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SOE Megamergers Signal New Direction in China's Economic Policy

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Table of Contents

Executive Summary

Under Chinese President and General Secretary of the Chinese Communist Party (CCP) Xi Jinping, the Chinese government is revamping its state sector via a series of "megamergers" (the joining of two or more firms worth billions of dollars) as it seeks to consolidate state control in strategic sectors of the economy. To evaluate the impact of large-scale state-owned enterprise (SOE) mergers for both China's economic growth and the international competitive landscape, this report seeks to address three questions:

1) How do megamergers fit into the context of China's previous SOE reform efforts?
2) Why is China merging its largest central SOEs?
3) What are the implications of Chinese SOE megamergers (and, more broadly, Chinese government control over the economy) for the global competitive landscape?

How do megamergers fit into the context of China's previous SOE reform efforts?

China's restructuring of SOEs began in 1978 with Deng Xiaoping's initiation of market-oriented economic reforms. SOE reforms in the 1980s were characterized by changes to management and profit sharing systems, followed by consolidation and privatization in the 1990s when many small and inefficient SOEs were closed, merged, or sold. At the same time, the government began building a group of large industrial SOEs concentrated in critical sectors of the economy which it saw as essential for national security and economic development. In the 1990s and 2000s, these reforms gave way to a series of measures aimed at promoting competition among SOEs. However, these measures largely failed to produce more efficient state-owned businesses and led to increased state control.

Why is China merging its largest central SOEs?

For the Chinese government, the economic aims of megamergers are twofold: first, they seek to improve firms' performance by cutting excess industrial capacity, minimizing competition among SOEs in China, and increasing economies of scale (thereby lowering prices); and second, they attempt to create larger, more competitive "national champions," which can compete internationally due to increased size and market share. Through these efforts, the Chinese government seeks to reduce debt and improve the efficiency of its state sector.

However, efforts to incentivize more efficient SOE operations have not been sufficient for reducing debt levels. Chinese banking officials and foreign economists alike warn that high debt levels may pose a systemic risk to the country's banks and to the health of the broader economy. Over the past five years, SOEs' returns and profit margins have steadily declined, forcing them to become increasingly reliant on government loans and subsidies to remain viable. SOE mergers have failed to address these challenges, offering only temporary debt relief through the consolidation of SOE assets and elimination of intra-state competition.

Beijing's pursuit of SOE consolidation is in line with efforts to enhance its control over state firms operating in strategic sectors of the economy. As China's General Office of the Communist Party stated in September 2015, SOE reform has reached a critical juncture where "Communist Party leadership can only be strengthened, it cannot be weakened."[1] Despite recent policies—including the promotion of a "mixed-ownership" SOE model—that policymakers in Beijing claim will reduce the role of the state in the economy, it is unlikely the Chinese government will take any meaningful steps to relinquish control over economic decision making.

What are the implications of Chinese SOE megamergers for the global competitive landscape?

SOE megamergers threaten to undermine the global competitiveness of U.S. businesses and other foreign firms operating in accordance with market principles. The Chinese government's efforts to merge large SOEs in critical sectors are increasing SOEs' share of the domestic economy, enhancing their international competitiveness, and deepening concerns about unfair competition in China and overseas. Government support enables Chinese SOEs to offer products far below market prices, shutting out foreign firms—particularly small- and medium-sized foreign firms—from designated sectors. As a result, the global competitive landscape could quickly become dominated by a shrinking number of firms. Global economic governance is at a crossroads to determine how massive mergers and acquisitions (M&As), particularly involving state-owned corporations, should be regulated to maintain free and fair economic growth and development.

History of SOE Reform in China

After decades of exerting near complete control over the economy, the Chinese government began transforming its planned economy to be more market-oriented in 1978, permitting private enterprises to develop and granting greater autonomy to SOEs.[2] Reform efforts in the 1980s and 1990s ended the "employment for life" system (referred to in China as the "iron rice bowl"), shut down or sold off the worst-performing companies, ordered the People's Liberation Army to divest from nearly all military-run businesses, and allowed state-owned businesses to keep a portion of their profits.[3]

Years of China's centrally planned economy left SOEs inefficient and unable to compete with private businesses, with industrial SOEs at the central, provincial, and local levels costing the Chinese government an estimated net loss of around 5 percent of gross domestic product (GDP)—or about $36 billion in current U.S. dollar terms—in aggregate by the mid-1990s.[4] To enhance SOE's financial performance, the government pursued policies in the 1990s aimed at closing underperforming small- and medium-sized SOEs, converting some SOEs into joint stock companies and publicly listing portions of their assets, and privatizing SOEs in some sectors to increase efficiency.[5] Many large SOEs were also merged to increase their profitability and preserve state control in key sectors.[6]

The influence and wealth of SOEs significantly increased under President Hu Jintao (2003–2013) despite promises to break up monopolies and increase market competition.[7] In 2003, the State-Owned Assets Supervision and Administration Commission (SASAC) was created under the State Council to exercise the government's rights as controlling shareholder in central government SOEs and manage SOE activities.[*] [8] SASAC consolidated the government's authority over SOEs—which had previously been dispersed among multiple government bureaus—and attempted to minimize conflicts of interests among them.[9] In December 2006, the head of SASAC announced SOEs would maintain "absolute control" over seven strategic industries[†] (military industry, electrical power generation and grids, petroleum and petrochemicals, telecommunications, coal, civil aviation, and shipping) while keeping strong influence over other pillar industries (machinery, automobiles, information technology, construction, steel, and nonferrous metals).[10] Through a series of government-directed mergers, a handful of large-scale enterprises came to dominate these key industries, protected from private and foreign competition and investment.[11] As a result, the scale of total SOE assets increased rapidly; between 1999 and 2008, the average total assets of industrial SOEs—including those at the local, provincial, and central level—increased 589 percent to more than $135 million per enterprise, while the average assets of industrial non-SOEs in China increased by only 67 percent to under $9 million per enterprise.[12]

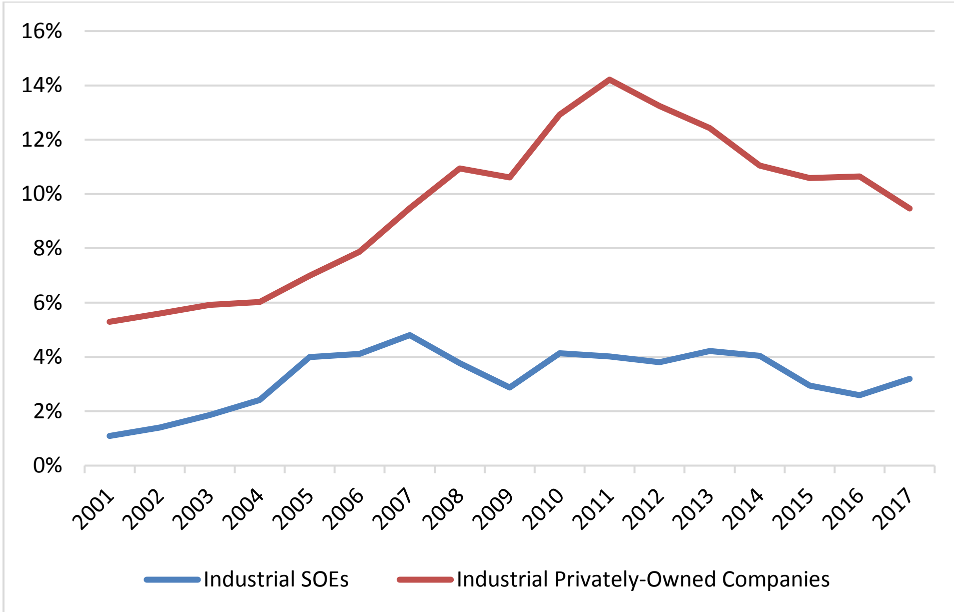
Chinese Government Support for SOEs

State-owned companies remain an essential part of China's economy, but they are struggling due to inefficient operations, increasing debt, and moral hazard.[13] According to the Beijing-based financial research firm Gavekal Dragonomics, all SOEs account for more than one-third of total investment and receive nearly 30 percent of all bank loans in China, yet they generate less than 10 percent of China's total gross domestic product.[14] In 2016, industrial SOEs (which consist primarily of commodities, agricultural products, automobile, infrastructure, and construction firms) saw 8 percent less return on their assets than privately-owned enterprises, enduring a third consecutive year of declining returns (see Figure 1).[15] Industrial SOE profits also sharply declined, dropping from $58 billion in 2012 to $26 billion in 2016, a 55 percent decline over that period.[16] Industrial SOEs saw a resurgence in 2017—a sign, the Chinese government claims, that reforms have made SOEs more profitable and competitive—with return on assets increasing 18.7 percent year-on-year and profits rising 24.3 percent year-on-year.[17] In January 2018, SASAC issued an order that central SOEs will earn profits in 2018, though the details and penalties for failing to comply are currently unknown.[18]

[*] Provincial- and local-level SASACs were created as well. The duties of SASAC include appointing top SOE executives, approving mergers and sales of stock or assets, and drafting SOE-related laws. China's State-Owned Assets Supervision and Administration Commission, *State-Owned Assets Supervision and Administration Commission*, May 21, 2003. *http://en.sasac.gov.cn/n1461859/c1463753/content.html*.

[†] These industries were chosen because of their significance to China's "national security and the national economic lifeline." Tingting Weinreich-Zhao, "Chinese Merger Control Law: An Assessment of its Competition-Policy," *Springer*, November 19, 2014, 19.

Figure 1: Industrial Enterprise Return on Assets, 2000–2017



Source: National Bureau of Statistics via CEIC database.

SOEs' financial security is implicitly or explicitly guaranteed by the Chinese government.[19] Chinese SOEs often enjoy rent-free use of land and discounted resources of production (e.g., land, electricity, and water), subsidized financing costs, tax rebates, and cash infusions, allowing unprofitable SOEs to remain viable.[20] Moreover, years of declining returns have made SOEs reliant on loans from state banks. From 2008 to 2014, SOEs increased their loans relative to assets from 53 percent to 64 percent, nearing the United States' 70 percent debt-to-asset ratio before the 2008–2009 financial crisis. Private companies' loans relative to assets declined over the same period.[21]

The government's central role in the economy leaves state firms without incentives to reduce debt levels and adopt more efficient business practices because they know the government will act as a backstop in case of any financial difficulty.[22] Fearing SOE defaults could send the economy into a downward spiral, Beijing has repeatedly bailed out SOEs like Dongbei Special Steel, which has defaulted ten times since 2016 on payments totaling over $1 billion but continues to operate with state support.[*] Large bailouts have been occurring since the early 2000s, when China used its foreign exchange reserves to rescue its four largest state banks after they extended too many loans to underperforming state-owned companies.[23] Years of these bailouts led SOE executives and shareholders to believe Beijing would not allow them to fail.[24]

China began allowing some SOEs to default at the end of 2015.[25] Baoding Tianwei Group, which makes power generation equipment, became the first state-owned company to default on bonds when it missed a $13 million interest payment in September 2015.[26] Two months later, state-owned China Shanshui Cement Group defaulted on a $315 million loan.[27] In March 2016, media reports revealed Guangxi Nonferrous Metals Group Co.—which had been receiving state aid since 2012—defaulted on $2.3 billion of its debt.[28] Six months later, Guangxi became the first interbank bond issuer liquidated by Beijing after it could not reach an agreement with investors to bail out the company.[29]

However, efforts to incentivize more efficient SOE operations have not been sufficient for reducing debt levels. In the first half of 2017, Chinese banking officials began warning that high debt levels may pose a systemic risk to the country's banks and to the health of the broader economy.[30] In July 2017 JPMorgan Chase estimated SOE debt represented 90 percent of China's GDP, a majority of its total corporate debt (165 percent of GDP).[31] China's central

[*] In November 2017, one of China's wealthiest private steel tycoons, Shen Wengron, announced he would invest nearly $700 million in the company, becoming Dongbei's largest shareholder (and making it an ostensibly private firm). According to a report by China's Caixin news service, Mr. Shen's decision to invest in Dongbei had "both commercial and political motives," although the specifics of those motivations are not clear. Gabriel Wildau and Xinning Liu, "Privatization of China 'Zombie' Steelmaker Sets Precedent," *Financial Times*, November 1, 2017. *https://www.ft.com/content/d859d86a-ae5c-11e7-aab9-abaa44b1e130*.

bank governor, Zhou Xiaochuan, has also expressed concern over the highly leveraged state of the economy, encouraging the development of "robust capital markets" to reduce China's reliance on debt and increase equity financing.[32] Chinese regulators have begun tightening oversight of SOE investments, implementing policies in August 2017 requiring central and provincial SOEs to conduct political and economic viability assessments of overseas investments and enforce stricter auditing mechanisms.[33] SASAC has also implemented new controls on central SOE borrowing, including bans on borrowing for industrial SOEs with debt-to-asset ratios above 70 percent and nonindustrial SOEs with debt-to-asset ratios above 75 percent.[34]

Megamergers: Trends and Objectives

Since President Xi came into office in 2013, an unprecedented number of megamergers[*] involving China's largest SOEs in key sectors—including transportation, energy, and shipping—have taken place. According to Chinese state media reports from July 2017, SASAC called for an acceleration of SOE consolidation in an attempt to cut the number of central SOEs down to 80 firms.[35] There are currently 97 central SOEs compared to 189 when SASAC was established in 2003.[36] In January 2018, SASAC chairman Xiao Yaqing indicated central government SOE mergers will continue through "a voluntary process," without providing a specific reduction target.[37]

The economic aims of megamergers are twofold: first, they seek to improve firms' performance by cutting excess industrial capacity,[†] minimizing competition among SOEs in China, and increasing economies of scale (thereby lowering prices); and second, they attempt to create larger, more competitive "national champions"[‡] abroad with increased size and market share.[38] Through these efforts, the Chinese government hopes to reduce debt and increase the efficiency of its state sector.

There are also significant political benefits to SOE consolidation, namely increasing state control over the economy.[39] As President Xi stated in his remarks at a Party conference in October 2017, "Government, the military, society and schools, north, south, east and west—the party leads them all."[40] The CCP can influence SOEs' business decisions through an array of political, extralegal, and financial pressures, incentivizing firms to pursue political—rather than commercial—objectives.[§][41] For instance, the CCP reserves the right to appoint all senior managers in central and local SOEs, while chairmen and chief executives of these companies are often concurrently the heads of their companies' party committees.[42] Chinese regulatory authorities also provide SOEs with extralegal advantages, including exemption from the Anti-Monopoly Law and bankruptcy rules,[**] which help SOEs maintain lower operating costs than private competitors.[43]

These practices give Beijing significant control over SOE activities in China, particularly in industries deemed strategic by the CCP.[44] Economically strategic sectors (e.g., industrial producers) enable the government to support

[*] Megamergers are the joining of two or more corporations, usually involving billions of dollars. They generally occur through mergers, acquisitions, or consolidations resulting in one corporation gaining a substantial or dominant market share in a single industry. Investopedia, "Megamergers." *https://www.investopedia.com/terms/m/megamerger.asp*.

[†] Li Jin, the chief researcher at the China Enterprise Research Institute in Beijing, explained that "at present, the biggest problem of overcapacity in the steel sector is that industrial capacity is too dispersed, causing a sequence of vicious competition and the irrational distribution of industrial capacity. The real solution to overcapacity is large-scale mergers and acquisitions." However, there remains little evidence that consolidation will significantly reduce Chinese steel overcapacity, with China's crude steel production increasing 5.7 percent year-on-year in 2017. China Radio International, "Experts Talk About New Round of State-Owned Enterprise Reform: How Central State-Owned Enterprise Reorganization Will Achieve 1+1>2," August 22, 2016. Translation. *http://news.cri.cn/20160822/dc922aea-6105-cc94-ab98-5d0c380a8564.html*; World Steel Association, "World Crude Steel Output Increases by 5.3% in 2017," January 24, 2018. *https://www.worldsteel.org/media-centre/press-releases/2018/World-crude-steel-output-increases-by-5.3--in-2017.html*.

[‡] Chinese "national champions" are large enterprises in a given industry capable of competing globally. They are supported by government policies and expected to advance the interests of the state. Derek Scissors, "Deng Undone: The Costs of Halting Market Reform in China," *Foreign Affairs*, May/June 2009. *https://www.foreignaffairs.com/articles/china/2009-05-01/deng-undone-0*.

[§] For more on how the Chinese government exerts influence over public and private Chinese firms, see U.S.-China Economic and Security Review Commission, Chapter 1, Section 2, "Chinese Investment in the United States," in *2017 Annual Report to Congress*, November 2017, 80; U.S.-China Economic and Security Review Commission, Chapter 1, Section 2, "State-Owned Enterprises, Overcapacity, and China's Market Economy Status," in *2016 Annual Report to Congress*, November 2016, 99–103.

[**] SOEs are granted de facto exemption from antitrust enforcement, in some cases receiving exclusive rights to a given industry that shield them from foreign competition, and can generate deficits for a long, undefined period of time without fear of bankruptcy. Ming Du, "China's State Capitalism and World Trade Law," *International and Comparative Law Quarterly* 63:2 (January 2014): 423–426.

short-term economic growth, while politically sensitive sectors (e.g., agriculture and biotechnology) are essential to the government's goals of advancing and controlling China's technology infrastructure, disseminating information, and protecting national security.[45] SOE megamergers are concentrated mainly in these strategic sectors, creating national champions that can compete abroad to advance CCP interests.[46]

President Xi has doubled down on state control over SOEs in critical sectors of the economy despite touting plans to increase mixed ownership of SOEs. Mixed-ownership reforms introduced in 2013 were intended to inject nonstate investment—including Chinese private equity and social welfare funds—into local and central SOEs.[47] However, the plan has not diminished the government's controlling stake in SOEs, as demonstrated by the case of Jiangxi Salt, a legal monopoly in China's salt market previously owned by the Jiangxi provincial SASAC.[48] After a deal in September 2015 to open Jiangxi Salt to foreign investors, the government's direct ownership of the company dropped from 100 to 47 percent, with four outside investors collectively holding a 47 percent stake and Jiangxi Salt's management buying a 6 percent stake.[49] However, of the four new investors in Jiangxi Salt, three were SOEs administered by SASAC while the fourth was 83 percent owned by the Ministry of Finance.[50] This reflects a pattern where the sale of Chinese state assets is made primarily to individuals or corporations with connections to the CCP, effectively keeping the assets in the state's hands. Rather than selling assets to new private investors and raising money for the provincial government, the Jiangxi deal was primarily structured as a capital injection that maintained government control over the firm.[51]

The Chinese government has launched two rounds of mixed-ownership pilot programs for 19 SOEs and announced a third round with an additional 31 SOEs in November 2017.[52] Although mixed-ownership reforms seek to increase private capital in public firms, Chinese policymakers have stated the reforms will not lead to the full privatization of state assets.[53] Instead, after being chosen by SASAC to participate in the program, firms sell a 30 to 45 percent stake in a unit of their business to the private sector.[54] For example, in August 2017, the state-owned telecommunications firm China Unicom raised $11.7 billion from private investors, including Alibaba, Baidu, and JD.com, as part of the mixed-ownership pilot program. Unicom Group remains the firm's biggest shareholder with a 37 percent stake, but has lost its majority share after selling 35 percent of the company.[55]

SOE Megamergers Since February 2015

The Chinese government is pursuing megamergers to: (1) improve SOE efficiency, including by reducing debt through the consolidation of assets and eliminating intra-state competition; and (2) increase state control over the economy. The following SOE megamergers are some of the most notable since 2015 (Table 1). For a more comprehensive list of Chinese domestic central, provincial, and local SOE mergers since 2014, refer to the Appendix.[*]

[*] Provincial and local governments are also consolidating their SOEs, although implementation has been slower with reforms prioritized at the central level. Xinhua, "Economic Watch: China SOE Reform Set to Accelerate," October 26, 2017. *http://www.xinhuanet.com/english/2017-10/26/c_136707498.htm*.

Table 1: Top Five Domestic Chinese Central SOE M&As Since 2015

Acquirer / Target	Total Assets of Company after Merger (US$ billions)	Date Approved
Shenhua Group Corp. / Guodian Group Corp.	271	August 12, 2017
China Grain Reserves Corp. (Sinograin) / China National Cotton Reserves Corp. (CNCRC)	219	January 12, 2017
China South Locomotive & Rolling Stock Corp. (CSR) / China North Locomotive & Rolling Stock Corp. (CNR)	130	June 8, 2015
State Nuclear Power Tech Corp. / China Power Investment	112	June 1, 2015
China Merchants Group / Sinotrans & CSC Holdings	110	December 30, 2015

Note: Value for the CSR/CNR merger is the firm's total market capitalization.
Source: Various.[56]

Shenhua Group Corp. and Guodian Group Corp.

In August 2017, the State Council approved a merger between Shenhua Group (China's largest coal miner) and Guodian Group (one the country's largest power generation companies). The new company, China Energy Investment Corp., will have assets totaling $271 billion and will be the world's largest power company by installed capacity (a measure of a power plant's output capacity) with more than 225 gigawatts,[*] surpassing the UK firm EDF Energy (149 gigawatts as of June 2016) and Italy's Enel (96 gigawatts as of August 2016).[57] The merger is the first in China's power industry and likely aimed at trying to reduce the country's industrial capacity.[58] Guodian will gain Shenhua's coal supply, infrastructure, and cash to pay off its debts, while Shenhua will benefit from its partnership with Guodian—a leading developer of alternative energy power generation—by easing its dependence on coal and transitioning toward cleaner fuel.[59]

China National Cotton Reserves Corp. and Sinograin

In January 2017, the State Council approved a merger between China National Cotton Reserves Corp. (CNCRC) and China Grain Reserves Corp (Sinograin).[60] When CNCRC is folded into Sinograin, the resulting company will reportedly have combined assets of around $219 billion, making it China's largest agricultural products company and more than seven times larger than its main competitor, the Singapore-based agribusiness Wilmart International.[61] The new company's total assets will also exceed that of Archer Daniels Midland ($40 billion as of 2016), Cargill Inc. ($55.8 billion as of 2017), and Louis Dreyfus Company ($18.5 billion as of 2015), which have collectively dominated global grain trading in recent years.[62] CNCRC stores, imports, and distributes cotton in China and has a presence in 15 provinces, as well as a grain depot in Tianjin.[63] Sinograin, meanwhile, has emerged as China's leading grain storage and transportation company.[64]

[*] Before the merger, Shenhua had 82 gigawatts of installed capacity and Guodian had 145 gigawatts. Bloomberg, "China Is Creating the World's Largest Power Company," August 28, 2017. *https://www.bloomberg.com/news/articles/2017-08-28/china-approves-guodian-shenhua-group-to-merge*.

CSR and CNR

The June 2015 megamerger between China's two state-owned railway companies, CNR and CSR, resulted in the creation of China Railway Rolling Stock Corporation (CRRC).[*] With a combined market value of approximately $130 billion, CRRC is now the world's second-largest industrial company (behind General Electric with a market value of $255.5 billion) as well as the world's largest train builder.[65] The merger, which was intended to limit competition among Chinese companies, created a global industrial giant.[66] When CRRC was formed, its market capitalization had already eclipsed major competitors such as Germany's Siemens AG and France's Alstom SA.[67] In the United States, CRRC outbid three competitors[†] to build the cars for Boston's new subway system, becoming the first Chinese rail car manufacturer to win a major transit contract in the United States.[68] CRRC's winning $566 million bid was half the amount of Montreal-based transportation company Bombardier's $1 billion proposal.[69]

State Nuclear Power Tech Corp. and China Power Investment

Like CRRC, the merger between State Nuclear Power Tech Corp. and China Power Investment—approved by the State Council in June 2015 and with total assets valued at more than $112 billion—was driven by both international and domestic factors.[70] Prior to the merger, China Power Investment was China's fifth-largest power generation company and controlled around 10 percent of China's nuclear power market, while State Nuclear Power Tech Corp. specialized in nuclear power technology.[71] The new company, State Power Investment Corp. (SPIC), represents a consolidation of China's nuclear sector that allows the resulting company to provide nuclear infrastructure and clean energy in China and abroad, though it still must compete with China's other two nuclear corporations: China National Nuclear Power Corp. and China General Nuclear Power Group (which both export nuclear reactors and other nuclear technologies abroad).[72] SPIC aims to begin exporting its first nuclear reactors by 2020 and become a major exporter by 2030, competing in a nuclear market currently dominated by firms like Japan's Toshiba Corp ($60 billion in total assets in 2015) and France's Areva ($32 billion in total assets in 2015).[73]

Sinotrans & CSC Holdings and China Merchants Group

In December 2015, China's State Council approved a merger between the transportation and logistics firm Sinotrans & CSC Holdings and China Merchant Group (CMG), a Hong Kong-based transportation, finance, and real estate company.[74] The merger sought to optimize CMG's shipping services and increase the scale of the company's logistics services to better compete with global rivals.[75] The deal reorganized the companies' shipping businesses, with Sinotrans anticipated to help CMG develop its integrated logistics, energy transportation, and port businesses.[76] After the merger, CMG's assets total around $110 billion, making it the largest shipping and logistics firm in the world ahead of the second-largest firm, the Danish container shipping company A.P. Moller-Maersk, which has assets totaling $63.2 billion.[77]

Chinese Global M&A

China's megamerger strategy is part of a worldwide trend toward large-scale M&As, with companies seeking to improve their global competitiveness, enhance their technological capabilities, and lower costs through large-scale acquisitions. According to the financial news and analysis firm MergerMarket, worldwide a total of 18,433 global M&A deals were completed in 2017 for a total of nearly $3.2 trillion.[78] Although the total value represents a 3.2 percent decline from 2016, it is still the fourth highest global M&A value since 2007.[79]

Like the rest of the world, China's global M&A activity—both outbound and domestic—has accelerated. In 2016, a combination of Chinese government policies and increased investor uncertainty in China contributed to the rise of investment outflows.[‡] One transaction, the $43 billion deal for the Switzerland-based agribusiness and

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[*] For more on CRRC and China's railway development, see Michelle Ker, "China's High-Speed Rail Diplomacy," *U.S.-China Economic and Security Review Commission*, February 21, 2017. *https://www.uscc.gov/sites/default/files/Research/China%27s%20High%20Speed%20Rail%20Diplomacy.pdf*.

[†] The other three bidders were Canada's Bombardier, South Korea's Hyundai Rotem, and Japan's Kawasaki Rail Car.

[‡] For more on drivers of Chinese outbound investment in 2016, see U.S.-China Economic and Security Review Commission, Chapter 1, Section 2, "Chinese Investment in the United States," in *2017 Annual Report to Congress*, November 2017, 76.

biotechnology firm Syngenta, also contributed to the spike in outbound M&A in 2016. That year, China's global outbound M&As swelled 45.8 percent year-on-year by volume (258 deals in 2016, up from 177 deals in 2015) and 277.4 percent year-on-year by value ($185.3 billion in 2016, up from $49.1 billion in 2015).[80] Capital controls and more stringent approval processes for outbound investments imposed by Beijing limited China's M&A activity in 2017, when only 170 Chinese outbound deals worth $52.5 billion were announced (see Table 2).[81] Chinese M&A activity is expected to rebound in 2018 as a result of a stable renminbi, increased foreign reserves, and projects related to China's Belt and Road Initiative.[82]

Table 2: Chinese Global Outbound M&As, 2015–2017

	Volume	Value (US$ billions)
2015	177 deals	49.1
2016	258 deals	185.3
2017	170 deals	52.5

Source: MergerMarket, "5 Charts that Represent 2017's M&A Activity," December 21, 2017. http://www.mergermarket.com/info/5-charts-represent-2017%E2%80%99s-ma-activity*; MergerMarket, "2016 Global M&A Trend Report," January 4, 2017, 3.* http://www.mergermarket.com/pdf/MergermarketFinancialLeagueTableReport.Q42016.pdf.

Chinese companies' M&A activity is also aimed at earning government subsidies and other financial incentives. By acquiring businesses in line with the Chinese government's industrial policy,[*] SOEs earn support from Beijing, including backing from state banks and capital markets.[83] These deals ultimately increase SOE debt in China, with companies relying on loans from state banks to finance the deals.[84] In 2016, indebted Chinese SOEs made a number of bids for large foreign companies, including China National Chemical Corp.'s (ChemChina) $43 billion bid in February 2016 for Syngenta.[†] ChemChina is classified as "highly leveraged" by Standard & Poor's—the firm's highest designation for financial risk—with nearly ten times as much total debt as the company earns annually, yet made the bid to acquire Syngenta with the backing of the Chinese state.[85] Along with ChemChina, Zoomlion (a Chinese construction manufacturer) made a $3.3 billion bid in January 2016 for U.S. rival Terex despite having debt amounting to 43 times its earnings in the first nine months of 2015.[‡] [86] Cofco Corporation, China's largest food manufacturer and trader, also reached a deal to acquire Noble Group, the Hong Kong-based commodities trader, for $750 million in January 2016 despite Cofco holding debt 52 times higher than its earnings.[87]

Chinese M&A activity in the United States increased significantly in 2016—reaching $56.7 billion, 4.7 times more than 2015—but declined to $10.7 billion in 2017, an 81.1 percent decline year-on-year.[88] In part, reduced Chinese investment in the United States in the first half of 2017 was the result of the government's efforts to limit capital outflows and fend off risks from mounting corporate debt.[89] Although the new policies tightening regulatory oversight over SOE investments could lead to a downturn in Chinese SOE overseas M&As in the short term, the trend toward domestic consolidation of SOEs—and thus the creation of companies with more capital to invest overseas—appears likely to continue.[90]

[*] China's industrial policy seeks to enhance indigenous innovation, reduce overcapacity, and develop the country's high-technology and environmental industries, including biotechnology, high-end manufacturing equipment, and new-generation information technology. U.S.-China Economic and Security Review Commission, Chapter 1, Section 3, "China's State-Led Market Reform and Competitiveness Agenda," in *2015 Annual Report to Congress*, November 2015, 158–162.

[†] For more information on the Syngenta acquisition, see U.S.-China Economic and Security Review Commission, *Monthly Analysis of U.S.-China Trade Data*, March 6, 2015, 9–10. *http://1.usa.gov/1T6uRZ4*.

[‡] In May 2016, Zoomlion withdrew the offer. Anne Marie Roantree and Tuomas Forsell, "Konecranes-Terex Deal to Proceed as China's Zoomlion Drops Rival Bid," Reuters, May 27, 2016. *https://www.reuters.com/article/us-terex-m-a-zoomlion/konecranes-terex-deal-to-proceed-as-chinas-zoomlion-drops-rival-bid-idUSKCN0YI0DC*.

Implications for the United States and Considerations for Congress

Megamergers are not signs of structural changes in China's state sector, as they have not increased SOE efficiency or profitability, but rather have contributed to increased debt levels in China. However, Beijing is poised to continue pursuing megamergers because they allow companies to overcome short-term financial troubles, realize greater economies of scale, and increase global competitiveness in key sectors while reducing competition between Chinese firms. U.S. policy makers should be cautious of interpreting recent mergers and share sales as efforts toward privatization, and should expect to see continued SOE megamergers and acquisitions as China pursues a strategy of state capitalism dominated by state-run monopolies. Ultimately, SOE inefficiency and unprofitability will endure until the state relinquishes control over resource allocation and industry development.

SOE megamergers threaten to undermine the competitiveness of U.S. businesses and other global firms operating in accordance with market forces. Government support enables indebted Chinese SOEs to acquire foreign businesses and offer products far below market prices, shutting out foreign firms. Chinese SOEs are also protected from competition by market barriers for foreign firms, as well as substantial subsidies and preferential loans from Chinese banks, breeding inefficiency and moral hazard. If Beijing continues to merge state enterprises in lieu of reforming the SOE model and reducing the role of the government, private sector competitors will find it increasingly difficult to compete with Chinese SOEs operating abroad. This trend toward megamergers poses a direct threat to the global competitive landscape, which could quickly become dominated by monopolies.

Global economic governance is at a crossroads to determine how massive M&A deals should be regulated to maintain free and fair economic growth and development.[*] Since before World War II, U.S. anti-trust regulations have been primarily governed by three laws. First, the Sherman Antitrust Act, passed in 1890 and later updated in 1976, prohibits any "monopolization, attempted monopolization, or conspiracy or combination to monopolize" along with "unreasonable" restraints of trade, including activities both within the United States and abroad as long as the activities impact U.S. commerce.[91] Second, the Federal Trade Commission Act of 1914 bans "unfair methods of competition" as well as "unfair or deceptive acts or practices."[92] Finally, the Clayton Act of 1914 prohibits M&As both domestically and abroad that decrease competition or create a monopoly.[†] [93]

These three laws—the Sherman Act, Federal Trade Commission Act, and Clayton Act—provided few restrictions on how or when U.S. courts could invoke antitrust laws against foreign parties so long as their operations either occurred in the United States or impacted U.S. commerce.[94] In 1982 however, the Foreign Trade Antitrust Improvements Act (FTAIA) was signed into law, limiting U.S. courts' ability to apply U.S. antitrust laws overseas. Under the FTAIA, U.S. antitrust laws are only actionable overseas if the alleged foreign conduct has a direct, substantial, and reasonably foreseeable effect on U.S. commerce and "gives rise" to the plaintiff's harm.[95] The language of the FTAIA has created uncertainty among U.S. courts, which disagree on the correct application of the statute as it relates to foreign conduct. As a result, U.S. courts have applied the law unevenly, with U.S. companies and their foreign competitors subject to different disciplines under antitrust laws.[‡]

While SOE M&A activity is not unique to China, the growing influence of Chinese state-owned companies raises questions about the motivations and implications of large-scale takeovers, particularly by state-owned companies.

[*] In November 2017, European Commissioner Margrethe Vestager met with the chairman and vice chairman of China's National Development and Reform Commission to discuss competition policy between the EU and China. In her remarks, Commissioner Vestager stated, "It is in our mutual interest to work together to promote fair global competition. Antitrust [and] merger review … are important tools in ensuring that consumers can benefit from competitive markets and companies can compete on their merits. Both the European Commission and the Chinese competition agencies will work closely together for a coherent and efficient competition enforcement." European Commission, "Competition: Commission and China Start New Dialogue on State Aid Control and Discuss Competition Policy," November 16, 2017. *http://europa.eu/rapid/press-release_IP-17-4705_en.htm*.

[†] The Clayton Act was amended in 1976 by the Hart-Scott-Rodino Antitrust Improvements Act to require companies planning large mergers or acquisitions to provide advance notice of their plans to the government. Hart-Scott-Rodino Antitrust Improvements Act of 1976, Public Law No. 94-435, 1976.

[‡] For more on how the FTAIA has been applied to overseas cases, see Abbot B. Lipsky, Jr., and Kory Wilmot, "Foreign Trade Antitrust Improvements Act: Did Arbaugh Erase Decades of Consensus Building?" *Antitrust Source*, 12:6 (August 2013).

To prevent the creation of global Chinese monopolies and ensure fair competition on international markets, Congress should consider the following questions:

- Does the current U.S. antitrust regime accurately assess the effects of SOE behavior on competition in U.S. domestic markets?
- Do U.S. investment review frameworks provide for thorough investigations into cross-regional, high-volume M&A activity?
- Can regulations governing large-scale, cross-regional M&As be made more consistent across countries to facilitate cooperation on M&A review procedures?

Appendix

M&As Involving Chinese SOEs Valued at More than $1 Billion Since 2014

Year	Acquirer / Target
2014	Citic Pacific Ltd / Citic Ltd (New Name: Citic Ltd)
	Investor Group / Sinopec Sales Co. (30% Acquisition)
	China National Machinery Industry Corporation (Sinomach) / China National Erzhong Group
	Shenyin & Wanguo Sec Co. / Hong Yuan Securities Co.
	Sinopec Oilfield Service Corp. / Sinopec Yizheng Chemical Fiber Co.
	China National Cereals, Oils, and Foodstuffs Corp. / China Huafu Trade and Development Corp.
	Sichuan Chengfei Integration Technology Corp. / Shenyang Aircraft Industry Group Co.
	Shanghai Jinfeng Investment Co. / Greenland Holding Group Co.
	Founder Securities Co. Ltd / China Minzu Securities Co. Ltd
	BesTV New Media Co. / Shanghai Oriental Pearl (Group) Co.
	Beijing Jingdong Century Trade Co. / Tencent Holdings Ltd
	China Textile Investment Development Co. / Anxin Securities Co.
	China Everbright Water Investment Co. / HanKore Environment Tech Group
	Investor Group (COFCO Corp.) / Noble Agriculture Co. (51% Acquisition)
2015	China South Locomotive & Rolling Stock Corp. (CSR) / China North Locomotive & Rolling Stock Corp. (CNR) (New Name: China Railway Rolling Stock Corp. [CRRC])
	State Nuclear Power Tech Corp. / China Power Investment (New Name: State Power Investment Corp. [SPIC])
	China Merchants Group Co. / Sinotrans & CSC Holdings Co.
	China Metallurgical Group Corp. / China Minmetals Corp.
	China Ocean Shipping Group Corp. (COSCO) / China Shipping Group Co. (New Name: China COSCO Shipping Corp.)
	Jiangsu Hongda New Material Co. / Focus Media Holding Ltd (Shanghai)
	Zhejiang Material Industrial Zhongda Yuantong Group Co. / Zhejiang Materials Industry International Co.
	Nam Kwong Group Co. / Zhuhai Zhenrong Co.
	China Communications Facility Services Co. / China Telecom - Communication Tower Assets
	Non-Beer Business China Resources Group Co. / China Resources Enterprise Co.
	China Yangtze Power Co. / Three Gorges Jinsha River Chuanyun Hydropower Development Co.
	PetroChina Pipeline Co. / China Petroleum Pipeline Co.
	Baoshan Iron and Steel Group (Baosteel) / Wuhan Iron and Steel Corp. (New Name: China Baowu Steel Group Corp.)

Year	Acquirer / Target
2016	China National Building Materials Group Corp. (CNBM) / China National Materials Group Corp. (Sinoma) (New Name: China Construction Materials Group)
	China National Cereals, Oils, and Foodstuffs Corp. (COFCO) / Chinatex Corp.
	China National Travel Service Group / China International Travel Services Corp. (Completed Merger. Name: China Tourism Group Corp.)
	Hainan Supply and Marketing Daji Holding Co. / Xi'an Minsheng Group Co. (Completed Merger)
	Maanshan Dingtai Rare Earth New Material Co. / SF Holdings Group Co.
	Jinan Diesel Engine Co. / China National Petroleum Corp.
	Changjiang Infrastructure Construction Group Co. / DUET Group Co.
	Dalian Dayang Creation Co. / Yuantong Express Co.
	China Grain Reserves Corp. (Sinograin) / China National Cotton Reserves Corp. (CNCRC)
2017	China National Machinery Industry Corp. (Sinomach) / China Hi-Tech Group Corp.
	Shenhua Group Corp. / Guodian Group Corp.
	China Poly Group Corp. / Sinolight Corp. & China National Arts and Crafts Group
	China Unicom (BVI) Ltd. / China Unicom Hong Kong Ltd (22% Acquisition)
	Guangzhou Wanxi Real Estate Co. / Guangdong International Travel Assets
	Sunac Real Estate Group Co. / Dalian Wanda Commercial Property Co.
	China CEFC Energy Co. / Rosneft Oil Co. (14% Acquisition)
	China Investment Corp. / Logicor Ltd
	Investor Group / China United Network Co.
	China National Nuclear Corp. / China Nuclear Engineering & Construction

Source: Various.[96]

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