ECONOMIC ANALYSIS

China's growing ODI: Where does it all go?

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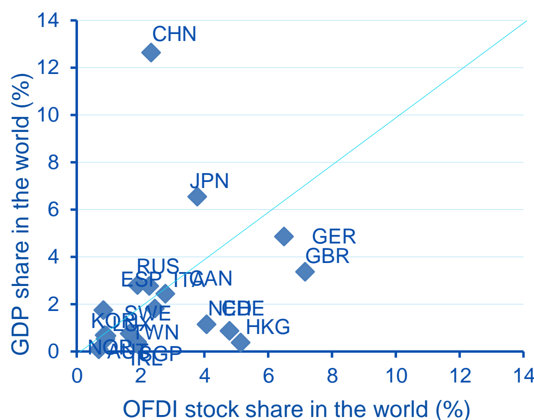
Summary

- Chinese official outbound direct foreign investment (ODI) statistics may be distorted by the presence of stop-over destinations such as Hong Kong and offshore centers in the Caribbean.
- According to estimates from our latest Working Paper, Chinese ODI flows in 2013 may have been overstated due to the presence of round-tripping, challenging previously held assumptions that the country is close to becoming a net exporter of FDI.
- Furthermore, the distribution of China's ODI may be more diversified than previously thought, with developed markets such as Europe and North America featuring more prominently.
- Finally, Chinese ODI is a relatively new phenomenon, so its global stock remains small compared to other major economies. This is bound to change rapidly following from a number of policy initiatives that aim to assist China to rebalance its economy and internationalize its companies.

China's ODI figures may be distorted by the presence of round-tripping and offshoring

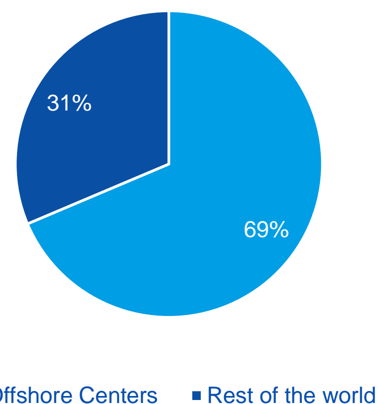
According to the Ministry of Commerce of the People's Republic of China (MOFCOM), China's outbound foreign direct investment (ODI) may have exceeded inbound foreign direct investment (FDI) for the first time in 2014. According to these figures, China's FDI increased by 1.7% y/y, reaching USD 119.6 billion in 2014, while non-financial ODI increased by almost 11.0% y/y, reaching USD 102.9 billion. Assuming that ODI growth rates to the financial sector remain constant, this would place total ODI flows for 2014 at over USD 120 billion, surpassing FDI by a notch.

Figure 1
China's share of global ODI stock remains relatively small compared to its GDP (2013)



Source: UNCTAD and BBVA Research

Figure 2
Hong Kong, the Cayman Islands and BVI account for the lion-share total ODI stocks (2013)



Source: CEIC and BBVA Research

This result is remarkable because it implies that China may have already become a net exporter of FDI, something surprising given the country's stage of development as well as relatively low share of global ODI stocks (Figure 1). In fact China could be far from being a net exporter of FDI. The reason for this is that ODI figures may be substantially distorted due to the presence offshore intermediaries such as Hong Kong and tax havens in the Caribbean, which accounted for circa 70% of China's total ODI flows and stocks in 2013 (Figure 2). MOFCOM requires companies to register the first (not the final) destination of their cross-border transactions and do not take into account reverse flows, making it hard to determine the final size and distribution of Chinese ODI. In our latest Working Paper, we recalculate China's Outbound Foreign Direct Investments (ODI) in a way which accounts for these distortions.

How much ODI goes where?

Our estimates show that China's ODI flows and stocks may have been overestimated and may be more diversified that previously thought (Figure 3). First of all, ODI flows and stocks in 2013 may have been much lower than reported by MOFCOM. The reason for this discrepancy is that approximately 40% of all flows to Hong Kong end up reinvested into China as inbound FDI to benefit from preferential conditions (Xiao, 2004).

In addition, the geographical distribution of Chinese ODI stocks and flows may be more balanced than previously thought, with developed markets in North America and Europe accounting for a larger share of final flows and stocks.

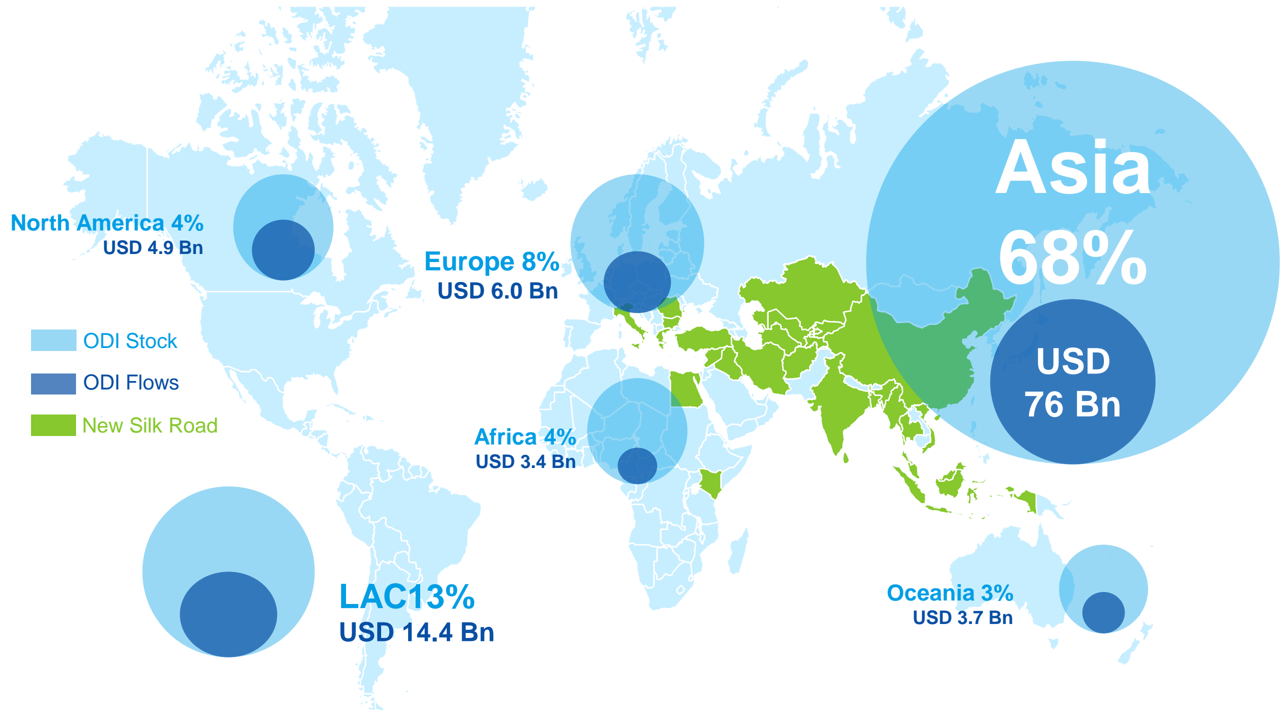
While Asia remains the largest recipient of Chinese ODI, its share falls from 70% to 50% according to our estimates. The fact that Asia is the major recipient of Chinese ODI makes sense given the region's geographical proximity and close trade links with China. However, Chinese official statistics define Asia in very broad terms – which include the Middle East and Central Asia – so this figure would decrease significantly based on narrower geographical classifications.

Europe emerges as the second largest recipient according to our estimates. The continent goes from being a relatively modest recipient of ODI (8% of stocks and 6% of flows in 2013), to accounting for 19% of total stocks, and 17% of total flows in 2013. Take the European Union (EU) as an example: recent media reports have claimed that we are witnessing a wave of Chinese investments into the EU; however official statistics place this figure at a modest USD 4.4 billion in 2013. Our estimates show that Chinese ODI flows into the EU could have been closer to USD 10.4 billion in reality, challenging previously held assumptions that China remains a minor investor in the EU.

North America also sees an increase in its share of ODI, with the United States accounting for over 75% of flows and stocks to North America. This comes as no surprise. MOFCOM's statistics show that Chinese ODI flows into the US were USD 3.8bn in 2013, a figure which is lower than the value of the largest transaction that year (the purchase of Smithfield's Food for USD4.7bn, which happened via the Cayman Islands). Our estimates put this figure at around USD 9.0 billion (stocks: USD 49.2 billion).

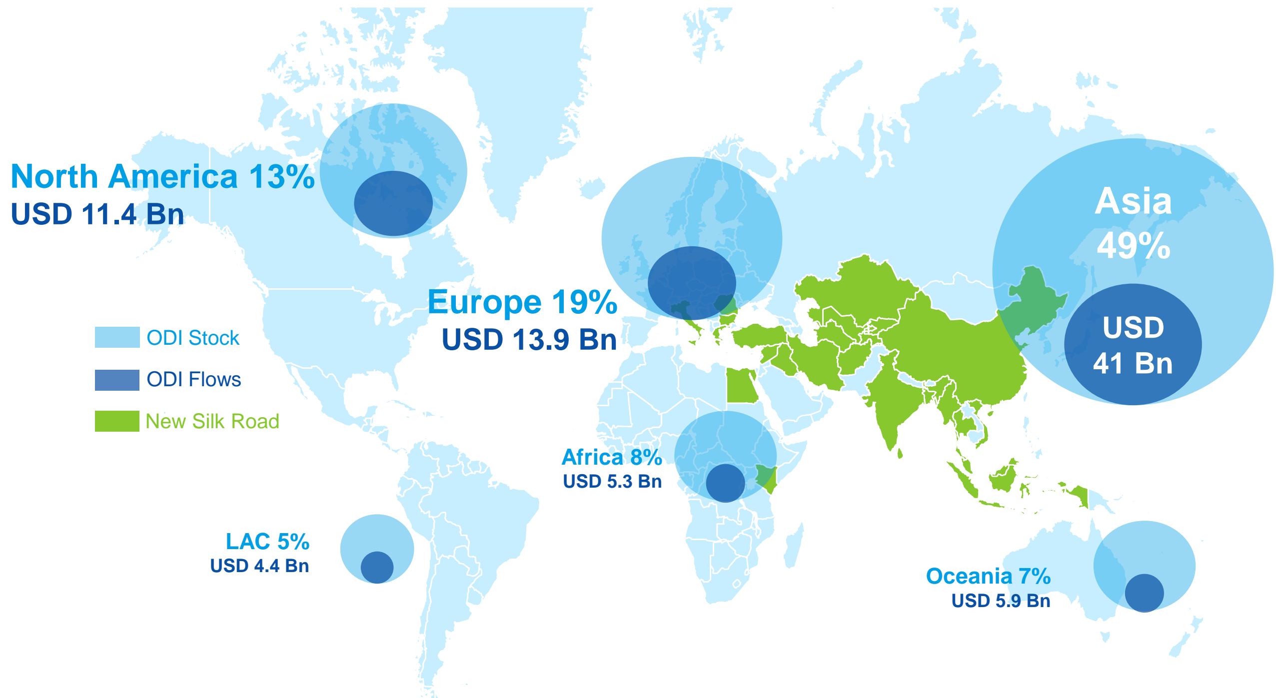
Latin America is the only region that experiences a drop in Chinese ODI, however if we exclude offshore centers from the equation, ODI stocks to the region actually increase after accounting data limitations based on our estimates (USD 9.9 billion according to MOFCOM vs. USD 23.2 billion based on our estimates).

Figure 3a
Distribution of Chinese ODI flows and stocks according to MOFCOM (2013)



Source: MOFCOM, NBS, SAFE and BBVA Research; Note: The bubbles are indicative and do not exactly represent the size of ODI flows and stocks.

Figure 3b
Distribution of Chinese ODI flows and stocks based on our assumptions (2013)



Source: MOFCOM, NBS, SAFE and BBVA Research; Note: The bubbles are indicative and do not exactly represent the size of ODI flows and stocks.

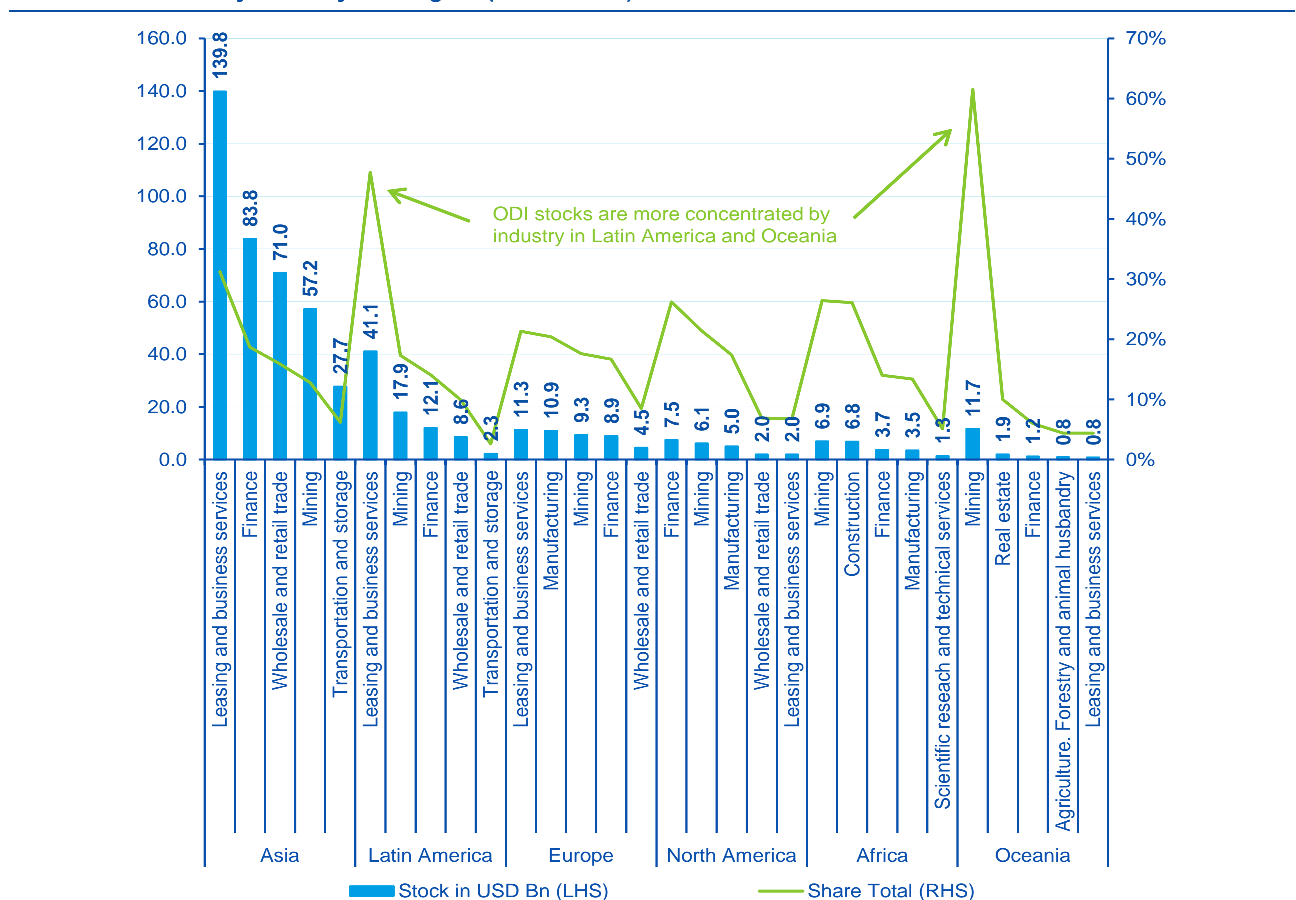
Mining and financial services continue to outpace other sectors in terms of growth of ODI flows

The steepest growth rates can be observed in sectors of strategic importance to China's national security and the internationalization of its corporations, such as mining (+83.2% y/y) and finance (+50% y/y). Leasing and business services accounted for the largest proportion of ODI flows in 2013, but their share of China's ODI stock is diminishing gradually. It is important to mention that industrial categories are based on Chinese definitions, so are not comparable to international standards such as the International Standard Industry Classification (ISIC).

Asia accounted for the lion share of total ODI stock in the mining sector (USD 57.2 billion or 52.4%), led by large-scale investments in oil and gas (Kazakhstan and Iran) and coal (Indonesia and Mongolia). Latin America came in second, led by investments in oil and gas (Venezuela) and non-ferrous metals (Chile). 71.6% of total ODI stocks in the finance sector went to Asia, which is not surprising given Hong Kong's role as an intermediary of capital flows between China and the world.

Finally, ODI stocks were more concentrated in Latin America and Oceania (Figure 4). In the case of Latin America, the unbalanced nature of China's ODI stocks in the region is underpinned by the role of tax havens as intermediaries of flows to North America, with relatively low ODI stocks in the rest of industries compared to other geographies. Stocks to Oceania are clearly skewed towards mining, reflecting the potentially disruptive dependency of Australia's mining sector to fluctuations in Chinese demand.

Figure 4
China's ODI stock by industry and region (end of 2013)



Source: MOFCOM, NBS, SAFE and BBVA Research

What trends will define Chinese ODI looking forward?

China may have become a net creditor in 2014, marking a crucial turning point in its development path. We believe that this trend will accentuate further, especially given that China's ODI stocks in the world are underrepresented relative to the country's size. In particular, a number of issues will add to the existing momentum behind Chinese ODI. These are namely:

1) Further easing of application procedures for ODI:

The recent trend in China's ODI policy framework has been towards more deregulation (see Appendix I). New measures, aiming to further simplify the approval and registration procedure for Chinese ODI, where put in place by the National Development and Reform Commission (NDRC) on June 2014. Under the new, more permissive rules, filling with the relevant municipal government body is generally sufficient for projects under USD 300 million. Investments in sensitive sectors and countries are still subject to approval by the NDRC at central level; however the new rules will put significant impetus behind the Chinese ODI looking forward.

Easing measures were introduced with the objective to accelerate China's going-out policy, assisting China's trans-national corporations (TNCs) to internationalize in order to facilitate China's rebalancing efforts. This will benefit in particular privately owned enterprises, where we are observing the largest increase in ODI flows. We expect this measure to boost ODI in non-sensitive projects under 300 million, including investments in foreign companies to expand market share overseas and access proprietary technology (manufacturing in the EU and the US), as well as investments that offer good yields overseas (real estate is a good example, including Wanda's purchase of landmark building in Spain for EUR 265 million in 2014).

2) The need to internationalize TNCs to boost productivity and enable China's rebalancing efforts:

China's rebalancing away from investments has left many sectors with excessive capacity (steel, cement, construction). Boosting ODI to overseas markets where demand is still on the rise, as is the case with most ASEAN countries, will enable China to outsource this excessive capacity. Labor-intensive sectors will also seek to expand overseas in order to benefit from relatively lower labor costs and maximize profit margins, favoring ODI flows to manufacturing activities in ASEAN and to a lesser extent Africa. On the other end of the spectrum, TNC's on the high value-added segment will look to expand overseas to purchase technology that will facilitate China's shift up global value chains (GVCs). This quest for technology has already driven many TNCs to purchase assets in the EU and the US.

These trends have already started to reflect in the industrial structure of Chinese investors. Contrary to popular belief, State Owned Enterprises (SOEs) accounted for little over 50% of total ODI stocks as per 2013, while Limited Liability Companies' market share grew by 5% y/y, standing at circa 40%. In fact, many of China's biggest (and rising) overseas investors are now privately owned TNCs (see Appendix II). This should put significant tailwind behind investments to Europe and the US.

3) The need diversify its international investment position away from reserve assets and towards ODI:

China has amassed an impressive amount of foreign reserves, equivalent to roughly USD 4 trillion in 2013. An estimated two-thirds of these reserves are held in USD denominated assets, primarily

government bonds and institutional bonds. Currently, China does not have a channel to hedge for the falling value of its vast USD denominated reserves in case of currency depreciation (or its Euro/Yen denominated reserves for that matter). Beijing could use ODI as an alternative to holding government debt securities, diversifying its hugely positive international investment position away from reserve assets and towards ODI.

In addition, US government bonds offer very low yields. By diversifying away from reserves towards ODI, China could achieve higher yields, particularly for higher-risk projects in emerging economies, thus complementing the strategic interests of its TNCs abroad. This is a huge opportunity for emerging economies to finance infrastructure projects required to close the competitive gap. We expect to see an increase in Chinese ODI for infrastructure projects in Asia, Latin America and Africa, as monetary expansion in the EU and Japan put forward downward pressure on China's foreign assets denominated in these currencies.

4) More government-led initiatives such as the 21st Century Silk Road:

The need to offshore excess capacity and expand overseas markets for Chinese TNCs coincides with an increase in the assertiveness of Chinese economic diplomacy, a shift which is embodied by China's 21st Century Silk Road. The initiative, announced in 2014, comprises the creation of a USD 40 billion Silk Road Fund to boost infrastructure investments and foster economic integration with countries along the historic Silk Road (Highlighted in green on Figure 3). The Silk Road Economic Belt (the land bound leg of the initiative), will target countries in Central Asia (many of which are important suppliers of oil and natural gas to China) and will finish in Turkey. The 21st Century Maritime Silk Road (the sea bound leg) will target ASEAN countries and will reach East Africa via the Malacca Strait as well as India and Sri Lanka. But this is by no means the only government-led initiative that aims to achieve this.

2014 was a remarkable year for Chinese development finance overseas. In addition to the Silk Road Fund, Beijing spearheaded the creation of a USD 50 billion Asian Infrastructure Investment Bank (AIIB) and a USD 50 billion BRICS New Development Bank (NDB). ODI flows to these regions will be greatly aided by improved economic integration and financing for infrastructure investments. Latin America is another region that is bound to receive more ODI on the back on new bilateral lending and investment deals. These include USD 20 billion in investments to Venezuela over the next 5 years and USD 7.5 billion in lending to Ecuador, both of which were announced at the recent China-CELAC Summit in Beijing, where Xi Jinping also pledged that China will strive to increase direct investment in Latin America USD 250 billion by 2025.

This type of government-led initiatives help to improve economic integration and expand the market for Chinese goods and services overseas, all of which will open opportunities for Chinese companies abroad. Once fully fletched, they will provide much needed capital for developing countries and increase China's ODI stocks in the world, primarily in the mining, transportation infrastructure, construction, and manufacturing and information transmission sectors.

Appendix I

Figure 8
China's ODI Policy Development

Source: Working Paper Number PB09-14, Peterson Institute of International Economics and BBVA Research

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