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Chinese Takeout

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Foreign investment has been a motor of China's growth, flowing into more than half a million mainland enterprises and accounting for $660 billion in asset value. Now the balance of investment is set to shift in the other direction. China will deploy its accumulated assets abroad to secure resources needed for future growth, making that nation an even greater driver of the world economy.

Under plausible assumptions and with adjustments to bring reported figures closer to the actual underlying flows, we project that China's outward direct investment (ODI) will overtake FDI inflows as early as 2010. Official figures show a rapid increase of ODI to $16 billion last year, a 32% increase over 2005. Latest statistics split ODI between 60% to Asia, 16% to Latin America, 7% each to North America and Africa, 6% to Europe and roughly 4% to Australia and New Zealand.

But the official total substantially understates the actual flows, since it includes only overseas investment carried out by Chinese registered firms, and not ODI channeled through offshore registered Chinese entities, especially via Hong Kong. Taking such unreported flows into account, actual Chinese ODI may be 50% higher, according to a recent calculation by Deutsche Bank. This would produce a 2006 figure of $24 billion.

One major factor boosting ODI in the next five years will be China's continuing quest for raw materials and energy, a quest led by major state-owned enterprises. The deals produced are typically large, often more than $1 billion.

Given China's ample cash hoard, these agreements and acquisitions are likely to grow in number and size. News that China is setting up a State Investment Agency with up to $200 billion of the country's international reserves for diversification abroad highlight the momentum behind this investment push.

As for smaller deals, these are often channeled through overseas subsidiaries, where financing is much easier to arrange than in China. Energy deals include investments in Iran, Kazakhstan, Venezuela and Russia, while Lenovo bought IBM's personal computer business. In Britain, apart from the deal with the Rover motor company, Chinese firms have made 22 investments in London, and 20 in northeast England.

As ODI grows, so too will the nature of FDI change. Last autumn, as the inflow touched $69 billion, Beijing released new policy blueprints on the role of foreign capital in China's growth strategy. With ever-higher trade surpluses and international reserve levels, Beijing's leadership is aware that the economic policy context is changing dramatically. Business as usual is no longer a viable policy option.

Burgeoning surpluses are transforming policy priorities. Across-the-board subsidies are giving way to targeted incentives to attract foreign capital into priority sectors and regions. The leadership wants more "quality" investment rather than the quantitative approach of the past. As a result, China's FDI inflows are likely to stabilize, or even decline modestly.

Under guidelines drawn up last autumn by the planning agency, the National Development and Reform Commission, FDI will be required to respect tightened environmental guidelines, and support coordinated regional development. In the booming coastal areas, it will focus on high-tech industries, telecommunications and services, especially banking and finance to support a modern financial sector and promote innovation, including technology, communications, appropriate legal environment and education.

But this does not mean, as some commentators have assumed, that China's open-door policy for FDI will be overtaken by economic nationalism. The red carpet will just be rolled out on a more selective basis, since China has no need for inflows of money. The challenge for policy makers will be to target remaining subsidies in an intelligent way, minimizing ad hoc political meddling, while limiting the market distortions that inevitably ensue.

Meanwhile, it is important to realize that FDI is not quite what it appears. It is becoming apparent that a sizeable proportion of this investment capital is not foreign at all. Rather it is money that arises from within China itself that does a "round trip" out to Hong Kong and tax havens before returning home in the guise of overseas investment that qualifies for tax breaks not available to domestic investors.

However, the government has already approved a draft bill to abolish the preferential tax rate for FDI. It is expected to come into law in March and becoming effective at the beginning of 2008. There will be a uniform 25% rate, instead of the 15% rate for FDI and 33% for domestic firms.

This change in tax treatment should help weed out some low value- added FDI, whose contribution to China's economic development is debatable once environmental and social infrastructure costs are taken into account. It will also discourage "round tripping" in search of tax breaks. While both factors should depress official FDI figures, the overall quality of the investments should rise.

Regionalism will remain strong -- with provincial governments encouraging pet projects. But the increasing marginalization of the "Shanghai Faction," which dominated the leadership under former President Jiang Zemin, has enhanced prospects that authorities around the country will fall in line when Beijing sends detailed policy guidelines in the future, rather than going their own way to attract foreign investment regardless of how it fits into national planning. The president's steady process of appointing trusted associates to key provincial posts will also help in this respect, though how far Beijing holds sway over the fastest growing region, Guangdong, must still be open to question.

As its capital investment outflows overtake its inflows in the next five years, China will become the fifth largest global foreign investing nation behind the United States, Britain, Germany and Japan. This prospect will, to put it mildly, take some getting use to -- as will the leveling off or even decline of incoming investment capital. At a minimum, the prospect of this change raises the question of how the leading players in the global economy -- the U.S., Europe and Japan -- will react.

If the past is any guide, global financial markets will happily welcome this potential new client with seemingly unbounded needs for financial services of every kind. But the politics of China's emergence will undoubtedly prove much more complicated. Balancing the shifting positions of power and interdependency in the global economic arena will guarantee a challenging future for international policy makers for some time to come.

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