LOCATION USA

Chinese Direct Investment in the United States — The Challenges Ahead

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Outward foreign direct investment (OFDI) from China is on the rise, and substantially so. In January 2008, China's Ministry of Commerce (MOFCOM) reported that Chinese companies invested a record US$37 billion overseas in 2007, up 76 percent over 2006 — split roughly equally between investment in the financial industry and all other sectors. Of China's cumulative OFDI of roughly $128 billion at the end of 2007, $109 billion (or 85 percent) has been invested since 2001. A prediction in World Investment Prospects to 2011: Foreign Direct Investment and the Challenge of Political Risk suggests that annual outflows will rise further in the coming years, reaching $72 billion as early as 2011.

So far, Chinese investments in the developed economies of North America, Europe, and Japan represent a small percentage of the total. For a variety of reasons — not least of which is the use of offshore holding companies — official estimates of Chinese OFDI in the United States are hard to come by, but a conservative estimate would place the cumulative figure at roughly $5 billion to $7 billion through the end of 2007. Clearly, the less mature markets (and ample natural resources) of neighboring Asia, Latin America, and, most recently, Africa have exerted a far stronger pull. Yet as more Chinese companies train their sights on the huge, lucrative markets of the developed world, two major, interrelated challenges will come starkly into relief: building human resource capacity and navigating overseas political environments. The former speaks directly to the readiness of Chinese companies to invest abroad, the latter to the reception they can expect to receive when they get there. Whether a "win–win" situation ultimately emerges will largely depend on how all stakeholders — public and private, U.S. and Chinese — can help Chinese executives mitigate these challenges.

Building Human Resource Capacity

At the most basic level, successfully engaging in OFDI is about managing complex, integrated cross-border production systems, consisting not only of parent companies and foreign affiliates but far-flung customers and suppliers as well. This is an extremely difficult task for well-established and aspiring multinationals alike, especially in today's competitive world market. To a great degree, success is predicated on an organization's ability to attract, develop, and retain middle and top-level managers with international experience across all key corporate functions. Moreover, these managers need to be able to work in a multicultural environment and have a familiarity with the regulatory framework of host countries, how they function politically, and the contours of their business culture. Since a substantial portion of Chinese OFDI can be expected to use mergers and acquisitions (M&A) to enter foreign markets (40 percent of China's OFDI during 2002–2006, according to MOFCOM), experts in making M&A work will also be in very high demand.

Given their ambitions, Chinese enterprises will need to identify and nurture an entire generation of such managers in very short order. What are the potential tools at their disposal? Chinese enterprises are already adopting a wide range of approaches, from internalizing global best practices for developing human resources to seeking like-minded partners in the external environment. Within their own organizations, senior managers are identifying the next generation of promising managerial talent and increasing their exposure to the most international segments of their business. Once accrued, this experience can be socialized internally, formally and informally, as part of a comprehensive capacity-building program. In addition to growing their own people, the entire process can be accelerated by bringing in individuals with specialized skills and/or global experience, drawing on China's extensive diaspora population as one reservoir of internationalized talent.

Outside the organization, many Chinese enterprises are teaming up with government, academia, and other stakeholders with a similar commitment to building China's human capital base. In particular, business schools in China are beginning to embark on intensive efforts to educate internationally oriented managers — in China itself and in cooperation with well-established programs abroad. Education in the political economy of the United States, the European Union, and other major markets will need to become an important part of the curriculum if Chinese executives are to have the practical knowledge needed to operate effectively overseas.

In any case, this effort at building human resources needs to not only be massive, it also has to be fast. Chinese enterprises do not have the time, as their competitors from developed countries once had, to deepen their human resources over years or even decades of experience abroad — they need them now, lest their globalization strategies lead them to make costly mistakes or even failure. Globalization is a highly risky endeavor — second chances for market entry, especially in the United States and other mature consumer markets are rarely an option. Fortunately, Chinese enterprises have proven time and time again to be exceptionally fast learners.

Navigating the U.S. and Other Overseas Political Environments

Globally, there are indications that the climate for FDI is becoming less welcoming just as Chinese enterprises are appearing on the global stage. In particular, a number of developed countries — including the United States, Japan, and Germany — are taking a more cautious approach to cross-border M&A, by far the most important mode of entry into foreign markets by multinationals and, increasingly, for Chinese enterprises as well. Yet particularly since the China National Offshore Oil Company withdrew its bid for Unocal Corp. in mid-2005, cross-border M&A by Chinese firms seem to be attracting special attention, and there is ample indication it will continue to do so for the foreseeable future.

The reasons for this nervous reaction to Chinese OFDI are mixed, but they are largely political in nature. Questions are raised about the governance of Chinese firms and the fear that Chinese acquirers, especially when they are state-owned, may enjoy financing advantages. This is less an issue for the shareholders of acquisition targets than for rival firms competing for the same assets. There is also some concern, especially in Europe, about the ability of Chinese firms to successfully manage cross-border M&A and the implication that any failures would have for host countries, especially in terms of employment and the business of suppliers. Most importantly, there is the suspicion that cross-border acquisitions by state-owned Chinese firms are not necessarily driven by commercial motives alone, but are rather the result of political or strategic calculations determined (or at least influenced) by the government that controls them. The formal launch in September 2007 of the China Investment Corporation, China's new sovereign wealth fund with $200 billion in foreign exchange reserves at its disposal, has only fueled speculation about the link between Chinese OFDI and the country's wider geopolitical goals.

If this were not enough, Chinese enterprises are seeking to enter the global FDI market at a time when economic tensions between China and its major trade partners are at an all-time high. In the United States, currency valuation has emerged as a lightning rod issue while fast-growing trade imbalances with the United States, Europe, and, more recently, Japan, have increased frictions as well. In fact, many observers trace a direct link between China's trade surplus and the rapid growth of Chinese OFDI, especially its state-financed portion. Other issues unrelated to Chinese OFDI have helped sour public perceptions of Chinese business, especially last year's product recalls involving Chinese-made goods. To the average American or European, unfamiliar with even the largest Chinese companies, it becomes quite easy to allow negative associations to fill the void, with very predictable consequences in the political arena.

Given the speed at which Chinese firms are expected to "go global" and the fact that state-owned enterprises still account for a substantial portion of China's OFDI, Chinese firms are encountering a rapidly evolving political environment in the United States and other developed markets. In July 2007, the United States revised the Exon–Florio Amendment, including a presumption that filings relating to acquisitions by state-controlled foreign entities will require investigation by the Committee on Foreign Investment in the United States (CFIUS). Notifications to CFIUS were up 30 percent in 2007 (147 vs. 113 in 2006, and just 65 in 2005), and while no deals were blocked, six were subject to investigation (after a record seven investigations in 2006). In February 2008, a filing involving a minority Chinese investment in a U.S. telecom firm was actually withdrawn in the face of U.S. national security concerns. In Europe, investment policy reviews are now in full swing, including the strong possibility that Germany will introduce a CFIUS-like screening mechanism for foreign investment in the near future. With Japan recently strengthening its oversight of cross-border M&A and political pressure building in Canada, South Korea, and elsewhere, the global investment environment seems to be tightening just as Chinese enterprises are poised to enter it.

The Way Forward for All Stakeholders

What to do in light of the vulnerability of Chinese OFDI? It is only natural that, with the re-emergence of China as a major economy, its firms spread their wings and become major players in the world FDI market. The world needs to accept that Chinese multinationals are here to stay, and that OFDI is another aspect of the country's integration into the world economy. The issue for all stakeholders is how to handle this process smoothly.

At the most basic level, it is essential that the non-discrimination principle — which is central to the international laws governing cross-border investment — is applied by the United States to Chinese OFDI as it is applied to the investments of other countries. If need be, this principle should be strengthened, either in the framework of a U.S.–China bilateral investment treaty, in the regional context of APEC, or even through a multilateral arrangement within the WTO.

Chinese companies, too, need to be mindful of managing their international growth in light of the sensitivities that exist — rightly or wrongly — about the transnationalization of Chinese business. This begins, as already discussed, with the training of executives not only in matters related to the management of their firms, but also in those related to the political economy and culture of the United States and other major host countries. Furthermore, any acquisition by a state-owned enterprise and/or investments with a potential impact on national security will need particularly careful preparation. The same goes for acquisitions in sectors which are perceived to be off-limits to foreign investors in China. On the public relations front, the message needs to get out that Chinese OFDI is fundamentally no different from that of other countries — and hence contributes to the economic growth and development of its host countries. Naturally, this message will be better received if Chinese companies behave as scrupulously good corporate citizens when operating abroad, not only by observing the laws and regulations of these countries (see sidebar), but by exercising exemplary corporate social responsibility as well.

Nonetheless, in a post-9/11 world, cross-border M&A will continue to be a sensitive matter, and whatever the overall impact and perception of Chinese OFDI, Chinese firms may want to draw from the experience of Japanese firms in the United States. When Japanese companies burst onto the world FDI market in the 1980s (partly through high-profile M&A deals), there was widespread fear that they would come to dominate the world economy, and attitudes in the United States in particular were quite defensive. Not coincidentally, much of the regulation that still governs foreign investment in the United States dates to this period. Some of these fears began to dissipate as Japan entered a period of stagnation in the 1990s. Yet perhaps more importantly, Japanese firms began to change their basic approach to investing in the United States. Their understanding of the U.S. market and ability to build key relationships with governments and communities grew. In addition to M&A, Japanese companies began to establish assembly facilities in the United States and, later, full production units. And as their readiness to address U.S. market entry challenges increased, they found that the receptivity of the U.S. business environment rose as well in a sort of virtuous cycle. Under the best of circumstances, Chinese firms will embark on a similar trajectory in a more compressed time frame, thus draining the fear creeping in to the cross-border investment environment before it firmly takes hold.

Conclusion

What does this all add up to? Two things seem to be particularly urgent:

• Chinese companies — by themselves and/or with the help of experts — need to take a hard look at their readiness to invest overseas, especially in the United States, the world's most competitive market. Where they need to strengthen their capabilities, especially with respect to the capacity to execute cross-border M&A, they will need to do so as rapidly as possible.

• Chinese companies will also need to familiarize themselves with the regulatory and institutional environment of the United States in order to determine its receptivity and better navigate the political process. This is particularly important now that attitudes toward cross-border M&A, especially from China, are hardening. Chinese managers can help meet this challenge by building positive social capital for their companies, including by being good corporate citizens.

To explore these and other challenges faced by globalizing Chinese companies, the Chinese Services Group of Deloitte LLP has teamed up with the Vale Columbia Center on Sustainable International Investment and Tsinghua University in Beijing on a year-long study to assess the readiness of Chinese firms to enter the United States and the investment environment which they are likely to encounter when they get here. A comprehensive report is expected to be made public later in 2008.

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