

Executive Summary Backgrounder

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Chinese Foreign Investment: Insist on Transparency

Derek Scissors, Ph.D.

China is the largest foreign holder of U.S. public debt. In just the last few years, it has also invested roughly \$100 billion in Africa, the Middle East, and elsewhere.

The financial crisis highlights the role of Chinese bond investment in the United States and prompts questions about whether Chinese investment in equities or other assets in addition would be helpful. Some in Congress are concerned that China will stop buying American bonds. At the same time, there is alarm over the extension of Chinese investment beyond bonds in the U.S. and around the globe.

Chief among the questions raised by China's outward investment is its intent. The objectives of the key actors involved are largely opaque. Many analysts believe that the investment is driven by political, not commercial, goals. This possibility is troubling in light of the massive financial resources at China's disposal.

This paper is a step toward providing open-source information to help evaluate Chinese foreign investment based on facts, both reassuring and disturbing. Using in part an original Heritage Foundation dataset on recent Chinese foreign non-bond investment, the paper begins to answer the questions of why, who, where, and how much the People's Republic of China (PRC) invests overseas, as well as why there has not been even more investment.

Many of the answers to these questions may be surprising. For example, China is not particularly

interested in the highest return on its outlays. Also, the much-touted China Investment Corporation is in fact a secondary player, with the State Administration for Foreign Exchange (SAFE) dominant. And while SAFE is the single largest global investor at close to \$2 trillion, total Chinese outward investment is still dwarfed by total American outward investment.

As is well known, China buys principally U.S. bonds. In terms of global non-bond spending, acquisitions in metals have recently been a bit larger than acquisitions in energy. Australia is the biggest national target for non-bond spending, there is significant planned spending in sub-Saharan Africa, and the Arab world has received comparatively little.

Perhaps a final surprise is that the PRC's involvement in global capital markets could be significantly larger. The Heritage dataset includes approximately \$100 billion in troubled transactions, impeded by market conditions, foreign opposition, or a veto from Beijing itself. The expansion of Chinese foreign investment is, therefore, not inevitable and its form can be shaped from both within and without.

This paper, in its entirety, can be found at:
www.heritage.org/Research/AsiaandthePacific/bg2237.cfm

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Despite these obstacles, Chinese foreign investment is very likely to continue in large quantities. Bond investment is almost sure to be much larger than non-bond investment. Mineral resources will continue to predominate within non-bond investment, but emergence from the financial crisis and accumulated experience will encourage a broader scope.

If Beijing does not enhance the transparency of its outward investment and permit greater foreign access to Chinese assets, developed markets could be walled off and competition for assets in the developing world politicized. In the worst case, violation by a Chinese state firm of American or international sanctions could trigger an economic clash.

In the best case, China offers both greater transparency in outward investment and greater reciprocity for inward investment, addressing both major foreign objections. Then, Chinese outward investment could take off, especially in non-bond outlays. Chinese foreign spending could grow to constitute a third wave, following petrodollars in the 1970s and Japanese spending in the 1980s.

Even if Chinese foreign non-bond investment increases only mildly, it will sharpen competition for global assets. American policymakers face known costs in attempting to manage China's entry into the global economy on free-market principles. An attempt to foil that entry, however, would be far more costly.

Given that foreign investment by the PRC should continue, the main problem is lack of transparency. China has embraced the Generally Accepted Principles and Practices for Sovereign Wealth (GAPP) guided by the International Monetary Fund (IMF), but has a great deal of work to do to make its

outward-investment practice transparent. Less pressing, but potentially helpful, is additional transparency on the American side to welcome legitimate Chinese investment as well as negotiate with the PRC for greater market access.

An ideal course for American policy includes the following actions:

- The Department of the Treasury and U.S. Trade Representative (USTR) should insist during global talks that SAFE and other Chinese government arms, not only China Investment Corporation (CIC), be considered sovereign wealth funds subject to international voluntary best practices now being created.
- The Committee on Foreign Investment in the United States (CFIUS) and other government review processes should be made as transparent as possible while preserving flexibility in the review process. The criteria by which foreign investment is judged should be set before a submission, rather than created after the fact.
- USTR and CFIUS should coordinate to ensure that negotiators have information necessary to make reciprocity an explicit factor in USTR market-access negotiations.
- The Department of the Treasury should work to ensure the success of multilateral efforts to compile better information on the activities of sovereign wealth funds around the globe, not only in the more developed economies.

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Background

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China made headlines by becoming the largest foreign holder of U.S. Treasury bonds at the end of September 2008. It was already the largest foreign holder of other U.S. public debt. In just the last few years, China has invested roughly \$100 billion in Africa, the Middle East, and elsewhere.

The current financial crisis further highlights the role of Chinese bond investment in the U.S. economy and prompts questions about whether Chinese investment in equities or other assets would be helpful in addition. Some in Congress are concerned that China will stop buying American bonds. At the same time, there is alarm over the extension of Chinese investment beyond bonds in the U.S. and around the globe.¹

For these and many other reasons, China's outward investment raises serious questions for American policymakers and the public. Chief among them is intent. The Chinese economy is still controlled by the state and, thus, so is its outward investment.² The objectives and performance of the key actors involved are largely opaque. In the absence of transparency, many analysts believe that Chinese investments are driven by political, not commercial, goals. This possibility is especially troubling in light of the massive financial resources at China's disposal.

The stakes are too high to make assumptions. This paper is a step toward providing open-source information that can help evaluate the Chinese intentions based on the facts, reassuring or disturbing, about their investment decisions. It starts to answer the questions of why, who, where, and how much the

Talking Points

- China holds more than \$1 trillion in American bonds. According to the new Heritage Foundation database on recent Chinese foreign non-bond investment, China has invested more than \$15 billion in the U.S. in addition to bonds.
- China's State Administration for Foreign Exchange (SAFE) is the largest foreign investor in the U.S., but has refused to make its activities more transparent. An American priority should be to enhance transparency in SAFE's spending.
- During global talks, the Treasury Department and USTR should insist that SAFE and other Chinese government arms, not only CIC, be treated as sovereign wealth funds that must adhere to international best practices.
- USTR and CFIUS should coordinate to ensure that negotiators have information necessary to make reciprocity an explicit factor in USTR market-access negotiations.

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People's Republic of China (PRC) invests overseas, as well as why there has not been even more investment, given China's potential.

These facts lead to one immediate conclusion: The main problem with foreign investment by the PRC is a serious lack of transparency. China has embraced the Generally Accepted Principles and Practices for Sovereign Wealth Funds (GAPP) guided by the International Monetary Fund (IMF), but has a great deal of work to do to make its foreign investment practices transparent.

Less pressing, but still helpful, would be additional transparency on the American side, both for the purposes of welcoming legitimate Chinese investment and negotiating with the PRC on greater market access. New regulations guiding the Committee on Foreign Investment in the United States (CFIUS) are a step in the right direction. In the international sphere, the U.S. should first compile information on Chinese spending in various regions, then review possible policy responses.

Why China Invests

Lack of transparency has generated suspicion of Chinese motives. Until recently, Beijing proceeded like any cautious investor, placing the vast majority of its funds in the safe haven of American government bonds. The last four years have seen a much-discussed drive to acquire foreign mineral assets but, much more significant in quantitative terms, have also seen Chinese state-owned enterprises drowning in cash and searching for an investment outlet—any investment outlet.

The financial crisis shows painfully how too much liquidity breeds overextension. The PRC is spending, and unintentionally wasting, a great deal of money in part simply because it has accumulated so much money through trade surpluses and purchases of foreign currency to defend the yuan.³ There is no conceivable balance of payments for the massive foreign exchange pile; it is almost twice as large as annual imports and debt accumulation combined. Hypothetical large-scale government purchases of imports to benefit Chinese consumers clash with the core objective of developing local industry. Moreover, the non-convertibility of the yuan, to which Beijing is just as staunchly committed as to developing local industry, means that reserves cannot be spent on domestic needs, a terrible waste.

This odd set of conditions makes for a very odd implication: Public talk aside, there is little practical value in gaining higher returns from investing reserves.⁴ Achieving higher yields would merely earn more foreign currency, which the Chinese government cannot use within the system it has created.

Hence, other motives for outward investment are at least as important. These are largely political. One aspect is domestic: U.S. treasuries appeal to Beijing because they cannot suffer visible and gigantic losses or outright defaults the way other bonds and stocks can—losses that infuriate the “Chinese street” far more than abstract complaints about merely 2 percent returns.

Outward investment can also bring foreign good will by providing the liquidity sought by policymakers worldwide in response to the financial crisis

1. In this paper, the standard distinction between direct and portfolio investment is replaced by a division between bond investment in fixed income assets and “non-bond” investment in everything else, including equities. Chinese data do not correspond precisely to the direct-portfolio distinction. In addition, Chinese investment is dominated by bonds in the U.S. and non-bond spending elsewhere. Most important, policy implications split along bonds and everything else, not along direct versus portfolio investment.
2. Derek Scissors, “U.S.–China Economic Dialogue,” Heritage Foundation *Background* No. 2200, October 21, 2008, at <http://www.heritage.org/Research/AsiaandthePacific/bg2200.cfm>; Eric C. Chang and Sonia M. L. Wong, “Political Control and Performance in China's Listed Firms,” *Journal of Comparative Economics*, Vol. 32, No. 4 (December 2004), pp. 617–636; and Wu Jiao, “Party Membership Up in Private Firms,” *China Daily*, July 17, 2007, http://chinadaily.com.cn/china/2007-07/17/content_5437279.htm (January 12, 2009).
3. “Hot and Bothered,” *The Economist*, June 26, 2008, at http://www.economist.com/finance/displaystory.cfm?story_id=11639442 (2/3/09).
4. Gao Weijie and Chang Song, “The China Investment Corporation: Keys to Success,” *APCO Worldwide*, Spring 2008, at http://www.apcoworldwide.com/content/newsroom/newsletter/2008-spring/sovereign_wealth_funds.cfm (January 12, 2009).

and from job creation. As Japan did in the 1980s, China can invest overseas in part as a political strategy to protect lucrative trade links. Purchases of American bonds certainly fit in this category. The PRC can also secure outright political gains in small countries. In January 2008, China's State Administration of Foreign Exchange (SAFE) bought \$150 million in U.S. dollar bonds from the Costa Rican government as part of a 2007 agreement under which Costa Rica cut ties with Taiwan.⁵

On the commercial side, investment activity begets better investment activity as experience is gained. Acquisition of equity stakes and joint ventures bring managerial learning and exposure to better corporate practice. Majority stakes, of course, bring control of either physical resources or of unique corporate assets.

This relates to the main objection to Chinese spending: In the U.S., it is a means to acquire technology; elsewhere, it is a resource grab of physical assets such as oil fields.⁶ There is a non-commercial component to the behavior of state enterprises: Following national priorities in securing mineral supplies can trump market valuation. Non-commercial investment bids up commodities prices beyond the additional demand naturally introduced by China's growth.⁷ In addition, SAFE takes small stakes in strategic sectors like energy to serve national interests without inciting a protectionist reaction.⁸

It is documented in later sections that the amount devoted to physical assets is far less than the amount stored in safe securities such as U.S. T-bonds. That merely augments the conclusion that strategic considerations are more important than commercial in most outward investment decisions.

Why China Invests

- 1) To store balance of payments surpluses
- 2) To acquire valuable assets
- 3) To defend foreign trade links
- 4) To assuage domestic agitation
- 5) Other foreign political goals
- 6) To maximize returns and increase the pile

Who Are the Players?

One common error is to view Chinese foreign investment through the prism of the China Investment Corporation (CIC), the explicit sovereign wealth fund. In fact, CIC is a minor player, at least by Chinese standards. The headliner in this drama should be SAFE and its \$1.9 trillion in reserves at the end of September 2008.⁹ The second act is a group of state financials, which have acted as a distributive channel for the overflow of foreign money pouring into SAFE. State-owned non-financial enterprises have also invested heavily overseas in recent years, often funded by government lender China Development Bank.

It is no contest. SAFE will shortly hold 10 times the assets of CIC, is presently adding the equivalent of at least two CICs annually, and is the largest securities investor in the world.¹⁰ It is an arm of the central government and should function as the definition of a sovereign wealth fund. SAFE's holdings of American bonds were approximately \$1 trillion by the end of June 2008.¹¹ These holdings flow

5. Jamil Anderlini, "Beijing Uses Forex Reserves to Target Taiwan," *Financial Times*, September 12, 2008, at <http://www.ft.com/cms/s/0/22fe798e-802c-11dd-99a9-000077b07658.html> (January 12, 2009).
6. China Metallurgical and Jiangxi Copper won the bidding for the Aynak Copper Mine in Afghanistan. See "Jiangxi Copper Says Afghan Project Worth \$4.4 Bln," *Reuters*, June 30, 2008, at <http://uk.reuters.com/article/rbssIndustryMaterialsUtilitiesNews/idUKHKG28945820080630> (January 12, 2009).
7. Elaine Kurtenbach, "Alcoa, Chalco Buy Rio Tinto Stake," *International Business Times*, February 1, 2008, at <http://www.ibtimes.com/articles/20080201/alcoa-chalco-buy-rio-tinto-stake.htm> (January 12, 2009).
8. "China Fund Takes \$2.8 Billion Stake in France's Total: FT," *Reuters*, April 3, 2008, at <http://www.cnn.com/id/23945610> (January 12, 2009).
9. "China's Foreign Exchange Reserves Top 1.8 Trillion Dollars," *Radio86: All About China*, July 14, 2008, at <http://www.radio86.co.uk/china-insight/news-today/7118/chinas-foreign-exchange-reserves-top-1-8-trillion-dollars> (January 12, 2009).
10. "Hot and Bothered," *The Economist*.

naturally from the fact that China runs a trade surplus with the U.S. China must do something with those dollars.

In an obvious bit of bureaucratic competition, SAFE began to move beyond bonds in 2007 coincident with the creation of the CIC.¹² SAFE is permitted to invest 5 percent into assets other than bonds, a number that passed \$90 billion by the end of September 2008 and grows higher each month. Other than American bonds, SAFE's major outlays appear to be in Britain, where, in barely over a year, it invested more than \$16 billion in firms from banking to utilities. All stakes are less than 3 percent and need not be disclosed under British law.¹³ This connects to a critical issue: SAFE is secretive, its activities uncovered only by outside investigators after the fact, and usually even then denied by SAFE.

The activities of China's state financial institutions have also been poorly documented. They received massive sums of foreign exchange as a means of capitalization.¹⁴ In the last two years, they have been ordered by the People's Bank to hold larger amounts of foreign currency as part of required reserves.¹⁵ In both cases, the money was transferred from SAFE, otherwise official reserves would be even larger. Brad Setzer at the Council on Foreign Relations calculates the amount of foreign money at Chinese state banks at no less than \$430

billion at the end of June 2008, on extremely rapid growth over the preceding 18 months.¹⁶

Well down the ladder, then, is CIC. Its high-profile launch and well-trained executive team made it the face of China's foreign investment. CIC's promises to abide by market norms, including those pertaining to transparency, were intended to offer reassurance about its investment. But CIC has been nearly irrelevant from the outset. Two-thirds of its \$200 billion endowment is allocated to domestic banks as capital.¹⁷ That leaves less than \$70 billion for "overseas" spending, but even that includes initial public offers by mainland companies in Hong Kong.¹⁸

The last set of players is state firms, with a helping hand from two of the state's national-level policy lenders, Export-Import Bank of China and, espe-

Who to Watch

China's Main Players	Level of Participation
State Administration of Foreign Exchange	\$1.9 trillion (and rising monthly)
State-owned financials	Approximately \$430 billion
China Investment Corp.	\$67–\$200 billion
State-owned enterprises	\$93–\$115 billion
Policy lenders	Unknown, but financing is in the tens of billions of dollars, at least

Source: Brad Setzer, "How to Handle a Couple of Trillion," *China Economic Quarterly*, Q3 2008.

Table I • B 2237  heritage.org

11. "China May Cut Its Dollar Holdings—CICC," *China Daily*, September 12, 2008, at http://www.chinadaily.com.cn/china/2008-09/12/content_7020656.htm (January 12, 2009); and "Major Foreign Holders of Treasury Securities," U.S. Department of the Treasury, December 15, 2008, at <http://www.ustreas.gov/tic/mfh.txt> (January 12, 2009).
12. China Investment Corporation Profile, "SWF Institute," 2008, at <http://www.swfinstitute.org/fund/cic.php> (January 12, 2009).
13. Dow Jones, "UPDATE: SAFE Steadily Building Stakes in UK—Thomson Reuters," EasyBourse, September 12, 2008, at <http://www.easybourse.com/bourse-actualite/rio-tinto/update-safe-steadily-building-stakes-in-uk-thomson-reuters-GB0007188757-520396> (January 23, 2009). SAFE is also an active seller in London.
14. "Two Major China Banks Plan Overseas Listing," *People's Daily*, January 30, 2004, at http://english.peopledaily.com.cn/200401/30/eng20040130_133536.shtml (January 12, 2009).
15. "PBoC Refunds Reserve Rate Cut in RMB, Not in USD," *ChinaStakes*, October 11, 2008, at <http://www.chinastakes.com/story.aspx?id=719> (January 12, 2009).
16. Brad Setzer, "How to Handle a Couple of Trillion," *China Economic Quarterly*, Q3 2008. It may be that reserve growth at state banks will slow considerably now that the reserve ratio was cut to stimulate China's economy.
17. "China's Sovereign Wealth Fund," Congressional Research Service Report to Congress, January 22, 2008, at <http://www.fas.org/sgp/crs/row/RL34337.pdf> (January 12, 2009). As of last disclosing, CIC holds about \$105 billion. Given that domestic banks are already swimming in foreign money, it is possible that a transfer back to CIC could occur.

cially, China Development Bank.¹⁹ These have invested a comparable amount to CIC—though over a longer period—in Africa, the Middle East, and elsewhere searching for energy and metal ores.²⁰ Their acquisitions are transparent, or at least visible, but sometimes made on a non-commercial basis because the firms are instruments of national strategy.

CIC is widely designated as a sovereign fund. SAFE is increasingly, and properly, recognized as a sovereign fund. State-owned banks are tightly connected to CIC in administrative structure and have behaved similarly to SAFE. The major investors among state-owned firms, such as China's oil giants, are tightly held. It is a diverse set of names making China's purchases overseas, but they are all very closely related. As such, Chinese foreign investment is best understood as almost entirely sovereign.

What China Invests In

It is also an error to view China's foreign investment through the lens of a few controversial events, such as China National Offshore Oil Corporation's (CNOOC) failed attempt to buy Union Oil Company of California (UNOCAL).²¹ In particular, while equities and direct investment receive most of the attention, the core of China's foreign investment consists of American government securities.

Over half of SAFE's holdings appear to be official American debt, both treasuries and agency debt, such as bonds issued by Freddie Mac. As of September 2008, China was the largest holder of U.S. treasuries at approximately 6 percent of the total. SAFE began moving into U.S. agency debt in 2003 when China's foreign reserves began to mushroom.²² For currency balancing, it holds official European and Japanese debt as well. There is corporate debt of many national stripes.

The composition of state banks' holdings has been obscured by SAFE's larger investments. Some banks have disclosed small positions in troubled institutions and companies, such as Fannie Mae or Lehman Brothers, but there is no external public auditing of their true exposure. In the aftermath of the financial crisis, at least, the political relationship between state sector and central government makes it likely that in 2009 the state will purchase U.S. treasuries almost exclusively. As for CIC, the financial crisis did reveal a multi-billion dollar placement with an American money market fund that likely reflects much more money placed by all Chinese institutions.²³

Beyond bonds, SAFE now also capitalizes foreign investment funds and buys equity stakes in individual foreign entities, such as British Petroleum. CIC

18. Bill Powell, "Sovereign Wealth Funds to the Rescue?" *Time*, December 6, 2007, at http://www.time.com/time/magazine/article/0,9171,1691617,00.html?iid=digg_share (January 12, 2009).
19. China Development Bank's major individual outlay was \$3 billion for 3.1 percent of Barclay's. It then spent an additional \$250 million to retain that stake in the midst of a Barclay's rights offering. Oddly, China Development Bank is being permitted to restructure as a share-holding, ostensibly commercial, entity, while retaining its explicit policy function. See Graeme Wearden, "China Takes £1.5bn Stake in Barclays," *The Guardian*, July 23, 2007, at <http://www.guardian.co.uk/business/2007/jul/23/china.internationalnews> (January 12, 2009).
20. "CNPC Beats Out Seven Companies for Niger's Agadem Block," IHS, June 9, 2008, at <http://energy.ihs.com/News/WW-News/news-2008/cnpc-beats-out-seven-companies-for-nigers-gadem-block.htm> (January 12, 2009); "China Metallurgical Group Intends to Construct Integrated Steel Plant in Philippines," *China Real News*, June 24, 2008, at <http://chinarealnews.typepad.com/chinarealnews/2008/06/china-metallurgical-group-intends-to-construct-integrated-steel-plant-in-philippines.html> (January 12, 2009); and "China Nonferrous to Co-Build Iran Alumina Project," *China Mining*, October 11, 2007, at <http://www.chinamining.org/Investment/2007-10-11/1192082237d7383.html> (January 12, 2009).
21. Ben White, "Chinese Drop Bid to Buy U.S. Oil Firm," *The Washington Post*, August 3, 2005, at <http://www.washingtonpost.com/wp-dyn/content/article/2005/08/02/AR2005080200404.html> (January 12, 2009).
22. U.S. Department of the Treasury, "Report on Foreign Portfolio Holdings of U.S. Securities, as of June 30, 2007," Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, April 2008, at <http://www.ustreas.gov/tic/shl2007r.pdf> (January 12, 2009); and "Major Foreign Holders of Treasury Securities," U.S. Department of the Treasury, at <http://www.ustreas.gov/tic/mfh.txt> (January 12, 2009).
23. According to SEC filings, CIC has placed US\$11 billion in U.S. money market funds. Martin Zhou and Daniel Ren, "CIC's US \$5.4b Investment Frozen," *South China Morning Post*, October 14, 2008.

does, too, though so far not very adeptly.²⁴ Acquisitions of both equity stakes and physical assets by state-owned enterprises range widely and geographically and in terms of sectors.

State banks have made a few discrete equities investments and also operate through a government-controlled program for foreign equities investment by commercial entities.²⁵ Approved Chinese institutions apply to act as mutual funds in the U.S., as well as in Britain, Hong Kong, Japan, Korea, and Singapore. Less than one-third of the \$42 billion authorized under this program has been invested.²⁶ But regulators have worked to jump start the program and, when global stocks recover from the current crunch, Chinese institutional investors could quickly become major players.

The principal concern with respect to the large investment in bonds is that it may stop or even unwind. The concern over the much smaller investment in equities and physical assets is that it will continue and intensify. This is partly because such investment has been concentrated in the sensitive areas of energy, finance, and metals.

Metals, not energy, have been the leading target for Chinese investment, with nearly \$43 billion committed in less than five years.²⁷ China's all-time biggest foreign non-bond investment was made by

Aluminum Corporation of China, spending \$12.8 billion—with partner Alcoa spending \$1.2 billion—for 12 percent of multinational mining company Rio Tinto.²⁸ While aluminum is important, iron and steel are the main focus, as with Minmetals and Xinxing Iron's planned venture with India's Kelachandra and Manasara to produce 6 million tons of iron pellets annually and build a 2.5 million ton steel mill in Karnataka, India, for \$2.2 billion.²⁹

The PRC has committed approximately \$40 billion to purchase energy assets of various types.³⁰ It may be surprising that energy is not the principal target, but the number of energy acquisitions peaked in 2006, and then tapered off somewhat as the cost of assets mounted. If pre-2005 transactions were included, energy would be the largest sector for China's foreign investment. And more energy investment emerged in the third quarter of 2008 when crude prices dropped from their peak.

Government arms and state firms have spent the money all over the globe. In May 2006, China Petroleum and Chemical Corporation (Sinopec) paid nearly \$700 million for control of three Angolan oil blocks. In April 2008, SAFE paid \$2.8 billion for 1.6 percent of the French oil and gas company Total.³¹ The sum goes higher if agreements to construct power plants and aid for power distribution

24. "CIC Suffers Huge Loss from Holding of Blackstone," *TradingMarkets.com*, February 18, 2008, at <http://www.tradingmarkets.com/site/news/Stock%20News/1106606> (January 12, 2009).

25. George Chen and Marius Bosch, "ICBC to Buy Standard Bank Stake," *Reuters*, October 25, 2007, at <http://www.reuters.com/article/innovationNews/idUSSHA11075020071025> (January 12, 2009).

26. George Chen and Kim Yeon-hee, "South Korea Says to Draw China Funds Under QDII," *Forbes*, August 25, 2008, at <http://www.forbes.com/afxnews/limited/feeds/afx/2008/08/25/afx5353100.html> (January 12, 2009); and "QDII Quotas Reach \$42bn," *China Economic Review*, November 5, 2008, at http://www.chinaeconomicreview.com/dailybriefing/2007_11_05/QDII_quotas_reach_42bn.html (January 12, 2009).

27. All sector estimates are on the low side, because the sector magnitudes of \$16 billion in SAFE investment in British stocks cannot be fully determined and have been excluded.

28. Simon Kennedy, "Rio Tinto Surges as Chinalco, Alcoa Get Big Stake," *MarketWatch*, February 1, 2008, at <http://www.marketwatch.com/news/story/rio-tinto-stock-surges-after/story.aspx?guid=%7BE2D65EF1-5DD4-4A19-82A3-941FD207C29B%7D> (January 12, 2009).

29. "India-China Steel JV to Invest Rs 8,735 Crore," *Deccan Herald*, February 28, 2008, at <http://www.deccanherald.com/Content/Feb282008/business2008022754570.asp> (January 12, 2009).

30. Several of the energy transactions in the Heritage dataset were provided by Wojtek Wolfe. See Wojtek M. Wolfe and Brock F. Tessman, "The Geopolitics of China's Energy Trade: A Method of Soft Balancing against the United States?" Meetings of the International Studies Association, 2008.

31. "Sinopec Deepens Oil Interests in Angola," *China Daily*, June 13, 2006, at http://www.chinadaily.com.cn/china/2006-06/13/content_616030.htm (January 23, 2009); and "China Fund Takes \$2.8 Billion Stake in France's Total: FT," *Reuters*.

in awards of these kinds as well as outright power investment in the past four years, highlighted by State Grid Corporation of China's participation in a consortium that won a 25-year, \$4 billion award to operate the Filipino power grid.³²

The leading sector in drawing contracts, however, is transport and logistics, featuring port management and highway construction. Investment in the sector stands at only \$1.5 billion, but more than \$16 billion in large engineering and construction contracts was inked from January 2005 to September 2008.

Most relevant to the global financial crisis, more than \$25 billion was committed in finance, all from May 2007 through the third quarter of 2008.³³ In addition to the stakes taken in Morgan Stanley and Blackstone by CIC, SAFE contributed \$2.5 billion to a fund created by Texas Pacific. The largest single transaction was outside the U.S.: Industrial and Commercial Bank's \$5.5 billion purchase of 20 percent of Standard Bank of South Africa, with an eye on financing China's activities on the continent.³⁴

Principal Sectors (Billions of Dollars)

	Investment	Construction and engineering contracts
Metals	\$42.9	\$4.6
Energy	39.1	0.6
Finance	26.4	0.0
Power	3.2	7.9
Technology	2.5	0.0
Transport	1.5	16.6

Source: Heritage Foundation dataset, China's Outward Investment: Non-bond Transactions over \$100 million, 2005–2008 (excluding Hong Kong), available upon request from The Heritage Foundation.

Table 2 • B 2237  heritage.org

How Much Is China Investing?

Addressing what China is acquiring naturally extends to how much it is spending. Available data provide only a partial answer. We know that China's acquisition of overseas assets using accu-

32. Karen Lema, "UPDATE 4-China State Grid Group Wins Philippine Power Auction," Reuters, December 12, 2007, at <http://uk.reuters.com/article/oilRpt/idUKMAN22547220071212> (January 11, 2009). Though not investment, large contracts of this kind, perhaps financed by participating Chinese firms or a PRC government body, are a major component of "going out." From the beginning of 2005 to the middle of 2008, the PRC inked 18 large contracts with a combined value of over \$30 billion.
33. Numbers on non-bond investment are taken from an ongoing Heritage dataset for large, non-bond investment transactions from 2005 and presently running through the third quarter of 2008. The dataset excludes Hong Kong and other offshore destinations and individual outlays smaller than \$100 million. It also excludes some publicly announced investments for which reliable information cannot be found in Iran, Sudan, the Russian Federation, and several other countries. It includes the value of construction and engineering contracts executed inside target countries, but not supply contracts or any contract involving trade or trade credits. Both the Heritage dataset and official Chinese data on outward investment include loan financing, which made up the majority of Chinese non-bond investment before 2007. "China's Outward Investment Ranked 13th in the World in 2006," Path to China, September 2007, at <http://www.pathtochina.com/chinabiz/2007/09/chinas-outward-investment-ranked-13th-in-the-world-in-2006/> (January 11, 2009). Large Chinese loans were almost always made in direct connection to access to foreign minerals and usually on such (final) concessionary terms they are effectively grants. From 2005 through the third quarter of 2008, 80 transactions in 42 countries are presently included in the dataset.
34. George Chen, "RPT-UPDATE 2-China's CIC to Launch \$4 bln Fund with JC Flowers," Reuters, April 3, 2008, at <http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSN0328781920080403> (January 12, 2009); "China to Invest \$2.5 Billion in TPG's Latest Fund: Report," *San Francisco Business Times*, June 11, 2008, at <http://www.bizjournals.com/sanfrancisco/stories/2008/06/09/daily30.html> (January 12, 2009); "ICBC Buys Up 20pc of Standard Bank (South Africa)," Industrial and Commercial Bank of China, October 29, 2007, at http://www.icbc.com.cn/e_detail.jsp?column=ICBC+NEWS&infoid=1193625041100&infotype=CMS.STD (January 12, 2009); "Ping An Buys Stake in Fortis for \$2.7 Billion," Reuters, November 29, 2007, at <http://www.iht.com/articles/2007/11/29/business/insure.php> (January 12, 2009); and Michael J. de la Merced and Keith Bradsher, "Morgan Stanley to Sell Stake to China Amid Loss," *The New York Times*, December 9, 2007, at <http://www.nytimes.com/2007/12/19/business/19cnd-morgan.html?ex=1355720400&en=367dea436a4bcc70&ei=5088&partner=rssnyt&emc=rss> (January 12, 2009).

mulated foreign currency, though extremely large, is far from the largest in the world.

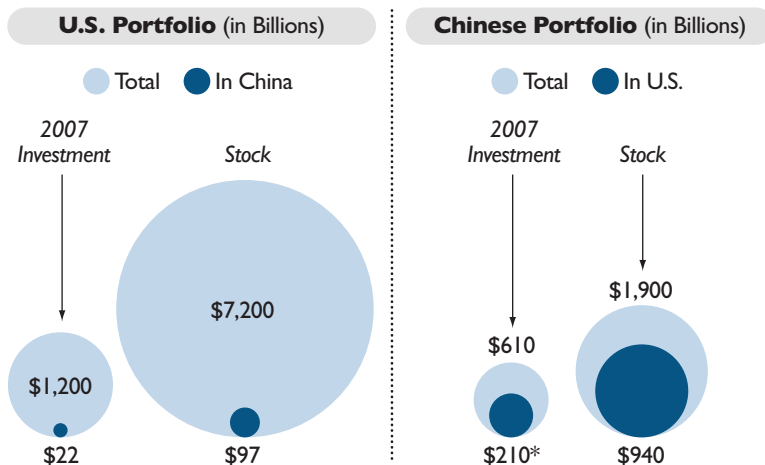
U.S. portfolio holdings overseas stood at \$7.2 trillion at the end of 2007, having expanded by \$1.2 trillion in 2007 alone.³⁵ In comparison, China's official reserves stood at \$1.53 trillion in 2007, or less than one-fourth of the U.S. total. Official reserves increased by \$460 billion in 2007. In addition, foreign currency holdings in the hands of CIC and state banks rose by as much as \$160 billion.³⁶ Combined with official reserves, that is still only about half of American investment for 2007.

A relatively small proportion of foreign currency is held for any length of time as actual cash. Much, perhaps even most, of China's reserves are held in U.S. bonds. With so much money on the move, China's bond positions are fluid.

Chinese U.S. Treasury bond holdings were \$585 billion at the end of September 2008, and holdings of U.S. agency debt were approximately \$447 billion at the end of June.³⁷ Treasuries are more closely watched but, as foreign money has poured into China from trade and investment, return purchases of U.S. agency debt soared. Investment categories also include corporate bonds and positions in the money market. Chinese holdings of these types in the U.S. were probably less than \$100 billion combined at the end of June.³⁸

How the U.S. and China Have Invested in Each Other

The U.S. has invested heavily in international corporations. Its stock holdings are currently valued at \$7.2 trillion, but only a small portion has been directed to Chinese companies. Conversely, China has placed a significant portion of its investments in U.S. companies.



* Chinese investment in the U.S. is understated due to use of offshore investment centers.

Sources: U.S. Department of the Treasury, Federal Reserve Bank of New York, and Board of Governors of the Federal Reserve System, "Report on U.S. Portfolio Holdings of Foreign Securities as of December 31, 2007," at <http://www.ustreas.gov/tic/shc2007r.pdf> (November 7, 2008); U.S. Department of the Treasury, Federal Reserve Bank of New York, and Board of Governors of the Federal Reserve System, "Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2007," at <http://www.ustreas.gov/tic/shi2007r.pdf> (November 7, 2008); Brad Setzer, "How to Handle a Couple of Trillion," *China Economic Quarterly*, September 2008; State Administration of Foreign Exchange, China's International Investment Position for year-end 2007, at http://www.safe.gov.cn/model_safe_en/news_en/new_detail_en.jsp?ID=3010000000000000,176&type=&id=2 (November 7, 2008).

Chart I • B 2237 heritage.org

China is officially the largest foreign bond investor in the U.S., passing Japan. Total Chinese holdings of bonds and similar securities are over \$1.1 trillion. In the current environment, this is less than two years' worth of U.S. government bond issues. It does understate the true amount,

35. "Report on U.S. Portfolio Holdings of Foreign Securities, as of December 31, 2007," U.S. Department of the Treasury, October 2008, at <http://www.ustreas.gov/tic/shc2007r.pdf> (January 12, 2009).
 36. Setzer, "How to Handle a Couple of Trillion." Illustrating the problem with Chinese data, SAFE puts outward portfolio investment beyond official reserves only \$11 billion higher in 2007, but "other investment" \$150 billion higher, led by a \$100 billion increase in "other assets." China's International Investment Position, SAFE, at http://www.safe.gov.cn/model_safe_en/tjsj_en/tjsj_detail_en.jsp?ID=3030700000000000,1&id=4 (December 10, 2008).
 37. "China May Cut Its Dollar Holdings—CICC," *China Daily*, September 12, 2008, at http://www.chinadaily.com.cn/china/2008-09/12/content_7020656.htm (January 12, 2009).
 38. Extrapolation from "Report on Foreign Portfolio Holdings of U.S. Securities, as of June 30, 2007," Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, April 2008.

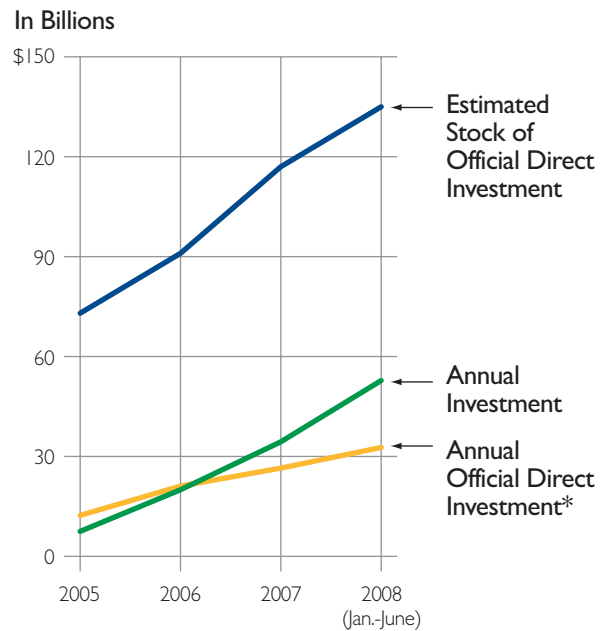
since some investment attributed to offshore sources, such as the Caymans, is Chinese in origin. In the third quarter of 2008, agency debt, corporate debt, and money market positions all likely fell in value as a result of the financial crisis, and growth in the value of China's reserves slowed, but Chinese purchases of U.S. treasuries increased. The Chinese bond market is extremely immature, and American bond holdings in the PRC are scarcely one-tenth of 1 percent the size of total Chinese holdings in the U.S.³⁹

Non-bond Investment. The value of Chinese investment in U.S. equities in mid-2007 was \$29 billion and may not have increased from that point, despite fresh investment, given the magnitude of stock losses. This is a negligible amount of the U.S. equities market. It is also minor in comparison to the U.S. equity position in China. U.S. holdings of Chinese stocks were estimated at \$96 billion, 2 percent of market capitalization, at the end of 2007.⁴⁰ It is worth noting, however, that China could become the dominant foreign player in U.S. stocks by shifting a portion of its bond investment.

What China calls outward investment is the focus of a great deal of foreign attention. Official data are not particularly reliable, especially when first issued. They are categorized into non-financial investment and financial investment, where the former is subject to major revisions and the latter is irregularly reported and invariably seems far too small.⁴¹

China's outward non-bond investment almost doubled in 2004, officially, but there is scant public information to verify that claim, much less earlier figures. Chinese foreign investment as a global phenomenon, not only aimed at a very small group of countries, was first recognized in 2005. It soared further in 2006, and then flattened out somewhat in 2007 at a level roughly 5 percent of the size of outward bond investment. By the end of 2007,

China's Non-Bond Investment



* 2008 figure excludes financial investment, which has not yet been released.

Sources: Heritage Foundation dataset, China's Outward Investment: Non-bond Transactions over \$100 million, 2005–2008 (excluding Hong Kong), available upon request from The Heritage Foundation; Hang Seng Bank, "Mainland China's Overseas Investment Escalating," Hong Kong Trade Development Council, February 5, 2008, at <http://info.hktdc.com/econforum/hsb/hsb080205.htm> (December 22, 2008); "China's Overseas Investments More than Double in First Half: Govt," Agence France-Presse, July 23, 2008, at <http://afp.google.com/article/ALeqM5gv8Gifdvv09Q7RITM4jUjSWpjkQA> (December 22, 2008); "Overseas Non-Financial Investment Rises 6%," China Daily April 23, 2008, at http://e.cnici.gov.cn/doce/news/news_detail.aspx?news_id=4455 (December 22, 2008); Chinanews.com, "2006 China Net Outward Investment Ranked the 13th in the World," Ministry of Commerce, September 19, 2007, at <http://gjs2.mofcom.gov.cn/aarticle/workaffair/200709/20070905110550.html> (December 22, 2008); Xinhua Financial News (Asia), "China 2007 Direct Investment Overseas Up 25.3 Pct at 26.51 Bln USD," Forbes, September 17, 2008, at <http://www.forbes.com/afxnews/limited/feeds/afx/2008/09/16/afx5434496.html> (December 22, 2008); Liu Li and Victoria Ruan, "China Vice Min: Yuan Has Great Potential To Rise," Alibaba, November 17, 2008, at <http://news.alibaba.com/article/detail/china/100023043-1-update%253A-china-vice-min%253A-yuan.html> (December 22, 2008).

Chart 2 • B 2237  heritage.org

39. "Report on U.S. Portfolio Holdings of Foreign Securities, as of December 31, 2007," U.S. Department of the Treasury.

40. "Major Foreign Holders of Treasury Securities," U.S. Department of the Treasury; "Report on Foreign Portfolio Holdings of U.S. Securities, as of June 30, 2007," Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York; "Report on U.S. Portfolio Holdings of Foreign Securities, as of December 31, 2007," U.S. Department of the Treasury; and U.S. Department of the Treasury, "Historical Data," Treasury International Capital System, at <http://www.treas.gov/tic/shlhistdat.html> (January 22, 2008).

excluding bonds, China had invested as much as \$117 billion overseas, whereby 7,000 domestic entities established 12,000 subsidiaries in 172 countries or customs zones.⁴² In the first three quarters of 2008, official Chinese investment easily surpassed the 2007 total.⁴³

Despite the leap in 2008, official figures do not appear to have kept up with the pace of activity of the past two years and may again be revised far upward.⁴³ For 2005 to 2007, the Heritage dataset is expected to generate smaller totals than Chinese data. And total investment is smaller in 2005. By 2007, however, the Heritage figure shoots past the official number. The gap then widens considerably in the first three quarters of 2008.⁴⁴

From 2005 through the third quarter of 2008, Chinese data show \$93 billion in outward investment. The Heritage total is \$120 billion. If our data are more accurate—they could be more accurate while still not being particularly precise—the stock of all Chinese outward investment at the end of September 2008 may have approached \$160 billion. In the third quarter, the bulk of the investment was in oil, signaling a return to that market in light of better valuations. The financial crisis deterred activity in the fourth quarter and may do so as well into 2009. In comparison, American direct investment overseas was many times higher at \$314 billion in 2007, with accumulated stock at \$2.8 trillion.

Finally, U.S. direct investment in China itself was \$6 billion in 2007, with accumulated stock of \$28.3 billion.⁴⁵ There is no official Chinese figure for direct investment in the U.S., and American figures, using a different definition, show it as negligible.⁴⁶ Following Chinese practice in surveying foreign investment, 2007 was the most active year yet for Chinese spending in the U.S. At the end of 2007, the stock of Chinese non-bond investment in the United States was almost certainly much smaller than U.S. non-bond investment in the PRC, but it is now conceivable this can change.

Where Is China Investing?

Of particular interest in international affairs is where China is spending. SAFE's lack of transparency in particular and the growing role of offshore financial centers undermine the value of Chinese figures. It is clear that the PRC's bond investment is heavily focused on the U.S., but less clear how much has been invested, on a final basis, in other markets. Reported Chinese investment in Japan is much, much smaller than in the U.S., at \$65.6 billion at the end of June 2008.⁴⁷ The same applies to other major investment targets, such as Germany, where reported Chinese investment is much smaller than in the U.S., even granted that it is understated in light of routing through offshore centers.

While bond investment is clouded, the Heritage dataset provides additional information on

41. In 2007, Chinese non-financial investment was originally estimated at \$18.7 billion, then climbed to \$24.8 billion. Jiang Wei, "Non-Financial Investment Rises 6%," *China Daily*, April 23, 2008, at http://www.chinadaily.com.cn/china/2008-04/23/content_6636423.htm (January 12, 2009). In comparison, non-financial investment was only \$1.7 billion, officially.

42. Wei, "Overseas Non-Financial Investment Rises 6%."

43. One reason for the disparities may be that it is not clear SAFE's recent non-bond investments are counted in official totals. Nor is it clear CIC's activities are counted. In any case, the Ministry of Commerce clearly struggles to catalog rapidly growing investment in a timely fashion. Not only the size, but the raw number of large transactions jumped in 2007, and then again in 2008.

44. A major source of discrepancy is that the Heritage dataset uses corporate announcements to fix the time of the investment, so some of the 2008 money Heritage includes was certainly not yet spent. On the other hand, Heritage is unable to fix times for and, therefore, excludes acknowledged SAFE investments in British stocks in the several billions of dollars in 2008. And the Ministry of Commerce is admittedly late in counting outward investment. The smaller Heritage figure for 2005 is likely explained by the preponderance of investments smaller than \$100 million, which are excluded. All data are affected by an increasing tendency by both China and its partners to exaggerate Chinese investment.

45. U.S. Department of Commerce, Bureau of Economic Analysis, International Economic Accounts, "U.S Direct Investment Abroad," 2004–2007, at <http://www.bea.gov/international/datatables/usdctry/usdctry.htm> (January 12, 2009). The considerable differences in definition hardly explain the difference in size.

46. U.S. Department of the Treasury, "Historical Data."

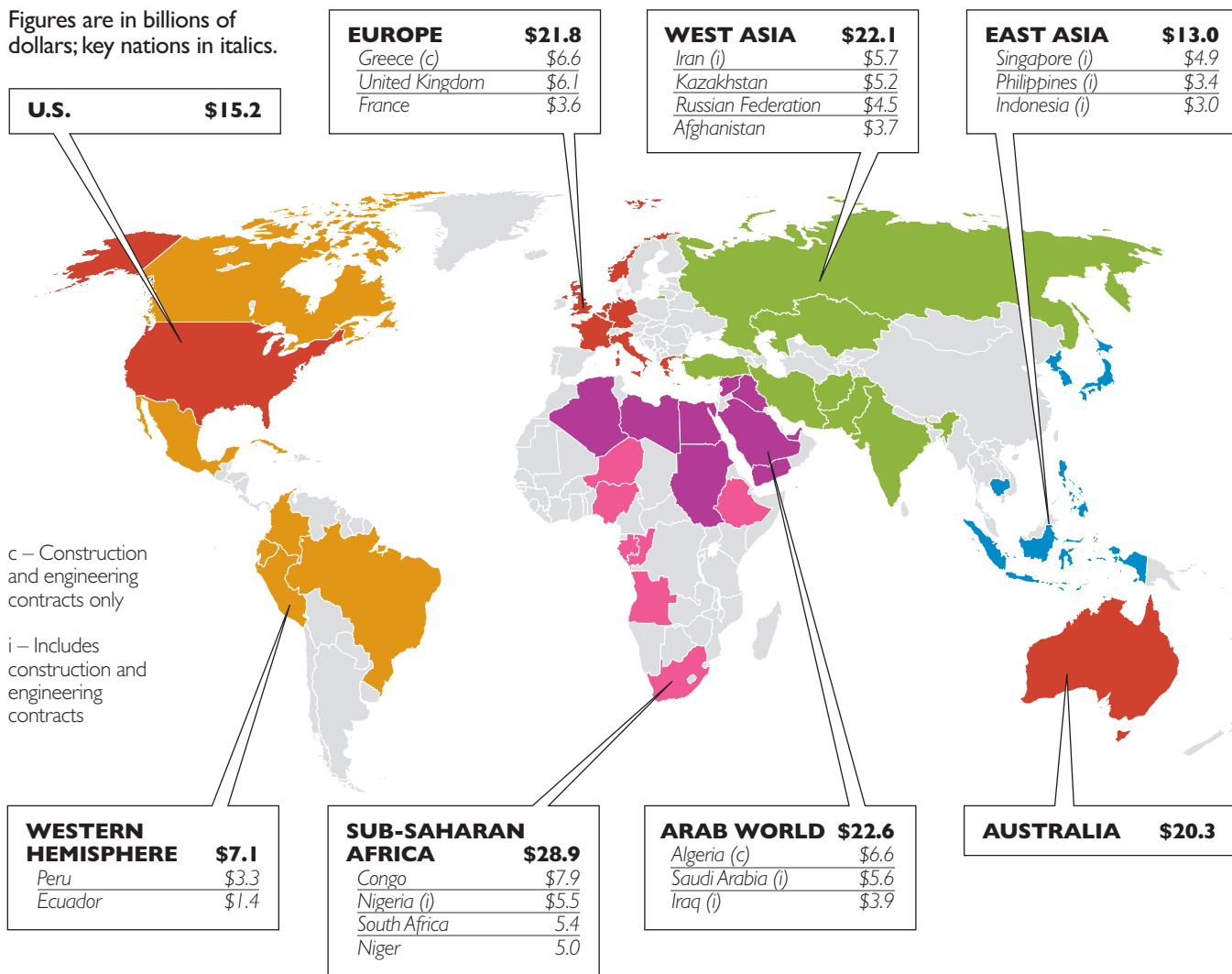
China's global investment in equities, direct investment in physical assets, and large-scale engineering and construction work. Equity stakes are naturally concentrated in more developed econ-

omies where attractive companies are based.⁴⁸ Direct acquisition of physical assets and major contracts are widely distributed. The expansion of Chinese business into Africa and the Middle East

Worldwide Non-Bond Investment, 2005–Q3 2008

The United States is second only to Australia in worldwide non-bond investment.

Figures are in billions of dollars; key nations in italics.



Source: Heritage Foundation dataset, China's Outward Investment: Non-bond Transactions over \$100 million, 2005–2008 (excluding Hong Kong), available upon request from The Heritage Foundation.

Map 1 • B 2237 heritage.org

47. Most of this is in equities and not disclosed publicly because stakes in individual companies are small. The true number is higher again due to the use of offshore investment sites. "Appendix: Outward/Inward Portfolio Investment (Excl. Securities Lending)," Bank of Japan, December 8, 2008, at <http://www.boj.or.jp/en/theme/research/stat/bop/bop/dlong/fuhyo2/> (January 12, 2009)

has received attention, but Australia is the single largest investment target.⁴⁹

Chinese non-bond investment in the U.S. through the third quarter of 2008 features 11 large transactions involving more than \$15 billion, chiefly overpayment for financial partnerships such as SAFE providing \$2.5 billion in capitalization to a fund created by TPG (the former Texas-Pacific Group).⁵⁰ While this is trivial compared to the size of the American financial sector, the first large investment did not occur until May 2007. There have also been smaller technology investments, such as Wuxi PharmaTech buying AppTec Lab Services for \$150 million. The rest of the Western Hemisphere drew only \$7 billion, chiefly to buy Canadian-owned assets in Latin America.⁵¹

The United States is not the largest target of Chinese non-bond investment. That honor goes to Australia. The Heritage dataset contains transactions worth over \$20 billion, spearheaded by the \$12.8 billion from Chalco. There were also several billion dollars in large transactions from 2003 to 2004. The trend is steeply upward. The value of Chinese applications to the Australian Foreign Investment Review Board between November 2007 and June 2008 exceeded \$28 billion, compared to a total of \$8.5 billion in fiscal years 2006 and 2007 combined.⁵²

East Asia saw transactions valued at \$13 billion, including more than \$6 billion in engineering contracts, led by Singapore, which is also a leading site for small-scale Chinese equities purchases. West Asia, including Iran, the Russian Federation, and the Indian subcontinent attracted over \$22 billion in investment, chiefly in energy.

Surprisingly, the Arab world drew only \$7 billion in investment but, tellingly, twice that in large engi-

neering and construction contracts. Even the latter did not emphasize energy, but transport. Some of the clamor over China's acquisition of energy assets is misplaced.

On the other hand, sub-Saharan Africa has received considerable attention as an outlet for Chinese investment and it drew \$25 billion, led by the Democratic Republic of Congo and Nigeria. This number may be something of an understatement, since the 2005 start for the dataset neglects considerable Chinese investment in Sudan. Details on the investments are especially difficult to obtain and recent dollar figures may be inflated for political reasons as the amounts simply cannot be spent at present. In addition, a larger portion of outlays than elsewhere is attributable to concessionary loan financing.

Europe received \$15 billion in Chinese investment as well as a very large port development contract in Greece. In addition, hidden investments in Britain have recently been uncovered. The Heritage dataset identifies only five large transactions valued at \$6 billion in the United Kingdom, led by policy lender China Development Bank. However, local media in September discovered small stakes accumulated by SAFE in more than 50 British companies. The total value of SAFE's stakes was calculated at more than \$16 billion.⁵³

Why Not More?

The trend clearly points to additional large sums of Chinese foreign bond investment and more explosive growth in Chinese foreign non-bond investment. The trend may very well continue, but there are powerful forces gathering in opposition, especially to the non-bond investment.

48. "Ping An Buys Stake in Fortis for \$2.7 Billion," Reuters.

49. Heritage location data is based on where the asset being acquired is located, rather than where the company owning the asset is headquartered. Note that we again exclude Hong Kong.

50. "China's Safe Invests \$2.5B in TPG Fund," *The Deal*, June 11, 2008, at http://www.thedeal.com/dealscape/2008/06/chinas_safe_invests_25_billion.php (January 12, 2009).

51. "China Minmetals/Jiangxi Copper to Acquire Northern Peru Copper Corp for C\$13.75 Per Share in Cash," *MarketWire*, December 6, 2007, at <http://www.marketwire.com/press-release/Northern-Peru-Copper-Corp-TSX-NOC-800240.html> (January 12, 2009).

52. Graeme Dobell, "China Investment: Confusion and Uncertainty," *The Interpreter*, September 5, 2008, at <http://www.lowyinterpreter.org/post/2008/09/Chinese-investment-Confusion-and-uncertainty.aspx> (January 12, 2009).

Auxiliary to the Heritage dataset of large non-bond transactions from 2005 is a series of troubled or failed transactions initially agreed to by the principals. These began to emerge in higher quantities, at least publicly, in July 2006 and have steadily increased since. This is partly a function of more attempts naturally breeding more failures and partly a function of greater attention paid to Chinese investment. Related to that, however, is increasing opposition outside and inside the PRC to China's "going out."

Twenty-eight such troubled or failed transactions are identified since the start of 2005 involving more than \$100 billion. Certain deals appear on both lists of completed and troubled transactions, but the value of whole and partial transactions lost make it clear that China's outward tilt could have been significantly greater. By country, Australia demonstrates its acceptance of Chinese business by appearing far down this list despite being the single largest recipient of foreign Chinese non-bond investment. The American political roadblock to the CNOOC–Unocal deal in 2005 assures the U.S. the position of the most reluctant investment partner.

By sector, two investments made by CNOOC totaling \$34 billion, the second in Iran, have been effectively blocked by the U.S., skewing some of the numbers. Blocked energy investments total \$38.3 billion, all of them from July 2005 to June 2007. In contrast, nearly all of the \$30 billion in troubled financial investment occurred in 2008. The results help explain the general perception that it is energy and finance where China is most rapidly acquiring assets.

Foreign Barriers. One of the most obvious factors in the international resistance to China's foreign

The Unwelcome Mat

Country/Region	Value of Failed Deals
United States	\$27.5 billion
European Union	\$24.6 billion
Iran	\$16.0 billion
Nigeria	\$10.6 billion
Philippines	\$5.9 billion
Australia	\$4.8 billion

Notes: The Iran figure reflects one contract with CNOOC with which the latter has refused to proceed due to fear of U.S. sanctions. It is exaggerated because CNOOC has gone ahead with alternate but undisclosed commercial arrangements with Iran. The Nigerian entry is also a single contract.

Source: Heritage Foundation dataset, China's Outward Investment: Non-bond Transactions over \$100 million, 2005–2008 (excluding Hong Kong), available upon request from The Heritage Foundation.

Table 3 • B 2237 heritage.org

investment is the absence of reciprocity. Beijing has labeled the bulk of its economy as essentially off-limits.⁵⁴ One of the principal benefits of Chinese investment overseas is the incentive it can provide to the PRC to integrate further into the world economy, including more foreign access to its own markets. There are already examples of effective swaps in market access. Small American specialty bank UCBH won access to the Chinese market in part by selling a stake to Mingsheng Bank.⁵⁵ China Construction Bank's purchase of Bank of America's Hong Kong unit occurred after the two established a relationship through Bank of America's purchase of Construction Bank stock.

The principal reason why China's outward steps are blocked is foreign suspicion; the principal reason for that suspicion is the PRC's lack of transpar-

53. "Secret Investments Reveal China's Stealthy Advance Into UK Plc," *The Telegraph*, September 22, 2008, at <http://www.telegraph.co.uk/finance/economics/2795787/Secret-investments-reveal-China-s-stealthy-advance-into-UK-Plc.html> (January 12, 2009). SAFE's acquisitions feature transactions not counted in our dataset because comparable information for other countries is not available. For a list of small transactions, see "SAFE Investments in UK-Listed Companies," *The Financial Times*, September 12, 2008, at http://www.ft.com/cms/s/0/8b39a890-8011-11dd-99a9-000077b07658,dwp_uuid=f6e7043e-6d68-11da-a4df-0000779e2340.html (January 12, 2009).
54. Scissors, "U.S.–China Economic Dialogue."
55. "Bank of America Doubles Down on China Construction Bank," *International Herald Tribune*, November 17, 2008, at <http://www.ihrt.com/articles/2008/11/17/business/17bank.php> (January 12, 2009); and Keith Bradsher, "Chinese Bank Is Buying Some Bank of America Branches," *The New York Times*, August 25, 2006, at <http://www.nytimes.com/2006/08/25/business/worldbusiness/25bank.html?n=Top/News/World/Countries%20and%20Territories/China> (January 12, 2009).

ency. The biggest culprit is SAFE. It holds far more foreign exchange than all other Chinese players combined, yet has fought the commitment to disclosure which at least has been offered by CIC. For their part, state banks and state firms have disclosure requirements connected to being public entities. In the case of entities listed only in Shanghai, these requirements are not ideal. However, they are still infinitely better than SAFE's disclosure requirement, which is presently non-existent.

When SAFE restricted its activities to the U.S. treasury market, its reticence was less important than its wallet. Now that it is buying a growing number of equity stakes, that may no longer be true. This goes well beyond the United States. SAFE declined to even acknowledge the arm used to take the dozens of positions in London stocks and insisted Costa Rica hide the large bond purchase it made in that country.⁵⁶ To be fair, there are transparency failures in recipient countries, as well. In the U.S., what is said to be off-limits to China is subject to political pressure and thus changes with circumstance, rendering unpleasant the operating environment even for desired Chinese investors.

The U.S. has raised other objections, of course. Private equity investors Bain Capital brought in Chinese telecom company Huawei to participate in its acquisition of 3Com because Huawei had a non-compete clause with 3Com. The U.S. Congress objected, the deal collapsed, and 3Com simply moved its headquarters from the U.S. to China.⁵⁷ Since then, the CFIUS mandate has been altered, featuring new federal government departments, an

expanded scope of inquiry, definition of key terms, and more communication with Congress. For most transactions, these alterations should make for a more transparent and possibly less politicized review process.

In comparison, the top recipient, Australia, has tolerated politically and processed bureaucratically a flood of Chinese investment. Canberra has extended the examination process for new investment applications and acknowledged closer scrutiny of investment by state entities and market share in commodities supply, but that is all.⁵⁸

A caveat: The financial crisis is having a possibly undesired impact. Shougang Steel's stake in Australian iron miner Mount Gibson Iron was originally limited by Australian regulations. As their demand for steel crumbled, key Chinese customers for Mount Gibson's iron defaulted. This left Mount Gibson hurrying back to Shougang to sell the larger stake that was originally denied.⁵⁹ It may be that financial need among Australian firms will cause the Australian government to interfere more often on grounds of national interest.

Chinese Barriers. Even if the world were to ignore issues of reciprocity, transparency, and other matters and welcome Chinese investment with wider arms, the Chinese floodgates may still not open. There are also qualms in Chinese corporate headquarters and, especially, in Beijing about outward investment.

There are high-profile failures, featuring the losses suffered by CIC in Blackstone and Morgan Stanley, but led perhaps by life insurer Ping An's

56. Jason Simpkins, "Beijing Flexes Financial Might to Turn Costa Rica Against Taiwan," *Money Morning*, September 12, 2008, at <http://www.moneymorning.com/2008/09/12/costa-rica-safe> (January 12, 2009); and Ben Harrington, "China Builds Up £9bn Stake in Top British Companies," *The Telegraph*, September 7, 2008, at <http://www.telegraph.co.uk/finance/economics/2795857/China-builds-up-andpound9bn-stake-in-top-British-companies.html> (January 12, 2009).

57. Kevin Drawbaugh, "U.S. Lawmakers Say 3Com-Bain-Huawei Deal a Threat," *Reuters*, October 15, 2007, at <http://www.reuters.com/article/reutersEdge/idUSN1534401720071015> (January 12, 2009).

58. John Garnaut, "Hurdles for Chinese Capital Appear to Make No Sense," *Sydney Morning Herald*, September 8, 2008, at <http://business.smh.com.au/business/hurdles-for-chinese-capital-appear-to-make-no-sense-20080907-4bis.html> (January 12, 2009).

59. Matthew Stevens, "Iron Ore Minnow Mount Gibson Iron is Still Swimming," *The Australian*, November 4, 2008, at http://www.theaustralian.news.com.au/story/0,,24597438-30538,00.html?from=public_rss (January 12, 2009). There are plenty of examples elsewhere, such as the top company China National Petroleum Corporation (CNPC) that sought \$2bn of Rosneft's IPO, but was given only \$500m; "CNPC Invests \$500M in Rosneft's IPO," *Xinhua*, July 19, 2007, at http://www.chinadaily.com.cn/china/2006-07/19/content_644031.htm (January 12, 2009).

futile partnership with the EU's Fortis.⁶⁰ Objections are beyond the financial industry. Chinese electronics giant TCL has had to ward off delisting after overreaching in 2004 in the acquisition of French counterpart Thomson's TV unit.⁶¹ Domestic steelmakers were agitated for months by the multinational BHP Billiton's offer to buy Rio Tinto, but admitted an inability to plan and implement a takeover of that magnitude.⁶²

There would have been more failures if not for vetoes from Beijing. Ping An's plan to buy half of Fortis' asset management arm, for EUR2.15 billion, was blocked. Chinese regulators properly stalled China's CITIC Securities' \$1 billion share swap with now-defunct Bear Stearns.⁶³ A massive deal was scuttled when even policy lender China Development Bank was thwarted in its desire to offer \$13.5 billion for Germany's Dresdner Bank. Indeed, Beijing rejected all large foreign investments in financial institutions for more than six months, well before the current crisis erupted in September 2008.⁶⁴

One solution is to build partnerships between Chinese giants and multinational companies. The fretting over the loss of an independent supplier in Rio Tinto was resolved in part by China Aluminum working with Alcoa to acquire a stake in Rio Tinto. The Chinese may see the alliance as a template for tapping foreign commercial experience, but also for overcoming foreign political opposition.⁶⁵

Perhaps more intractable and dangerous for China is the threat to its outward bond investment. It is well known that inflation-adjusted investments in U.S. government bonds over the period of renminbi appreciation, from July 2005 to July 2008, have lost considerable value.⁶⁶ More salient is that the system that generates the foreign exchange being invested in U.S. bonds requires the People's Bank to sell large amounts of short-term bills. To keep its own costs down, the People's Bank requires state commercial banks to buy these bills at very low yields; it then compensates the banks by keeping (controlled) deposit rates very low. The Chinese government has been losing money at the one end on low U.S. bond yields and Chinese savers are still losing money at the other end on low deposit yields.

Of course there are compelling reasons to maintain outward bond investment. Most important, the outlays result from a system that has kept China's exports price competitive, creating millions of jobs. Also, were the PRC to try to sell its U.S. dollar assets, the dollar would fall, reducing the value of China's foreign reserves.

Nonetheless, the financial crisis has turned a sticky situation into a potentially explosive one. It has been the case that China's own policies were costing the country money and spurring public dissatisfaction while economic development was proceeding apace, more than compensating for the discontent. An extended slowdown could bring a

60. Ping An reported a 15.7 billion yuan loss on a 5 percent stake in EU financial institution Fortis. Ping An invested 23.9 billion yuan in Fortis, part of a drive to become a full-service institution, but Fortis collapsed. Harroten Wolde and Reed Stevenson, "Fortis Scraps Asset Management Deal with Ping An," Reuters, October 1, 2008, at <http://uk.reuters.com/article/idUKLU46925520081001> (January 12, 2009).

61. "TCL to Switch to Own Brand," *China Daily*, June 20, 2007, at http://www.china.org.cn/archive/2007-06/20/content_1214437.htm (January 12, 2009).

62. "Chinese Steelmaker Wants Rio Tinto Takeover Stopped," Agence France-Presse, December 5, 2007.

63. Sameera Anand, "Citic's Close Call with Bear Stearns," *Business Week*, March 19, 2008, at http://www.businessweek.com/globalbiz/content/mar2008/gb20080319_886607.htm?chan=top+news_top+news+index_global+business (January 12, 2009).

64. Gwen Robinson, "Beijing's Caution Scuppered Dresdner Bid," *Financial Times*, September 5, 2008, at <http://ftalphaville.ft.com/blog/2008/09/05/15626/beijings-caution-scuppered-dresdner-bid> (January 12, 2009).

65. Elaine Kurtenbach, "Alcoa, Chalco Buy Rio Tinto Stake," February 1, 2008, at <http://www.ibtimes.com/articles/20080201/alcoa-chalco-buy-rio-tinto-stake.htm> (January 12, 2009).

66. Keith Bradsher, "Main Bank of China Is in Need of Capital," *The New York Times*, September 4, 2008, at <http://www.nytimes.com/2008/09/05/business/worldbusiness/05yuan.html?ref=business> (January 12, 2009). In U.S. bonds, Beijing has invested a large chunk of savings in assets earning 3 percent annually in dollars. Over the past two to three years, returns have been closing on negative 10 percent annually after factoring in inflation and yuan appreciation.

public outcry from Chinese citizens that they are subsidizing America, no matter the non-convertibility of the yuan. China's Communist Party does not have to run for re-election but it is consumed with concern over broad social unrest. As the financial crisis might spur sometimes irrational economic nationalism in the U.S., it might also do so in the PRC.

The Future

The expansion of Chinese foreign investment is, therefore, not inevitable and its form can be shaped. In all cases, it is almost sure that bond investment will be much larger than non-bond investment. Non-bond investment may increase only slowly, but will still sharpen competition for global assets.

Beyond that, reciprocity is crucial. Developed markets will be walled off and competition in the developing world will be politicized if Beijing does not permit greater foreign investment access to Chinese assets. In the worst case, violation by a state firm of American or international sanctions could trigger a sustained economic conflict. In this situation, SAFE would move to diversify away from dollars.

More likely, foreign and Chinese investment will muddle through. The PRC will continue to restrict foreign access, but will enhance the transparency of its outward investment. This would allow for more Chinese acquisition of small stakes in foreign blue chips, among other developments, with foreign control or ownership in China still largely barred.

If transparency is supplemented by reciprocity, Chinese outward investment could take off, especially in non-bond outlays. In the second half of 2008, regulators in the PRC took steps to liberalize outward investment for both enterprises and individuals.⁶⁷ If inward investment is also liberalized sufficiently to impress suspicious foreign partners, Chinese foreign spending could grow to constitute a third wave, following petrodollars in the 1970s and Japanese spending in the 1980s.

Mineral resources will initially predominate, but emergence from the financial crisis and accumulated experience will encourage broader Chinese investment. In particular, if foreign stocks recover before Chinese stocks, Chinese participation in the next international equities rally will be considerable, including, but perhaps not limited to, the existing scheme for Chinese institutional investors.

A drawback to the liberalization scenario is that competition for financial and physical assets will increase, boosting asset prices. American policymakers face acknowledged costs in attempting to properly manage China's entry into the global economy on free market principles. An attempt to foil that entry, however, would be far more costly.

What the United States Should Do

- The Department of the Treasury and U.S. Trade Representative (USTR) should insist during global talks that SAFE and other Chinese government arms, not only CIC, be treated as sovereign wealth funds subject to international voluntary best practices now being created.
- Pending China's broad implementation of Globally Acceptable Best Practices for Sovereign Wealth, the U.S. Congress should ensure that CFIUS evaluates all SAFE investments on the basis of the national security criteria that CFIUS is charged with applying.
- CFIUS and other government review processes should be made as transparent as possible while preserving flexibility in the review process. The criteria by which foreign investment is judged should be set before a submission, rather than created after the fact.
- USTR and CFIUS should coordinate to ensure that negotiators have information necessary to make reciprocity an explicit factor in USTR market-access negotiations.
- The Departments of Commerce and Treasury should simplify administrative and tax rules per-

67. Chris Oliver, "China Approves Banks to Invest in Japan Stocks under QDII," *MarketWatch*, February 22, 2008, at <http://www.marketwatch.com/news/story/china-approves-banks-invest-japan/story.aspx?guid=%7B33780515-E645-4AA6-B0D1-B27C06B1719D%7D> (January 12, 2009). An important technical barrier still to overcome is liberalization of the capital account to permit the use of Shanghai-listed stock in bids for international assets. This would permit much greater Chinese participation in global M&A spending.

taining to partnerships between American and Chinese firms in order that these partnerships can more easily be used as a vehicle to expand mutual market access. The simplifications should be part of any bilateral investment treaty (BIT), but should not await the difficult negotiations necessary to complete a proper BIT.

- The Department of the Treasury should work to ensure the success of multilateral efforts to compile better information on the activities of sovereign wealth funds around the globe, not only in the more developed economies.

- U.S. policy toward Africa should include on-the-ground monitoring of Chinese investment and promotion of awareness of the differences between the behavior of American firms and that of the American government compared to the Chinese practice of lending for mineral exploitation rights.

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