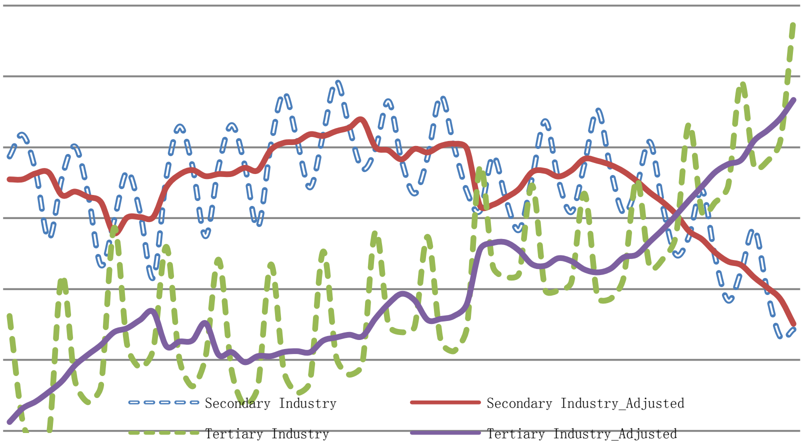

Figure 14. The Share of Secondary Industry and Tertiary Industry in China
Source: CEIC

It is certain that the growing relative strength of China will inevitably lead to the reshape of global governance. In western political and academic circle, the sharp rise of China has led to considerable controversy regarding potential repercussions for the current global governance architecture. There are at least two opposing scenarios are conceivable: China's adaptation to the rules and norms system shaped by developed countries or the pursuit of a distinctive policy approach, a possibility that involves the danger of clashing regulatory policies (Berger, 2008). As a stakeholder in the current international economic system, China will be play an active role in reforming global governance to defend its expanding national interests and to enhance its status in the world, through addressing the unreasonable and unjust components in the existing world economic order (Wang and Rosenau, 2009). The establishment of Asian Infrastructure Investment Bank and BRICS Development Bank reflects China's new attempts to enhance the status of emerging countries in global economic architecture. Considering into the national interests and limited abilities in global governance, it is clear that China will adapt to the current rules and norms system shaped by developed countries and won't aspire to create an alternative global governance system.

In sum, under the background of gloomy global demand, rapidly rising labor cost and serious environment pollutions, China's current growth mode can't be sustainable, with an overdependence on exports of low-and-middle-end manufacturing products and heavy investment. To realize the state of new normal, China should enhance its economic structure, encourage the development of the sectors of service, high-technology and middle-and-high-end manufacture, and restrict the expansion of industries of low value added, resource intensive and heavy CO2 emission. As a large nation with huge oversea assets, China can make use of ODI activities to effectively upgrade its industrial structure and improve the status in the international specifications and global value chains, through acquiring advanced technology, well-known brands, marketing networks and resources, and transferring domestic overcapacity industries. The initiative of "One Belt and One Road" will provide large potential for Chinese enterprises to go globally. However, as a late comer in international investment field, Chinese enterprises have faced more obstacles and prejudices than those of their western counterparts, such as fewer investment opportunities, insufficient international business experience, and political intention suspicions. The following two sections will investigate the current circumstances and challenges of China's ODI, and how ODI can enhance China's status in the global value chains and upgrade the industrial structure.

4. Chinese ODI's Facts, Challenges and Policy Suggestions

China has become an important player in the global international investment scene. In flow terms, Chinese ODI realized 11-year sustained growth with the average rate of 39.8 percent between 2003 and 2013. From an international comparison, China has been ranked for the first time the world's third largest outward direct investment (ODI) source nation after the United States and Japan in 2012. Thereafter, Chinese ODI has maintained a strong growth pattern and reached a new high record in 2013 with the total investment of $107.8 billion, up 22.8 percent over the previous year.

The rapid expansion of Chinese ODI is a result of policy support and economic development. Before 2000, a key strategy for China is to attract foreign capital while overseas investment is strictly controlled. Since the release of "going out" policy in 2000, making overseas investments get encouraged and supported by Chinese government. And the accumulated huge amount of foreign exchange could be used for Chinese ODI. In addition to government support, the economic reality also requires overseas expansion. With rising domestic costs and heightened competitiveness, investing overseas becomes entrepreneur's natural choice.

Along with the phenomenal growth, risks and barriers against Chinese ODI have also been strengthened. State owned enterprises (SOEs) as the dominant players of Chinese ODI are usually considered by host country the threat to fair market competition and even national security. Chinese investors are also often accused of bringing technology, resources, and jobs in host country back to China and thereby undermining sustainable development in local communities. Chinese enterprises' overseas journey is filled with twists and turns. Considering most Chinese enterprises being inexperienced in overseas operation, governmental guidance and service is vital for their subsistence and development.

4.1 Investor, Industry and Destination

By the end of 2013, the number of Chinese ODI investors had reached 15.3 thousand. Among these investors, a key feature is the significance of state-owned enterprises (SOEs), especially those centrally-administered SOEs (CSOEs). In 2013, among the non-financial ODI investors, CSOEs accounted for only 3.5 percent, while local enterprises from provinces, autonomous regions and municipalities took a lion's share of 96.5 percent. Nevertheless, China's non-financial ODI flows reached $56.3 billion in the same year, accounting for as many as 60.7 percent of China's total non-financial ODI flows.

CSOEs are a special enterprise group in China. They are few in number with one hundred and twelve in total under the state-owned assets supervision and administration commission of the state council. But they are more powerful compared with private enterprises and local-administered SOEs in the sense that CSOEs enjoy more financial and administration resources. Besides, China's CSOEs face less competition since they are more likely to be in monopolized or highly-controlled industry, such as finance, power and utility, petrochemical and energy, and aircraft and telecommunications. China's CSOEs are keen in making overseas investment under the ambition to be larger, stronger, and globally influential and competitive. But they are often criticized to threaten fair competition because of their special status, as well as have strategic intention which might pose threats to host country's national economic security.

East China is the engine of local Chinese ODI. In 2013, China's local non-financial ODI reached $36.4 billion, with a year-on-year increase of 6.5 percent. Among these overseas investments, $29.2 billion, or 80.2 percent, was from East China, with a year-on-year increase of 14.8 percent; $3.5 billion and $3.7 billion was respectively from Central China and West China with the year-on-year growth rate of 9.6 percent and -33.9 percent for each. Guangdong, Shandong, Beijing, Jiangsu, Shanghai, Zhejiang, Liaoning, Tianjin, Fujian and Hebei were top 10 provinces (municipalities) in terms of local Chinese ODI (see Table 2). They accounted for 73.8 percent of China's total local ODI flows in 2013.

Table 2. Top 10 Provinces (Municipalities) in Terms of Local Chinese ODI, 2013

No.	Province (Municipality)	Flows ($ Billion)
1	Guangdong	5.9
2	Shandong	4.3
3	Beijing	4.1
4	Jiangsu	3.0
5	Shanghai	2.7
6	Zhejiang	2.6
7	Liaoning	1.3
8	Tianjin	1.1
9	Fujian	1.0
10	Hebei	0.9

Source: 2013 Statistical Bulletin of China's Outward Foreign Direct Investment

In the aspect of industrial distribution, Leasing and business service attracts the largest amount of Chinese ODI. there were

$27.1 billion Chinese overseas investments to this sector in 2013, basically the same as last year, accounting for 25.1 percent in total (see table 3). After Leasing and business service, mining, finance, wholesale and retail trade were another three industries that respectively attracted Chinese ODI of $24.8 billion, $15.1 billion and $14.7 billion in 2013. These four industries were over 75 percent of total Chinese ODI, which further increased by 3.6 percentage points compared with last year.

Table 3. Industrial Distribution of China's ODI Flows

	2013 $ Billions	2012-13 Change %	Share in 2013 %
Leasing and business service	27.1	1.2	25.1
Mining	24.8	83.2	23.0
Finance	15.1	50.0	14.0
Wholesale and retail trade	14.7	12.3	13.6
Manufacturing	7.2	-17.0	6.7
Construction	4.4	34.2	4.0
Real estate	4.0	95.5	3.7
Transport, storage and post	3.3	10.7	3.1
Agriculture, forestry, husbandry fishing	1.8	24.0	1.7
Scientific research and technical service	1.8	21.0	1.7
Information transmission, computer services and software	1.4	13.0	1.3
Residents service, repair and other services	1.1	27.0	1.1
Production and supply of electricity gas and water	0.7	-65.0	0.6
Culture, sports and entertainment	0.3	55.0	0.3
Hospitality and Catering	0.1	-42.9	0.1

Source: 2012 and 2013 Statistical Bulletin of China's Outward Foreign Direct Investment

Although China is called "world factory", the scale of Chinese manufacturing ODI is relatively small, and Chinese manufacturing firms do not move their factories abroad on a large scale. This is likely due to the diversity and imbalance of the economic development among different areas of China. In face of rising domestic production cost, Chinese enterprises are able to relocate their factories inward to the country's less prosperous central and western regions from the more developed eastern coastal areas rather than setting up new facilities in foreign countries which could entail more uncertainties. However, the amount of Chinese manufacturing ODI is likely under-reported, and disguised as Leasing and business service.

It can be implied from the distribution of top 10 countries (regions) of Chinese ODI destinations that offshore financial center, developed economies and resource-rich countires are attractive places for Chinese enterprises (see table 4). Among these, Hong Kong is the most important transit and destination of Chinese ODI. It received $62.8 billion in 2013, accounting for 58.3 percent of the total. A large share of Chinese overseas merger and acquisition is conducted through re-investments from Hong Kong, such as the acquisition of the Canadian oil company Nexen by China National Offshore Oil Corporation (CNOOC) and etc.

Table 4. Top 10 Countries (Regions) as Destinations for China's ODI Flows

No.	Countries (Regions)	2013 $ Billions	2012-13 Change %	Share in 2013 %
1	Hong Kong (China)	62.8	22.6	58.3
2	Cayman Islands	9.3	1018.9	8.6
3	United States	3.9	-4.3	3.6
4	Australia	3.5	59.1	3.2
5	British Virgin Islands	3.2	43.9	3
6	Singapore	2.0	33.8	1.9
7	Indonesia	1.6	14.8	1.5
8	United Kingdom	1.4	-48.8	1.3
9	Luxembourg	1.3	12.5	1.2

10	Russia	1.0	30.2	0.9

Source: 2012 and 2013 Statistical Bulletin of China's Outward Foreign Direct Investment

4.2. Challenges and Risks

Along with the increasingly significant presence of Chinese enterprises in overseas investments, their journey is filled with twists and turns. Several major investments have run into obstacles, blocked or subject to long delays. Even for those finally completed projects, in many cases, they go through hardship and some come to a bad end.

The first challenge is investment barriers and resistance. A typical case is a series of difficulties that Chinese telecoms giant Huawei has experienced in some developed countries, especially in the United States and Australia. National security is one pretext that host country's regulatory body use to justify their concerns over Chinese ODI. A key reason is that China adopts the nonalignment policy, the independent diplomatic policy that does not form an alliance with any superpowers, and does not form any military ally of countries like the United States. Another reason is that the major players of Chinese ODI are SOEs. They are considered to be agents of the Chinese government, and their ODI is usually seen as having some hidden agenda.

But things are more complicated underneath the national security fears. Some Chinese ODI are being adversely affected by the tensions of international relations. The failure of Huawei's proposed acquisition in 2010 of a US internet software provider 2Wire came at a time in the US mid-term elections when members of Congress were especially sensitive because they were concerned about their prospect of re-election and scandals over cyber-attacks and data theft sparked fears over internet security. It seems that Chinese ODI tend to fall victim to the domestic politics of host countries. Opposition parties favor to utilize Chinese investments as an easy target to attack the ruling party. The investment by Chinese private enterprise Zhongkun Group in an undeveloped land in Iceland for tourism in 2011 is a case in point. In addition to political considerations, sometimes commercial interests hide behind claimed national security concerns. The series of frustrations that Huawei has met in the United States at least partly bears on opposition from existing US telecommunications firms.

The second challenge is investment risks in politically vulnerable countries and regions. China has large amounts of investments in Afghanistan, Sudan, Iran, Iraq, Libya, Venezuela, North Korea and other unstable regions. Chinese ODI in these regions accounted for 11.4 percent in total stock in 2011. The political changes in Middle East, North Africa, and South America have triggered turbulence and instability in these regions. Besides, the fact that commodities bull market has run its course brings huge pressure to those emerging markets that rely heavily on strong prices of major commodities. Chinese investment is easy to become a target and suffer heavy losses wherever there is political turmoil, terrorist attacks, civil wars or sudden regime changes. In fact, Chinese companies have suffered huge losses in the Libyan and Iraq unrest.

Although other foreign investors share the same concern and need to guard against such investment risk, Chinese enterprises are more likely to suffer losses. A key reason is that most Chinese companies, big or small, SOEs or private, are newcomers in the international investment arena. . A survey in 2010 shows that more than 80% of Chinese ODI firms began investing abroad after 2000, while only 4 percent of them had outward investments before 1990[1]. It is easy for them to ignore the potential risks in overseas markets. Moreover, some Chinese investors are accustomed to building close connections with juntas, local strongmen, and powerbrokers, but do not know how to communicate with the local community and its people. Is there any political turmoil or sudden regime changes, they have trouble winning support from local

[1] China Goes Global 2011: Survey of Outward direct investment Intentions of Chinese Companies, prepared by China Council for the Promotion of International Trade, the United Nations Conferences on Trade and Development and the Asia Pacific Foundation of Canada.

community and its people.

The third challenge is the international recognition of its unique identity. China has overtaken Japan to become the world's second largest economy. But it is still a developing country and a middle income country. So it needs some space to maneuver when negotiating with developed countries. What's more, China is a socialism country with its own characteristics and does not follow the orthodox 'Washington Consensus', a set of policy proposals made by the International Monetary Fund (IMF) and the World Bank to reduce government interventions, and promote trade and financial liberalization. To the Western eye, China's growth and rising influence remains a mystery. In fact, China itself does not have a clear idea of what the 'China Model' is, and has been 'crossing the river by feeling the stones'[2]. But what is certain is that Chinese government has played an important role in the country's economy. And the state ownership is the pillars of Chinese economy.

Such domestic situation has exercised an inevitable influence upon its overseas investment. The former US Secretary of State Hilary Clinton during her visit to Zambia in 2011 criticized China's "reckless misuse" of the continent's resources as a "new colonialism". Hilary's criticism as well as other label of Chinese ODI as pursuing 'state capitalism' is not fair. The issue of state ownership has been overestimated.

4.3. Policy Suggestions

The large scale of Chinese ODI is still a recent phenomenon. Most Chinese enterprises are inexperienced in overseas operation, and their investment risk awareness is very weak. Therefore, governmental guidance and service is vital for their subsistence and development. As the third largest ODI nation in the world, China should based on its own characteristics to systematize and

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[2] "Crossing the river by toughing the stones" means there is no fixed mode to follow, but groping in the forward step by step.

institutionalize its policies for promoting, supporting and reducing risks of overseas investments.

Chinese ODI policy system should be on the one hand in line with global conventions, and on the other in the service of the nation's overall economic development. The first principle is to guide but not control, service but not intervene. Making overseas investments is the spontaneous behavior and commercial activity for the micro-enterprises. The governmental ODI policy system should guide but not control the enterprises' overseas investment. It's a service-oriented system, and should refrain from involvement in microeconomic decisions.

We think there are several key policies that should be high on agenda.

The first is to develop and strengthen the function of overseas chamber of commerce in risk elimination, disputes settlement and promotion of the communications between Chinese investors and host country's each side. Overseas chamber of commerce is familiar with local laws and regulations, market structures and conditions as well as social customs. It could maximize the synergy between domestic and foreign cultural differences, bring together solitary enterprises, and therefore greatly enhance viability and the ability to resist risks. Besides, it is needed to establish information consulting service system and support the development of local intermediaries to provide high-quality investing, financial, legal, accounting and other ODI services.

The second is to alleviate the financing problem at various levels. The problem of financing is one impediment of Chinese ODI. This is largely blamed on the underdevelopment of Chinese domestic financial market as well as low degree of internationalization of Chinese domestic financial institutions. To alleviate this problem, it requires to make better use of both domestic and international financial markets and resources.

This includes: (1) built up a promotion platform for enterprises to be listed in China and overseas. (2) increase the share direct financing, in particular, encourage large enterprises to issue corporate bonds and small and middle-sized enterprises (SMEs) to issue set bond. (3) increase the government support to SMEs finance. For instance, establish a SMEs ODI fund with the focus on supporting those overseas investments that facilitate the restructure of Chinese economy or move abroad domestic excess capacity. (4) sign strategic cooperation agreement with foreign banks so as to encourage them providing financial support for Chinese ODI in host countries. (4) enrich and expand overseas business by Chinese local commercial banks to support overseas investments by Chinese enterprises. (5) integrate “bring in” and “going global”. for example, when Chinese enterprises make overseas merger and acquisition, the target foreign enterprises are also allowed to have the stake of investing Chinese enterprises in the form of stock-for-stock deal. This strategy is likely to reduce financial burden of Chinese enterprises as well as lower investment resistance in the host country.

The third is to accelerate negotiation of Bilateral Investment Treaties (BITs) with the United States and Europe. Although China has concluded BITs with 131 countries, these BITs have not played an enough role in protecting Chinese ODI. A key reason is that most of existing BITs were concluded in the 1980s and 1990s, and thus don’t not reflect Chinese interests as the major source of foreign capital. China should push ahead with bilateral BIT negotiations with the US as well as Europe. China-US BITs negotiations started in 2008 while China- Europe BITs negotiations began last year.

There are several points of disagreement in both negotiations, include the degree of market access and investor protection; fair competition issue that what standards should be set as a treatment of SOEs, labor practices and the environment; and dispute settlement issue that to which extent arbitration is governed by the Convention on Settlement of Investment Disputes between States and Nationals of Other States. Through exceptional arrangements and other legislative techniques, coming to an agreement does not mean the resolution of all these differences. But each side should make its part of concessions. China has taken the lead in making a major concession. During the fifth Sino-US strategic and economic dialogue in July 2013 in Washington, China for the first time promised pre-establishment national treatment for investments. The next breakthrough depends on whether China could give a satisfactory negative list in 2015 that balance a greater openness and domestic economic interests.