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Chinese Outward Investment: Better Information Required

The debate over the nature and implications of Chinese investment around the globe suffers badly from too much speculation and too few facts. It is in the PRC's interest to dampen the former by addressing the latter. However, there is very recent evidence that domestic political motives inhibit Beijing from increasing transparency in outbound investment. Ideally, this commission's report will be able to shed much-needed light on the matter rather than generating still more heat.

For Chinese spending outside of bonds, The Heritage Foundation tracks large transactions from 2005–2009, when the bulk of Chinese outward investment has occurred.[1] The U.S. is the second-largest target for Chinese non-bond investment, but the amount remains negligible within the American economy. There are other concerns, however, such as Chinese investment in Iran. The trend over time, regional distribution, and industry breakdown for Chinese investment outside of bonds are outlined below.

For Chinese purchases of American bonds, the U.S. government has done a poor job of providing public information in a timely fashion. This failure has contributed to an unproductive discussion of the meaning of Chinese investment here. In particular, Chinese bond purchases are not nearly as important as their size seems to dictate.

China's Indirect Purchasing

The numbers showing official Chinese holdings of American Treasury bonds are close to meaningless. There are multiple reasons for this, highlighted in the most recent data from the Department of the Treasury.

Earlier this month, the December 2009 data on foreign holders of U.S. treasuries stirred up a hornet's nest. They seemed to show Chinese holdings declining sharply in December and barely budging over the course of 2009,[2] even as the federal deficit soared to $1.4 trillion. Stark conclusions were drawn from these figures when, in fact, they are unusable.

Treasury sorts data using the physical location of the buyer. Coincident with supposed Chinese disinterest was a more than doubling of purchases from Britain and Hong Kong. The magnitude of the increase for Britain and Hong Kong makes no commercial sense.

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[1] Derek Scissors, "China Global Investment Tracker: 2010," Heritage Foundation *White Paper*, February 22, 2010, at *http://www.heritage.org/Research/AsiaandthePacific/wp022210a.cfm*.
[2] U.S. Department of the Treasury, Office of International Affairs, *Major Foreign Holders of Treasury Securities*, February 2010, at *http://www.ustreas.gov/tic/mfh.txt* (February 21, 2010).

It does, however, make sense for the PRC. China accumulated $453 billion in additional reserves in 2009 and cannot spend that money at home.[3] The PRC government body that buys foreign bonds—the State Administration of Foreign Exchange (SAFE)—has two of its four international offices in London and Hong Kong.[4] It is all but certain that some purchases made by agents in Britain and Hong Kong were on behalf of SAFE.

Unfortunately, exactly how much is unknown. The single biggest problem with Chinese outward investment is SAFE's aversion to transparency.[5] SAFE's love of secrecy is strong even by the standards of the Chinese state. It refuses to respond to inquiries regarding the existence even of offices it has registered under local regulations, much less any actions taken at the branches.

There are also powerful forces at work within China. The central government has been criticized for wasting "the people's money" in low-return or loss-making investments in the U.S., punctuated by outrage that a poor country is seen to be subsidizing a rich country. This outrage stems from a misunderstanding of the financial relationship, one that is duplicated to some extent on this side of the Pacific.

The Chinese yuan's peg to the dollar is well known. Closely connected to this are capital controls that prevent money from freely entering or leaving the PRC. Together, these have brought considerable benefit to China, but they also mean that Beijing cannot spend foreign currency at home. Any attempt would merely cause an expansion in domestic money supply and end with the foreign cash right back in state coffers.

Due to many kinds of mercantilist policies, China runs by far the world's largest balance of payments surpluses. These cannot be spent at home and are too large to put anywhere other than the United States. No other country has financial markets capable of absorbing them. To hide the unavoidable extent of China's exposure to low-yield American bonds and try to avoid domestic flak, SAFE is routing money through third countries.

America's Inadequate Monitoring

Perhaps the second-biggest problem with Chinese outward investment is the U.S. government's seeming lack of interest in transparency. SAFE will take all action to obscure its behavior, but America should not aid and abet. Treasury holdings classified by the geographic location of the buyer are not useful for policy formulation. At the least, some effort should be made toward publicly disclosed revisions that track the true nationality of the ultimate bond-holder.

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[3] Derek Scissors, "China Is a Banker over a Barrel," *The Washington Examiner*, March 14, 2009, at *http://www.washingtonexaminer.com/opinion/columns/Sunday_Reflections/China-is-a-banker-over-a-barrel-41252887.html* (February 21, 2010).

[4] "State Administration of Foreign Exchange," Sovereign Wealth Fund Investments, at *http://www.sovereignwealthfundinvestments.com/state-administration-foreign-exchange.html* (February 21, 2010).

[5] Derek Scissors, "Chinese Foreign Investment: Insist on Transparency," Heritage Foundation *Backgrounder* No. 2237, February 3, 2009, at *http://www.heritage.org/Research/AsiaandthePacific/bg2237.cfm*.

Moreover, numbers on American bonds other than Treasuries are not provided in anything like a timely fashion. In June 2008, the PRC's holdings of American bonds outside Treasuries exceeded holdings of Treasuries.[6] That was before the financial crisis, which prompted a massive change in the Chinese position out of agency bonds such as from Fannie Mae and Freddie Mac and into Treasuries.

The shift featured $175 billion in Treasuries bought by SAFE in the second half of 2008 alone, which triggered the absurd talk of China being our banker. It is almost sure that what occurred was not new PRC purchases, but a transfer from perceived risky Fannie and Freddie debt to perceived safe Treasury debt. We will not know definitively, however, until April of this year when Treasury updates the data on bonds held outside Treasuries. Even then, the update will cover only up to June 2009.

Augmenting the point is the case of the other, smaller sovereign wealth fund, China Investment Corp. (CIC). CIC's disclosure earlier this month of roughly $10 billion in equity holdings was incomplete with regard to equities,[7] much less money market positions.[8] Yet it was superior to anything made public by the U.S. government, despite general expressions of concern about the intentions of sovereign funds.

The lack of good numbers makes it difficult for everyone involved in this hearing to do their job. The first order of business should be to recommend that Treasury devote more resources to publishing timely and pertinent data.

With proper numbers, the mechanical nature of the relationship between China's external surpluses and holdings of U.S. bonds would be exposed. The PRC does not buy for leverage and does not sell for leverage. It does not act for any reason other than to recycle domestically unusable funds stemming from its currency peg and closed capital account.

China's Global Investment Outside Bonds

China's purchases of U.S. government bonds have received the most political attention, often in misguided fashion. The PRC's investment outside those bonds is much smaller but mushrooming and requires more study.

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[6] U.S. Department of the Treasury, Office of International Affairs, *Report on Foreign Portfolio Holdings of U.S. Securities*, April 2009, at *http://www.ustreas.gov/tic/shla2008r.pdf* (February 21, 2010).

[7] Aileen Wang and Alan Wheatley, "China's CIC Gives Breakdown of U.S. Equity Stakes," Reuters, February 9, 2010, at *http://www.reuters.com/article/idUSTOE61802J20100209* (February 21, 2010). CIC's stake in Blackstone and part of its stake in Morgan Stanley were excluded as non-voting shares.

[8] Miles Weiss and Belinda Cao, "China's CIC May Have $5.4 Billion Frozen in Money-Market Fund," *Bloomberg*, October 13, 2008, at *http://www.bloomberg.com/apps/news?pid=20602002&sid=ancX7qXx0kXk&refer=markets* (February 21, 2010).

As a first step, The Heritage Foundation has created a public dataset of large Chinese business transactions outside bonds starting in 2005.[9] The dataset tracks with official Chinese data on outward investment but is updated faster and more frequently and contains far more useful information.

For example, Chinese non-bond investment did falter in 2009 due to the global financial crisis. However, it began to recover last May and, in fact, was soaring by the third quarter of last year. The peak to date of roughly $55 billion annually is likely to be exceeded, if not in 2010 then 2011. Given the size of China's foreign reserves, non-bond investment has the capacity to exceed $100 billion annually and eclipse investment into the PRC.

China's Non-Bond Investment, Two Views[10] ($ billions)

	Ministry of Commerce	The Heritage Foundation
2005	12.3	8.7
2006	17.6	19.5
2007	26.5	35.0
2008	55.9	56.3
2009	43.3*	54.9
Total	155.6	174.3

* Not yet revised. Upward revisions have been substantial every year the data have been issued.

Sources: Ministry of Commerce of People's Republic of China, *2008 Statistical Bulletin of China's Outward Foreign Direct Investment*, at *http://hzs2.mofcom.gov.cn/accessory/200909/1253869308655.pdf* (February 21, 2010); "China's Overseas Investment up 6.5pc," *The Daily Star*, January 17, 2010, at *http://www.thedailystar.net/newDesign/news-details.php?nid=122171* (February 21, 2010); Heritage Foundation Dataset, China's Outward Investment: Non-bond Transactions Over $100 Million (2005–2009).

Perhaps the most politically relevant feature of Chinese non-bond investment is the geographic distribution. As in its other reporting, the PRC treats Hong Kong and other offshore financial centers as final destinations rather than transit points. This leads to absurd results, which are contradicted by host countries, by the Chinese companies involved, and even occasionally by PRC government officials.

The Heritage dataset overcomes this weakness. Over the past five years, the U.S. has been the second-largest destination of non-bond investment, at $21.2 billion total. In a $14 trillion economy, this is negligible. Specific technologies may need to be shielded from acquisition, but general Chinese influence through non-bond investment is minimal.

[9] "Chinese Outward Investment: Dataset 4. Investments and Contracts," linked in Scissors, "China Global Investment Tracker: 2010," at *http://thf_media.s3.amazonaws.com/2010/xls/China_Global_Investment_Tracker2010.xls*.

[10] The principal difference between the two series is that the Heritage dataset does not include transactions worth less than $100 million. It nonetheless generates slightly larger figures. One source for the discrepancy is investment funded by Hong Kong subsidiaries of mainland companies. This would not be counted by the Ministry of Commerce but can appear in our dataset.

It is illuminating, as well as unsurprising, that the largest destination for Chinese non-bond investment is also an open economy—Australia. Another such economy—Britain—is the fifth-largest destination. While SAFE abhors transparency, Chinese firms are no different from other multinationals and seek transparent economies as better for business.

A second set of target countries has received a good deal of attention: resource-rich economies with closed or otherwise troubled political systems. For energy, the Heritage dataset confirms that Iran is the leading example; in metals, it is the Democratic Republic of the Congo (DRC). The DRC exemplifies China's willingness, when particular assets are in play, to do business with little regard for local conditions or global sentiment.[11]

Top Destinations

Country	Total, $ billion
Australia	29.8
U.S.	21.2
Iran	10.7
Kazakhstan	9.7
Britain	8.2
Democratic Republic of the Congo	7.9

Source: Heritage Foundation Dataset, China's Outward Investment: Non-bond Transactions Over $100 Million (2005–2009).

The Heritage dataset clarifies the geographic areas of concern. Approximately 40 percent of PRC non-bond investment from 2005–2009 was in OECD countries. Sub-Saharan Africa and West Asia (including Iran) attracted another 35 percent, combined. East Asia, Latin America, and the Arab world lagged in attracting Chinese investment.

There is an important qualifier, though, to the figures on pure investment. During the past five years, the PRC has also inked close to $50 billion in large engineering and construction contracts worldwide. By far the leading region for this activity is the Arab world. The pursuit of energy has taken multiple forms.

Chinese data do not provide useful sector breakdowns. In the Heritage dataset, there are clear patterns in the PRC's behavior, and the conventional wisdom of a focus on commodities turns out to be correct. Energy and power draws over 40 percent of investment and accounts for over one-third of engineering and construction contracts. Metals draw another 35 percent of investment. Finance and real estate investment, chiefly in the U.S., takes 20 percent. Transport leads in engineering and construction contracts.

Sector Patterns ($ billions)

Sector	Non-bond Investment	Engineering and Construction Contracts	Troubled Transactions

[11] The chief example is Sudan, where the bulk of Chinese investment took place well before 2005.

Energy and Power	72.2	16.7	49.3
Finance and Real Estate	33.4	1.2	29.0
Metals	62.5	4.9	32.8
Transport	3.2	20.8	7.6
All other	2.9	5.2	12.1
Total	174.3	48.8	130.9

Source: Heritage Foundation Dataset, China's Outward Investment: Non-bond Transactions Over $100 million (2005–2009).

Bumps in the Road

Just as with purchases of American bonds, there is a good deal of misinformation about non-bond Chinese investment. The sources of and motivations for this misinformation vary widely. A key facet of Chinese investment over the past five years is that it could have been much higher: Failed investments are frequent and sizable.

The PRC's outward investment is characterized by the same strategic maneuvering as any other nation's. A few countries simply fabricate large deals. Other host governments exaggerate the benefits of agreements to win domestic approval.[12] Eyeing stockholders, some corporations partnering with Chinese investors similarly exaggerate.[13] Working in the opposite direction, Chinese firms attempt to minimize or obscure transactions that might have undesirable repercussions—for instance, those involving Iran.[14]

The Heritage dataset excludes transactions that are not confirmed by all parties and those marred by conflicting or missing information. Media coverage of large investments often has a touch of breathlessness, while ensuing reports that nothing has yet occurred are lost in the pile. The "leader" in this field is Venezuela, which explicitly politicizes its energy relationship with the PRC.[15] Every few years, a new announcement is made concerning development of the same fields.[16] Some money certainly will be spent eventually, but there is far more smoke than fire.

[12] See, for example, Andre Soliani, "Lula Seeks to Revive China Pledge With China Trip," *Bloomberg*, May 18, 2009, at *http://www.bloomberg.com/apps/news?pid=20601086&sid=adgY8IWasHIs* (February 21, 2010).

[13] See, for example, Vivian Wai-yin Kwok, "Fortescue's China Deal Jeopardized," *Forbes*, September 30, 2009, at *http://www.forbes.com/2009/09/30/fortescue-chinese-loan-markets-commodities-iron-ore.html* (February 21, 2010).

[14] "US Panel to Review CNOOC–Iran Gasfield Development Deal," *Forbes*, December 31, 2006, at *http://www.forbes.com/feeds/afx/2006/12/31/afx3290055.html* (February 21, 2010).

[15] "Venezuela and China Build a Pluripolar World Through Socialism," Petróleos de Venezuela, at *http://www.pdvsa.com/index.php?tpl=interface.en/design/salaprensa/readesp.tpl.html&newsid_obj_id=4768&newsid_temas=54* (February 21, 2010).

[16] "Train Wreck at Pdvsa," *Caracas Gringo*, February 11, 2009, at *http://caracasgringo.wordpress.com/2009/11/02/train-wreck-at-pdvsa/* (February 21, 2010).

The Heritage dataset tracks a separate category of genuine investments and business contracts that partly or entirely failed. These are not transactions where the Chinese side was outbid—those are rare—but rather where local or PRC regulators objected late in the game or where Chinese firms were unable to fulfill the conditions of their initial offers.

Where China Stubs Its Toe

Country	Amount, $ billions
Australia	27.2
U.S.	25.5
Iran	19.6
Germany	14.0
Nigeria	8.5

Source: Heritage Foundation Dataset, China's Outward Investment: Non-bond Transactions Over $100 million (2005–2009).

Such transactions turn out to be a major feature of China's "Going Out." From 2005 through 2009, there were 40 failures of $100 million or more, with aggregate lost value of a weighty $130 billion. These naturally follow the PRC's geographic priorities in investment. The leading cause of failure is mistakes or the incapacity of Chinese enterprises themselves, but actions by taken by Congress and U.S. Administrations have blocked or contributed to the collapse of at least $35 billion worth.

There are also notable exaggerations and failures beyond simple investment. Very large and long-term trade deals, almost all focused on energy supply, have been announced with great fanfare but often mischaracterized. Some merely formalize existing trade relationships; others are not binding and never even begin to come to fruition.[17]

Policy Implications

The obvious theme runs through the PRC's bond investment, non-bond investment, and various other business activities, both failed and successful: China has a lot of money at its disposal.

Much-advertised oil-for-loans exchanges, for instance, are as yet a trivial phenomenon but would have no potential at all if the PRC did not have cash on hand and a desire to use it. Chinese banks are now active globally, lending to support national acquisition of resources but also joining other multinationals in syndicated loans in aviation and elsewhere.[18] Similarly, China's recent contribution to the International Monetary Fund's

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[17] Peter Smith, "China–Australia $40bn Gas Deal Expires," *Financial Times*, January 4, 2010, at *http://www.ft.com/cms/s/0/112f80bc-f903-11de-80dc-00144feab49a.html* (February 21, 2010).
[18] Laura Mueller, "Singapore 2010: Chinese Lessors Look to Expand Internationally Even as Local Lending Eases," Flight Global, January 25, 2010, at *http://www.flightglobal.com/articles/2010/01/25/337455/singapore-2010-chinese-lessors-look-to-expand-internationally-even-as-local-lending.html* (February 21, 2010).

capital base is minor in itself but portends a future where the IMF faces more contention among principal donors (as well as the standard disagreements with borrowing countries).

With a variety of options for a huge pile of cash, the need for good information on China's behavior is great. Perhaps surprisingly, this is not yet vital with regard to Treasury bonds. Until the Chinese government is willing to break its dependence on the dollar—which there is not the slightest indication it is willing to do—the PRC is compelled to buy American bonds and lacks the flexibility to wield any influence.

When China finally does muster the courage to have its own currency, it will be absolutely necessary for Congress and the Administration to know SAFE's true behavior as it happens, not just what China-based buyers are doing or the state of play 15 months ago. The inescapable first order of business is to improve U.S. monitoring capability.

This will also be helpful beyond bond purchases. At present, policy discussion is generated in good part by rumors of Chinese activity—for instance, in Latin America—that are often poorly founded. Where possible, the U.S. should begin to conduct on-the-ground estimation of the extent of Chinese investment or construction.

A second step should be consultation with America's friends. Australia is the front line of the Chinese investment boom and is holding a serious discussion of the very hefty benefits of the PRC's economic expansion and the need to hedge in important ways.[19] India has recently struggled with the best response to a perceived flood of Chinese workers employed in legitimate projects but purportedly not with Indian consent.[20]

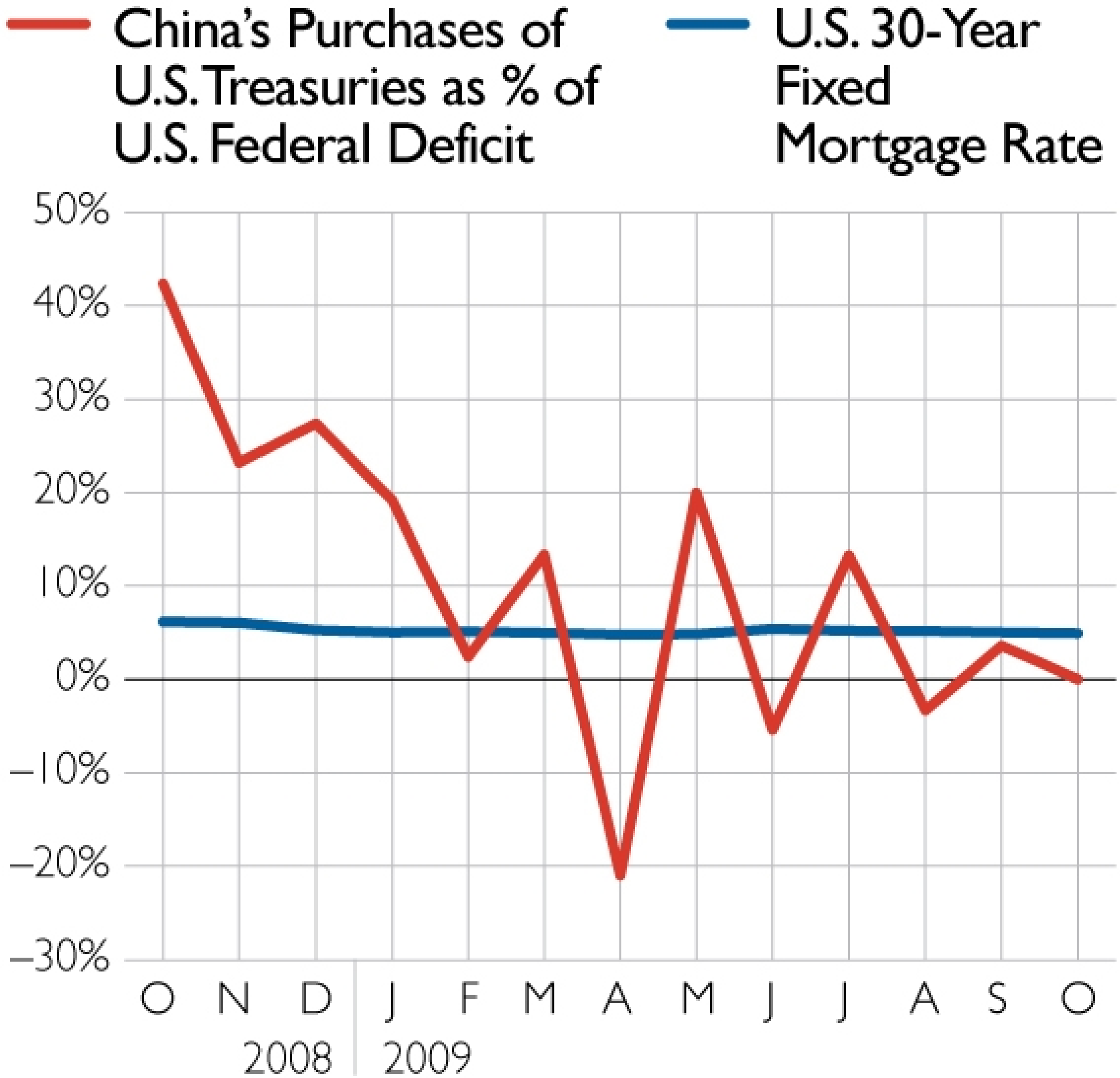
The PRC's very globalization raises the possibility of a third, related action. With Chinese enterprises now possessing considerable business interests around the world, a coordinated, multilateral effort to enhance disclosure requirements would benefit all parties. Even the firms themselves would gain from a more open and trusting atmosphere in host and potential host countries.

It should be emphasized that the multilateral objective is greater disclosure, not greater restrictions. The PRC has the same right to engage in international commercial activity as the U.S. Under the right conditions, China's outward investment could benefit much of the planet. The first of these conditions is transparency, and America's own efforts to shed light on Chinese behavior must be enhanced.

[19] John Garnaut, "China's Energy Fears Good for Our Miners," *The Sydney Morning Herald*, November 2, 2009, at *http://www.smh.com.au/business/chinas-energy-fears-good-for-our-miners-20091101-hrlw.html* (February 22, 2010), versus Rob Taylor, "Australia Tries to Placate China over Navy Expansion," Reuters UK, May 1, 2009, at *http://uk.reuters.com/article/idUKTRE5400QF20090501* (February 22, 2010).
[20] Smita Aggarwal, "Labour Ministry Raises Red Flag over 'Illegal' Chinese Workers," *Indian Express*, May 27, 2009, at *http://www.indianexpress.com/news/labour-ministry-raises-red-flag-over-illega/466451/* (February 22, 2010). While not a concern in the U.S., Chinese labor often follows Chinese capital around the globe and is often a more explosive political issue.

Appendix: Chinese Investment in Pictures

U.S. Interest Rates and Chinese Purchases of Treasury Bonds



Sources: *http://www.freddiemac.com/pmms/pmms30.htm, http://www.fms.treas.gov/mts/MTS.xls,* and *http://www.treas.gov/tic/mfh.txt*.

Chart 1 heritage.org