China Economic Watch

China | Five facts about outward direct investment and their implication for future trend

Betty Huang / Alvaro Ortiz / Tomasa Rodrigo / Le Xia

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This report takes stock of China's outward direct investment (ODI) in 2018. Our findings include: (i) China's ODI continues its downtrend; (ii) the share of Belt Road Initiative (BRI) countries is increasing; (iii) the energy sector outperforms other sectors; (iv) POEs and SOEs have different troubles; and (v) other countries' sentiments toward China's investment remain mixed. We project China's ODI is likely to bottom out in 2019 amid the headwinds while the long-term prospect of China overseas investment remains positive.

Fact 1: China's ODI continued trending down in 2018

After peaking in 2016, China' Outward Direct Investment (ODI) continued its downtrend during 2017-2018. In particular, China's ODI slumped by 18% to USD 129.8 billion in 2018, the biggest drop since 2003 according to the Ministry of Commerce. As a result, China's ODI (excluding financial sector) was outpaced by inbound foreign direct investment in 2018, tipping the country back to a net debtor again.

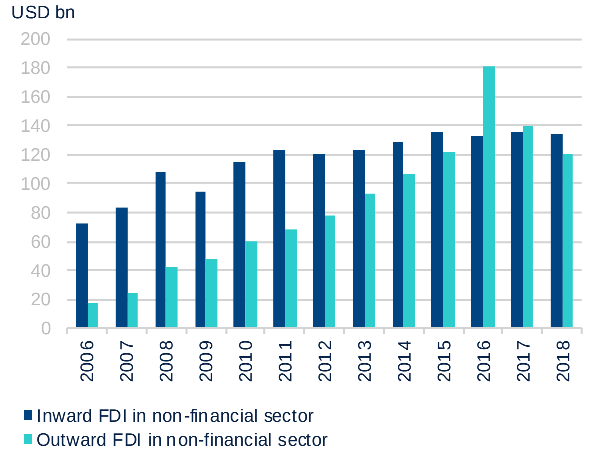
A confluence of factors lurk behind the slump:

First, a series of implemented restrictive measures, which were enacted since 2016 to combat capital flight, significantly slowed China's non-financial ODI. In particular, the "Guidance of Outbound Investment Regulation" unveiled in August 2017 blacklist a number of industries for ODI such as real estate, sports club, entertainment etc, which used to be the favourites of Chinese investors. (Please see our report ODI from the Middle Kingdom: What's next after the big turnaround?)

Second, the wind in some potential host countries of China's ODI also turned as many advanced countries start to perceive China's ODI in their high-tech sectors as a potential threat to their leading position at the technological frontier. Led by the US, western countries have tightened their screening on Chinese investors, which led to 21 cases of Chinese acquisitions worth of USD 25 billion being cancelled or blocked by foreign regulators in 2018, indicating a 28% increase from last year.

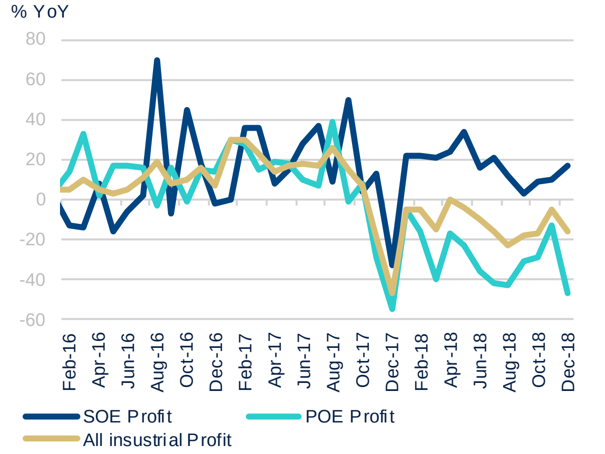
Last, the domestic economic downturn also hindered Chinese firms from making more investment overseas. In 2018, a combination of US-initiated tariff war and lingering effects of domestic deleveraging took a heavy toll on Chinese firms' profitability (Figure 2). Sluggish domestic growth unavoidably affected Chinese firms' appetite for international assets.

Figure 1 China became a net debtor again in 2018



Source: MOFCOM and BBVA Research

Figure 2 Chinese firms' sluggish profit dragged ODI



Source: CEIC and BBVA Research

Fact 2: ODI to BRI countries accounted for a larger share

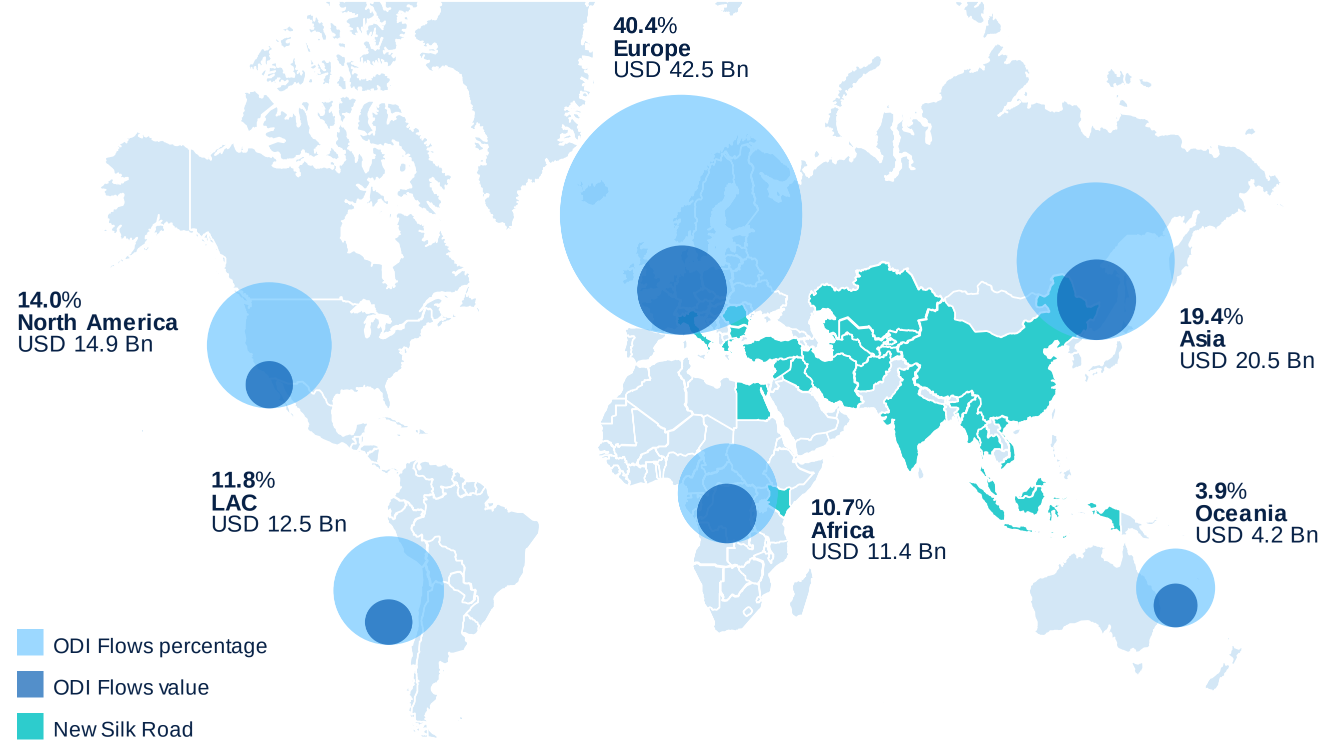
China's official ODI data is notoriously inaccurate for reporting its destinations. In total, approximately 60% of China's total ODI flows to Hong Kong and some tax havens in the Caribbean, through which funds are expected to be channelled to their final destinations at a later stage. Therefore, we use a more detailed database by CGTI which includes all verified investment and construction transactions worth USD 100 million or more to detect where ODI goes. The CGTI data features more than 1,300 investment deals worth more than USD 1 trillion in total. Such a deal-based database enables us to better track China's ODI flows and stocks to different destinations (Figure 3).

In terms of geographic distribution, China's ODI flows to Europe, Asia, and North America, which remains the first largest recipient continents of China's investment, all saw significant declines in 2018. In particular, the declines in China's ODI to Europe and North America amount to -56.3% and -60.0% respectively. In Asia, the ODI decline is led by Japan and Singapore. The same trend is observed in Oceania. Overall, it reflects advanced countries' increasing concerns over China's investment.

Meanwhile, China's ODI flows to emerging markets are still booming thanks to China's Belt and Road Initiatives (BRI) which aims to increase China's investment in a large number of developing countries which have traditional trade links with China. In 65 BRI countries earmarked by China's authorities, China's investment even increased by 8.0% in 2018. The share of investment in these BRI countries now accounts for 21.6% from 16.8% in 2016. The BRI effect is particularly pronounced in Africa, where the number of host countries of China's ODI increased to 11 in 2018 from only 4 in 2017.

Apart from these BRI countries, the performance of Latin America also held well as the total China ODI to the region almost remained flat in 2018. In this respect, Chile ranked first with an aggregate USD 6.4 billion thanks to a big acquisition of metal mine, followed by Peru (USD 3.6 billion), Brazil (USD 1.3 billion), and Ecuador (USD 0.9 billion).

Figure 3 Distribution of Chinese ODI flows and stocks based on CGIT data (2018)



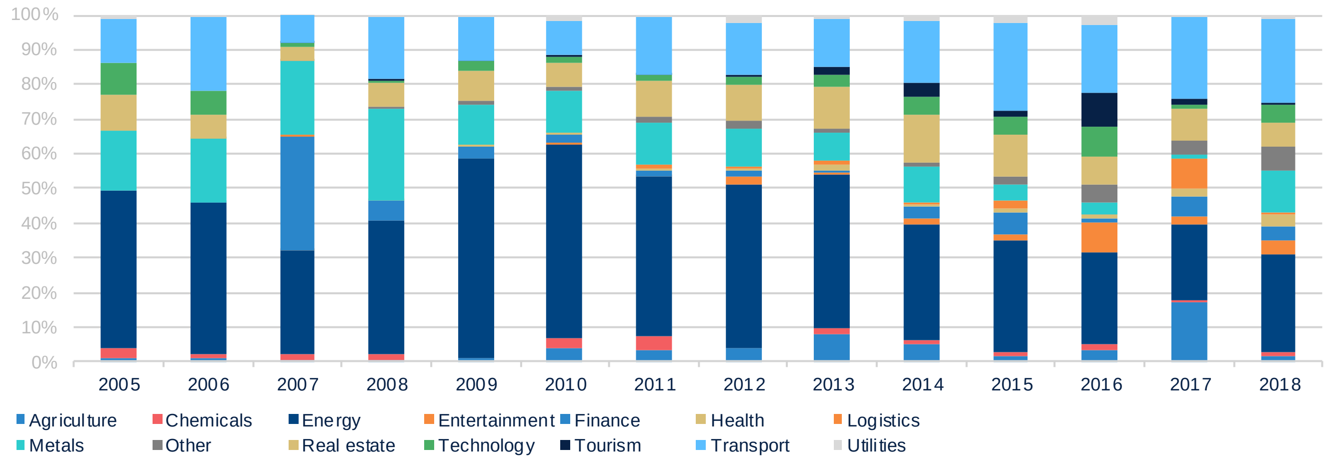
Source: China Global Investment Tracker and BBVA Research; Note: The bubbles are indicative and do not exactly represent the size of ODI flows and stocks

Fact 3: Energy sector continues to outpace other sectors

By industry, China's ODI in the energy sector still dominated in 2018, in line with the trend during 2005-2018. Energy sector received USD 21.1 billion in investment in 2018, with Gas and Hydro seeing more activity than coal and oil. Investment in the transport sector also picked up significantly thanks to China's Geely's high-profile acquisition of Daimler. The metals sector received USD 18.85 billion investment last year, led by copper and steel. Health and technology sectors expanded their shares of the total received ODI. However, the once-hot fields of entertainment, real estate and tourism (hotels) registered just USD 5 billion in investment compared with USD 12.9 billion in 2017, after Beijing imposed restrictions to stem capital flight.

Most of the transactions are dominated by large firms. For most of them, the value of top 3 transactions e.g. Agriculture, Chemicals, real estate, technology etc. accounted for over half of that of total transactions, while sectors in energy, transport, and metals showed a more diverse investment. (Table 1)

Figure 4 China's ODI flow by industry



Source: China Global Investment Tracker and BBVA Research

Table 1 China large enterprises dominated in the ODI flow

Sectors	Enterprises No.	Enterprises involved in the top 3 transactions	Share (%)
Agriculture	8	Chinese Academy of Sciences,China Resources,Alibaba	66.9
Chemicals	7	State Development and Investment,Power Construction Corp, China National Chemical Engineering	63.4
Energy	43	CNPC,China Energy Engineering, Power Construction Corp, Sinopec	38.2
Entertainment	9	Anta Sports,Orient Securities,Tencent	87.6
Finance	9	Oceanwide,Ping An,China Reinsurance	82.2
Health	13	CDH, China Grand,Creat,By-Health	53.1
Logistics	2	China Communications Construction,Shanghai Lingang	100.0
Metals	22	Chengdu Tianqi,Zijin Mining,Zhongrong Xinda	41.9
Real estate	20	State Construction Engineering,Sino Great Wall,Sinomach	60.3
Technology	13	Tsinghua Unigroup,AVIC,Wingtech	64.0
Tourism	2	Huazhu Hotels,China Communications Construction	100.0
Transport	34	Geely Auto,China Communications Construction,China Railway Engineering	40.6
Utilities	9	Southern Power Grid,Hunan Construction Engineering,Power Construction Engineering	49.3

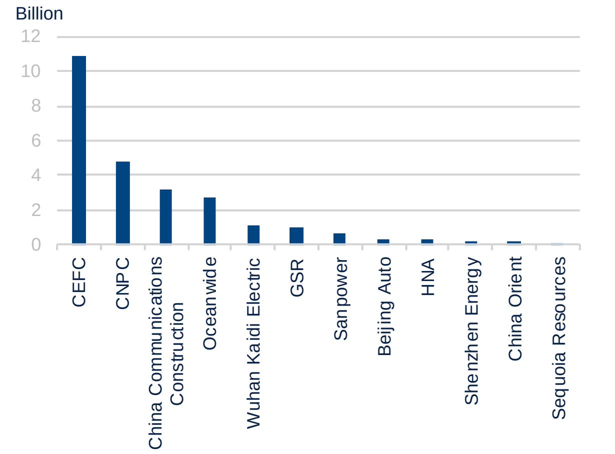
Source: China Global Investment Tracker and BBVA Research

Fact 4: POEs and SOEs have different troubles

The ODI of Chinese private enterprises (POEs) was suppressed by the authorities' clampdown on a capital flight during 2016-2017. Now Chinese POEs continued to struggle with more restricted domestic regulations which led to more troubled transactions of ODI. (Figure 5) Moreover, the tightening financing condition in China makes it increasingly difficult for those POEs to find financing sources to meet their demand for ODI. Notwithstanding the above obstacles, the absolute volume of POE overseas investment at least held up in 2018. (Figure 6)

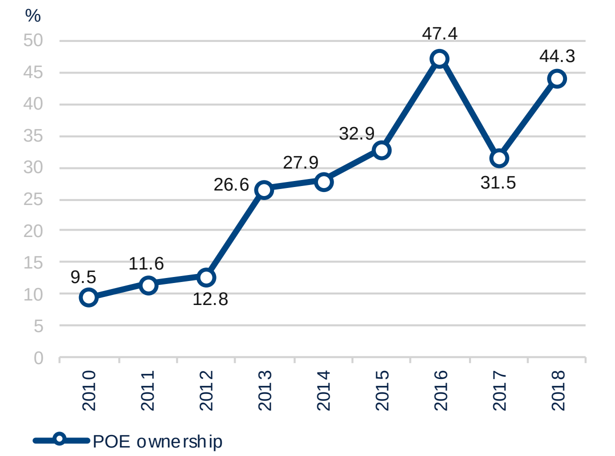
Meanwhile, China's state-owned enterprises (SOEs) are facing a different set of problems in making ODI. Compared to their private peers, SOEs can easily find overseas construction projects tied to the government's favoured BRI strategy as well as concessionary financing. However, the suspicion of foreign governments made it increasingly difficult for them to pass the host countries' screening mechanism of foreign investment.

Figure 5 China Private firms account for a major share among the troubled transaction list



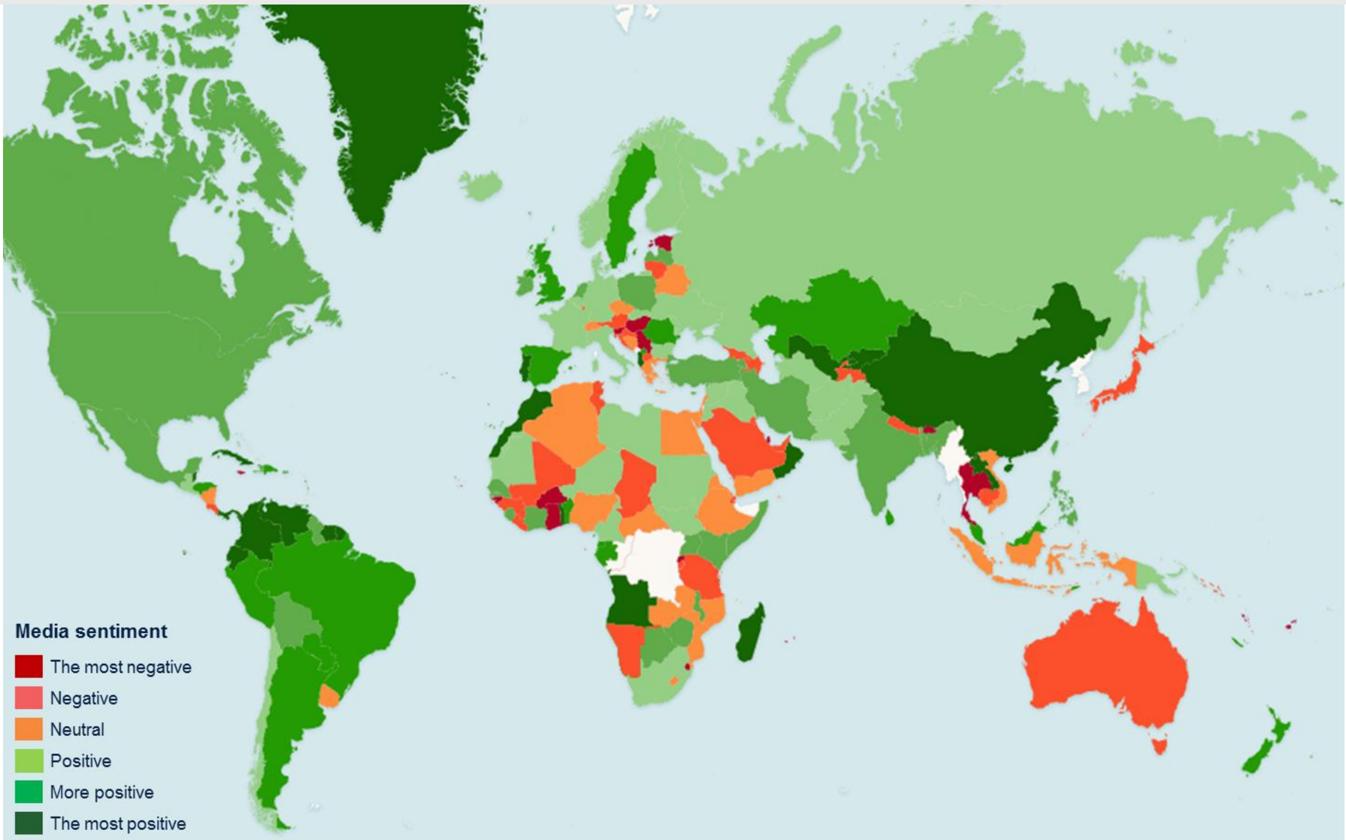
Source: China Global Investment Tracker and BBVA Research

Figure 6 POE ownership rebounded in the ODI outflows



Source: China Global Investment Tracker and BBVA Research

Figure 7 Media Sentiment on Chinese investment on infrastructure (In terms of change from 2016 to 2018)



Source: BBVA Research and www.gdelt.org

Fact 5: Other countries' sentiment toward China's investment is mixed

Encouragingly, many foreign countries' views toward China's investment have somewhat improved over the past two years despite the rise in the populism around the globe. Using Big Data and information from the media (GDELT), we measure the media coverage and sentiment on news related to the BRI initiative. Reassuringly, we find that the evolution of media sentiment of Chinese investment on infrastructure has improved generally in 2018 compared to 2016 (Figure 7). Among these regions, Latam America has the most positive sentiment toward China's investment, while South Asia has the least-positive sentiment of the investment e.g. Bhutan, Maldives, Thailand and Indonesia, reflecting these regions' long-term territory dispute and economic competition with China. That being said, China needs to carefully tackle these sensitive issues with its neighbours if it wants to successfully push forward the BRI around the globe.

China's ODI is likely to bottom out in 2019

At the beginning of the report, we identified three important factors which had an adverse impact on China's ODI, including tightened domestic regulations, increasing concerns of foreign governments and sluggish economic growth. These three factors are unlikely to improve in the near term. Capital flight continues to be a concern of China's authorities while foreign governments' suspicion toward China's investment in their high-tech sector is more likely to strengthen rather than fade (Please see our recent report of China-gauging-the-impact-of-us-tech-war-on-china-an-input-output-table-analysis/). Moreover, the deceleration of China's growth is more likely to continue in the next couple of years.

Despite the abovementioned headwinds, we still hold a conservatively optimistic view of China's ODI over the medium term and anticipate the country's ODI to bottom out in 2019. Compared to its share of global GDP (18.3%), China's share of global FDI still has room to grow (4.7%). Moreover, China's ODI will benefit substantially from the BRI strategy. In this respect, a number of newly established China-initiated institutions, including Silk Road Fund, Asian Infrastructure Investment Bank (AIIB), BRICS New Development Bank (NDB), China LAC Industrial Cooperation Investment Fund and the China-Latin America Infrastructure Fund, will play an increasingly important role. As such, infrastructure and commodity sectors in emerging markets will attract more Chinese capitals.

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