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EU-China FDI: Imbalances challenge bilateral investment relations

Jelena Cerar, Phillip C. Nell, Arnold Schuh

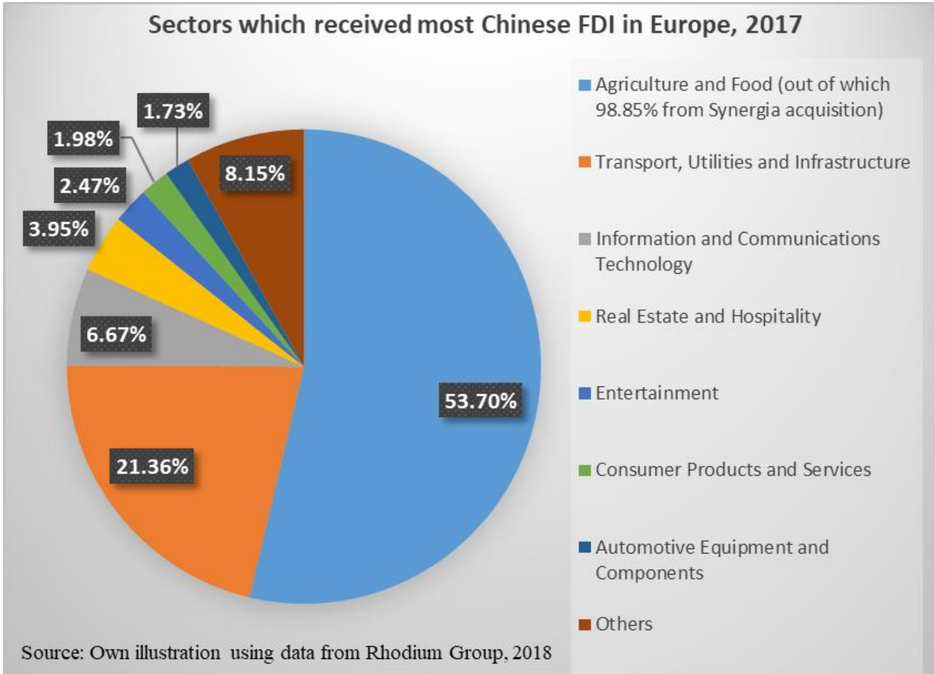
The European Union (EU) has become one of the favorite destinations for Chinese foreign direct investment (FDI). Annual Chinese outward investments to the 28 EU countries have grown from EUR 700 million in 2008 to EUR 35 billion in 2016.[1] However, in 2017, Chinese direct investment in the EU dropped to EUR 30 billion, which was a 17% decline compared to previous year.[2] This EUR 5 billion decline was the first Chinese FDI decline in the EU in the last four years, which raised the question whether Europe will remain a hub for China's FDI and how their FDI relations will develop.

The drop of FDI in the EU followed the global decline of FDI from China. In 2017, China's global FDI flows fell (from EUR 177.22 to 119.7 billion) for the first time in more than a decade, as Beijing enacted capital controls.[3] Despite the drop, 2017 was still the year with the second largest inflow of Chinese FDI into the EU, and it was the year with the largest single Chinese investment in Europe, namely the EUR 38 billion Syngenta takeover in Switzerland.[4] Moreover, this decline in Chinese FDI in Europe was lower than the 29% drop in Chinese FDI globally.

This drop was mainly caused by Beijing's informal policies to slow down "irrational" FDI in late 2016, after Chinese outward FDI had grown to an average of more than USD 50 billion per month in 2016.[5] These policies were mainly executed through guidance for banks to limit the conversion of Yuan into foreign currency for the purpose of overseas acquisitions and an informal campaign to prevent "irrational" outbound investment containing large capital outflows that were depleting China's reserves.[6] Finally, in August 2017, these informal policies

were codified in a new FDI regime, based on a list with “encouraged”, “restricted” and “prohibited” investments, as ranked by the Chinese government.[7]

The change in directives led to a drop of investment in "restricted sectors", such as real estate and hospitality, from about 22% to still a considerable share of 5%. On the other hand, "encouraged sectors", which include all infrastructure investments under the Belt-and-Road Initiative (BRI), high-tech and advanced manufacturing investments, energy, agricultural and service sector investment[8], attracted significantly more investment compared to previous years.



Source: Own illustration using data from Rhodium Group, 2018

Acquisitions in four sectors remain the main targets for China’s FDI in Europe. The split between acquisitions and greenfield projects remained pretty similar to previous years, with acquisitions accounting for 94% of total investment.[9] Agriculture and food, transport and infrastructure, information and communication technology (ICT) and real estate and hospitality were the top four sectors in Europe, receiving multibillion-dollar investments from China in 2017.[10]

Another important development is the rise of Chinese non-FDI investment, including venture capital and portfolio investment stakes of less than 10%. This trend was especially visible in Germany in the past three years, with Chinese companies taking large portfolio stakes in companies, such as Daimler or Deutsche Bank.[11]

China’s new regulations increased the investment by state-owned companies. Chinese investors in the EU in 2017 were mainly state-owned companies, which followed the mission

to advance China's development strategies such as the Belt-and-Road Initiative (BRI). However, just a few years ago, private companies such as HNA, Wanda, Fosun and Anbang were responsible for more than 25% of the total value of Chinese deals targeting assets in Europe and North America.[12] Since Chinese government began placing greater restrictions on outbound investment in late 2016, especially on highly leveraged private companies with a history of aggressive overseas expansion, the investor mix has changed. The relative share of sovereign and state-owned companies in total Chinese FDI in Europe jumped from 35% in 2016 to 68% in 2017.[13]

The biggest Chinese takeovers in the EU in 2017 were China Investment Corporation's (CIC)[14] EUR 12.3 billion acquisition of Logicor, China Jianyin Investment and Wise Road Capital's EUR 2.4 billion acquisition of NXP Semiconductors' Standard Products business, and Wanda Group's EUR 855 million acquisition of Nordic Cinema Group.[15] Other Chinese acquisitions in Europe outside of the EU – especially in Switzerland - included also ChemChina's EUR 38 billion Syngenta takeover in Switzerland and Chinese HNA Group' has acquisition of a 16.2 percent stake in Swiss airport retailer Dufry AG worth EUR 1.2 billion.

Top 5 Chinese FDI transactions in Europe, 2017 (EUR billion)

Target country	Target company	Investor	Value	Industry
Switzerland	Syngenta	ChemChina	38	Agriculture and Food
UK	Logicor	CIC	12.3	Transport, Logistics and Infrastructure
The Netherlands	NXP Semiconductors' standard product business	China Jianyin Investment, Wise Road Capital	2.4	ICT
Switzerland	Dufry	HNA	1.2	Consumer Products and Services
Sweden	Nordic Cinemas	Wanda	0.9	Entertainment

Source: Rhodium group, 2018

Many of the largest Chinese EU takeovers could not have happened the other way. While Chinese investors enjoy the same rights in the EU market as any European business, China ranks as one of the most restrictive economies in the world. China still heavily restricts FDI in its markets, despite promises to remove formal and informal barriers for European companies operating in China. These barriers have already led to visible imbalances in EU-China FDI flows on an aggregate level.

One quarter of all Chinese takeovers with a value of USD 1 billion or more in the period from 2000 to 2017 would not have legally been possible in the other direction at the same time as foreign investment in those sectors was prohibited or restricted.[16] In half of the instances, the transactions would have been legally permissible but highly unlikely to be approved because of state interference, industrial policies, and other factors.[17] That means that roughly three out of four of the largest Chinese acquisitions in Europe since 2000 could not have happened the other way around.

Traditionally, EU FDI outflows into China were significantly higher than Chinese FDI outflows until 2010. This is in line with economic theory predicting that emerging economies in a catching-up and liberalization phase typically attract more FDI than what they invest abroad. Looking at FDI flows, since 2010 the situation has changed a lot and Chinese FDI outflows into the EU overtook flows in the other direction for the first time in 2014.[18] In the aftermath of the global financial crisis an increasing number of European firms was for sale at depressed prices. From 2014 on, Chinese FDI outflows into the EU surpassed EU outward investment into China by a factor of three, mainly driven by Chinese M&A in Europe.[19] From a cumulative value of transactions perspective, China's FDI stock in Europe (EUR 131.9 billion) has caught up to Europe's FDI stock in China (EUR 132.2 billion) for the first time in 2017.[20]

Moving toward greater reciprocity is in China's own interest. China's leaders are aware that the current investment barriers do not only trigger foreign disapproval, but are ultimately also harmful for China's own economic welfare. For that reason, China's leaders have already taken some initial steps in removing investment barriers, such as entry restrictions as well as post-market entry discrimination. They have made some progress on both goals, mainly by replacing its traditional FDI regime with a framework that is based on pre-establishment rights restricted by a negative list only. In 2017, the State Council of China promised to open 12 additional sectors to foreign investment, including electric vehicles and financial services.[21]

In spite of these announcements, (west-)European business leaders and politicians have become more defensive on China's shopping spree in Europe. China's reliance on the state-capitalist system with restricted market access for foreigners and prevailing protectionism while exploiting the advantages of a liberal market system abroad raises questions of fairness and reciprocity in Europe. Opaque ownership and financing structures, the dominance of state-owned or state-controlled firms on the acquirers' side and Beijing's clear intention to use

outward FDI not just to catch-up technologically but also to dominate the home market and world markets have made EU investors and politicians wary.

In 2015, the Chinese government launched the "China Manufacturing 2025" (CM2025) initiative to promote and support the development of advanced industries and technologies in domestic firms.[22] The plan sets ambitious goals for developing the technological and innovative capacities in ten industries.[23] Based on "indigenous innovation" China wants to achieve domestic market shares between 40-80% in these core sectors by 2025. This may offer in the short-term business opportunities for foreign firms by helping their Chinese partners in their technological up-grading, but in the long-term the goal is obviously a large-scale replacement of foreign firms on the domestic market and on international markets too. Not surprisingly, outward FDI into Europe has increasingly targeted these industries in the last years.[24] CM2025 follows a top-down industrial planning logic and builds on subsidies and government-backed investment funds for local firms. It is hard to imagine that its implementation will abstain from protectionist measures such as limiting the market access for foreign firms, government procurement restrictions for foreign businesses and forced technology transfers in exchange for faster market access.[25] It is exactly this inconsistency in the Chinese governments' propositions and activities that raises the uncertainty for European businesses in China. As a further consequence, we see an increasing skepticism towards the EU's relatively open trade policy with China and the call for reciprocity in EU-China investment relations.

So has the German government started discussions to limit Chinese investments in areas that are linked to national security.[26] Now the government plans that the threshold for blocking a foreign takeover is lowered from 25% to 15%.[27] Other EU states are considering similar restrictions and the EU leaders called on the EU Commission to draft legislation that would impose unified European tests on possible foreign direct investments.[28] While not directly forbidding the takeover of an EU firm, the process will involve more scrutiny, more parties and leverages to obstruct an takeover attempt, and, finally, mean more uncertainty regarding the outcome for the involved parties.

The example of EU-China FDI shows that an imbalance in market access and direct investment opportunities in addition to a huge merchandise trade deficit is politically hard to defend. Mixed signals sent by the Chinese side are not helping in building mutual trust. At this point, the actors have to be aware that their actions may trigger negative reciprocity causing a downward spiral that eventually threatens economic cooperation between EU and China.

Notes

[1] Hanemann, T. and Huotari, M., 2018. EU-China FDI: Working towards reciprocity in investment relations, Rhodium Group and Mercator Institute for China Studies
[2] *Ibid*
[3] McKenzie, B., 2018. Rising Tension, Assessing China's FDI drop in Europe and North America, Rhodium Group
[4] *Ibid*
[5] Hanemann, T. and Huotari, M., 2018. EU-China FDI: Working towards reciprocity in investment relations, Rhodium Group and Mercator Institute for China Studies
[6] McKenzie, B., 2018. Rising Tension, Assessing China's FDI drop in Europe and North America, Rhodium group
[7] Source: Regulations published jointly by the National Development and Reform Commission (NDRC), the Ministry of Commerce (MOFCOM), the People's Bank of China, and the Ministry of Foreign Affairs
[8] *Ibid*
[9] Hanemann, T. and Huotari, M., 2018. EU-China FDI: Working towards reciprocity in investment relations, Rhodium Group and Mercator Institute for China Studies
[10] McKenzie, B., 2018. Rising Tension, Assessing China's FDI drop in Europe and North America, Rhodium group
[11] Hanemann, T. and Huotari, M., 2018. EU-China FDI: Working towards reciprocity in investment relations, Rhodium Group and Mercator Institute for China Studies
[12] McKenzie, B., 2018. Rising Tension, Assessing China's FDI drop in Europe and North America, Rhodium group
[13] *Ibid*
[14] A sovereign wealth fund responsible for managing part of the People's Republic of China's foreign exchange reserves.
[15] Hanemann, T. and Huotari, M., 2018. EU-China FDI: Working towards reciprocity in investment relations, Rhodium Group and Mercator Institute for China Studies
[16] Hanemann, T. and Huotari, M., 2018. EU-China FDI: Working towards reciprocity in investment relations, Rhodium Group and Mercator Institute for China Studies
[17] *Ibid*
[18] Hanemann, T. and Huotari, M., 2018. EU-China FDI: Working towards reciprocity in investment relations, Rhodium Group and Mercator Institute for China Studies
[19] *Ibid*
[20] *Ibid.* However, Eurostat FDI statistics show a different picture: EU firms held in 2016 stocks of EUR 177.7 bn. in China, while China only held EUR 45.1 bn. in the EU. European Commission, http://ec.europa.eu/trade/policy/countries-and-regions/countries/china/
[21] *Ibid*
[22] European Union Chamber of Commerce in China, 2017. China Manufacturing 2025 - Putting Industrial Policy Ahead of Market Forces, www.europeanchamber.com.cn
[23] These target industries are next generation IT, industry automation, aerospace/aviation equipment, maritime engineering equipment, advanced rail equipment, energy-saving vehicles, electrical equipment, agricultural machinery, new materials and biopharmaceuticals and high-performance medical devices.
[24] Hanemann, T. and Huotari, M., 2018. EU-China FDI: Working towards reciprocity in investment relations, Rhodium Group and Mercator Institute for China Studies
[25] European Union Chamber of Commerce in China, 2017. China Manufacturing 2025 - Putting Industrial Policy Ahead of Market Forces, www.europeanchamber.com.cn
[26] The trigger for this move was the acquisition of a majority stake in the German robotics manufacturer Kuka, a key player in Germany's Industry 4.0 initiative, by the Chinese Midea Group in 2017. In 2018, Chinese firms buying (portfolio) investment stakes below 10% in German business icons, HNA in Deutsche Bank and Geely in Daimler, have contributed to the feeling that Germany has to defend its economy against a Chinese economic invasion.
[27] Germany considers tightening controls on buying strategic firms. Reuters, 7.8.2018,
[28] Taking aim in China: How to safeguard national security without scaring off investment, The Economist, 11.8.2018

Jelena Cerar, M.A. M.Sc. is a Program Manager EM&CEE at WU's Competence Center for Emerging Markets and CEE and a Doctoral Student of International Business at Vienna University of Economics and Business (WU).

Prof. Dr. Phillip Nell is a Chaired Professor at the Institute for International Business at Vienna University of Economics and Business (WU) and Head of WU's Competence Center for Emerging Markets and CEE.

Ass. Prof. Dr. Arnold Schuh is Director of WU's Competence Center for Emerging Markets and CEE and Assistant Professor at the Vienna University of Economics and Business (WU).