

PREPARING FOR A NEW ERA OF CHINESE CAPITAL

Chinese FDI in Europe and Germany

Thilo Hanemann | Mikko Huotari

June 2015



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Mercator Institute
for China Studies

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Preparing for a New Era of Chinese Capital

Thilo Hanemann and Mikko Huotari

A Report by the
Mercator Institute for China Studies
and Rhodium Group



About this Report

Partner Institutions

The Mercator Institute for China Studies (MERICS) is a research institute established in 2013 and based in Berlin. It is an initiative of Stiftung Mercator, a major private European foundation. MERICS is one of the largest international think tanks for policy-oriented research into and knowledge of contemporary China.

Rhodium Group (RHG) is an economic research firm that combines policy experience, quantitative economic tools and on-the-ground research to analyse disruptive global trends. It supports the investment management, strategic planning and policy needs of clients in the financial, corporate, non-profit and government sectors. RHG has offices in New York, California and Washington, and associates in Shanghai and New Delhi.

Authors

Thilo Hanemann leads Rhodium Group's Cross-Border Investment Practice, supporting private and public sector clients in assessing new trends in global capital flows and their implications. One of his areas of expertise is the evolution of China's international investment position and the implications for the global economy. Since 2014, he has also been Senior Policy Fellow for China's Global Investment at MERICS, supporting the Institute's research on assessing China's changing position in the global economy.

Mikko Huotari leads the Research Programme on Foreign Policy and Economic Relations at MERICS. He is also Deputy Director of the Research Area on Innovation, Environment and Economy. His research focuses on China in East Asia, China-Europe relations and the role of China in global finance. Before joining MERICS, Mikko Huotari taught at the University of Freiburg where he finished his PhD on China and the Transformation of the East Asian Monetary and Financial Order. Previously he worked for the German-Chinese Law Institute (Nanjing), the German Embassy in Beijing and the German Council on Foreign Relations (DGAP).

Contact

thanemann@rhg.com
mikko.huotari@merics.de

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Authors' Acknowledgements

This report is a collaboration between the Mercator Institute for China Studies (MERICS) in Berlin and Rhodium Group (RHG) in New York. We are grateful to both organisations for providing us with the freedom and resources to pursue this project. We owe particular thanks to Sebastian Heilmann at MERICS and Daniel H. Rosen at RHG for their support and encouragement.

Both authors benefitted from the insights and advice of a great number of individuals in Europe and China. We were able to discuss this report and previous research on Chinese investment in Europe with representatives from many relevant organizations, including China's Ministry of Commerce, China Exim Bank, the EU Commission, the European External Action Service, the European Chamber of Commerce in China, the German Ministry of Economic Affairs and Energy and Germany Trade and Invest.

The participants of a study group in Berlin in March 2015 provided useful feedback and comments that helped to sharpen our analysis. We particularly benefitted from the feedback of researchers who have previously published important research on Chinese investment in Europe and Germany, including Margot Schüller, Cora Jungbluth and Angela Stanzel.

Finally, special thanks go to our colleagues in Berlin and New York for their intellectual and administrative support in finalising this study, including Cassie Gao, Ben Eckersley, Joy Ma, Rebecca Wertz, Björn Conrad, Theresa Höhn, Kerstin Lohse, Roman Wilhelm, Luisa Kinzius, Ferdinand Schaff and Fabienne Frauendorfer.

While all these people helped to improve the outcome of this report, any remaining errors are the sole responsibility of the authors.

Thilo Hanemann, Mikko Huotari
Berlin, June 2015

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Executive Summary

We are entering a new era of Chinese capital: China's policy liberalization and adjustments to its growth model will turn the country from a nobody to a driving force in global cross-border investment in the coming decade. Projections see China tripling its global assets from currently \$6.4 trillion to almost \$20 trillion by 2020 – a catch-up process that will have significant implications for host economies and global markets. This shift in China's global investment position will require political leaders around the globe to adjust their economic policy configuration towards China both to reap the benefits of this next stage of global integration as well as minimizing potential new risks. This is particularly true for the countries of the European Union, whose economies are now intimately linked up with China following three decades of trade integration and significant investment of European businesses in China.

The first wave of Chinese capital has arrived in Europe

The first wave of this new era of Chinese capital has already begun and it is increasingly impacting Europe: Outbound Foreign Direct Investment (OFDI) by Chinese companies now exceeds \$100 billion per year and has shifted from natural resources in developing countries to technology, brands, real estate

and other assets in advanced economies. This report presents a comprehensive and timely snapshot of the direct investments by Chinese companies in the European Union based on a novel dataset that aggregates individual transactions and thus avoids the distortions and significant time lag in official statistics.

Annual investment by Chinese companies in **EU member states** soared from virtually zero in the mid-2000s to €14 billion in 2014. For the period 2000 to 2014 we count over 1,000 Chinese greenfield projects and acquisitions in the EU together worth more than €46 billion. The sectors that attracted the most Chinese capital are energy, automotive, food and real estate. State-owned companies play an important role in China's investments in Europe, but growth in recent years is mostly driven by private companies and financial investors from the most advanced eastern coastal provinces.

Germany is the second largest recipient of Chinese OFDI in Europe, with investments in the period 2000 to 2014 adding up to €6.9 billion. Since 2011, annual investment levels have jumped up and stayed stable at €1-2 billion per year, which differs from the volatile patterns found in other economies. Germany's advanced manufacturing capabilities were the biggest attraction for Chinese investors with automotive and industrial equipment accounting for more than 65% of total Chinese investment since 2000. In recent years, the industry mix has broadened with IT equipment, finance and business services as well as consumer products gathering interest. Instead of mega mergers, most deals in Germany

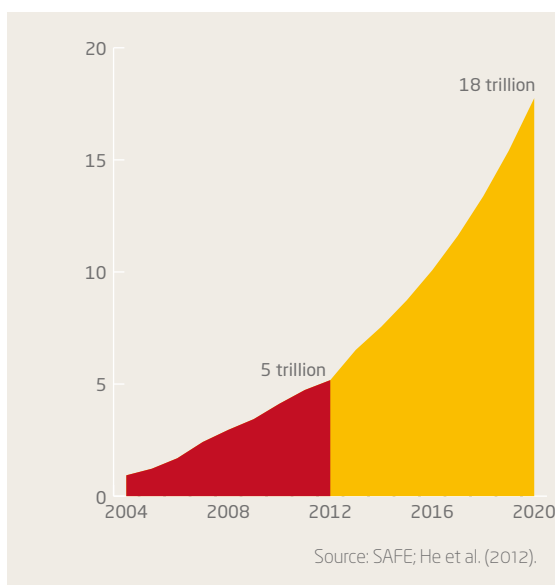


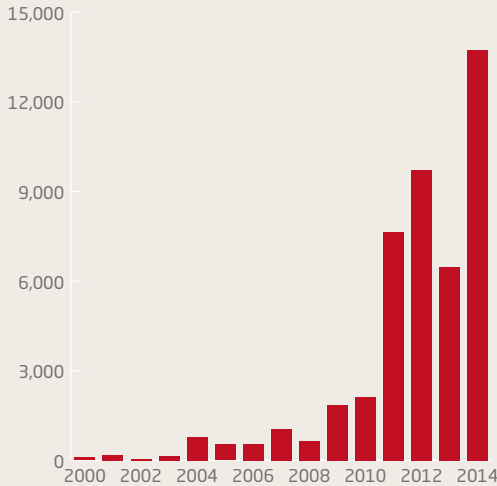
Figure 1:
China's Global Investments Projected to Triple by 2020

Assets in China's international investment position based on assumption of fully convertible capital account by 2020

USD trillion

Figure 2:
Chinese FDI in Europe Grows Exponentially
Value of greenfield projects and acquisitions with stake of 10% or more by Chinese companies in EU-28 economies

EUR million

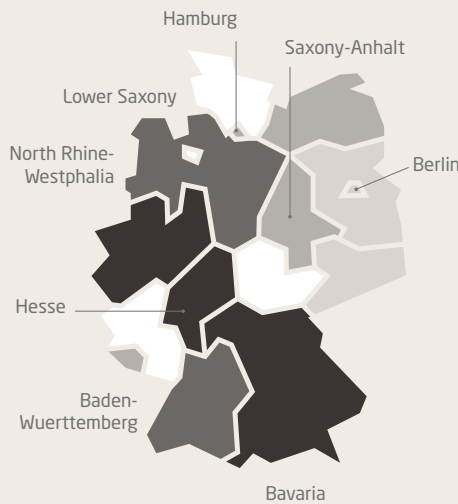


Source: Rhodium Group.

Figure 3:
Germany is a Top Destination for Chinese Investors
Cumulative value of FDI projects by Chinese companies in Germany 2000–2014

Shading indicates cumulative value (EUR) in the respective federal states

- < 50 mn
- 50 – 100 mn
- 100 – 500 mn
- 500 mn – 1 bn
- > 1 bn



Source: Rhodium Group.

were small and medium sized takeovers, with state-owned companies accounting for a higher share of investment than in the European average.

China’s OFDI boom: Europe’s test case for a new era of Chinese capital

This OFDI boom will be the first test case for EU leaders’ ability to respond to the new era of Chinese capital. We show that China is clearly different from other countries with significant OFDI assets in Europe. Characteristics such as the size, growth and complementarity of the Chinese economy create unique opportunities for Europe. At the same time, some specific concerns that are related to the nature of China’s political and economic system, for example subsidies, China’s authoritarian political system and lack of openness to FDI in China, create particular challenges. China’s uniqueness does not question the existing paradigm that FDI is beneficial on net for recipient economies, but it highlights that new approaches are needed to maximize the benefits and hedge against risks related to these new flows to avoid hasty knee-jerk reactions that would poison the outlook

for deeper EU-China investment relations. This report catalogues the special opportunities and risks related to growing Chinese OFDI and makes recommendations for policy priorities on different governance levels.

China’s OFDI catch-up: a huge opportunity for attracting much needed capital

First and foremost China’s changing global OFDI footprint presents a once in a lifetime opportunity for attracting capital to Europe and helping re-start investment and economic growth. Other benefits include innovation spill overs and backward linkages to the Chinese consumer market, while fears that Chinese investment negatively impacts local employment and innovative capacity is not supported by our review of more than 1,000 deals. We see several priorities for securing and maximizing those benefits in the future: **First**, Europe needs to implement the necessary structural reforms to ensure it is well positioned to compete with other advanced economies for Chinese FDI that increases growth, innovation and productivity. **Second**, the emergence of China as a significant

source of capital requires a re-thinking of existing approaches to investment promotion and investor support, including an increase in capacities on the ground in China. **Third**, policymakers need to be prepared to defend the principle of investment openness against populist and local backlashes.

China's unique political and economic system elicits special concerns related to foreign investment

At the same time, there are legitimate concerns related to China's specific nature, which, if unaddressed, could threaten European economic and security interests and undermine public support for investment openness. Given the particularities of the rise of China as a global investor, a hedged welcoming needs to work with risk scenarios in order to be prepared should problems arise. We identify the following priorities. **The highest priority** is to conclude a robust bilateral investment agreement (BIA) that addresses the existing asymmetries in market access through pre-establishment rights for European companies and a short negative list for sectors restricted to foreign investment. A robust BIA is also important to ensure that the principle of investment openness towards China continues to have the support of EU citizens and parliaments. **Second**, European leaders need to grapple with the question of how to react if the structural economic reforms promised by Beijing to address subsidies and other non-market elements that distort global competition happen slower than required by the reality of growing outbound FDI. Existing competition policy instruments including the state aid regime would be the best starting point from which to think about potential options on the European level. Nation states have a range of instruments that could potentially be used to address these problems in the future, including competition policy, mandatory disclosures, government procurement and others. **Third**, there is an urgent need to initiate a debate about greater coordination of security review processes within Europe to increase the efficiency and coherence of such reviews from a security point of view, but also to increase the confidence of European citizens that there is a functioning solution in place to monitor and mitigate potential security risks.

A reality check for global investment governance

The rise of China as an investor and the commensurate shift in Chinese preferences also opens up a unique window of opportunity to improve investment governance in Europe and globally.

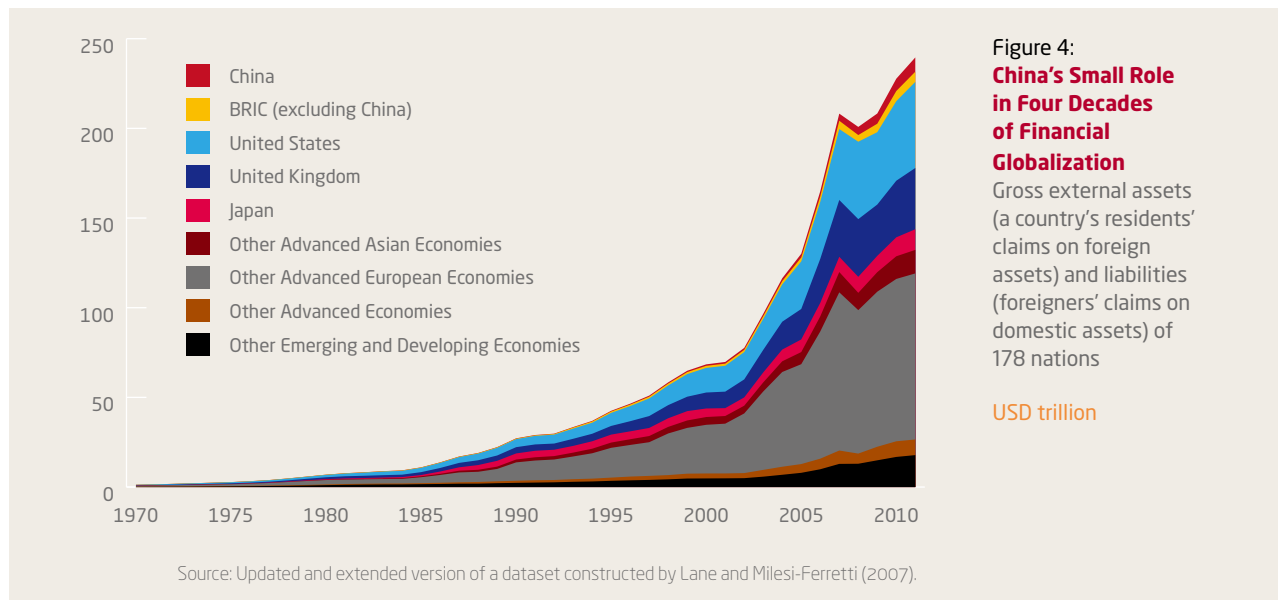
In Europe, nation states will have to re-think their strategy as the EU has taken over the mandate to negotiate investment agreements. In our view it is critical that Germany and other large EU member states stand behind current EU efforts to conclude an effective bilateral investment agreement with China. Europe must speak with one voice instead of following national agendas. Nation states must also explore new channels for pursuing their interests outside of bilateral investment treaties. In the case of China, governments will be critical for reminding their Chinese counterparts of their promise of implementing a new regulatory regime that levels the playing field between domestic and foreign firms. This includes flagging delays and unsatisfactory progress as well as grappling with policy options that set an incentive to accelerate convergence with market economy standards.

The emergence of China as a global investor also opens up the opportunity to revive plurilateral and multilateral initiatives related to global investment flows. As opposed to

trade, the existing institutional frameworks for governing global investment flows and resolving disputes are underdeveloped because the dominance of developed economies in global FDI flows did not create urgency for global rules and institutions. The rise of emerging markets as significant global investors is challenging this status quo, and China's growing global investments will be an important indication of the path forward. A joint high-level working group on investment governance between the three poles of the global economic order which together account for more than 67% of the world's out-bound FDI stock – the EU, the US and China – would be a good starting point.

1. Introduction: A New Era of Chinese Capital

After three decades of successful economic reforms, China surpassed Japan to become the world's second largest economy in 2010. Yet the impact of China on global markets is imbalanced. Its integration in Asian production and trading networks turned China into a major trading power, which transformed the global trading system.¹ China's role in financial globalization, however, remained negligible compared to its position in global trade. As of 2011, China accounted for only 3.4% of financial cross-border assets and liabilities globally, and only 2.1% if we exclude reserves managed by the central bank (Figure 4). This is the result of an investment-driven development model that required a tightly controlled capital account to avoid volatility and capital flight.



Today, we are on the verge of a massive growth in China's cross-border capital flows, which will result in major shifts in the global financial landscape. The old growth model that embraced trade integration but limited financial linkages is coming to an end and Chinese leaders have begun to gradually implement a fundamental overhaul of the Chinese economy.² Greater openness to global capital flows will be critical for China's long-term economic outlook, as greater freedom of capital flows will be indispensable for many goals including globally competitive companies, promotion of new overseas markets, efficient domestic markets or catch-up in innovative capacity.

Recognizing these necessities (and the close alignment of greater outbound investment with foreign policy goals), Chinese leaders have in principle reached a consensus in favour of a decisive liberalization push, communicated in high-level policy documents such as the Third Plenum decisions. Plans for external financial liberalization are encountering heavy resistance from special interest groups, but the majority of financial liberalization measures

Today, we are on the verge of a massive growth in China's cross-border capital flows, which will result in major shifts in the global financial landscape.

1 See di Giovanni, Levchenko, and Zhang (2012).

2 For a comprehensive review of the Third Plenum reform programs, see Rosen (2014).

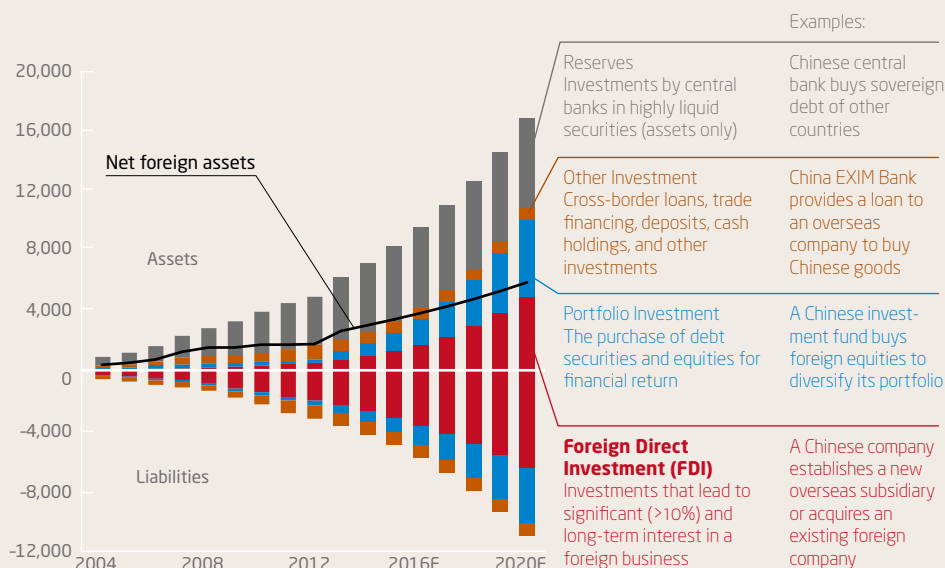
announced at the Third Plenum in November 2013 are on track and increasingly converge.

While the exact timetable of capital account liberalization remains unclear, it is widely agreed that reforms towards a fully convertible currency will trigger a massive wave of all types of capital flows from and to China. A number of academic papers have tried to extrapolate the magnitude of such flows, and they all generated numbers that would truly present a shock to global finance.³ The most detailed of such assessments, a report by the Hong Kong Institute for Monetary Research, projects that China's combined foreign assets and liabilities will soar from \$8 trillion in 2011 to \$28 trillion by 2020, assuming full capital account convertibility in that year (Figure 5). Under this scenario, China's global assets will triple to almost \$20 trillion by 2020, driven by fast expansion of outbound FDI and portfolio investment.

Figure 5:
China's Global Investment Footprint Is Poised to Grow Rapidly

Projections for China's global assets (Chinese residents' claims on foreign assets) and liabilities (foreigners' claims on assets in China) under full capital account convertibility by 2020

USD billion



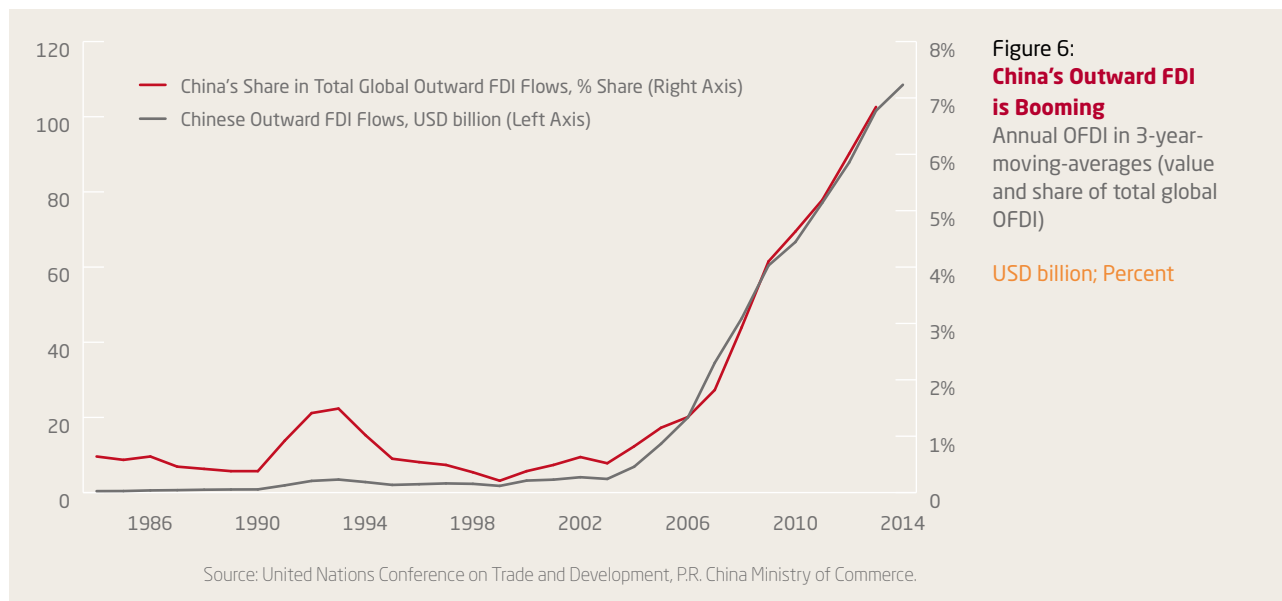
Source: He et al. (2012); SAFE.⁴

The past years have shown that such bold projections are far from unrealistic, illustrated by the fast growth of outbound foreign direct investment (OFDI). Since 2000, the Chinese government has gradually implemented more liberal rules for outbound FDI. These changes have allowed Chinese firms to follow their growing commercial incentives to expand globally, triggering fast growth in OFDI flows since the mid-2000s. In barely a decade, annual flows have grown from virtually zero to more than \$100 billion per year, catapulting China into the top 5 ranks of FDI exporters globally (Figure 6). Moreover, the composition of Chinese OFDI has shifted from predominantly targeting natural resources to a more diverse mix of assets including technology, brands and consumer capabilities. China's investment focus is increasingly moving from developing and emerging economies to advanced economies.⁵

³ See He et al. (2012), Hooley (2013), Bayoumi and Ohnesorge (2013), Ma and McCauley (2014), Rosen (2014) and Sanyal (2014).

⁴ For more information on categories of global investment flows, please see IMF (2010).

⁵ See Rosen and Hanemann (2011), Rosen and Hanemann (2009).



This growth in outbound FDI and subsequent waves of Chinese capital outflows will transform the policy agenda of China's partner economies. For most of the past two decades, this agenda has been dominated by a few core issues such as trade imbalances, market access for foreign firms in China, and a lack of intellectual property rights protection. The changing nature of China's position in financial globalization will challenge existing doctrines in recipient economies (such as the unconditional embracing of FDI) and it will require a more holistic approach to economic policy towards China than in the past.

This growth in outbound FDI and subsequent waves of Chinese capital outflows will transform the policy agenda of China's partner economies.

The reactions to the first wave of Chinese investment, outbound FDI by Chinese firms, show that such a comprehensive perspective on OFDI does not exist. While mayors, governors and executives try to attract more investment, national governments and lawmakers have often reacted with populist defensive measures (such as the hasty new rules in Canada limiting investment by state-owned firms) and the politicization of deals based on personal interests. An objective assessment of the trends and potential impacts of Chinese investment is urgently required for the formulation of a policy response that both maximizes host country benefits from the current wave of OFDI and also looks beyond just OFDI and thinks about the next wave of Chinese capital.

This report analyses Chinese investment in Europe with the goals of more accurately describing relevant patterns, elaborating on benefits and risks, and synthesizing a policy agenda. A special focus will be on Germany's interests in the broader European context. Part two of the report provides a snapshot of how much Chinese OFDI has come to Europe's shores to date, based on a novel transactions dataset developed by the authors. Part three describes the opportunities related to these new flows and discusses what leaders can do to maximize those benefits. Part four looks into the potential risks from growing Chinese OFDI and possible solutions to address some of those existing concerns. Part five synthesizes the recommendations of previous sections and provides a priority list for European and German decision-makers.

2. Europe as a Recipient of Chinese Outbound FDI

The first wave of Chinese outbound FDI mostly targeted resource-rich developing economies. In the past five years, investment interest has shifted to advanced economies. The countries of the European Union have become major recipients of Chinese direct investment. However, the data available to analysts and policymakers for assessing Chinese investment in Europe is problematic due to both general trends in global transaction structures and specifically Chinese characteristics.

This section provides an overview of available data points for the purpose of assessing and describing the extent and direction of Chinese FDI in Europe. We first briefly review available official data sources for Chinese OFDI in Europe and then present detailed snapshots of Chinese OFDI patterns in Europe and Germany based on an alternative transactions dataset, which allows for a detailed description of trends, industry mix, geographic location and investor characteristics.

Official Data Shows Fast Growth but Has Time Lags and Gaps

The challenge for statistical agencies to accurately measure global cross-border investment flows has increased greatly in the past decade due to the sheer growth of transactions as well as the extensive use of offshore vehicles and complex financing structures.⁶ The task of capturing investments from and to China is further complicated by specific Chinese characteristics, including a statistical system that was designed to keep track of domestic flows and administrative restrictions on cross-border investment flows, which lead to statistical distortions as companies often find grey channels for getting money in and out of the country. The official data on Chinese outbound FDI in Europe illustrates these problems, showing that new avenues of data analysis are necessary to fully understand the patterns of Chinese capital outflows and their implications for recipient economies.⁷

Official data from China's Ministry of Commerce (MOFCOM) and Europe's statistics agency Eurostat both confirm that Chinese OFDI in Europe is growing quickly (Figure 7). However, both datasets show different trajectories, suffer significant delays and do not provide detailed breakdowns of sectors and other policy-relevant metrics, which makes them of limited use for policy analysis.

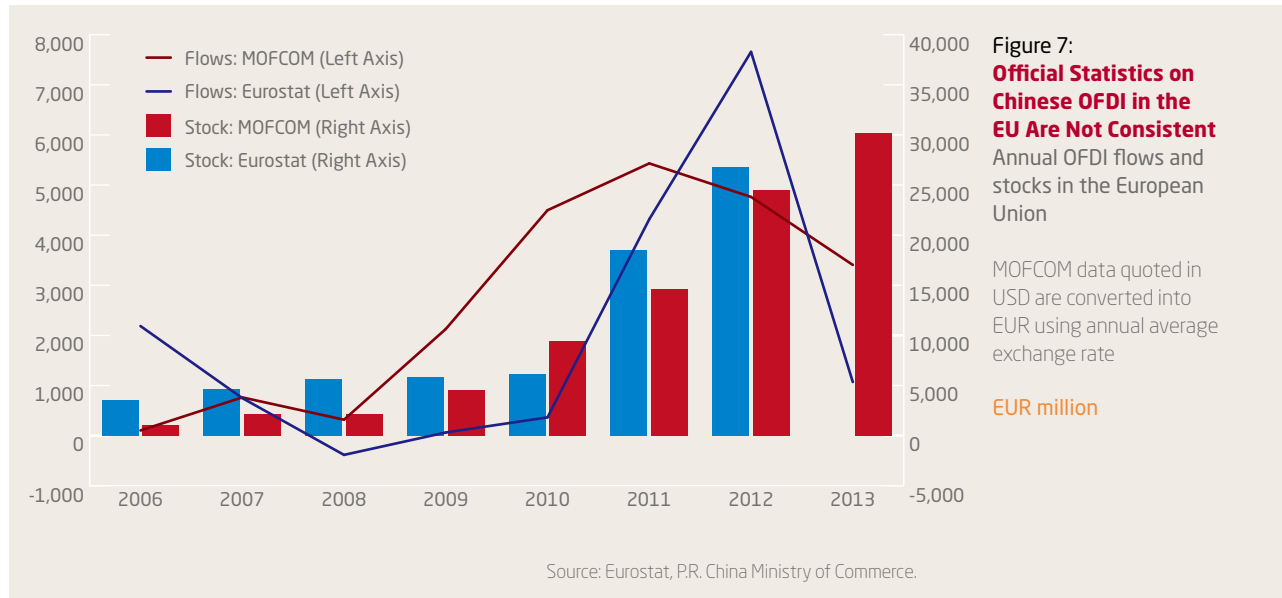
MOFCOM's data on Chinese OFDI to European economies covers the period of 2006 to 2013, showing a big jump of annual investment flows since 2008 to a peak of €5.4 billion in 2011 and a subsequent drop in 2012 (€4.8 billion) and 2013 (€3.4 billion). Total OFDI stock amounted to more than €30 billion by the end of 2013. The MOFCOM data are not suitable for a real-time analysis as there is usually a nine-month time lag. Moreover, MOFCOM does not provide further breakdown by industry or other relevant metrics.

Eurostat data paints a different aggregate picture to MOFCOM's numbers, showing low and even negative flows from 2006-2010 and then a sudden jump in annual flows to €4.3 billion in 2011 and €7.7 billion in 2012. For 2013, preliminary data shows a significant drop of annual flows to €1 billion. Total stock amounted to €27 billion in 2012 (the latest year available). As Eurostat mostly relies on data submissions from national governments, the time lag is even greater than for Chinese data (currently 1.5–2 years). Eurostat

⁶ See United Nations Conference on Trade and Development (2005).

⁷ Schüler-Zhou et al. (2012).

provides more granular data on the distribution of investment by industry and country, but its usefulness is limited because of the large number of gaps and data points suppressed for confidentiality reasons.⁸



Transactions Data as an Alternative

Given these problems with quality, accuracy and timeliness, official data are not sufficient for an in-depth, real-time analysis of Chinese investment patterns. Think tanks, academic institutions and private sector firms have therefore come up with alternative approaches for tracking Chinese outward investment. Most of those datasets are based on a bottom-up approach of collecting data on individual transactions or companies.⁹ Those datasets are not comparable to traditional FDI data, but they avoid some of the existing problems and permit a real-time assessment of Chinese outward investment patterns with detailed information on sectoral and geographical distribution.

Chinese OFDI in the EU-28 soared in the past five years

In this report we draw from a dataset on Chinese direct investment transactions in Europe developed by Rhodium Group. It covers acquisitions and greenfield projects by ultimately Chinese-owned companies in the 28 member states of the European Union.¹⁰ From 2000-2014, we count a total of 1,047 FDI transactions in the EU-28 economies. This includes 726 greenfield projects, or projects that are newly-established, and 321 acquisitions, which involve the purchase of existing companies (Figure 8.1). Annual investment flows were small until 2008, nudged up to about €2 billion per year in 2009 and 2010, before soaring to more than €7 billion in 2011 and 2012. After a small drop in 2013 to €6 billion, annual spending reached a new record high of €14 billion in 2014. The total cumulative value of all transactions from 2000 to 2014 was €46 billion.

8 Similar shortcomings exist for official data on Chinese FDI in Germany. For the latest data, see Bundesbank (2015).

9 Examples are the Heritage Foundation's China Investment Tracker; Rhodium Group's China Investment Monitor; the University of Sydney's database on Chinese investment in Australia; and the China-Canada Investment Tracker.

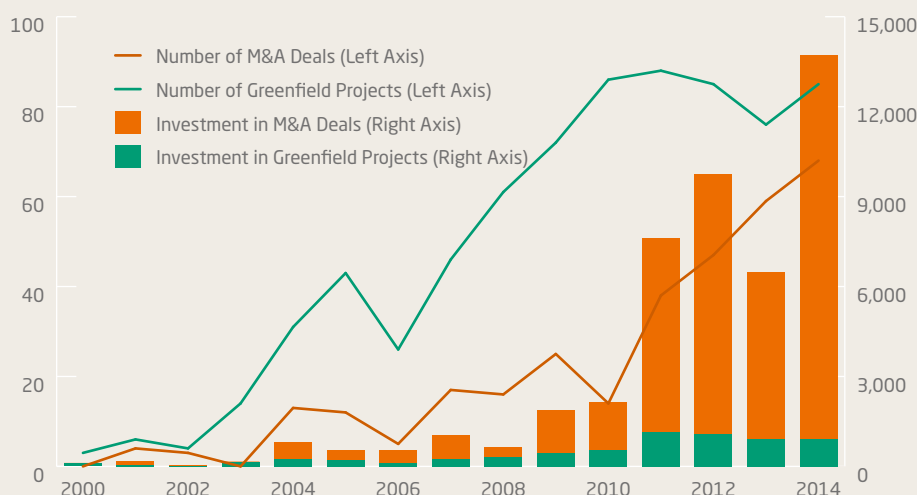
10 For more information on data compilation and comparison to official data, please see the Data Appendix.

Figure 8.1:
**Chinese Greenfield
and M&A Transactions
in the EU-28**

Number of transactions and investment value 2000–2014

Only considers M&A transactions with resulting stake of 10% or more.

EUR million



Source: Rhodium Group.

A detailed explanation of sources and methodology can be found in the Data Appendix.

Core Europe is the main focus but Southern and Eastern Europe are catching up

Just as with overall FDI into the EU, Europe's biggest economies are also the top recipients of Chinese investment. More than 50% of cumulative investment from 2000 to 2014 went to the UK, Germany and France. In recent years, Chinese investment in Europe has become more geographically diverse. Most importantly, the share of the PIIGSC countries (Portugal, Ireland, Italy, Greece, Spain, and Cyprus) in total Chinese investment in the EU grew from less than 10% before 2011 to more than 30% in 2012-2014 as Chinese companies seized opportunities in formerly state-controlled sectors including utilities and transportation. A second trend is that Eastern European economies have gradually increased their share of total Chinese inbound FDI, attracting Chinese capital in manufacturing, agriculture and infrastructure. Over the entire period Eastern European economies accounted for 8% of total investment value. In short, the core of Europe is still receiving the bulk of capital but Chinese investment has become more diverse and now extends to all parts of the European Union.

Energy and advanced manufacturing are the biggest recipients of Chinese capital

This broader geographic spread of Chinese capital partially reflects a more diverse mix of industries that Chinese investors are interested in. With nearly €13 billion of investment in utilities, fossil fuel assets and renewable energy projects, energy is the number one sector. Advanced manufacturing sectors including automotive (€6 billion), machinery (€4 billion) and information and communications technology (€3 billion) are other important recipients of Chinese investments. Services sector investments are mostly concentrated on transportation (€2 billion) and more recently higher value-added sectors such as biotech and finance (€3 billion combined). Two sectors that have not been on the radar of Chinese companies for most of the period covered but which have seen rapid growth in the past two years are agriculture and food (€5 billion) and commercial real estate (€5 billion).

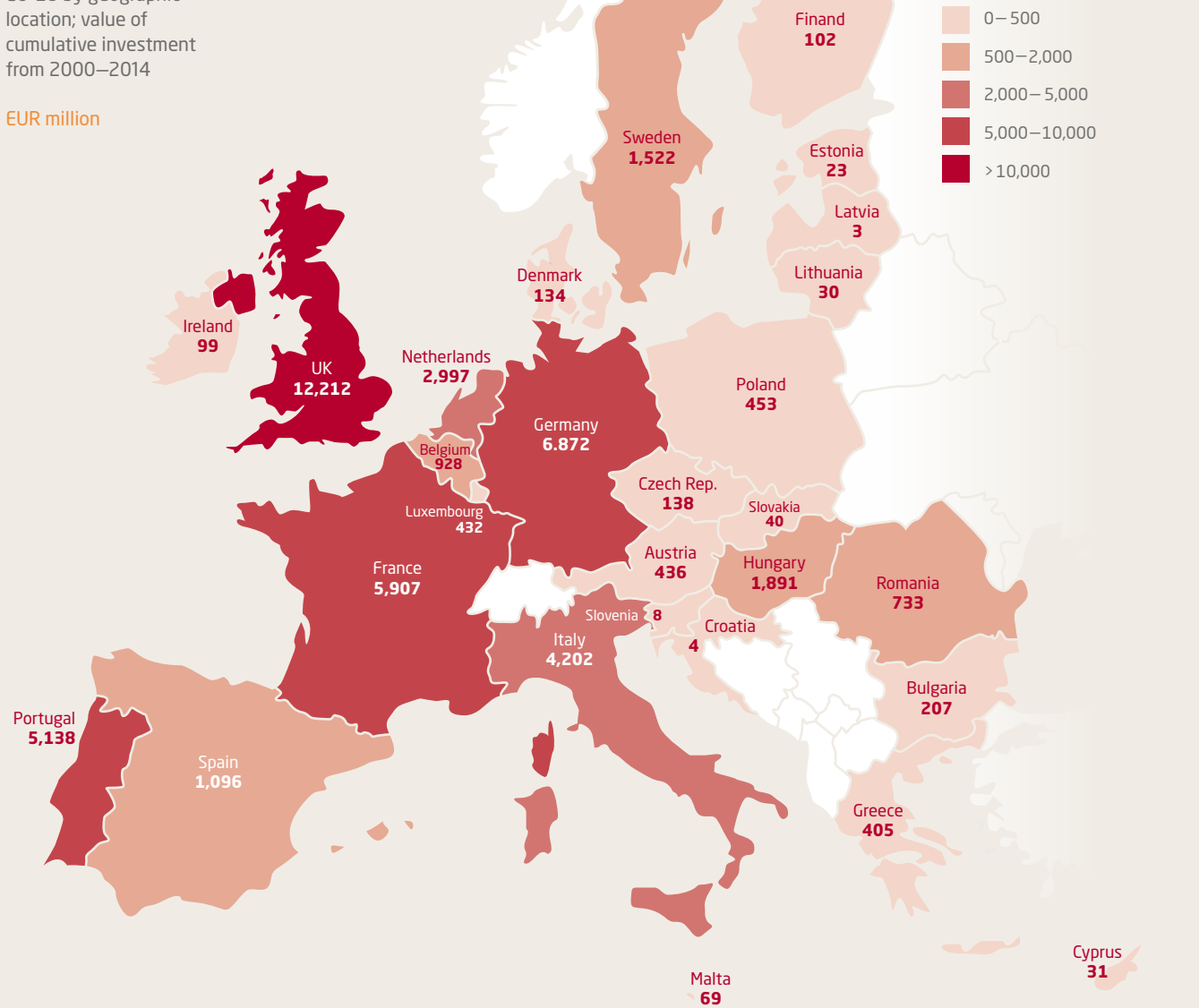
Figure 8.2:

Chinese FDI in the EU-28 2000–2014

Chinese FDI is Spread Across All of Europe

Greenfield and M&A transactions in the EU-28 by geographic location; value of cumulative investment from 2000–2014

EUR million



28%
Energy



13%
Automotive



12%
Agriculture
and Food



11%
Real Estate



9%
Industrial
Equipment



6%
Information
Technology



5%
Basic Materials



4%
Finance and
Business Services



4%
Transport and
Construction



2%
Healthcare and
Biotechnology



2%
Consumer Products
and Services



2%
Electronics



1%
Metals and
Minerals



1%
Entertainment and
Hospitality



1%
Aviation

Source: Rhodium Group. A detailed explanation of sources and methodology can be found in the Data Appendix.

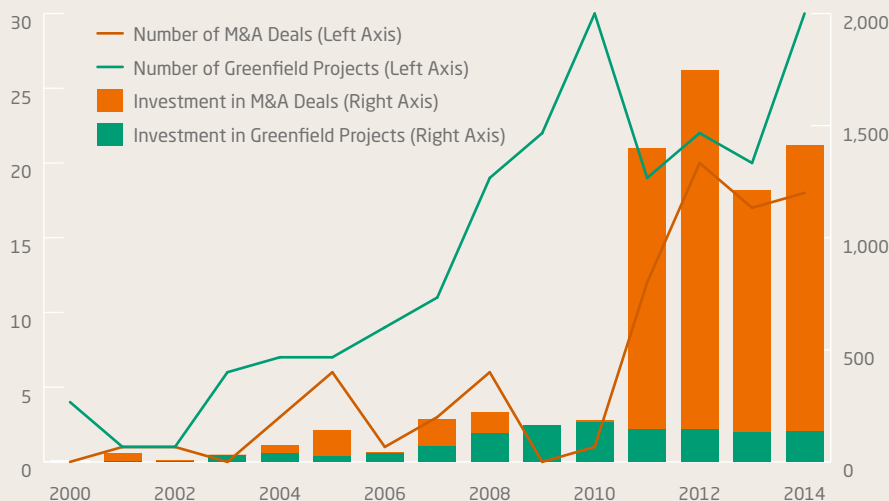
A Snapshot of Chinese FDI in Germany

Germany is the second largest recipient of Chinese OFDI in Europe, with investments in the period of 2000 to 2014 adding up to €6.9 billion (Figure 9.1). The level of annual inflows increased throughout the mid-2000s, but it mostly took the form of smaller sized greenfield projects such as headquarters and trade-facilitating operations. Since 2011, the annual investment levels have soared, driven by a sharp increase in the number of acquisitions. Ever since, the level of annual investment has stayed remarkably stable at €1–2 billion per year, which differs from the volatile patterns found in other economies.

Figure 9.1:
Chinese Greenfield and M&A Transactions in Germany
Number of transactions and investment value 2000–2014

Only considers M&A transactions with resulting stake of 10% or more.

EUR million



Source: Rhodium Group.

A detailed explanation of sources and methodology can be found in the Data Appendix.

The interests of Chinese investors are broadening from manufacturing to services

One of the reasons for these stable inflows is that the German economy provides Chinese investors with a broad mix of opportunities across different sectors. The two most important sectors are automotive and industrial equipment with €1.9 billion and €2.7 billion of investment deals respectively, reflecting great Chinese interest in high-end manufacturing assets. Other sectors include renewable energy, consumer products, and finance and transportation services (Figure 10.1 and 10.2).

Most Chinese capital enters Germany through acquisitions

The majority of Chinese FDI comes to Germany in the form of acquisitions (82%), as takeovers present a way of rapidly entering the market or acquiring existing know-how, brands and other assets. The biggest Chinese acquisitions in Germany were Lenovo's investment in Medion in 2011 (€530 mn), AVIC's acquisition of Hilite International in 2014 (€473 mn) and Weichai Power's investment in Kion Group in 2012 (€467 mn).

However, Germany is also a major recipient of greenfield investment, highlighting its role as the biggest economy in the centre of Europe.¹¹ Major greenfield projects in manufacturing include Sany's production site in Bedburg near Cologne and Greatview Aseptic's facility for producing packaging materials in Saxony-Anhalt (Halle/Saale). A more recent trend is the

11 For a more detailed perspective on greenfield investments, see GTAI (2015).

Figure 9.2:

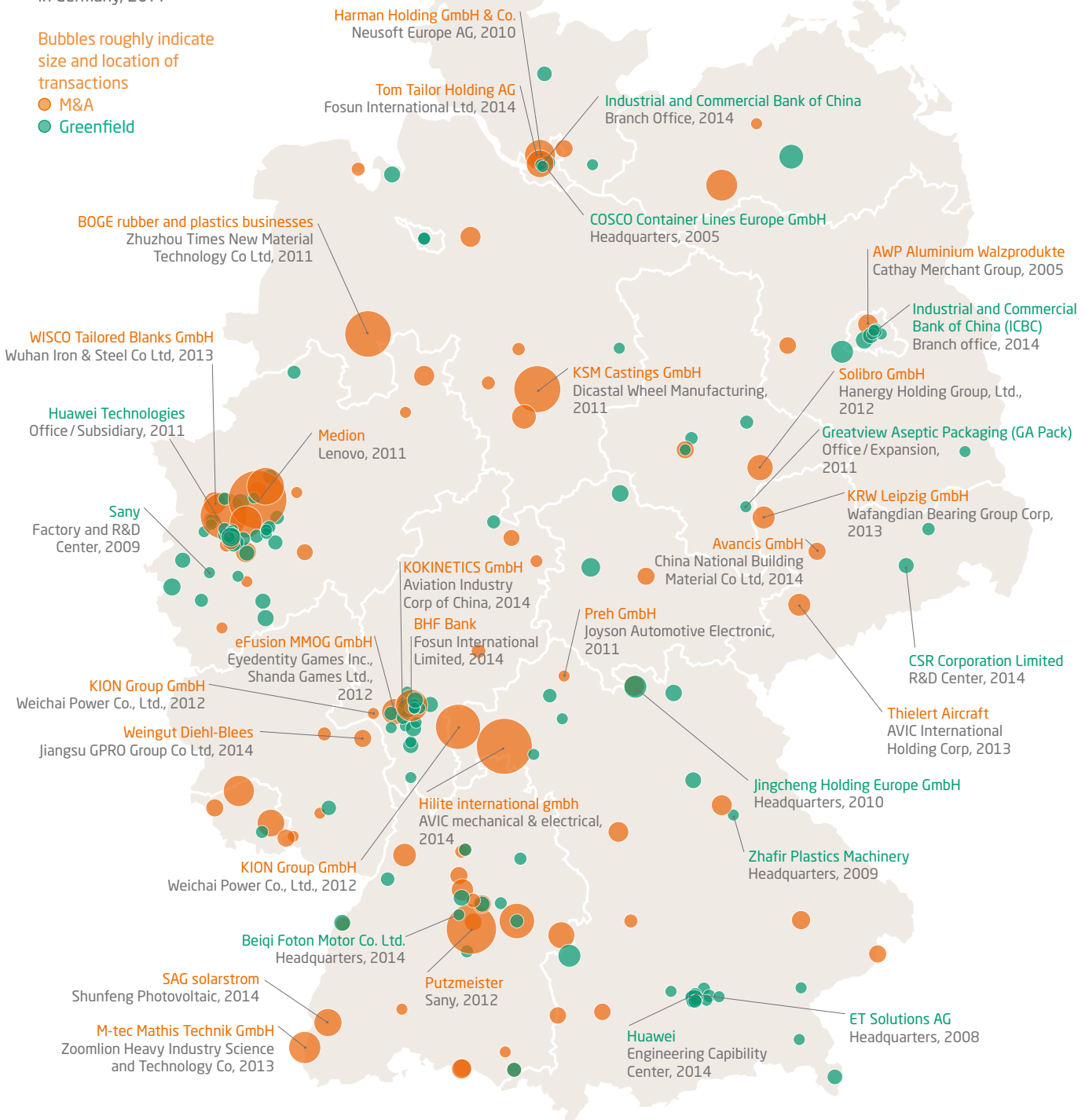
Chinese FDI in Germany 2000–2014

The Geography of Chinese Establishments in Germany

Location of Chinese (co-) owned establishments in Germany, 2014

Bubbles roughly indicate size and location of transactions

- M&A
- Greenfield



Source: Rhodium Group. A detailed explanation of sources and methodology can be found in the Data Appendix.

Figure 10.1:
The Scope of Chinese Investors Has Broadened from Advanced Manufacturing to Services

Industry distribution of Chinese FDI transactions in Germany from 2000–2014

EUR million

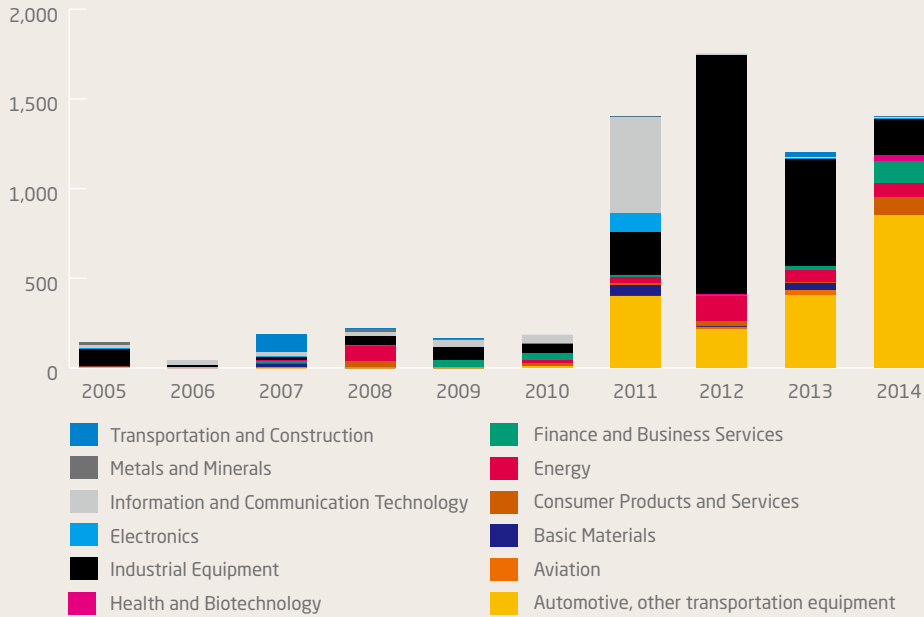
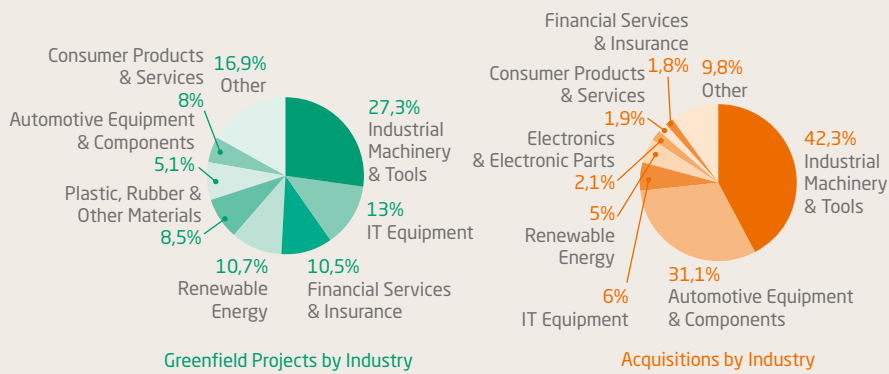


Figure 10.2:
Chinese Companies Are Entering Germany through Greenfield Projects and Acquisitions

Industry breakdown of greenfield projects and acquisitions from 2000–2014

Percent



Source: Rhodium Group.
 A detailed explanation of sources and methodology can be found in the Data Appendix.

growing capital expenditure by Chinese firms on greenfield facilities for research and development, finance and other higher value-added services, for example Huawei’s 2014 investment in an engineering capability centre in Munich or the subsidiaries of major Chinese banks like the Industrial and Commercial Bank of China and the Agricultural Bank of China in Frankfurt.

Investment is spread across Germany but concentrated in the old federal states

The geographic breakdown of Chinese investments in Germany mostly reflects existing industry clusters, the attractiveness of local economies for greenfield investment, targeted investment promotion efforts, and the location of subsidiaries of bigger companies that were acquired by Chinese investors.

As of 2014, all 16 German states were hosting Chinese companies, but the old states of former West Germany had attracted the majority of investment. This makes sense as

they account for nearly 90% of GDP and nearly 90% of manufacturing turnover.¹² The top five states for Chinese investment are North Rhine-Westphalia, Hesse, Bavaria, Baden-Wuerttemberg, and Lower Saxony. The biggest recipient of Chinese investment in the East is Saxony-Anhalt, which attracted significant greenfield investors such as Great-view Aseptic.

Another important observation is that states that have received early Chinese investments had a first movers' advantage in subsequently attracting other Chinese companies. Hesse and Bavaria for example were among the preferred early investment destinations and today record the largest numbers of transactions among all German states.

One key factor for understanding the geographic distribution of Chinese investment is existing industry clusters. Baden-Wuerttemberg for example has attracted major investments in the automotive and heavy industry sectors, such as HIB Trim, Putzmeister, and Emag Machine Tools. North Rhine-Westphalia is another centre for machinery, with Chinese subsidiaries like Schwing, Kiekert, and Tailored Blanks. Frankfurt is Germany's financial city and therefore not surprisingly attracted Chinese financial firms including the Bank of China, the Agricultural Bank of China, ICBC, and the Bank of Communications, as well as Fosun's minority stake in investment bank BHF. Hamburg, as a major centre for shipping and trade logistics, is home to many branch offices of Chinese trading companies and state-owned multinationals including COSCO and ICBC.

Figure 11 provides a snapshot of how Germany has performed compared to other European economies in terms of attracting Chinese investment for 15 different sectors.

Germany tops in industrial machinery, automotive and information technology

As a key sector of export strength, Germany's place as the top recipient of Chinese FDI in industrial machinery comes as no surprise. Investment in machinery ranges from large transactions, such as Sany's purchase of pump maker Putzmeister and Xuzhou Construction's purchase of concrete mixer developer Schwing, to smaller transactions, such as the acquisition of milling machine manufacturer Waldrich Coburg. Germany's *mittelstand* companies are particularly attractive targets for Chinese companies seeking technology leadership in exchange for assistance with market access in China. Other European countries that have attracted investment in machinery include Italy, France and Poland.

Germany also takes the top spot in automotive investment, in front of Sweden, the UK, France and Italy. However, higher levels of Chinese investment in Germany's automotive sector are a recent trend, with nearly all investment occurring in the past three years. Chinese interest has focused on automotive parts at intermediate stages in the value chain. Some of the largest investments in this category are WISCO Tailored Blanks and KSM Castings, manufacturers of tailored blanks and aluminium and magnesium castings respectively. Access to technology and know-how is an important driver for acquisitions. Examples are Hilite International, now a subsidiary of AVIC, which develops automotive valves; and BOGE, now owned by Zhuzhou TMT, which produces vibration control components. Those investments reflect growing sophistication in the Chinese automotive industry, which is now expanding into areas traditionally specialized in by advanced economies.

¹² Calculations exclude Berlin.

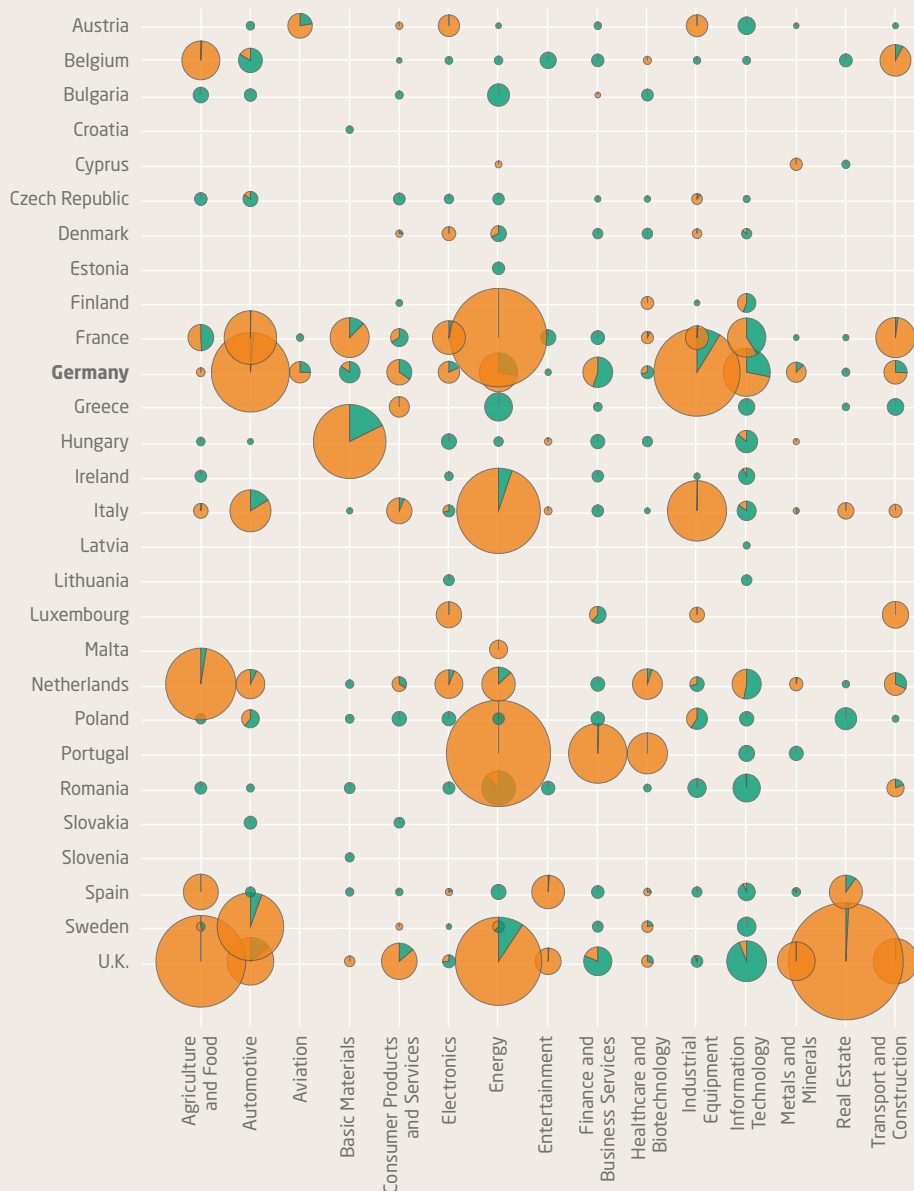
In information technology, Germany is the leading recipient of Chinese capital in Europe, receiving twice as much investment as France and the UK. The largest acquisition to date is Lenovo's purchase of consumer IT products manufacturer Medion in 2011. Huawei, the telecommunications firm, is an important presence, particularly in Dusseldorf through its R&D operations and European headquarters. Its competitor, ZTE, has a similar set of operations with R&D across the country and its headquarters also in Dusseldorf.

As one of only two European economies, Germany has also attracted Chinese investment in aviation. In 2013, AVIC purchased the plane engine maker Thielert, reflecting a push by Chinese aviation companies to catch up and build a more competitive domestic industry. The other major aviation transaction in Europe was the acquisition of Fischer Advanced Composite Components in Austria.

**Figure 11:
Germany's
Attractiveness to
Chinese Investors
in European
Comparison**

Chinese cumulative OFDI in the EU-28 by Country and Industry, 2000–2014

Bubble size represents investment value; share of greenfield projects in green, acquisitions in orange



Source: Rhodium Group.
A detailed explanation of sources and methodology can be found in the Data Appendix.

Germany is also well positioned to receive a substantial share of fast-growing Chinese investment in services. In consumer products and services, Germany is one of the top recipients behind Italy and the UK. Most investments aim at building brands for the Chinese and global markets (Tom Tailor) and offering customer and after-sales services (Midea). Germany's attractiveness in finance and business services reflects the expanding presence of Chinese banks and other financial firms in Frankfurt (which now has an RMB clearing centre) and other cities. Healthcare and biotechnology has only attracted moderate investment from China, and growing interest in other European economies (Portugal and the Netherlands) suggests room for future growth.

Still not much investment in energy, electronics transportation and infrastructure

In electronics, Germany lags behind a number of European countries, coming in fifth after France, the Netherlands, Luxembourg, and Austria. Most investments are focused on R&D and other high value-added activities such as Lenovo's innovation centre in Stuttgart. Auto-related electronics have also attracted Chinese interest, for example the takeover of Preh, a developer and manufacturer of climate control and driver control systems.

Energy is the biggest sector for Chinese investment in Europe overall but there are comparatively few deals in Germany. Chinese activity in Germany's energy sector has largely been limited to renewable energy, particularly in solar manufacturing. However, the combined investment value of the more than 40 deals in renewable energy are small compared to the investments in energy extraction and utilities in other European economies. The largest investment is Astronergy's solar module plant in Frankfurt, purchased from Conergy.

Other sectors where Germany underperforms compared to the rest of Europe are transportation and infrastructure (with the only significant investment being a cargo airport in Mecklenburg-Vorpommern); basic materials (reflecting a consolidated industry structure with few entry opportunities); and metals and minerals. Germany has also not attracted significant investments in commercial real estate to date, in stark contrast to other European economies and particularly the UK. However, there are signs of greater activity going forward with rumours of high-level purchases in Frankfurt and Berlin. Germany has also received comparatively little investment in the entertainment and hospitality sectors, which has grown rapidly elsewhere. Finally, the growing Chinese interest in agriculture and food assets, leading to deals worth €5 billion in the past three years, has not yet affected Germany.

The landscape of Chinese companies in Germany is diverse

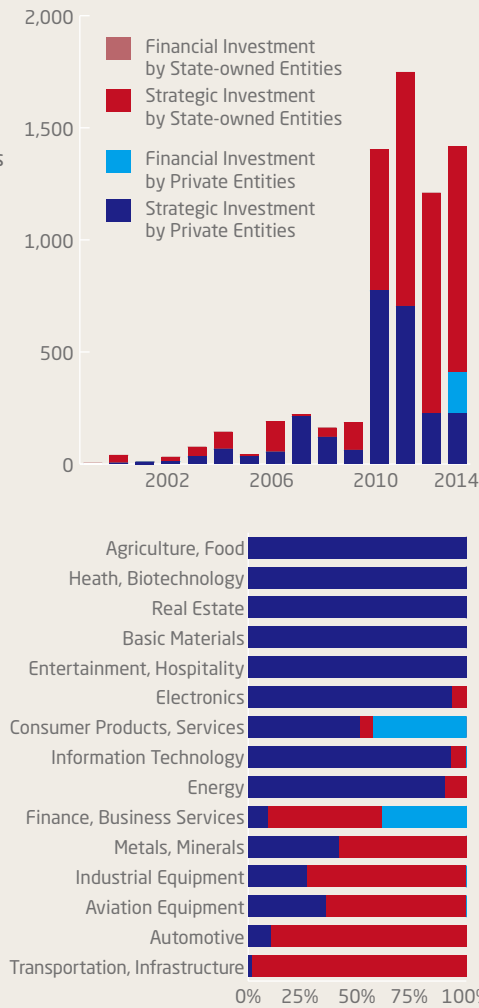
The mix of Chinese companies investing in Germany is diverse, reflecting the heterogeneous ownership mix in today's Chinese economy. Figure 12.1 shows the composition of transaction value along two variables: ownership of the investor (privately owned or state-owned companies) and the type of investor (strategic investors, or real economy companies that make long-term investments to exploit advantages, access markets, or increase competitiveness, and financial investors, which are companies and funds that invest primarily for financial returns).¹³

It illustrates that the vast majority of investments comes from strategic investors, i.e. real economy firms that invest in one of their core areas of business. This reflects the great

¹³ We consider a company privately owned if at least 80% of the equity is held by private investors. For more information on the dataset, please see Data Appendix.

Figure 12.1:
Ownership Characteristics of Chinese Investors in Germany
 Chinese FDI transactions in Germany by type of investor and industry, 2000–2014

EUR million;
 Percent



Source: Rhodium Group. A detailed explanation of sources and methodology can be found in the Data Appendix.

attractiveness of Germany to Chinese manufacturers for moving up the value chain and leveraging existing expertise and brand value in the Chinese market. Although the role of financial investors is still small and limited to consumer products and finance/business services, it is gradually increasing across Europe.

Another important finding is that state-owned enterprises (SOEs) play a significant role in China's OFDI footprint in Germany. More than 60% of the total transaction value originated from firms with 20% or more government ownership. Sectors that are dominated by state owned capital include automotive, machinery, aviation and transportation. This reflects the historical legacy of those industries as traditionally controlled by provincial and local governments. Out of the €4 billion of state-owned investments, more than two-thirds originates from companies controlled by provincial or local governments. Private companies, on the other hand, dominate investment flows in sectors including information technology, electronics and renewable energy.

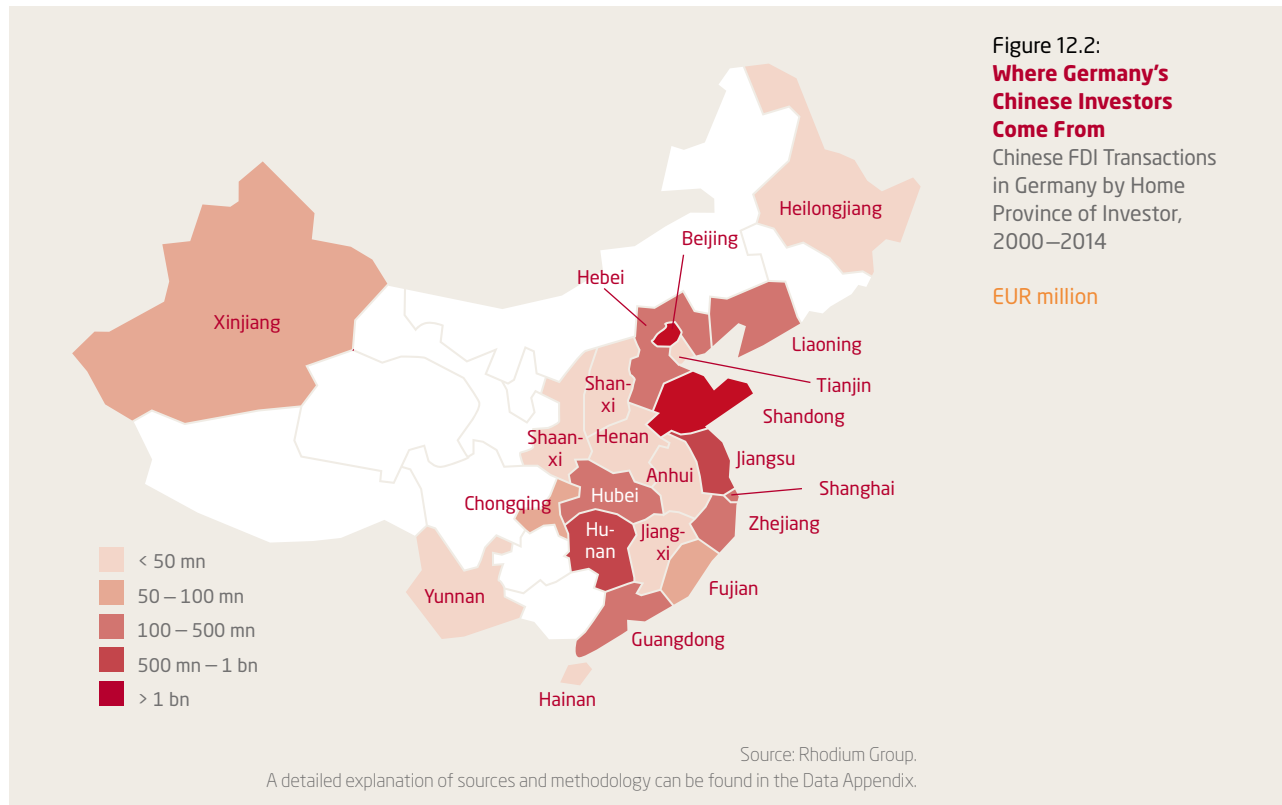
Chinese FDI in Germany comes from the East Coast and Industrial Heartland

Figure 12.1 shows the location of the headquarters of Chinese companies that have come to Germany since 2000. Not surprisingly, the provinces that export the most FDI to Germany are found on the prosperous eastern coast. Beijing, Shanghai and Guangdong are home to large investors in diverse sectors, such as Lenovo in Beijing, Fosun in Shanghai and Huawei and ZTE in Guangdong. Coastal provinces with vibrant private sectors including Zhejiang and Shanghai are also significant sources of OFDI for Germany. Beijing is important because it is home to a large number of national SOEs, such as AVIC, China National Building Materials Company and the Power Construction Corporation of China.

State-owned enterprises (SOEs) play a significant role in China's OFDI footprint in Germany.

At the same time, companies from the industrial heartland in the North and Central China are also important investors in Germany. These regions all have strong capacities in industrial machinery and automotive sectors, which makes Germany an interesting investment destination. Important investors from those provinces include

CITIC Dicastal (a subsidiary of the state-owned conglomerate CITIC) in Hebei and Weichai Power and Qingdao Machinery Industry Corp in Shandong, Wuhan Iron & Steel in Hubei and Sany Construction in Hunan.



3. Seizing New Opportunities

The previous part has made clear that Chinese investment in Germany and other parts of Europe is growing fast and the growth is more pronounced than outdated official figures suggest. What is less clear is how these new flows will impact upon European economies and how Brussels, Berlin and other European capitals should respond. EU member states principally have a very positive stance towards FDI. They all adhere to the principle of openness to foreign capital, and the EU as a whole hosts more than 30% of the global FDI stock.¹⁴ The emergence of China opens up a unique opportunity to further increase this stock and reap the associated benefits. At the same time, China has many characteristics that warrant a debate over particular risks associated with those flows and the question of whether the existing belief that benefits vastly exceed risks needs to be revisited against the backdrop of growing investment from emerging economies.

This section assesses the opportunities and potential benefits that growing Chinese OFDI brings for Europe in light of China's unique characteristics. We first sketch out how a unique mix of political, macroeconomic and market factors will likely sustain Chinese outbound investment in coming years, making China one of the world's most critical sources of FDI. We also summarize how China could be important for European economies with respect to other benefits generally associated with FDI, such as backward linkages or innovation spill-overs. Finally, we discuss several recommendations for Europe with regard to positioning itself to maximize these benefits in the coming years.

A Massive New Source of Global Investment

The first and most intuitive benefit of FDI from a host economy's perspective is an increased level of investment. China is so unique and important because it is already a major global investor and it has the potential to become the single most important driver of global FDI growth over the next decade. While growth over the past decade was already impressive, China's OFDI stock to GDP ratio currently stands at only 7%. This is still below the average of middle income economies (10%) and well below that of the most advanced economies such as the United States (38%), Japan (20%), and Germany (47%).¹⁵ In other words, China's OFDI boom is only beginning and will likely continue in light of more liberal OFDI policies and changing commercial realities in the Chinese marketplace which are forcing firms to expand beyond China's borders.

China is so unique and important because it is already a major global investor and it has the potential to become the single most important driver of global FDI growth over the next decade.

More liberal rules for outbound investment are an important prerequisite for China's OFDI boom

The liberalization of the policy regime for outbound investment was one of the prerequisites of China's OFDI boom in the past decade and the Chinese leadership sees outbound investments as an instrumental part of their push for a more market-oriented, efficient, innovation-driven and modern economy. In the past year, China has implemented a series of policies to further support firms' internationalization in line with the 12th 5-year plan

¹⁴ Data point based on 2013 FDI stock data by UNCTAD. Includes intra-European FDI.

¹⁵ All ratios are from 2013 and based on official national statistics and data points provided by UNCTAD.

(2011–2015) and the Third Plenum reform program. This includes the deregulation of administrative controls for outbound investors as well as new incentives for firms and individuals to invest abroad. The most significant change was the shift from a system that required administrative approvals from various government entities to a much less restrictive system that requires most firms only to register with relevant authorities.¹⁶

Changing commercial realities in the Chinese market place are the most important driver for OFDI growth

The biggest factor for future outbound investment flows, however, is the changing commercial reality in the Chinese marketplace. Recent trends in domestic economic development and the pressure to diversify and compete in a slowing economy foster a greater appetite for international expansion and increase the willingness to take larger risks. Most importantly, the base of outbound investors is becoming more diverse. Private companies are increasingly seizing their new won freedom to invest overseas and have become the key drivers of outbound FDI activity in Europe and other parts of the world. Attempts to restructure the state-owned sector and make SOEs more competitive internationally will also contribute to a stronger outbound investment push. Finally, new institutional investors including sovereign wealth and social security funds, as well as insurance firms, asset management companies, private equity funds and financial conglomerates, are increasingly active in outbound investment as they seek to diversify the large pools of money that they manage and that currently are overwhelmingly in the form of domestic assets.

It is difficult to accurately forecast OFDI flows, given the uncertainty about the pace of economic reforms and other relevant variables including macroeconomic factors such as monetary policy and exchange rates. However, we can sketch out some scenarios based on the historical experiences of other countries and their OFDI stock to GDP ratios over time. These calculations suggest that if there are no major crises and China takes a similar OFDI path as other emerging economies have in the past, we expect China's global OFDI stock to grow from the current \$744 billion to \$1-2 trillion by 2020 (Figure 13).

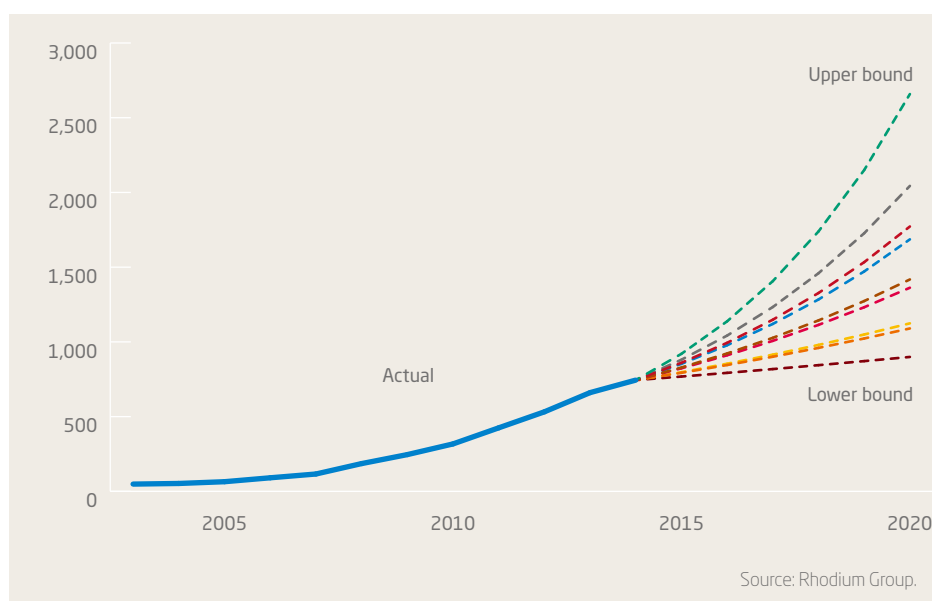


Figure 13:
China's Global OFDI Stock to Grow to \$1–2 Trillion by 2020

Projections for China's global outward FDI stock in 2020

This chart combines three scenarios for GDP size (\$11.2, \$13.6, and \$17.7 trillion) and OFDI stock to GDP ratio (6%, 10%, 15%) to estimate the upper and lower bounds of China's outward FDI stock in 2020.

USD billion

16 See the "2014 State Council Notice on Government Approval of Investment Projects", State Council, November 2014, available at: http://www.gov.cn/zhengce/content/2014-11/18/content_9219.htm

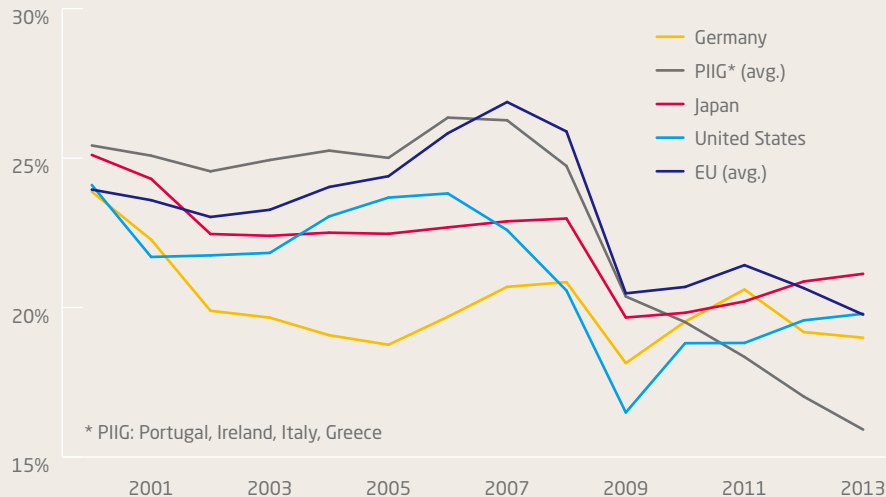
Europe urgently needs investment

The rise of China as a critical source of capital globally is particularly relevant for Europe, as it is happening at a time of depressed levels of FDI and overall investment spending in Europe. Investment levels in Europe have fallen rapidly since the financial and fiscal crisis, especially in smaller economies, dampening growth prospects (Figure 14).

Figure 14:
Europe's Investment Trap
Gross capital formation as share of GDP

Gross capital formation consists of outlays on additions to the fixed assets of the economy plus net changes in the level of inventories. FDI does not equal or immediately contribute to gross capital formation, but recent research assumes a strong connection (see Fichtner et al. 2014)

Percent



Source: World Bank.

The EU and its member states urgently need to ramp up investment levels to avoid a lost decade. It is unclear to what extent the “Juncker plan” can help European economies to overcome the “investment trap”, and the infrastructure focus of such projects overlooks important cash-strapped parts of the economy.¹⁷ Foreign sources of productive direct investment that create and maintain jobs are therefore a pressing demand across Europe. Compared to other more volatile and pro-cyclical capital flows, FDI will contribute to economic stability and development.¹⁸ Due to the sheer number of investors, private and state-owned, with their variegated interests, Chinese investment has the capacity to provide important simultaneous stimuli for economic development across different sectors in Europe.

Market Linkages: Strengthening Export Opportunities

Aside from capital spending, FDI can bring a range of other more indirect benefits to host economies, which are particularly important to consider in the case of China. One important benefit of FDI for local economies is that it is a channel for building linkages to overseas markets, thus helping to facilitate exports and otherwise connect a host country to the world economy.¹⁹ Through such linkages companies in host economies benefit from product specification, integration into new production chains and access to new operational networks.

In general, smaller firms often don’t have the capacity to fully utilize and understand the huge market in China. Having a Chinese partner helps them to do this and having one with actual equity in the local firm is generally more promising than engaging in a joint

¹⁷ See Veugelers (2014 and Fichtner et al. (2014).

¹⁸ For more background on global capital flows to Europe, see Darvas et al. (2013).

¹⁹ See World Trade Organization (1996).

venture in China. Many potential target industries for Chinese investment will continue to capitalize on their export opportunities to the massive Chinese market. Chinese companies bring knowledge of and open channels to China as one of Europe's core export markets.

Examples of such productive linkages include Bright Food's acquisition of Weetabix or Joyson's stake in Preh, now positioning themselves in the Chinese market with customized goods. Putzmeister's strategic fusion with Sany was also explicitly intended to expand and create synergies between German and Chinese markets. Companies like Germany's Durkopp Adler and Swedish car-maker Volvo have been undergoing a renaissance under Chinese ownership (ShangGong Group and Geely respectively). For Volvo, China became its largest market in 2015 and the company is growing its commercial and industrial presence while still emphasising the brand's "Swedishness". Mediated through AVIC's 40% stake in KHD Humboldt Wedag, the company located in Cologne has expanded its sales of cement machinery and services in the BRICS economies. Vensys, owned by Xinjiang Goldwind, equally raised its sales of higher-quality wind turbines to China.

Specialization and Innovation: China's High-Tech Ambitions as Opportunity

Another important contribution of FDI to host economies is that it can strengthen local know-how and innovative capacity.²⁰ In addition to the abstract benefits of fuelling the overall level of competition in the marketplace (which is an important driver for innovation), there are three primary channels through which FDI can positively affect the know-how and innovative capacity of host economies. First, foreign companies often train workers, nurturing a more qualified local workforce. Second, foreign firms settle down in existing research clusters, contributing to local spending on research and development. Third, foreign firms often bring technology and knowledge with them, leading to innovation and productivity spill-overs to local economies.

For most of the past, Chinese companies have been dismissed as low-tech firms with little innovative potential. However, the new reality is that Chinese firms are now at the cutting edge of innovation in several industries, and that the shift to a new growth model that emphasizes innovation and IPR protection will further accelerate this process. Chinese firms are already significant contributors to local R&D spending in Europe. Huawei has set up more than 30 R&D sites and innovation centres across Europe in Belgium, Finland, France, Germany, Ireland, Italy, Sweden and the UK with its R&D headquarters in Munich. Besides large Chinese R&D spenders such as Sany and CSR, there are thousands of Chinese enterprises that have the potential to innovate in new production practices, infrastructure solutions, technologies and customized consumer goods. The most immediate areas for innovation spill-overs from China include (consumer) electronics and the internet industry, but increasingly also for machinery and in the transport and infrastructure sector (railway, energy, telecommunication networks etc.).

Foreign companies also bring different models and organizational innovation. Like Japanese just in time production and lean management, Chinese companies have already proven their ability to introduce new standards and models, for instance "high tempo cost out" production or innovative approaches to e-commerce.²¹ One particularly interesting area is the experience of Chinese companies with implementing large-scale infrastructure

²⁰ See Caves (1974).

²¹ See Steinfeld and Beltoft (2014).

projects at home and increasingly abroad. While also a possible source of tension (see below), this experience combined with novel approaches to mega-infrastructure initiatives (such as the “One Belt One Road” Initiative) could yield benefits for European economies.

Table 1:
Chinese Firms Are Outsourcing and Localizing Research and Development

Selection of Chinese greenfield projects in Europe in research, development and design

Project	Chinese Investor	Location	Industry
R&D Centre	CSR Corporation	Dresden, Germany	Other Transportation Equipment
R&D Centre	Sany	Bedburg, Germany	Industrial Machinery and Tools
R&D Centre	Xuzhou Construction Machinery Group	Krefeld, Germany	Industrial Machinery and Tools
R&D Centre	Huawei Technologies	Duesseldorf, Germany	IT Equipment
R&D Head-quarters	Huawei Technologies	Munich, Germany	IT Equipment
Design Centre	Shanghai Automotive Industry Corporation	Birmingham, UK	Automotive Equipment and Components
Design Centre	Chang'an Automobile Group	Turin, Italy	Automotive Equipment and Components
Test Centre	Beijing Genomics Institute	Prague, Czech Republic	Pharmaceuticals and Biotechnology

Source: Rhodium Group

Policy Recommendations to Maximize Benefits

It is not guaranteed that Chinese capital will continue to flow to Europe. There is intense global competition and leaders around the world are now trying to attract Chinese capital. Moreover, it is not certain that inward FDI from China will lead to the benefits mentioned above. To maximize the benefits, Europe will want to encourage FDI that increases long-term productivity and growth rather than fire sales of assets that present a change in ownership but are not certain to produce much change in local investment, jobs or innovation. In order to maximize both the quantity and the quality of OFDI flows from China, European policymakers can focus on three major areas.

Structural reforms are key to attracting productive FDI

The first and most critical task is to implement the necessary structural reforms to ensure the long-term attractiveness of Europe as a destination for Chinese investment. The medium- and long-term growth potential of an economy is a key factor for foreign investors' location decisions.²² This is principally true for Chinese investors, along with a wide range of other factors that depend on the investor type and industry.²³ The attractiveness of Europe is diminished by the still unresolved euro crisis, a slow economic recovery, demographics and other structural deficiencies. In order to ensure that Europe continues to be an attractive place for Chinese companies to invest, it needs to implement reforms and kick-start economic growth. While the crisis has opened up some short-term opportunities for Chinese investors, for example through the privatization of state assets in Portugal or Greece, Europe has a strong interest in ensuring that Chinese investment does not just flow to such “fire sale” assets that largely function as a store of value for institutional

²² See Dunning (1993).

²³ See Dreger et al. (2015).

long-term investors. Instead, governments need to create the right institutional and commercial environment to steer Chinese cash into “productive”, job-creating FDI that utilizes local production factors and contributes to long-term prosperity and competitiveness.

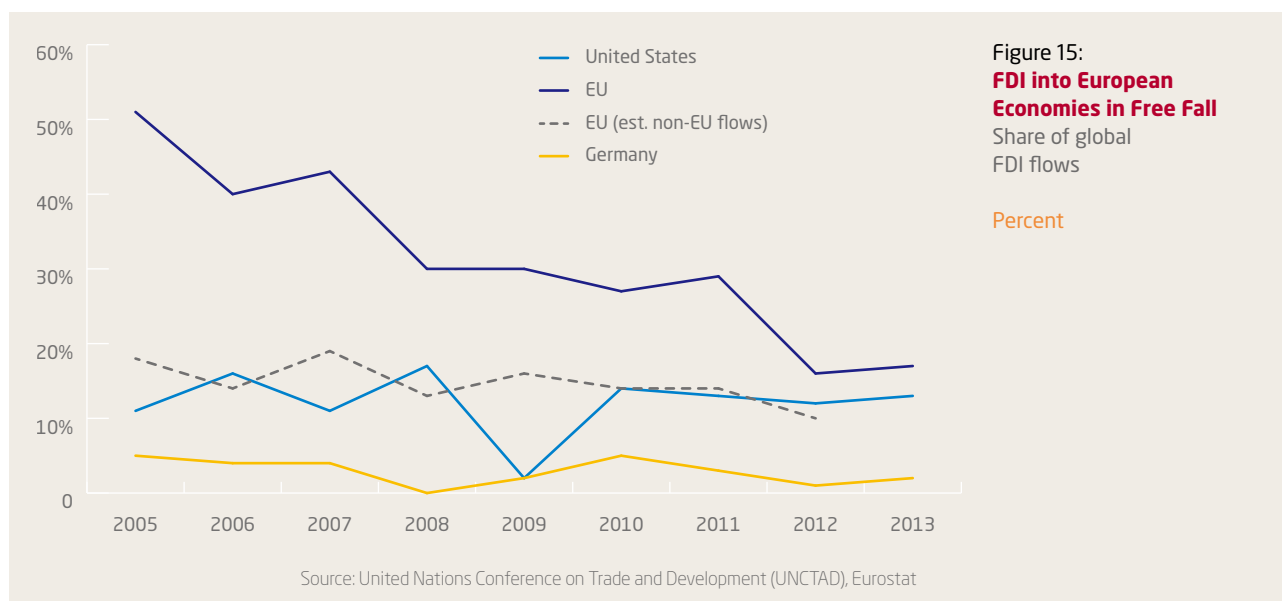


Figure 15:
FDI into European Economies in Free Fall
Share of global FDI flows

Percent

Germany is well positioned as one of the healthiest economies and seems highly attractive to international investors, including those from China.²⁴ Besides Germany, recent research shows that the United Kingdom, the Netherlands and France in particular continue to be attractive to foreign investment.²⁵ However, there is a huge imbalance within Europe as a whole, with 18 economies ranking below the top 25 globally most competitive economies. It is in Germany’s interest to ensure that Europe as a whole becomes more competitive and manages to draw in more investment. Berlin needs to take a leadership role in catalysing the necessary changes and driving required reforms in the European context.

Europe must resist the politicization of Chinese investments

A second core ingredient for positioning Europe well for Chinese capital will be to defend the traditional openness of European economies to FDI despite potential tensions arising from Chinese deals. Europe has a long tradition of FDI openness and every member state is committed to openness to capital from third countries, with only very few exceptions. Germany in particular has a very open regime and only restricts foreign investment in a few sectors and cases.

The rise of China has shaken up this traditional openness in many countries. Formally, countries such as Australia and Canada have introduced stricter laws and regulations, and lawmakers in the US and elsewhere have introduced legislation that tightens the review of FDI with particular reference to investment from China.²⁶ Informally, there has been a huge backlash against Chinese investors with deals being politicized, for example in the

24 A new report by the Chinese Academy of Social Sciences’ Institute of World Economy and Politics ranks Germany as the most attractive destination from a risk-analysis perspective. See CASS-IWEP (2014).

25 Semi-official and commercial reports rank Germany, the UK, the Netherlands and France very highly in terms of their competitiveness and attractiveness as investment locations. See WEF (2015), EY (2015) and AT Kearney (2015).

26 See DeLauro (2014).

case of CNOOC's takeover of US oil company Unocal in 2005.²⁷ Those regulations and most importantly the politicization of transactions, tainted the reputation of the respective countries as potential investment destinations for Chinese companies and sometimes led to a sharp drop in FDI from China (most visibly in Canada since 2013).²⁸

Europe has fared well so far without major cases of politicization, but the danger of openness being pulled back is real. While formal openness is cemented in EU law, there is a significant degree of discretion as national economies are left to define what justified "grounds of public policy or public security" are. One recent example is France's reaction to a bid for Alstom by US firm General Electric under the label of "economic patriotism",

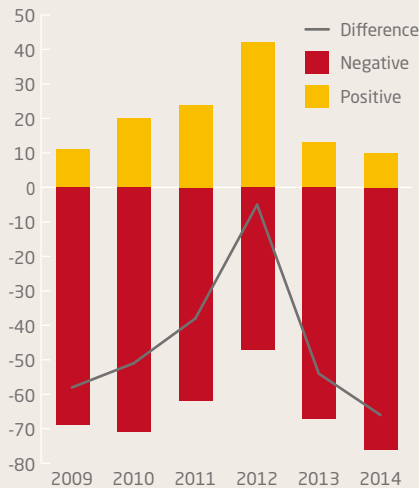
which extended a 2005 law on defence and other industries giving the state much-increased powers to block foreign takeovers in a wide range of sectors (requiring that they be approved by the economic minister). Tendencies to interpret national security more expansively could be aggravated by greater flows of Chinese capital in the future.

In addition to greater formal regulatory hurdles based on security risks, there is also a significant risk of informal discrimination and politicization. The call of former EU Industry Commissioner Tajani to obstruct a Chinese bid for Dutch cable maker Draka in order to protect European technology leadership shows that the European bureaucracy is not immune against such knee-jerk reactions. Even more important, there is fertile ground for populist stances against Chinese takeovers in European societies. Many Europeans have a rather negative view of China and its economic rise and strongly negative attitudes towards foreign takeovers in general (Figures 16.1 and 16.2). Combined with the increasingly politicized debate about international investment agreements, there is a real risk of popular political backlash against Chinese

Figure 16.1:
Germans Are Sceptical About China's Global Influence

Share of respondents in Germany articulating a positive/negative perception of China's influence in the world.

Percent

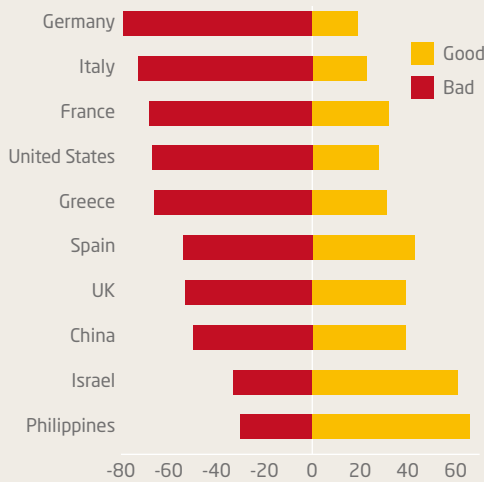


Source: BBC World Service Country Poll

Figure 16.2:
Europeans Have Negative Views of Foreign Takeovers

Share of respondents evaluating the "effect of foreign companies buying domestic companies on country" as good/bad.

Percent



Source: PEW Research Spring 2014 Global Attitudes Survey.

27 See Ng, Loretta and Wing-Gar Cheng, "Cnooc Drops \$18.5 Bln Unocal Bid Amid U.S. Opposition," Bloomberg, August 2, 2005, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ajw_HHJkvuE4.

28 We discuss the necessity of national security review mechanisms in the next section.

investment, particularly if it grows further and we see acquisitions opposed by domestic interest groups or hostile takeover bids.²⁹

Against this backdrop, on the European level, openness to Chinese investment should be cemented internally and externally through the formal Bilateral Investment Agreement. In the ongoing negotiation process, the “promise of openness” remains the most important bargaining chip vis-à-vis China. Furthermore, an EU internal discussion on what essential public security interests means in the EU context (see recommendations below) might help to mitigate nation states’ discretion for ad hoc changes.

Openness also needs to be defended against populist outrage to avoid negative knee-jerk reactions. On the national and local level, officials that are interested in promoting Chinese investment need to find the right strategies to educate the public about the motives and benefits of Chinese investments for local economies and communities, and communicate the many success stories that highlight those benefits.

New strategies for investment promotion efforts are needed

The third area that Europe must work on to realize the full potential of future Chinese investment is a better approach to investment promotion. Promotion efforts have become an important part of competing for global FDI flows and European economies including the UK, France and Germany have strong investment promotion units.³⁰ They are also an important instrument of regions or cities trying to attract foreign investors to local economies.

Compared to other foreign investors, Chinese companies are very inexperienced and therefore require a different approach to investment promotion and local support. Elements of successful strategies to attract Chinese OFDI include continuous high-level political support, hand-holding in the pre- and post-establishment phase, local incentives and training, as well as special initiatives such as conferences that create a “welcome culture”.³¹ Some forms of “informal” barriers can be addressed easily. Among the top concerns of Chinese enterprises entering the European market are administrative hurdles regarding visa issuance. While overzealous “golden visa” regulations potentially also create unproductive avenues for intra-European competition, some economies need an urgent reality check to see if regulations are in line with the new realities of China as a major capital exporter.

European economies already possessing strong capabilities should fine tune their approach to accommodate specific Chinese needs and think about creative approaches to foster investment in new areas, especially research and development and other innovation-intensive activities. Germany’s federal investment promotion agency (Germany Trade and Invest) is among the strongest in Europe and has a good track record in working with Chinese investors. It can improve its efficiency further by expanding its scope from its strong focus on greenfield projects to include certain aspects of investors that enter Germany through acquisitions, for example support with post-M&A expansions, for

29 A hostile takeover is defined as an acquisition that is accomplished not by coming to an agreement with the target company’s management, but by going directly to the company’s shareholders or fighting to replace management in order to get the acquisition approved.

30 See Morisset and Andrews-Johnson (2004).

31 See Joint Recommendations of the Inaugural Meeting of the Chinese-German Economic Advisory Committee, available at: <http://www.asien-pazifik-ausschuss.de/downloads/positionen/JointRecommendationFinalJuly2014.pdf>.

which there is great interest according to our data. Other areas that can be improved is to increase resources for local personnel in China and targeted outreach based on investment patterns and clusters. The networking and data sharing among federal, state and local officials also has room for improvements. Finally, closer collaboration with the Chinese Chamber of Commerce and other especially private Chinese business organizations would also help.

While the EU does not formally have a strong mandate for investment promotion, and the competition among nation states for foreign investment limits the potential for supranational efforts, several things can be done on the EU level to respond to the specific needs of Chinese investors. First, the EU Commission should explore models to attract Chinese (and other foreign) investment in projects that cross European borders (for example infrastructure) with a particular focus on sovereign entities and large institutional investors that will seek to deploy a significant share of their capital overseas in coming years. Second, the EU could set up a European “welcome and information centre” for foreign investors to leverage local and national promotion efforts. An umbrella organization such as “Select USA” that functions as first stop and then connects investors with national and local IPAs could be a cost-efficient solution. Such an organization could also improve coordination and exchange of information between local IPAs; come up with good practices and benchmarks for catering to Chinese investors; and support smaller European economies that do not have the resources and experience for efficient investment promotion structures.³²

32 See Ecorys (2013).

4. Addressing Concerns

China presents a unique opportunity for Europe to increase investment levels and reap associated benefits. However, there are also a number of particular concerns related to the nature of China as a new major source of FDI. These concerns are not based on industry- or company-specific factors that determine the failure or success of particular acquisitions or greenfield projects, but are related to broader reservations about the nature of China's economy, its political system and its position in the international system that require a re-assessment of traditional risks related to FDI from a recipient country perspective.³³

In this section we assess the six most important areas (macroeconomic volatility; asymmetry in market access; subsidies and other unfair advantages; technology transfer; national security; and a regulatory race to the bottom) and provide suggestions for how to address and mitigate concerns in each of those areas.

Macroeconomic Volatility

One of the oldest concerns associated with foreign capital is that it can expose recipient countries to volatility in investment levels and large swings in asset prices, which in turn can negatively impact economic growth and stability. Such volatility is mostly associated with shorter-term and highly mobile portfolio investment flows, but there are many historic examples of "boom and bust" cycles that were caused or amplified by FDI. Smaller economies with large foreign investment in extractive sectors are at particular risk to suffer from such volatility.³⁴

China is a potentially difficult case because it combines two features: First, China is the world's second largest economy and the magnitude of its current and future capital outflows exceeds those of previous emerging global investors. Second, China is still an emerging economy that is in the midst of a difficult process of internal and external financial and economic reform, with a fair chance of major swings and volatility in coming years. These two characteristics increase the potential risk of "boom and bust" cycles in countries with high Chinese investment levels in coming

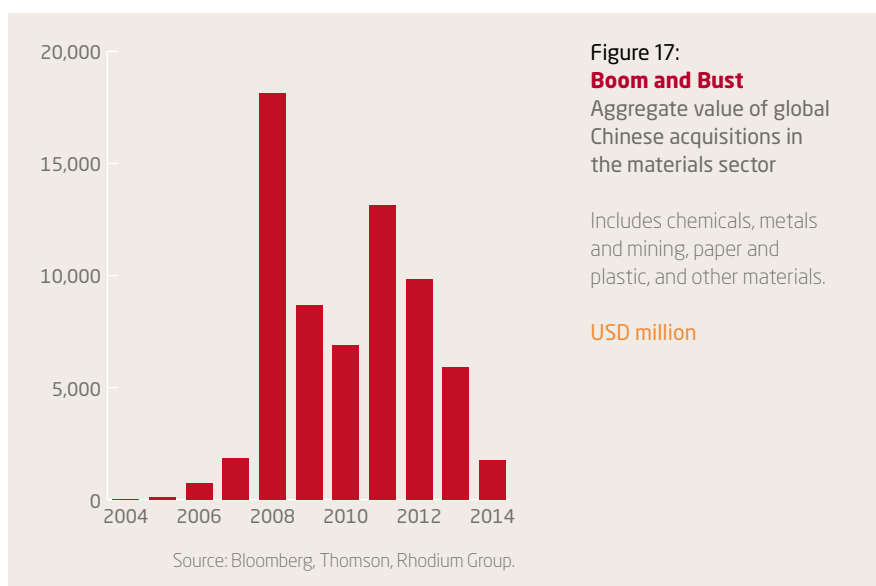


Figure 17:
Boom and Bust
Aggregate value of global Chinese acquisitions in the materials sector

Includes chemicals, metals and mining, paper and plastic, and other materials.

USD million

33 The analysis of failure and success of individual projects or patterns in specific industries is beyond the scope of this report. However, we want to emphasize that our dataset does not support the concern that Chinese investors are more prone to failure than investors from other countries. While there are examples of high profile FDI projects in Europe and Germany that did not meet expectations in terms of capital expenditures and job creation, significant discrepancies between announced and actual investment figures for greenfield projects are a common phenomenon globally.

34 For more background on the volatility of FDI and other private capital flows and the impacts on recipient countries, see United Nations Development Programme (2011, Chapter 3).

years. The recent rise and fall of Chinese investments in global mining and materials sectors illustrate this risk (Figure 17). This swing and, especially, the recent fall in capital expenditures associated with those investments have tremendously impacted the host economies, from Latin America to Africa and North America.

Risk for Europe is low but better data is needed for effective monitoring

For Europe as a whole and Germany in particular such concerns are comparatively minor at this point in time. Despite recent growth, China still accounts for a small share of total inward FDI to the EU across all sectors. Additionally, Europe is economically diverse and not reliant on natural resources extraction and other highly cyclical sectors. One development that warrants attention is the recent explosive growth of OFDI from “financial” investors including private equity firms, insurance companies and sovereign investment vehicles. Flows from these entities could reach a very large scale in coming years and thus far their investments have predominantly targeted only a few industries, which could contribute to asset price inflation and fuel bubbles in certain parts of Europe. One example is commercial real estate, where annual investment has soared from next to nothing before 2013 to a combined \$6 billion in 2013 and 2014.

While we place a fairly low priority on this area at the moment, this concern will become much more urgent when non-FDI flows begin to appear in Europe. Going forward, it makes sense for European institutions to particularly monitor Chinese capital flows to smaller EU economies, accession candidates and third countries in order to identify potential bubbles and volatility that could spill over and impact EU economies. The rise of China and other emerging economies as major capital exporters is also a good reason for improving the transparency of data on capital flows to Europe in general – for example following the Treasury International Capital (TIC) system in the United States that provides information on foreign holders of domestic government bonds, equities and debt securities.³⁵

Asymmetry in Market Access

A second important concern is that FDI can distort the playing field between companies competing internationally if there are different degrees of investment openness in those markets. Such asymmetries in market access are not just problematic from a fairness perspective; they are also undesirable from an economic welfare perspective as they distort the optimal allocation of capital and can lead to politically induced investment imbalances between two countries. Historically, concerns about market access were mostly addressed through bilateral agreements between advanced economies (which for a long time were the dominant force of global FDI) that guaranteed a certain degree of reciprocity in openness, or multilateral and regional agreements such as the OECD Codes of Liberalisation of Capital Movements, the General Agreement on Trade in Services (GATS) or the Maastricht Treaty, which cemented the principle of free capital movement in the European Union.³⁶

35 See the U.S. Department of The Treasury, Treasury International Capital (TIC) System, available at: <http://www.treasury.gov/resource-center/data-chart-center/tic/Pages/index.aspx>.

36 See OECD (2013); For the full text of the General Agreement on Trade in Services (GATS), see https://www.wto.org/english/docs_e/legal_e/26-gats_01_e.htm; For the full text of the Treaty on European Union –Maastricht Treaty, see http://europa.eu/eu-law/decision-making/treaties/pdf/treaty_on_european_union/treaty_on_european_union_en.pdf.

The recent rise of emerging economies as significant exporters of capital puts this question back on the agenda and China is at the centre of attention. Openness to FDI has been a core element of China's economic reforms since the 1980s and it has embraced foreign investment as an important source of growth, innovation and employment. At the same time, China is still restricting foreign access to many sectors of its economy. In terms of formal restrictions to FDI, China is considered one of the least open countries among the G-20 economies (Figure 18). Moreover, there is rampant informal discrimination against foreign companies as well.³⁷ In the past, this wasn't hugely problematic as China was a developing country without significant overseas investment interests. However, now that China has become a major exporter of FDI and its firms enjoy virtually unrestricted access to most advanced markets, the situation has changed profoundly.

The contrast in formal market access is particularly stark when comparing China to Europe. EU governments have committed not only to allowing free capital inflows from other European economies but also from third countries, including China. That means that Chinese companies are on paper free to invest in European markets without significant restrictions and the recent trajectory of Chinese investment is evidence that this is also true in practice. At the same time, European companies are hit particularly hard by existing market barriers in China. EU firms are highly competitive in many advanced manufacturing and services sectors, which are the most heavily restricted areas in the Chinese economy.

Figure 19 provides a detailed breakdown of formal investment restrictions in China and Germany by sector, illustrating this gap. For Germany in particular, greater symmetry in market access is a top priority as it is one of world's major exporters of capital and its companies have a huge interest in currently restricted sectors of the Chinese economy.

More equal market access is critical for sustaining EU-China investment relations

In our view, asymmetries in market access is one of the most important issues that needs to be tackled in the near term. While there is no immediate danger that current imbalances lead to systemic market distortions, the current situation creates a strong sense of unfairness among Europeans, which makes it difficult for decision-makers and officials to advocate for greater investment integration with China. In short, greater reciprocity in market access should be a top priority for EU leaders to both ensure a level playing field for EU companies and, more importantly, to defend Europe's long-term commitment to openness vis-à-vis China.

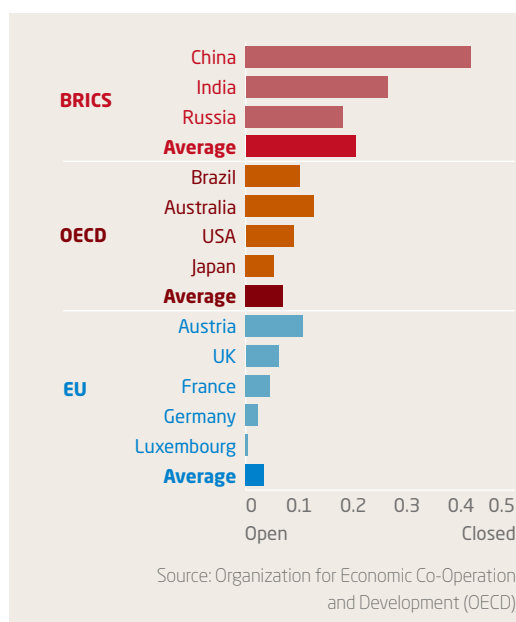


Figure 18:
China Remains One of the Most Restrictive Environments for FDI
FDI Restrictiveness Index, selected economies and country groups, 2014

The FDI Regulatory Restrictiveness Index measures statutory restrictions on foreign direct investment

Index: 0=Open;
1=Closed

37 A summary of these informal restrictions can be found in a 2014 report prepared for the European Commission Directorate-General for Trade by Covington & Burling (2014). The EU Chamber of Commerce in China annual position paper also elaborates on investment environment for foreign companies in China. See European Chamber (2014).

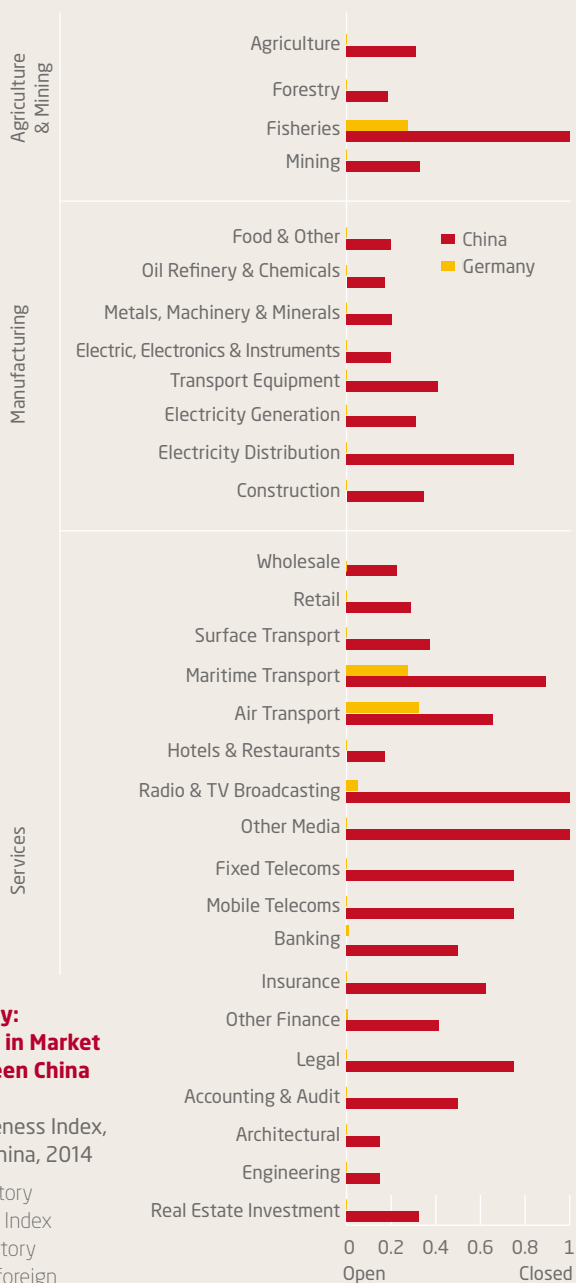


Figure 19:
No Reciprocity:
Asymmetries in Market
Access between China
and Germany
 FDI Restrictiveness Index,
 Germany vs. China, 2014

The FDI Regulatory Restrictiveness Index measures statutory restrictions on foreign direct investment.

Index: 0=Open; 1=Closed

Source: Organization for Economic Co-Operation and Development (OECD).

The good news is that China is aware of this issue and has openly acknowledged its current FDI governance as an important pillar of economic reforms. In early 2015, the State Council introduced a law that would formally abolish the current approach of maintaining three lists of encouraged, restricted and prohibited sectors and would implement a modern FDI regime that is based on pre-establishment rights only restricted by a narrow “negative list”, national security reviews and competition policy.³⁸ While this is positive, there remains significant uncertainty: the timeline for implementation is unclear; the extent of the negative list is as yet unclear; and the scope and process of national security and competition policy reviews is not narrowly defined and codified so that it leaves plenty of room for potential informal discrimination. In short, China’s partners cannot lean back but need to take action to catalyse fast and efficient FDI reforms in China.

On the European level, there are several channels to utilise. First, since the implementation of the Lisbon Treaty in 2008 the EU Commission has had the authority to negotiate bilateral investment agreements (BIAs), which are a primary instrument for discussing and defining two-way investment openness. A robust BIA with China that includes pre-establishment rights for European companies and ensures

that there are few exceptions through a negative list would be a big step toward facilitating the broader FDI reforms announced in China. The EU Commission has made significant progress in negotiating a BIA text and negotiations have now entered the difficult phase of agreeing on a negative list. Given its mandate for investment agreements, a second strategy for the EU would be to work with other interested economies to promote global investment openness through other agreements and initiatives on the

38 See Ministry of Commerce (2015).

bilateral, plurilateral or multilateral levels. Bilateral or regional agreements can help to set new standards of openness and promote a “race to the top”. Even better, given the demonstrated interest in open investment flows by the three largest economies on the planet (the US, EU and China) accounting for 60% of GDP and 67% of global OFDI, it makes sense to explore the option of re-starting talks about a multilateral investment agreement that sets global standards for cross-border investment openness and best regulatory practices to defend legitimate national interests.

While the EU now has the lead on negotiating investment treaties, individual member states have an important role to play in achieving greater symmetry in market access with China. For one, it will be important that larger EU states such as Germany are fully aligned with European interests instead of putting their focus on a national agenda, which would dilute European leverage in BIA negotiations. Moreover, in light of the uncertainty about the timeline for concluding a BIA, large EU member states such as Germany should work through bilateral channels to hold China accountable to its promises of reforming its foreign investment law and to ensure it makes progress toward ending informal discrimination against foreign firms.

Subsidies and Non-Market Advantages

A second potential source of unfair competition in the global FDI arena are subsidies and other non-commercial advantages arising from preferential treatment of specific companies. Such advantages can lead to distortion in global markets, for example when a company wins a competitive bidding process for a global asset not because it can most efficiently use this asset but because it has access to preferential loans and other political privileges. As opposed to trade, where the World Trade Organization (WTO) and other bodies settle disputes related to subsidies, there is neither a global definition of investment subsidies, nor an institutional framework that addresses disputes in the investment context. The reason is that traditionally more than 80% of global OFDI flows have come from developed economies, which have all dramatically reduced state ownership and limited subsidies largely to companies with a mandate to provide public goods or address market failures in the domestic context.

Again, the rise of emerging economies, and particularly China, challenges this status quo of past decades. The role of state-owned enterprises in the Chinese economy has changed dramatically over the previous decades of reform, but they continue to play an important role in many sectors of the Chinese economy and still receive preferential access to capital and other resources.³⁹ Moreover, it is not only state-owned enterprises that benefit from preferential political treatment, but also large private companies that operate in areas with important national development goals or that are important to regional and local governments with regard to employment or tax revenue. In short, many of China’s globally operating companies are receiving preferential treatment from local or central governments and derive substantial advantages from those relationships.

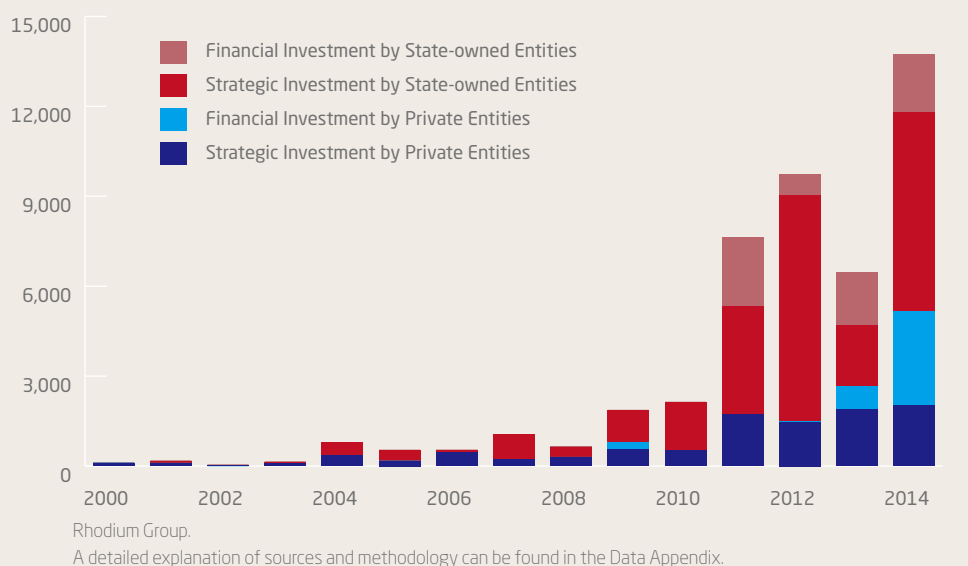
In the past, European companies have mostly been affected by such subsidies because they had to compete with these companies in China. The recent growth in OFDI means that these firms are now competing head-to-head with European firms in their home markets. Figure 20 shows that EUR 31 billion out of EUR 46 billion of Chinese FDI deals

39 See Meissner et al. (2015).

originated from state-owned Chinese companies. In many cases those companies beat private European companies also bidding for those assets.⁴⁰ What adds to the fairness problem is that European law prevents European companies from receiving “state aid” from their governments, which is monitored and enforced by the EU Commission’s competition authorities.⁴¹ However, this “state aid” review requirement only applies to European companies, not to companies from third countries. In short, European companies are bound by European state aid rules but at the same time have to compete against Chinese firms with credit lines from state-owned banks and favourable industrial policies at home.

Figure 20:
State Companies Still Dominate China’s Investment Footprint in Europe
Chinese FDI Transactions in the EU-28 by Type of Investor, 2000–2014

EUR million



Europe needs a “Plan B” if Chinese reforms disappoint

The good news is that China has recently announced structural reforms that aim at making the market the dominant force in the Chinese economy. If properly implemented, those reforms would address many elements of China’s growth model that are currently considered problematic, including a market-driven financial system and the reform of state-owned enterprises.⁴² Supporting and demanding rapid progress on those self-prescribed reforms should be the priority of the EU and national governments for dealing with the non-market advantages of Chinese firms in the global context. The new reform agenda also offers a window of opportunity for European officials to convince their Chinese counterparts that “competitive neutrality” is not a tool to contain China but a useful instrument to ensure the productive co-existence of state-owned companies and a competitive marketplace. In fact, researchers at Chinese government think tanks have made the point that China has a long-term interest in establishing its own state aid regime if it wants to efficiently modernize its state-owned sector.⁴³ Europe has come a long way in modernising its own state companies and can therefore credibly share its experiences.

40 For example, China Three Gorges outbid German utility company E.ON for a 21% stake in Energias de Portugal in 2011.

41 See the overview of the European Commission’s state aid control regime, available at http://ec.europa.eu/competition/state_aid/overview/index_en.html.

42 See Rosen (2014) and Ahlers et al. (2014).

43 See Liao and Zhang (2012).

At the same time we believe that the rapid implementation of market reforms cannot be taken for granted. The timeline and success rate for the implementation of economic reforms are unclear and there are strong vested interests opposing reform. Moreover, recent developments suggest that things are moving in an opposite direction. Some of the announced SOE reforms consist of large-scale mergers of Chinese companies aimed at creating globally competitive giants in sectors such as high-speed railway, engineering or nuclear power. Moreover, the Chinese government is raising to a new level strategies of utilising state-owned lending and OFDI to create new markets and offload domestic overcapacity.⁴⁴

Therefore it is important for EU policymakers to think about potential options for hedging against a scenario of continued Chinese growth without addressing such market distortions. The goal is not to block investment by SOEs but to create rules that provide greater transparency about types and scope of government support for specific investments. On the EU level, the most intuitive place to start would be to think about an external dimension of the already existing state aid regime. National policy makers could explore the option of specific SOE disclosure requirements including ownership structures, financing and subsidies.

Technology Transfer and Headquarters Effect

A fourth important traditional concern is that FDI and particularly acquisitions can lead to the transfer of technology and related high value-added economic activities from the host to the source country. This so-called “headquarters effect” was an important theme in the FDI debate in the 1980s, but its importance has declined in recent years as researchers failed to find much empirical evidence.

The rise of China as a global investor raises this question again for a range of different reasons. For one, China is still at a comparatively early stage of development and it has the declared goal of utilising OFDI as a channel for moving up the technology ladder. At the same time, China has strong industrial policies that encourage domestic R&D and indigenous innovation. These policies were intensified in May 2015 with the government’s new “Made in China 2025” strategy, aiming at positioning China as an innovative global manufacturing superpower.⁴⁵

In the past, this has often resulted in policies that forced foreign firms to share technology with their Chinese partners. With outbound FDI, the prevalence of a national technology agenda could lead to a situation where industrial policy directives trump commercial logic when Chinese companies are deciding where to locate their research and development activities.

This is a particularly central concern for Europe. European firms are often among the leaders in technology in their fields, particularly in industrial applications. At the same time, China has major ambitions in those areas and Chinese companies are using investments in Europe to access technology and know-how both in the form of acquisitions and greenfield facilities (see Table 2). This is particularly true for Germany, where almost all significant M&A transactions were driven by the desire to access technology and know-how.

44 See Irwin and Gallagher (2014), Aizenman et al. (2015).

45 See State Council (2015).

Table 2:
Many Chinese Acquisitions are Targeting European Technology
 Selection of technology-seeking Chinese acquisitions in Europe

EU Company	Chinese investor	Location	Industry
Schwing	Xuzhou Construction Machinery Group	Herne, Germany	Industrial Machinery and Tools
WISCO Tailored Blanks	Wuhan Iron & Steel	Duisburg, Germany	Automotive Equipment and Components
Thielert Aircraft Engines	AVIC International	St. Egidien, Germany	Aerospace Equipment and Components
Medion	Lenovo	Essen, Germany	IT Equipment
Alcatel-Lucent Enterprise in Colombes, France	China Huaxin Post & Telecommunication Economy Development Center	Boulogne-Billancourt, France	IT Equipment
PSA Peugeot Citroen	Dongfeng Motor Group	Paris, France	Automotive Equipment and Components
Compagnia Italiana Forme Acciaio	Zoomlion Heavy Industry Science & Technology Development	Milan, Italy	Industrial Machinery and Tools

Source: Rhodium Group.

Track record suggests positive contribution from technology-seeking investments

While the track record of technology-seeking Chinese investments in Europe is very limited (most deals are less than 5 years old), there are currently no signs that Chinese investment has led to a politically mandated shift of value-added activities to China. First and foremost it is important to recognize that the growing number of technology-seeking investments is a positive development from the perspective of IPR holders. Instead of forced technology transfer and blatant theft of IPR, Chinese companies are now ready and willing to pay for technology at market prices in open and market-based transactions. This shows the growing importance of innovation and technology in the new Chinese growth model. Second, to date there is no evidence to support the concern that Chinese firms could be buying EU technology assets and then moving related activities and jobs back to China.

The contrary is true: most Chinese companies are doubling down on Europe and expanding their EU R&D presence and local staff count after they enter the market through greenfield projects or acquisitions. This makes perfect sense as Chinese companies face a massive shortage of talent at home and the legal framework for IPR protection is advantageous. In short, there is no evidence thus far that Chinese companies behave differently from other multinationals when thinking about global R&D value chains.

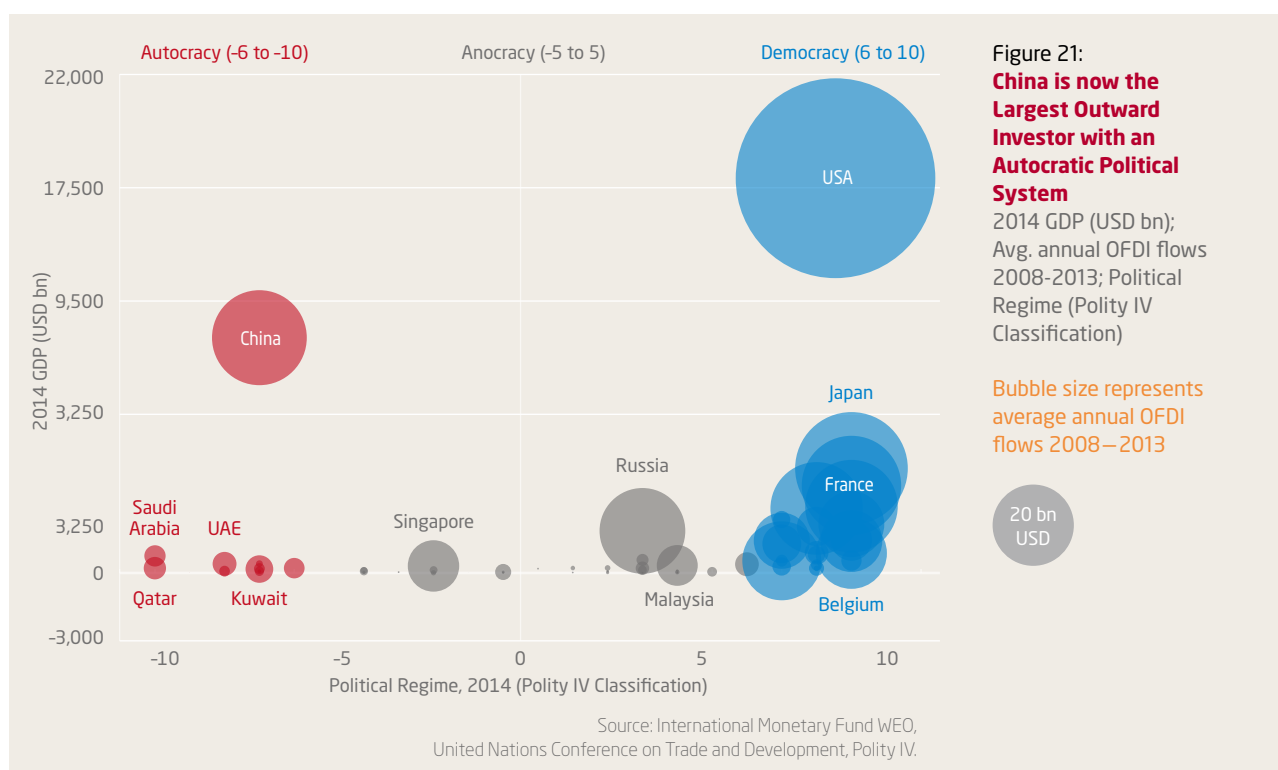
There is no evidence thus far that Chinese companies behave differently from other multinationals when thinking about global R&D value chains.

Therefore the most important task for policymakers is to continue their efforts to position Europe well in competition with other parts of the OECD for the billions of dollars that Chinese multinationals will spend in the coming years to globalize their research and development efforts. On the national and local level it is important to think more strategically about potential Chinese contributions to local innovative capacity and to consider possible models to accelerate collaboration. Finally, in order to better understand potential negative long-term impacts, we do see the need to spend more time and resources on evaluating the impacts of technology-seeking investments in the medium to long term and, particularly, to assess trends in sectors with strong industrial policies and other government involvement.

National Security Threats

In addition to economic risks, FDI can also raise particular national security concerns for host economies. While FDI is principally considered to be a net positive for political stability between two countries, foreign ownership of assets can pose concerns if it gives foreign firms the opportunity to deny the provision of goods and services that are critical for the functioning of an economy, in particular the industrial base for defence. FDI can also be harmful if it provides foreign interests with additional channels for infiltration, surveillance and sabotage of critical infrastructures in energy, transportation, cyber and financial networks. FDI may also lead to the transfer of technology or expertise to a foreign-controlled entity that might be deployed in a manner harmful to a nation's interests.⁴⁶ Many countries reserve the right to review foreign acquisitions or FDI in general for all or some of these considerations. Security-related reviews are also common exceptions for free capital flows in most bilateral investment treaties and other undertakings like free trade agreements with investment provisions.⁴⁷

In the context of national security screenings, China poses new challenges for host countries. In recent decades, all major exporters of FDI were market economies with democratic political systems, with the only significant exceptions being Singapore and Russia (Figure 21). Newly emerging major exporters, most importantly Japan, were either military allies or simply not large enough to matter. China is an outlier: it is now the world's second largest economy and has become one of the top five OFDI exporters in the world. At the same time it is a country with an authoritarian political regime, a unique economic system, weak security relationships with most major recipient countries and increasing assertiveness on the global stage.



46 See Moran (2009).

47 See, for example, Yannaca-Small (2007).

Security screenings are important and better intra-EU coordination is needed

Considering these realities and the uncertain outlook for China's behaviour in global geopolitics⁴⁸, it is important that European economies screen Chinese investments to detect security risks and if necessary block investments or find appropriate mitigation measures. A second important reason to have such vetting mechanisms in place is that they are a prerequisite for governments to defend general openness to foreign investment: citizens will only support greater Chinese ownership of EU assets if they are reassured that those security threats are appropriately monitored and addressed. Most European nations already have review processes in place, but the approaches and definitions vary greatly (Table 3).⁴⁹ Germany follows an approach of having the right to review any acquisition that results in an ownership of 25% or more for potential security or public policy threats. France follows a more expansive approach and has recently extended review mandates. Several countries including the Netherlands, Croatia and Latvia do not have investment reviews in the first place.

While the national approaches of most EU member states (and Germany in particular) are appropriate and have worked well in the past, the rise of China as a significant investor requires an overhaul of the fragmented European landscape of security reviews towards a more coordinated approach. For one, Chinese investors have begun to take greater interest in European assets with not just national but regional security implications, for example utilities, transportation or telecommunication infrastructure. Two, the projected growth of Chinese OFDI in coming years will likely overwhelm the capacity of smaller EU economies to properly review relevant investments. Three, a more coordinated approach with clearer criteria will also help to prevent the politicization of individual deals by national governments.

Europe does not need any China-specific mechanisms but EU member states should initiate an EU-wide dialogue on best practices on national security screenings based on the OECD's four principles for investment reviews (non-discrimination, transparency and predictability, regulatory proportionality, and accountability).⁵⁰ While nation states are unlikely to give up their sovereignty and informal exchanges do already happen among core European countries, it would be a step forward to improve shared understandings of national security threats and to implement coherent procedures and timelines for security reviews across Europe.⁵¹ Another important component would be better exchange of information on deals and threat scenarios, and collaboration on investments that impact more than one country, with the recent majority stake in Toulouse Airport (the "Airbus Airport") being a case in point.⁵²

Another potential element of a better approach to national security screenings would be greater transparency through provision to the public of basic information such as the number of deals reviewed and the definition of national security threats in each country. While very successful so far in avoiding politicization of deals, the German investment

48 See Heilmann et al. (2014).

49 See also Nicolas (2014).

50 See OECD (2009).

51 See Röller and Véron (2008).

52 "French plans for airport sale to China spark unease," available at <http://www.france24.com/en/20141205-france-sell-major-stake-toulouse-airport-firm-china>.

screening process would benefit from greater transparency and dissemination of at least basic information to the public and the parliament.

Finally, China's rise as a direct investor provides a window of opportunity to have a broader discussion of norms and standards for security screenings. While Europe could be a good starting point for that, ultimately this topic will need to be debated on a global scale. This is even more important as China now has its own national security screening framework, and there are already concerns that it could be another source of informal discrimination against foreign investors.⁵³ In short, the risk of over-applying national security exceptions for inward investment approval worldwide is becoming acute. Coordination on definitions, concepts and frameworks is crucial for buttressing investment liberalism.

Austria	Non-EEA investors acquiring at least a 25% stake in firms in certain sectors must obtain Ministry of Economy approval. These sectors include defence, power, telecommunications, transportation, and other industries.
Cyprus	A mandatory security review process was abandoned but restrictions still apply in the mass media, property and construction sectors.
Denmark	The Ministry of Justice must approve foreign investments that result in ownership of more than 40% or voting rights exceeding 20% in firms producing defence materials.
Finland	Finland restricts foreign acquisition of influence in companies that produce defence materials or provide goods and services vital to national defence.
France	The Minister of Economy and Finance reviews acquisitions in certain sectors when investors will surpass certain ownership thresholds. These sectors are related to public order, public safety, and national defence interests including aerospace construction, nuclear energy, communications interception and detection, cryptography, arms, munitions and war materials, gambling and casinos, and other industries.
Germany	The Federal Ministry of Economic Affairs and Energy may review and block acquisitions that result in 25% or greater ownership if such transactions constitute a threat to the security or public policy of the Federal Republic of Germany. This review process is not confined to certain sectors.
Italy	Italy has a national security screening system that applies to national defence, energy, transport, and communications sectors "in cases where an acquisition or other form of transaction triggers a threat of severe prejudice to essential interests of the State".
Lithuania	Lithuania prohibits foreign investment in state security and defence sectors. The State Defense Council may make exceptions for investors from EU and NATO countries.
Poland	Foreign enterprises require government approval to acquire real estate in border areas and to invest in enterprises that manage airports. Enterprises with foreign participation may not establish airports.
Portugal	There is no formal national security review for foreign investment in Portugal. Only a few sensitive areas are regulated by industry-specific agencies, such as transportation and telecom.
Slovenia	Foreign firms may not produce or trade in armaments.
Spain	Foreign investors seeking to participate in Spanish companies related to defence must first seek government authorisation.
Sweden	A government permit is required for foreign-controlled enterprises to produce war munitions.
United Kingdom	The Secretary of State may intervene in merger deals that could adversely affect national security or certain public interest considerations under various regulations, including the Industry Act and the Enterprise Act. There exist additional regulations on investment in Aerospace, Energy, and Maritime sectors. Specific review of foreign investment is conducted by the Office of Fair Trading (OFT) and the Competition Commission.

Source: National government sources, OECD Investment Policy Reviews, OECD-WTO-UNCTAD Reports on G20 Trade and Investment Measures, and US Department of Commerce Investment Climate Statements.

Table 3:
The Patchwork of FDI Security Screening Practices in Europe
National security FDI screening practices in selected EU countries, 2014

53 China's security screening framework is based on a very broad definition of security, including national security, economic stability, and social order. See China's 2011 National Security Review (<http://www.mofcom.gov.cn/article/b/f/201102/20110207403117.shtml>) and 2015 draft Foreign Investment Law (<http://tfs.mofcom.gov.cn/article/as/201501/20150100871010.shtml>).

A Regulatory Race to the Bottom?

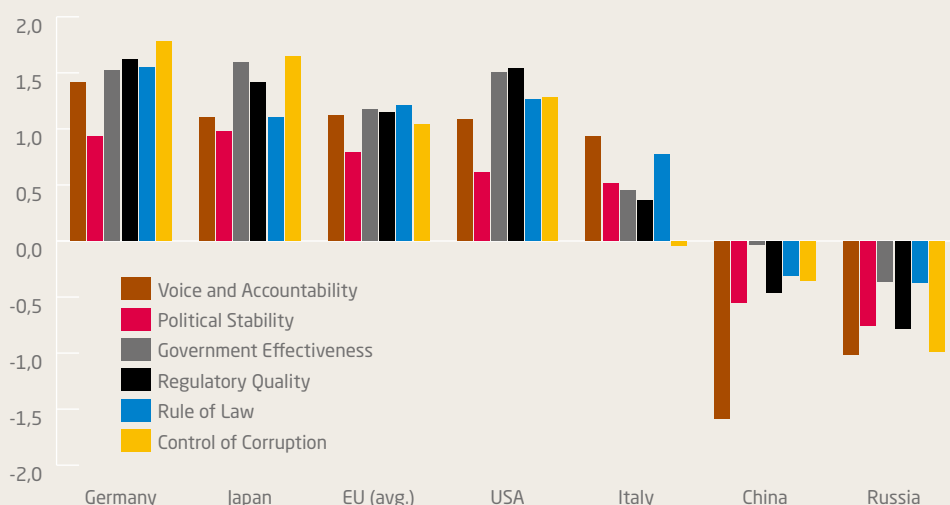
One final concern from the perspective of host economies is that foreign investors sometimes “export” bad practices and fuel a “race to the bottom” in labour, environmental and other standards. This is a particular concern for FDI from emerging economies, as those are generally less well regulated than advanced economies.

Chinese firms do operate in an institutional and regulatory environment that is very different from most other major investor countries (Figure 22). Several cases in Europe have provoked fears that greater Chinese investment will erode local labour standards, environmental rules, tax compliance. Prominent examples are the Italian city of Prato, where Chinese entrepreneurs have replicated the Chinese sweat shop model in Europe; COSCO’s operations in the Port of Piraeus, which boosted productivity but undermined the position of local labour unions; and the case of COVEC in Poland, which did not fulfil its contractual obligations after massively undercutting competitors in terms of price.⁵⁴

Figure 22:
Chinese Investors
Have A Different
Regulatory
Environment at
Home

Governance Quality
Index, selected
economies

Index: 2.5=High;
-2.5=Low



Source: World Bank

Concerns about regulatory compliance are irrelevant as long as local enforcement capacities are sufficient

We argue that such fears are not warranted if robust local regulations are in place and properly enforced. Once they set up a physical presence in Europe, Chinese firms have to follow local regulations and are subject to penalties and litigation if they do not comply. The above-mentioned examples of “bad” practices of Chinese firms and entrepreneurs in Europe are mostly a result of weak local capacities for rule enforcement and punishment of violations. We believe that greater physical presence of Chinese companies in Europe through FDI in fact increases the incentives for Chinese companies to converge with advanced economy regulatory standards and increases the ability for Chinese firms to be held accountable in local courts for misbehaviour.

The best way to address concerns about a regulatory race to the bottom from the market entry of China and other emerging market investors, therefore, is to continue to harmonise

⁵⁴ Ceccagno, Antonella (2012), van der Putten (2014), and Le Van (2012).

labour, environmental and other regulatory standards across Europe and to improve local enforcement capacity. In addition, European leaders should think about how best to seize the new reality of growing physical Chinese presence to make progress on areas that are relevant to EU companies but were difficult to address in the past. One example is the enforcement of intellectual property rights, where the existence of Chinese companies with significant assets in Europe opens up new opportunities for courts and prosecutors for litigation and compensation. Another area where we see an opportunity for national governments to step up their game is better cooperation with China on economic crimes to increase the accountability of Chinese executives. The strong interest in getting hold of Chinese nationals accused of corruption provides an additional window of opportunity to make progress on bilateral cooperation in this area.

5. A Policy Agenda for Europe

We have demonstrated that China is indeed a different case to other previous significant foreign investors. On the one hand, characteristics such as the size, growth and complementarity of the Chinese economy creates unique opportunities for Europe. At the same time, some specific concerns that are related to the nature of China's political and economic system, such as the prevalence of non-market elements or China's position in the international system, create some unique challenges. This uniqueness of China does not question the existing paradigm that FDI is beneficial on net from a host country perspective. However, there are some urgent items that European policymakers should address in response to China's rise as an exporter of FDI in order to maximize the benefits while addressing concerns.

We need better data to understand the new era of Chinese capital

One important finding we presented in this report is that the current data situation is simply inadequate, even for relatively tangible and traceable flows such as direct investment. The emergence of China as a huge and relatively opaque investor highlights that we need better approaches to understand the extent, direction and trends of global capital flows. National statistical agencies should be provided with adequate resources to improve data collection in order to be more helpful not just for understanding trends dating back two or three years, but for the analysis of flows and metrics relevant for policy-making. Organisations such as the IMF, OECD and UNCTAD all have expertise and can facilitate a multilateral process to improve transparency and real-time understanding of global capital flows, instead of just documenting flows retrospectively with significant time lags. Think tanks and the private sector can supplement this process with new ideas and innovative approaches.

Policy priorities for the EU level

Aside from the data challenge, we identified several areas that warrant immediate attention from leaders. On the EU level, we see the following priorities:

First and foremost, in order for Europe to receive productive and job-creating FDI from China, it will be critical to address current structural impediments that stand in the way of future economic growth. Chinese investment is an exciting prospect for Europe as an additional source of growth, but Europe is competing with others for these flows and needs to implement the necessary structural reforms to succeed.

Second, it will be important to conclude a robust bilateral investment agreement that addresses the existing asymmetries in market access through pre-establishment rights for European companies and a short negative list. This is important for the sake of safeguarding a level playing field for EU companies and also for ensuring that investment openness towards China continues to have the support of EU citizens and parliaments.

Third, we see the need to initiate a debate about greater coordination of security review processes within Europe to increase the efficiency and coherence of such reviews from a security point of view, but also to increase the confidence of European citizens that there is a functioning pan-European solution in place to address potential risks, which will be the prerequisite for avoiding popular backlash and the politicization of deals. The

ultimate mandate for such reviews will remain the responsibilities of individual member states, but common rules and better coordination are important to sustain confidence in and efficiency of these national procedures.

Fourth, European leaders need to grapple with the question of how to react if the structural reforms that Beijing promised for the purpose of addressing subsidies and other non-market elements that distort global competition occur slower than required by the reality of growing outbound FDI. Existing competition policy instruments including the state aid regime would be the best starting point from which to think about potential options on the European level.

Policy priorities for Germany and other nation states

From the perspective of nation states, we see the following priority areas, which we illustrate with the example of Germany:

First, it will be important to defend the principle of investment openness. As members of the EU, Germany and other EU states are obliged to keep their borders open to third country capital flows and Chinese investors are enjoying fair and equitable treatment. However, it is possible that growing Chinese deal making will trigger populist backlashes similar to those seen in other parts of the world, in which case governments and leaders need to stand up and defend the principles of investment liberalism.

Second, while Germany already has a comparatively effective and well-endowed investment promotion system, the emergence of China as a significant source of capital requires a re-think of existing approaches to investment promotion and investor support, including an increase in capacities on the ground, efforts to identify and abolish China-specific regulatory hurdles, and a greater focus on innovation-intensive industries and post-acquisition expansions.

Third, it is critical that large and important EU member states such as Germany stand behind current EU efforts to conclude a strong BIA with China and that Europe speaks with one voice instead of following national agendas.⁵⁵ Moreover, national governments will have an important role in monitoring progress on ending informal discrimination of foreign companies in China, which is something that cannot be addressed by a BIA. Here, it is important that states take the Chinese government up on their promise of implementing a new regulatory regime that levels the playing field between domestic and foreign firms and flag delays and unsatisfactory progress.

Fourth, it makes sense for Germany and other EU states to spend more resources on exploring potential worst-case scenarios under which preferential treatment for national champions, industrial policies and techno-nationalism remain pillars of China's new growth model. Nation states have a range of instruments that could be used to address these problems in the future, including competition policy, mandatory disclosures, government procurement and others. It is important to grapple with such scenarios now to be prepared should they unfold.

55 Meunier (2014).

Window of opportunity for rethinking global investment governance

In addition to EU and national governance levels, the emergence of China as a global investor also opens up the opportunity to revive plurilateral and multilateral initiatives related to global investment flows. The failure of talks about a multilateral agreement on investment (MAI) in 1998 impeded a truly global approach to investment governance. However, the newfound interest of China in outbound investment offers a historic opportunity to re-open discussions about a new set of rules to cement global investment openness and set ground rules for exceptions including national security reviews, competition policy and investment subsidies. Such a process could be mediated through the G20, regional organizations, through an expansion of existing institutional platforms for discussing those issues including the OECD or the IMF, or through an attempt to revive multilateral talks about a next generation MAI. A joint high-level working group on investment governance between the three poles of the global economic order which together account for more than 67% of the world's outbound FDI stock – the EU, the US and China – would be a good starting point. Germany can play a key role to initiate and steer such a process.

Beyond OFDI: The new era of Chinese capital requires different policy approach

Finally, OFDI will only be a test case for a broader change that is required to respond to the new era of Chinese capital. The opportunities and challenges related to OFDI summarised here illustrate that China's rise as a capital exporter will require a different economic policy approach towards China in Europe and other parts of the world. In the past two decades the economic policy agenda of most nations towards China has largely been focused on a few discrete areas (trade, IPR and market access in China), which will need to change going forward towards a more comprehensive set of issues. This represents a more "normal" coverage of economic policy fields, albeit with the challenge of China being an exceptionally large economy with many unique characteristics that distinguish it from other economic partners.

This change in the policy agenda will also require greater coordination and collaboration between different ministries and bureaucracies within nation states, better cooperation between nation states, and a clearer distribution of competencies between nation states and the EU. If this adaptation does not happen and business as usual prevails, Europe will not only miss out on exciting new opportunities arising from this sea change, but it will undermine the interests of European citizens and businesses, which could trigger a greater popular backlash against Chinese investment and economic integration with China.

Table 4:

The European Policy Agenda in Response to Growing Chinese Outbound Foreign Direct Investment

	China specific considerations	Policy Recommendations for the EU	Policy Recommendations for Germany
Opportunities			
FDI increases local investment level	China will be one of the fastest growing exporters of FDI in coming decade (\$1-2 trillion)	(1) Address long-term competitiveness problems to sustain attractiveness to FDI (2) Discipline member states' adherence to principle of open capital flows (3) Improve coordination in investment promotion, particularly linkage with European infrastructure agenda	(1) Take leadership role in restoring EU competitiveness (2) Increase number of China-specific staff for investment promotion and identify opportunities for targeted investment promotion, subnational and intra-European coordination (3) Be prepared to defend FDI openness in case of high profile/controversial deals
FDI creates linkages to global value chain and export markets	China is already one of the EU's most important export markets and better linkages can further leverage this position		
FDI contributes to local R&D spending, cluster building and training of workers	Chinese firms are looking to address gaps in human talent through overseas R&D and will become important innovators themselves		
Concerns			
FDI can expose host economies to volatility of capital flows	China is still an emerging market with a fragile domestic financial system and the difficult process of capital account liberalization still ahead	(1) Monitor risks for smaller EU states/ accession candidates (2) Monitor flows to specific asset classes including real estate (3) Improve transparency/data collection on capital flows in general (including lending and government procurement) and particularly from emerging economies	(1) Develop a framework to assess potential risks from Chinese capital surge for specific industries/assets (2) Track financial and real estate investments more closely
FDI can lead to imbalances if there is asymmetry in market access between two countries	China enjoys the EU's freedom of capital privilege, but maintains many formal restrictions on foreign investment; there is also rampant informal discrimination of EU firms in China	(1) Conclude BIA with robust pre-establishment rights (2) Work with others to promote global FDI openness as incentive (3) Initiate EU-US-China Dialogue on Global Investment Governance	(1) Be insistent with China on better market access (2) Maximize European leverage by aligning more strongly with European interests
Subsidies and other advantages can distort competition for global FDI assets and lead to suboptimal economic outcomes	Chinese firms and particular SOEs still enjoy subsidies and other advantages that give them an advantage over market-based firms and the current push for large-scale mergers will aggravate the situation	(1) Support reforms but prepare for worst case if they are not implemented (2) Explore option of external dimension of EU's State Aid regime (3) Explore transparency instruments including SOE disclosure requirements	(1) Hold Chinese side accountable for reform promises on subsidies and SOEs (2) Contemplate options for addressing investment subsidies outside of security review process
Technology related FDI can create uncertainties about transfer of core know-how and industrial capacity of recipient economies	Access to technology and know-how is the major motive for Chinese companies' investment in Europe and industrial policy could mandate transfer of innovative capacities to China against market logic	(1) Strengthen EU competitiveness and attractiveness for R&D activities to incentivize Chinese greenfield FDI (2) Monitor long-term impacts of Chinese investment on local technology and competitiveness (3) Utilize competition policy and other available instruments to address concerns about innovation-threatening takeovers	(1) Think strategically about Chinese contributions to local innovative capacity and generate models to accelerate collaboration (2) Fund research to analyse risks in different industry clusters
Under very specific conditions foreign ownership of assets through FDI can result in national security concerns for host economies	The growth and size of China's OFDI combined with China's different political-economic system makes China a special case in security assessments	(1) Initiate EU-wide dialogue on better coordination of national security screenings (2) Facilitate EU-China talks about definitions and best practices (3) Drive global discussion of best practices and models	(1) Enhance transparency by publishing basic information on reviews (2) Participate in European dialogue on coordination or information sharing
FDI can lead to the "export" of bad practices and fuel a "race to the bottom" for labour, environmental and other standards in recipient economies	The institutional and regulatory environment that Chinese firms are exposed to at home are very different from advanced market economies	(1) Improve harmonization of labour, environmental and other standards across Europe (2) Ensure that weaker nations have proper capacity in place to enforce those standards (3) Support institutional development in China to encourage greater convergence with market economies	(1) Explore new opportunities from greater physical presence of Chinese firms (2) Improve the cooperation with China on economic crimes and extradition of suspects

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Data Appendix

This report draws from a dataset on Chinese direct investment transactions in Europe developed by Rhodium Group (RHG). It covers acquisitions and greenfield projects by ultimately Chinese-owned companies in the 28 member states of the European Union.

Official statistics from both the Chinese and European side are not suitable for an in-depth and real-time analysis of Chinese investment patterns as they are only available with a significant time lag and suffer from distortions through the extensive use of offshore financial centres and other factors. Datasets that aggregate information on individual transactions that meet the FDI definition are a useful alternative for assessing Chinese outbound direct investment patterns.

The RHG dataset is compiled from tracking investments by mainland-Chinese companies in the EU utilising a mixture of channels including commercial databases, online search algorithms, media reports, regulatory filings, company reports, industry associations, official sources, investment promotion agencies, industry contacts, and other sources. The dataset only includes transactions that qualify as direct investment under common international definitions, i.e. new establishments (greenfield projects) or acquisitions of stakes in existing EU companies that exceed 10% of equity or voting shares. Services contracts, procurement and other elements not defined as investment in the IMF's Balance of Payments Manual are not counted. The minimum value for individual deals to be included in the database is €1 million.

Acquisitions are only included if they are completed and they are recorded at the date of completion. Greenfield projects must have been started to be included and they are recorded at the time they have broken ground or begun. Expenditures for multi-year greenfield projects are logged incrementally over time as they occur. The deal values are added based on either the officially announced value or estimates based on variables such as the number of employees, annual revenue, or the value of similar projects. Transaction values reported in RMB and other foreign currencies are converted into EUR using the average exchange rate in the year the deal is counted. The values for M&A transactions include equity investment as well as debt assumption.

The transactions data avoids several problems visible in official data, most importantly the significant time lags and distortions resulting from extensive use of offshore vehicles. Thus, the dataset is a useful alternative for a real-time assessment of aggregate investment patterns, as well as the distribution of those investments by industry, modes of entry, geographical spread, and ownership. However, transactions data are not directly comparable to FDI statistics compiled according to balance of payments principles and cannot be used to analyse balance of payments-related questions.

The combined annual values of FDI transactions in the RHG dataset are generally higher than annual flows from official statistics due to two major reasons: First, it traces investments back to the ultimate beneficiary owner, whereas BOP data largely misses investments routed through offshore entities. Second, definitions and accounting used for the RHG dataset slightly differ from BOP principles. For example, the RHG dataset counts the full value of M&A transactions (including assumed debt) and does not account for reverse flows back to China through, for example, intracompany transactions or divestitures. There may also be differences in counting transactions that are at the edge of portfolio and direct investment flows, such as commercial real estate transactions, non-operating stakes in extractive industries, and expenses related to long-term leases, air transportation and infrastructure projects.

Imprint

Mercator Institute for China Studies
MERICS gGmbH
Klosterstraße 64, 10179 Berlin, Germany
Phone: +49 30-3440 999-0
Email: [info\(at\)merics.de](mailto:info(at)merics.de)
www.merics.org

Design: Roman Wilhelm,
INSIDE A Communications AG

