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CHINA'S STATE-OWNED ENTERPRISES AND CANADA'S FDI POLICY*

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SUMMARY

In December 2012, after Ottawa approved the takeover of Canada's Nexen by the state-owned Chinese oil giant, CNOOC Ltd., Prime Minister Stephen Harper offered an explanation to clarify the government's evolving position on takeovers from foreign state-owned enterprises. But rather than clarifying, the government succeeded instead in adding further ambiguity to an already opaque approvals process. Such takeovers would face "strengthened scrutiny" over the extent and nature of the foreign government's corporate control, he said, and would only be permitted in "exceptional circumstance." In other words, an approvals process already contingent on subjective judgment — thanks to the lack of transparency inherent in the pivotal "net-benefits test," and the onus it puts on the bidder to prove itself a worthy buyer — would now involve even more layers of subjective judgment. This is particularly ironic given that, as Canada's foreign-investment rules become cloudier and more prone to government interference, in China itself, regimes governing foreign direct investment (FDI) and state-owned enterprises are becoming increasingly transparent and market-oriented.

The government's enhanced stringency may be a response to popular fears that China is "buying up" Canadian assets. Such fears are, for the time being at least, overblown: China's global outward FDI stocks are still lower than Canada's, and a fraction of those held by the U.S., the U.K. and Germany — although China will undoubtedly continue to expand its foreign investment portfolio. But China's investment strategies are little different these days than those of western investors: China's government has planned to reduce its role in commercial decision-making, and seems more comfortable with allowing both nationalized and (increasingly) private businesses to pursue growth based on maximizing shareholder value, rather than enhancing national security. Moreover, modern governance practices are now gradually being introduced to the Chinese corporate world, with boards becoming more independent from the state, and improved transparency in accounting and auditing practices.

Whatever worries Canadians may have about Chinese state-owned enterprises investing in Canada, raising investment barriers is a blunt and flawed solution. Rather than block Chinese capital, Canadian regulators should monitor the behaviour of all firms to ensure standards are met for safety, environment, labour laws, transparency and national security. Closing off Canadian companies to Chinese bidders can hurt Canada's economy. It could increase risk for, and discourage, private-equity investors who often see foreign takeovers as a possible exit strategy, while potentially sheltering poorly managed firms from takeovers, dragging down our economic efficiency.

Furthermore, Canada may well need access to Chinese capital in order for the oilsands to reach their full economic potential. The Canadian Energy Research Institute estimates that, to achieve full development, the oilsands will require $100 billion in capital investment to 2019. Currently, Chinese investment controls roughly two per cent of Canada's total FDI stocks. If that proportion remained constant, China could — based on the projected scale of its FDI by 2020 — provide 40 per cent of the estimated funding required to optimally develop the oilsands. If Canadian markets prove hostile, Chinese capital will, of course, find assets elsewhere. But as long as regulators enforce practices that safeguard Canadian interests, there is no reason for Canada to impede Chinese investment. Indeed, there is good reason to encourage it.

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RÉSUMÉ

En décembre 2012, lorsqu'Ottawa a approuvé le rachat de Nexen au Canada par CNOOC Ltd, un géant pétrolier appartenant à l'État chinois, le Premier ministre Stephen Harper a tenté d'expliquer l'évolution des positions du gouvernement sur les prises de contrôle par des entreprises d'État étrangères. Malheureusement, il n'a fait qu'ajouter à la confusion sur un processus d'approbation déjà nébuleux. Il a alors affirmé que les prises de contrôle feraient dorénavant l'objet d'une « évaluation renforcée » sur l'étendue et la nature du contrôle de l'entreprise par le gouvernement étranger, et qu'elles ne seraient permises que dans certaines « circonstances exceptionnelles ». Autrement dit, il a ajouté un jugement subjectif à un processus déjà éminemment subjectif — en raison du manque de transparence inhérent à l'incontournable « mesure de l'avantage net » et au fardeau imposé au soumissionnaire, qui doit prouver qu'il est un acheteur solvable. Il est particulièrement ironique de constater que les règles en matière d'investissement étranger sont de plus en plus nébuleuses et enclines à l'ingérence gouvernementale au Canada, tandis que les régimes régissant les investissements directs étrangers (IDE) et les entreprises publiques sont de plus en plus transparents et axés sur le marché en Chine.

La rigueur accrue du gouvernement vise peut-être à faire taire les craintes populaires voulant que la Chine « achète » des actifs canadiens. Ces craintes sont exagérées, pour le moment du moins : les stocks d'IDE étrangers de la Chine demeurent moins élevés que ceux du Canada et ne représentent qu'une fraction de ceux des États Unis, du Royaume-Uni et de l'Allemagne. Cela dit, il ne fait aucun doute que la Chine va continuer à élargir son portefeuille d'investissements étrangers, mais ses stratégies d'investissement ne sont guère différentes de celles des investisseurs occidentaux. En effet, le gouvernement de la Chine envisage de réduire son rôle dans les décisions commerciales, et il semble prêt à permettre aux entreprises nationalisées et (de plus en plus) privées de poursuivre leur croissance dans le but de maximiser la valeur des actions plutôt que de renforcer la sécurité nationale. Qui plus est, l'adoption progressive de pratiques de gouvernance modernes dans le monde des affaires chinois rend les conseils d'administration de plus en plus indépendants de l'État et améliore la transparence des pratiques de comptabilité et de vérification.

Quelles que soient les inquiétudes des Canadiens à l'égard des entreprises publiques chinoises qui investissent au Canada, il n'en demeure pas moins que les barrières à l'investissement constituent une solution peu efficace et imparfaite. Au lieu de bloquer le capital chinois, les organismes de réglementation canadiens devraient plutôt veiller au respect, par l'ensemble des entreprises, des normes relatives à la sécurité, à l'environnement, au droit du travail, à la transparence et à la sécurité nationale. En privant les soumissionnaires chinois de l'accès aux entreprises canadiennes, nous risquerions de nuire à notre économie. Cela pourrait diminuer notre efficacité économique, en décourageant les investisseurs privés — pour qui les prises de contrôle étrangères constituent souvent une stratégie de sortie — et en empêchant le rachat potentiel d'entreprises mal gérées.

En outre, le Canada pourrait avoir besoin de capitaux chinois pour optimiser le potentiel économique des sables bitumineux. Selon l'Institut canadien de recherche énergétique, l'exploitation optimale des sables bitumineux nécessitera un investissement en capital de 100 milliards de dollars d'ici 2019. Or, à l'heure actuelle, les investissements chinois contrôlent près de 2 % du total des stocks d'IDE du Canada. Si cette proportion demeure constante, la Chine pourrait — si l'on se fie à l'échelle projetée de son IDE d'ici 2020 — fournir 40 % du financement estimé nécessaire pour exploiter de façon optimale les sables bitumineux. Il est néanmoins certain que les Chinois investiront leurs capitaux ailleurs si l'environnement des marchés canadiens ne leur est pas accueillant. Le Canada n'a cependant aucune raison de bloquer les investissements chinois, tant et aussi longtemps que les organismes de réglementation appliquent des pratiques qui protègent les intérêts canadiens. Il a au contraire toutes les raisons de les encourager.

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INTRODUCTION

The purpose of this paper is twofold: to examine (a) the drivers and future evolution of China's rapidly growing outward flows of foreign direct investment (FDI) and (b) the patterns and evolution of Chinese investments in Canada and their future implications for Canadian policies. The paper begins with the evolving role of state-owned enterprises (SOEs) as outward investors, both globally and in the context of China's development. It then outlines China's evolving SOE policies before focusing on Chinese investments in Canada in the context of China's total FDI outflows and China's small relative position in Canada's total FDI stocks (currently less than two per cent). Significantly, as discussed in the final section, by 2020 China will be one of the world's largest outward investors. As the policy recommendations in the final section suggest, Canadian policy should anticipate this trend.

STATE-OWNED ENTERPRISES AS OUTWARD INVESTORS

State-owned enterprises are suspected of defying market principles through the support they may receive from national governments, which include subsidies, concessionary finance, guarantees and regulatory preferences or exemptions from competition policies. Yet such enterprises exist in many countries. OECD member countries reported in 2009 the existence of more than 2000 SOEs, mostly in sectors considered strategically important to competitiveness such as transportation, power generation, energy, financial institutions and partly privatized telecommunications companies.[1] The 2000 largest companies on the Forbes Global 2000 list in the business year 2010–11 included 204 SOEs.[2] Chinese enterprises were most prominent in the group, with 70 SOEs, followed by India (30), Russia (9), the United Arab Emirates (9), Malaysia (8), Indonesia, Saudi Arabia, Brazil, Thailand and Norway. China is of particular interest because of its size, projected growth path and future economic significance.

Since it joined the World Trade Organization (WTO) in 2001, China's inward FDI stock has grown from a small base. Between 2006 and 2011 it doubled to $711 billion from just under $300 billion.[3] Outward FDI has also grown since 2006, when the government encouraged a "going global" policy. Since then, Chinese capital has flowed abroad at a fast pace to acquire foreign assets, particularly in the United States. Between 2009 and 2012, official data from the United Nations Conference on Trade and Development (UNCTAD) shows that China's stock of outward FDI more than doubled. Because of China's rapid economic growth (GDP grew from $5 trillion to more than $8 trillion in this period), the ratio of outward FDI to GDP grew slightly from five to six per cent, but was still much lower than Thailand (whose ratio was 10 per cent).

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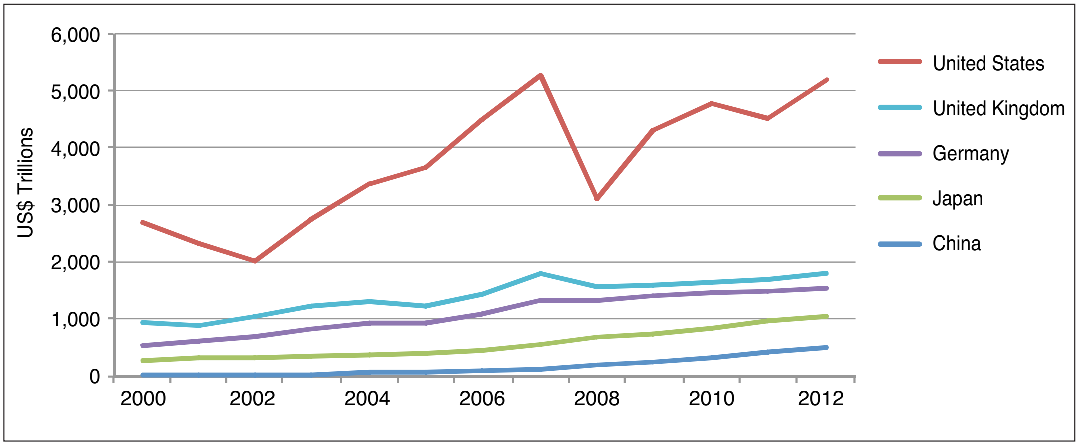
1 Hans Christiansen, "The Size and Composition of the SOE Sector in OECD Countries," *OECD Corporate Governance Working Papers* 5 (Paris: OECD Publishing, 2011), http://dx.doi.org/10.1787/5kg54cwps0s3-en.

2 Measured by equal weighting of sales, profits, assets and market value. See: Przemyslaw Kowalski et al., "State-Owned Enterprises," *OECD Trade Policy Papers* 147, (Paris: OECD Publishing, 2013) http://dx/.doi.org/10.1787/5k4869ckqk71-en.

3 Daniel H. Rosen and Thilo Hanemann, Open Door? *Maximizing the Benefits of Chinese FDI* (New York and Washington, D.C.: Asia Society and Woodrow Wilson Center for International Scholars, May 2011).

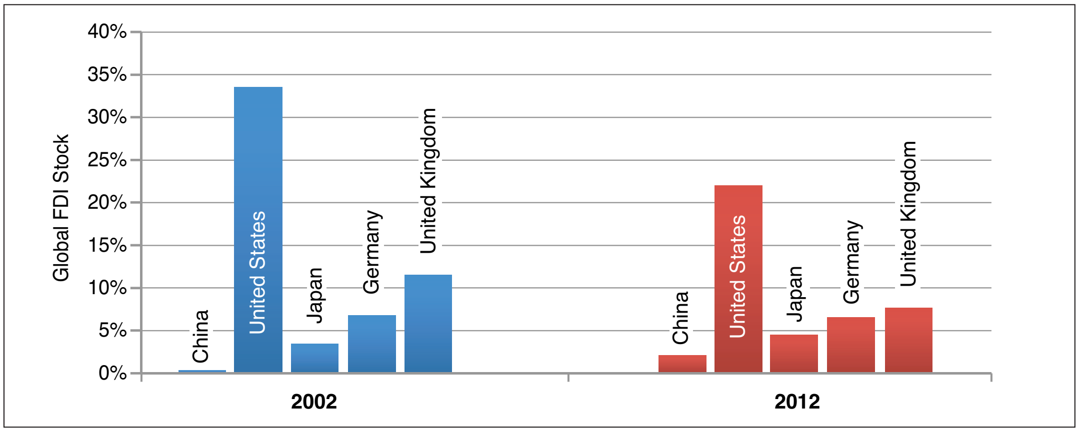
UNCTAD statistics for 2012 rank China among the world's top-dozen largest outward investors with its total stock (US$509 billion) representing 2.1 per cent of the global stocks held abroad. This is still a smaller stock than Canada's ($715 billion, or three per cent of the total), and far behind U.S. stocks of $5,190 billion (22 per cent), the U.K. ($1,808 billion, or 7.7 per cent), Germany ($1,550 billion, or 6.5 per cent), and Japan's ($1,054 billion, or 4.4 per cent) (Figures 1 and 2).[4] By 2020, however, as we see in the final section, China's stocks will be among the world's largest.

FIGURE 1: OUTWARD FDI STOCKS BY MAJOR HOST COUNTRY, 2000-2012



Source: unctad.org/Sections/dite_dir/docs/WIR2013/WIR13_webtab04.xls, UNCTAD database, Web Table 04, Inward and outward foreign direct investment stock, annual, 1980-2012

FIGURE 2: COMPARATIVE SHARES OF GLOBAL STOCKS OF OUTWARD FDI, 2000 AND 2012



Source: unctad.org/Sections/dite_dir/docs/WIR2013/WIR13_webtab04.xls, UNCTAD database, Web Table 04, Inward and outward foreign direct investment stock, annual, 1980-2012

This comparison provides some perspective on such populist claims as "China is buying up the world" or that China is "building an economic empire."[5] Two main attributes of China's outward investment prompt such claims. One is the speed of growth in the stocks since China's accession to the WTO, and the second is the frequency with which investing firms are

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4 UNCTAD, *World Investment Report*, Web Table 4, "FDI outward stock by region and economy, 1990-2012" (2012), available at www.unctad.org.

5 Araujo Heriberto Rodrigues and Juan Pablo Cardenal, "China's Economic Empire," *The New York Times*, June 1, 2013.

state-owned and seen to be playing by different rules, both inside and outside of China. Until the major rationalization of SOEs in the late 1990s, China's few privately owned firms were small and focused on the domestic market; they are only now beginning to appear in international transactions. As we will see below, private enterprises are gaining capabilities, and the prominence of SOEs in the Chinese economy is steadily dwindling, although they remain prominent abroad. While it was convenient to portray CNOOC's acquisition of Nexen (the largest Chinese transaction to date) as emblematic of SOE dominance, this transaction should be seen in the context of more recent large acquisitions by privately owned enterprises (POEs), also discussed below.

SOES AND CHINESE DEVELOPMENT

Following the founding of the People's Republic in 1949, China was bankrupt and faced a Malthusian crisis, with population growth outstripping food production. The enormous task of rebuilding the strife-torn nation was shouldered by the state. There was one bank, which was responsible for both monetary policy and financial intermediation. State-owned enterprises were set up under the control of line ministries and charged with meeting output targets at prices set by central planners. Like the agricultural communes, they had social responsibilities to provide the "iron rice bowl" of guaranteed employment, housing, education and health-care services for their employees. Since 1978, market principles have gradually been introduced; while banks continue to be state owned, management is directed to pursue commercial profitability. In the late 1990s, SOEs were rationalized with the closure, merger or privatization of tens of thousands of smaller loss-making enterprises, many of them owned by lower levels of government.[6]

Between 2003 and 2006, policy changed again, designating seven "strategically important" sectors critical to national security in which the state was to play a leading role and SOEs were to "grow into leading world businesses." These world businesses would be supported by governments to facilitate exports, acquire brands and acquire natural resources, mainly through mergers and acquisitions. With the changeover of China's top leadership in 2012–13, and its emphasis on rebalancing the producer-dominated economy, the emphasis has shifted to increasing SOE efficiency, improving corporate governance and reducing government intervention.

Today, China's SOEs are distinguished by their ownership, with 113 very large monopolies and oligopolies remaining in the hands of the central government and an uncertain number of smaller SOEs owned by provincial and municipal governments. Many operate in industries where private firms face entry restrictions. Oversight of these enterprises is the responsibility of the State-Owned Assets Supervision and Administration Commission (SASAC). It receives the dividends and recycles them back into SOEs in the form of financial support for restructuring, upgrading and investments. Some reports indicate SOEs have used the funds in ways that an investment bank would, participating in risky but lightly regulated shadow-banking activities and setting up affiliates that make property investments.

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6 World Bank, *China 2030: Building a Modern, Harmonious, and Creative High-Income Society* (Washington, D.C. and Beijing: World Bank and Development Research Center of the State Council, the People's Republic of China, 2012): 26.

SASAC was created in 2003 by transferring ownership of industrial SOEs from several line ministries, allocating policy and regulation to the line ministries, responsibility for oversight of state assets to SASAC, and responsibility for day-to-day operations to SOE managers. In 2006, Li Rongrong, SASAC's chairman, stated that "State capital must play a leading role in these sectors, which are the vital arteries of the national economy and essential to national security."[7] The industries in which sole or majority ownership in enterprises was reserved for the state included defence, power generation and distribution, petroleum and petrochemicals, telecommunications services, coal, aviation and shipping. Central SOEs were also directed to become "heavyweights" in "pillar" industries, including machinery, automobiles, IT, construction, steel, base metals and chemicals, all industries where non-state enterprises are also active. Reform and restructuring was encouraged to enhance competitiveness; ownership was to be diversified through shareholding or attracting strategic investors; and the number of central SOEs (161 at the time) was to be reduced.

The sizes and economic contributions of SOEs and state-invested firms are difficult to estimate because of lack of reporting and the wide range of ownership forms. Enterprise ownership is highly elastic in China, but use of the term "private enterprise" now applies to privately owned unlisted companies, publicly listed companies, collectively owned companies, co-operatives, jointly owned companies (including those co-owned by foreign investors) and self-employment. Such enterprises are dominant in IT and e-commerce, telecommunications equipment, real estate and, to a lesser extent, energy and autos. By this definition, private enterprises accounted for 60 per cent of fixed-asset investment in 2011 and 75 per cent of employment.[8] They include very large telecommunications-equipment companies, such as Huawei (unlisted) and ZTE (publicly listed); IT companies, such as Alibaba, Tencent, Sina and Baidu; real estate companies, such as Dalian Wanda, China Vanke, Evergrande Group and Country Garden; and a few auto companies, such as Geely.

SOE shares of industrial assets, output and employment are steadily declining [Figure 3]. By 2011, their absolute numbers had shrunk to less than five per cent of total industrial enterprises. Their shrinking share of industrial output (to 12 per cent) and employment (10 per cent) relative to their share of total assets (to 20 per cent) reflects the capital intensity of their operations. Even so, many are large conglomerates with numerous affiliates expected to carry out a range of economic and social functions. They continue to be prominent in China's international transactions, particularly direct investment. In 2008–09, SOEs accounted for nearly 70 per cent of China's stock of outward investment, but only 15 per cent of the projects. By far the largest number of projects (more than half of the total) was accounted for by private companies, although the transactions tended to be small in size, accounting for only 21 per cent of the total stock of outward FDI.[9] An industrial breakdown of outward investment does not distinguish ownership but indicates that, on average during the 2008–10 period, the service sectors dominated China's outflows, with primary-sector investment coming second, mainly in minerals and energy. This pattern differs from world averages where — while services dominate across the board — manufacturing industries are much more prominent as outward

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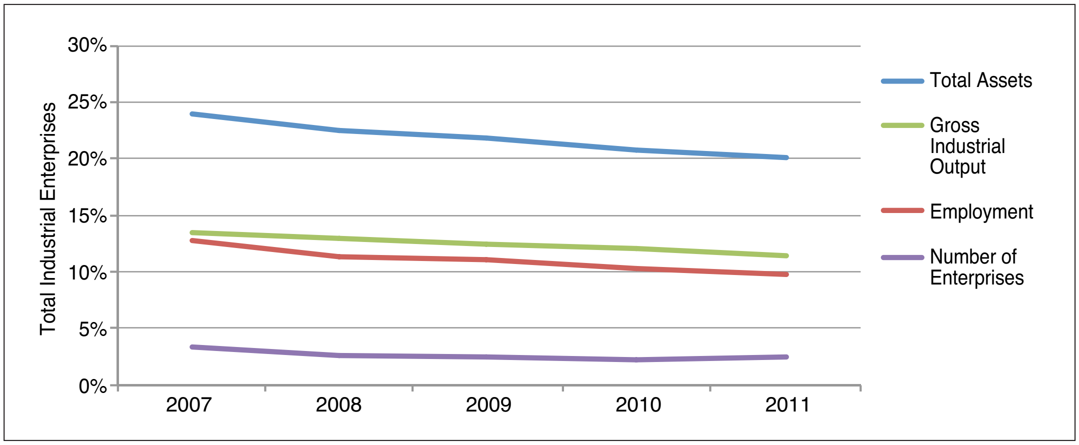
7 Zhao Huanxin,"China names key industries for absolute state control," *China Daily*, December 19, 2006. The leading role was later stipulated as at least 50 per cent state ownership of a firm.

8 Fan Gang and Nicholas C. Hope, "The Role of State-Owned Enterprises in the Chinese Economy," *China-US 2022*, (2013), Chapter 16, 7, available at www.uschina2022.com.

9 Yiping Huang and Bijun Wang, "Chinese Outward Direct Investment: Is There a Chinese Model?" *China & World Economy* 19, 4 (2011): 6.

investors than is the case in China, which has been a major recipient of inflows (Table 1). The Chinese industries that had accumulated the largest stocks abroad were mainly in services (leasing and business services, banking, and wholesale/retail trade) as well as mining, including oil and gas (Table 2).

FIGURE 3: SOE ASSETS, OUTPUT, EMPLOYMENT AND NUMBERS AS SHARES OF TOTAL INDUSTRIAL ENTERPRISES



*Source: **China Statistical Yearbook**, China Statistics Press*

Note: SOE includes State-owned enterprises and state solely-funded corporations

TABLE 1: INDUSTRY DISTRIBUTION OF OUTWARD DIRECT INVESTMENT FLOWS (2009-2011, PER CENT SHARE)

Sector/industry	Developed Countries	Developing Economies	Transition Economies	World	China[a]
Primary	**8.23**	**13.69**	**7.89**	**9.27**	**16.35**
Agriculture, hunting, forestry and fishing	0.10	0.82	0.07	0.23	0.96
Mining, quarrying and petroleum	7.98	12.87	7.82	8.91	15.38
Unspecified primary	0.15	0.00	0.00	0.12	-
Manufacturing	**16.76**	**11.60**	**15.28**	**15.77**	**7.09**
Food, beverages and tobacco	2.09	1.25	0.86	1.92	-
Chemicals and chemical products	6.51	0.50	0.54	5.33	-
Metal and metal products	0.99	0.91	12.48	1.06	-
Services	**68.35**	**71.79**	**76.81**	**69.06**	**74.56**
Electricity, gas and water	2.99	1.03	0.00	2.60	1.92
Trade	6.05	7.81	33.13	6.57	12.44
Transport, storage and communications	5.74	3.85	0.97	5.35	4.64
Finance	24.62	15.37	14.07	22.78	13.83
Business activities	27.08	40.55	27.67	29.65	36.31
Private buying and selling of property	**0.31**	**0.00**	**0.00**	**0.25**	**0.93**
Unspecified	**6.35**	**2.92**	**0.02**	**5.65**	**-**

Source: http://unctad.org/Sections/dite_dir/docs/WIR2013/WIR13_webtab27.xls, UNCTAD Database, Web Table 27. Estimated world outward FDI flows, by sector and industry, 1990-1992 and 2009-2011

a) *Source: MOFCOM, 2012 Statistical Bulletin of China's Outward FDI, Page 122, Table 3. Distribution of China's outward FDI flows by industry, 2004-2012*

TABLE 2: OFDI STOCK BY INDUSTRY, 2012

	$USD millions	% Share
Agriculture, Forestry, Husbandry, Fishing	4,964.43	0.93
Mining	74,784.20	14.06
Manufacturing	34,140.07	6.42
Production and Supply of Electricity, Gas and Water	8,992.10	1.69
Construction	12,856.04	2.42
Transport, Storage and Post	29,226.53	5.49
Information Transmission, Computer Services and Software	4,819.71	0.91
Wholesale and Retail Trade	68,211.88	12.82
Lodging and Catering Services	763.27	0.14
Banking	96,453.37	18.13
Real Estate	9,581.41	1.80
Leasing and Business Services	175,697.95	33.03
Scientific Research, Technical Service and Geologic Prospecting	6,792.76	1.28
Water Conservancy, Environment and Public Facilities Management	70.56	0.01
Services to Households and Other Services	3,581.24	0.67
Education	164.79	0.03
Health, Social Security and Social Welfare	46.76	0.01
Culture, Sports and Entertainment	793.51	0.15
Total	**531,940.58**	**100.00**

Source: MOFCOM, 2012 Statistical Bulletin of China's Outward FDI, Page 123, Table 4, "Distribution of China's Outward FDI Stock by Industry, 2004-2012.

Many SOEs have retreated from labour-intensive industries and most are now focused in strategic industries defined as central to national security or business competitiveness. Others, such as the three petroleum SOEs — CNOOC, China National Petroleum Corporation (CNPC) and Sinopec — have affiliates listed on international stock exchanges and aim to become globally diversified players. Government ownership stakes in such companies as Lenovo and Haier are less prominent and those companies operate more independently in international markets. But they are favoured companies with political and personal ties at home, where they face increasing competition from private enterprises and foreign firms; similarly competition is growing in strategic sectors such as telecommunications services.

SOE GOVERNANCE IN CHINA

SOEs are expected to carry out the government's strategic goals. Although SASAC has improved the competitiveness and efficiency of many SOEs, their financial performance can be undermined by requirements to deliver public services and charge regulated prices for their products. An estimated one-quarter are loss-making,[10] but many others have become profitable and, by some reports, more efficient. In 2010, SOE profits were estimated to be five per cent of GDP.[11]

[10] World Bank, *China 2030*, 25.

[11] Nicholas R. Lardy, Sustaining China's Economic Growth after the Global Financial Crisis, (Washington, D.C.: Peterson Institute for International Economics, 2012): 18:

SOE governance is opaque, but as Downs[12] has pointed out, "ownership does not equal control." Central-government SOEs are supervised and managed by SASAC; the party's Central Organization Department appoints and evaluates the performances of CEOs on political as well as commercial criteria, of which return on investment is likely to rank near the top of the list, along with profitability and market share.[13] Heads of the largest SOEs have ministerial rankings giving them status equal to the minister of commerce.

The national oil companies (NOCs) are directed to contribute to energy security. But they must also respond to compelling commercial factors. As global latecomers they must replace and diversify their reserves in competition with other NOCs and the multinational corporations; they have also had to compensate for domestic pricing favouring consumers, which has caused them to lose money in downstream operations (pricing is now moving toward market-determined levels). At the same time, they seek to become internationally competitive and world-class companies.[14]

In the case of CNOOC, the parent owns 64 per cent of the equity in its affiliate CNOOC Ltd., while 36 per cent is publicly held through listings on the Hong Kong and New York stock exchanges. CNOOC Ltd., the world's largest energy explorer by market value, acquired Nexen, a troubled Canadian oil and gas producer with significant international assets. Standard corporate information on this affiliate is transparently available through routine required disclosures. It follows standard practices in corporate governance and transparency, with internationally known non-Chinese citizens serving as independent non-executive directors; it has a standard committee structure populated with independent individuals, and transparent financial and corporate-social-responsibility disclosures.

Are this affiliate's business decisions made by SASAC or the Chinese government on political grounds? Available evidence suggests that the answer is no, for several reasons. First, as a publicly listed company there are many other stakeholders besides government, including investors, employees and regulators. Second, it is in the company's interests to observe regulatory requirements that emphasize the transparency needed to promote trust between issuer and investors. Third, the independent directors are also responsible for the transparency and accuracy of investor disclosure. Regulatory disclosures confirm this responsibility. In short, CNOOC Ltd.'s incentive structure encourages good corporate citizenship. Even so, it is difficult for outsiders to disentangle in any definitive way the political and commercial factors in SOE investor decisions.

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[12] Erica S. Downs, *Who's Afraid of China's Oil Companies?* (Washington, D.C.: Brookings Institution, 2010): 3, http://www.brookings.edu/research/papers/2010/07/china-oil-downs.

[13] Andrew Szamosszegi and Kyle Cole, "An Analysis of State-owned Enterprises and State Capitalism in China," prepared for the U.S.-China Economic and Security Review Commission (Washington, D.C.: CapitalTrade Incorporated, 2011): 72-78.

[14] Downs, *Who's Afraid*, 6.

The Changing Policy Regime

With the recent top leadership changes in China, further SOE restructuring is in the works, but is a sensitive political topic. Policy change is more likely to be done by stealth than by explicit action. The SOEs' home operating environment will change in ways that force them to become more efficient. Key input prices are being deregulated, led by interest rates and the cost of capital; more sectors are being opened to competition from non-state enterprises, as has already happened in railroads and health care. Dividend payments will be raised, cutting into their retained earnings. Recent high-profile corruption investigations in the pharmaceutical, petrochemical and telecom sectors add further pressures for reform.[15]

In 2012 a controversial marker was laid down in *China 2030: Building a Modern, Harmonious and Creative Society*, a study endorsed by Premier Li Keqiang and prepared by the World Bank and the State Council's think tank, the Development Research Center. This study defines two relevant policy goals: to use state resources more efficiently; and to modernize the state's governance of SOEs, advocating that government's role in production should be one that produces only public goods.[16] It also emphasizes that government's appropriate role is to provide public goods and services "which result in unremunerated positive externalities" such as defence, infrastructure, social protection and basic R&D.[17]

Existing practices have involved multiple layers of government, often working at cross purposes and producing outcomes the opposite of what was intended. State interventions have covered a wide range of actions, from administrative approvals and inspection to industrial policy restrictions, which undermine market forces in allocating resources. These discretionary actions also cause rent-seeking, increase the uncertainty of the business environment and maintain business dependence on government. Evidence that governments still own retailing and restaurant establishments, hardly public goods, underlines the case for further rationalization of government ownership.[18] Strengthening the anti-monopoly law, adopted in 2008, would help as well, particularly with respect to enforcement, which is currently voluntary.

The second challenge is to separate government ownership from management, introduce modern corporate governance into SOEs and eventually divest government holdings to (state) asset-management companies subject to stringent rules of transparency.[19] If SASAC's mandate were revised according to this principle it would become the regulator and supervisor of industrial SOEs rather than the owner. The scope for producing public goods remains significant, mainly in social projects such as public housing and in providing reliable electricity supplies and communication channels. Modern corporate practices are gradually being introduced, as noted earlier, separating boards and senior-management roles from party roles in the enterprise. Accounting and external-audit practices are gradually becoming more independent and transparent.

Nevertheless, ownership practices still have a long way to go. If government ownership stakes were to be transferred to professional state asset-management companies, the asset managers should gradually diversify the portfolios over time and transfer dividend payments to the treasury,[20] since there is wide support for allocating some SOE profits to social spending.

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[15] Stephen Green, "The Third Plenum Briefing Pack," *On the Ground* (Shanghai: Standard Charter Bank, 2013).

[16] World Bank, *China 2030*.

[17] World Bank, *China 2030*, 26-28.

[18] World Bank, *China 2030*, 119.

[19] ibid.

[20] ibid.

As long ago as 2007, a dividend policy was approved, setting a sliding scale by the size of enterprise. Initially the rates were phased in and set too low, but they have recently been raised and the net has been widened to include more SOEs. Current reports indicate such changes are being debated, but there is significant pushback from such large, profitable and politically connected entities where incumbents would lose their privileged positions.

OUTWARD FDI: CHINESE BUSINESSES INVESTING ABROAD

Central-government SOEs are prominent players in Chinese outward investment. A ranking of the top 30 non-financial investing firms puts the petroleum SOEs at the top of the list, followed by a wide variety from other industries, some of which are non-SOEs (Table 3). A longer list would include some well-known brands such as Huawei and ZTE, but not Lenovo (computers) and Haier (consumer appliances), which are also brands that are well known outside of China. The Industrial and Commercial Bank of China (ICBC) and China Construction Bank, which rank first and second on the Forbes Global 2000 list in 2013, are of course not included here.

TABLE 3: TOP 30 NON-FINANCIAL CHINESE ENTERPRISES BY OUTWARD FDI STOCK, 2012

No.	Name of Enterprise	Industry	Ownership
1	China Petrochemical Corporation (Sinopec)	Petroleum	SOE
2	China National Petroleum Corporation (CNPC)	Petroleum	SOE
3	China National Offshore Oil Corporation (CNOOC)	Petroleum	SOE
4	China Mobile Communication Corporation	Telecommunication	SOE
5	China Resources (Holdings) Co., Ltd.	Cross-industry	SOE
6	China Ocean Shipping (Group) Company (COSCO)	Transportation	SOE
7	Aluminum Corporation of China	Metal	SOE
8	Sinochem Corporation	Chemical	SOE
9	China Merchants Group	Cross-industry	SOE
10	China State Construction Engineering Corporation	Construction	SOE
11	China Unicom Corporation	Telecommunication	SOE
12	China Minmetals Corporation	Metal	SOE
13	China National Chemical Corporation	Manufacturing	SOE
14	CITIC Group	Finance	SOE
15	China National Cereals, Oils & Foodstuffs Corporation (COFCO)	Food	SOE
16	China National Aviation Holding Corporation	Transportation	SOE
17	State Grid Corporation of China	Utility	SOE
18	SinoSteel Corporation	Metal	SOE
19	China Three Gorges Corporation	Utility	SOE
20	SINOTRANS Changjiang National Shipping (Group) Corporation	Logistics	SOE
21	China Shipping (Group) Company	Logistics	SOE
22	China Huaneng Group	Utility	SOE
23	HNA Group	Transportation	SOE
24	Huawei Technologies Co., Ltd.	Telecommunication	POE
25	China Nonferrous Metal Mining & Construction (Group) Co., Ltd.	Mining	POE
26	GDH Limited	Cross-industry	SOE
27	China North Industries Group Corporation	Manufacturing	SOE
28	China Communication Construction Company Ltd.	Construction	SOE
29	Shanghai Baosteel Group Corporation	Metal	SOE
30	Shanghai Geely ZhaoYuan Investments International Ltd.	Manufacturing	POE

Source: MOFCOM, 2012 Statistical Bulletin of China's Outward FDI, Page 129, Table 11, "The top 50 non-financial Chinese TNCs ranked by outward FDI stock 2012."

The China Entrepreneur Research Institute estimates that, in the first half of 2012 alone, 2,407 enterprises expanded their businesses in 117 countries with merger and acquisitions worth $30 billion.[21] The Vale Center at Columbia University's estimates of the number of companies invested abroad in 2010 show that 12,000 parent companies had invested in 34,000 affiliates.[22] As noted earlier, SOEs accounted for the largest share by far — 69 per cent — of China's stock of outward investment. By industry, 77 per cent of the outward flow of transactions were in the services industries, particularly in business services, finance and trade; only five per cent were in manufacturing, while 18 per cent were in mining and petroleum.[23] Much of the activity up to now has been mergers with and acquisitions of existing businesses rather than "greenfield" investments in new capacity. As also noted earlier, privately owned enterprises have recently joined the fray, with Shuanghui International Holdings' $4.7-billion bid for Smithfield Foods Ltd. (approved by CFIUS — the Committee on Foreign Investment in the United States) representing the largest Chinese investment in U.S. assets to date. Other examples include Dalian Wanda Group's $2.6-billion acquisition of AMC Entertainment Holdings Inc., the world's second-largest theater chain, Haier Group's $700-million bid for Fisher & Paykel Appliances Holdings Ltd. of New Zealand and Wanxiang Group's $26-million acquisition of the assets of A 123 Inc., the insolvent American car-battery maker.[24]

Chinese enterprises have both advantages and disadvantages in investing abroad. Among the advantages are active government-policy encouragement and support to "go out" as a result of decisions in 2006 to build SOEs into national champions. Entrepreneurial (non-SOE) enterprises have since been included in the policy. They are encouraged to access the natural resources required to feed China's industries, enter new markets, and acquire brands and foreign technology. A second advantage is that the global downturn since 2008 created unique opportunities to acquire distressed assets at reasonable prices. Third, SOEs have healthy balance sheets due to their oligopolistic positions in home markets; they have had to pay minimal dividends to the state; they have also benefited from subsidized input prices for energy, land and use of the environment.

As indicated earlier, these advantages are now being phased out. At the time of CNOOC's controversial 2005 bid for Unocal, studies by both the Brookings Institution and the Peterson Institute for International Economics concluded that SOEs did not have access to subsidies that would be actionable under the WTO. While many argue that China's SOEs access low-cost preferred financing, Cornish[25] and others argue that, as in OECD economies, large enterprises are often banks' highest-quality credits and are able to borrow at lower rates than riskier customers. So are their competitors in international transactions. SOEs' bank loans are commercial decisions by the banks, both Chinese and foreign-owned. The fact that smaller non-state enterprises may be charged higher interest rates should be seen as a reflection of the still-immature risk-management capabilities of Chinese banks.[26]

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[21] Fu Jing, "Golden period for Chinese investment," *China Daily*, September 29, 2012.

[22] Karl Sauvant, "Chinese Investment: new kid on the block learning the rules," *East Asia Forum*, August 29, 2012.

[23] Huang and Wang, "Chinese Outward."

[24] Cai Xiao, "Outbound M&A Activity Mounts Up," *China Daily*, March 11, 2013.

[25] Margaret Cornish, "Behaviour of Chinese SOEs: Implications for Investment and Cooperation in Canada," (Ottawa and Toronto: Canadian Council of Chief Executives and Canadian International Council, February 2012).

[26] See: Cornish, "Behaviour of Chinese," 11-13; Wendy Dobson, *Gravity Shift* (Toronto: University of Toronto Press, 2009): 54-74; and Fan and Hope "The Role."

Chinese enterprises also face a number of disadvantages when investing abroad. First, they are inexperienced latecomers; many of the world's most desirable assets and locations have already been taken by experienced investors from more advanced economies. Second, while many of the SOEs are huge oligopolies or monopolies in the home market, with close ties to their government owners and regulators and little domestic competition, they have little experience with market-based international business practices and global rules of the road. Lack of such knowledge can erode the profitability of a transaction when inexperienced managers overpay for an asset or misinterpret or fail to take local business conditions and regulatory environments into account in their operations. Third, rightly or wrongly, Chinese SOEs have gained reputations for failing to apply market principles in their strategic and operational decisions. This perception problem matters for at least two reasons. One is the importance of market principles to the realization of benefits to the host economy. The second reason is that such perceptions undermine the trust and transparency that are fundamental building blocks of efficient markets. Both imply that Chinese SOEs need to overcompensate with efforts to develop "brand" for commercially oriented decision-making.

Perceptions about political rather than commercial decision-making underlie national security concerns, which are a particular worry in advanced countries receiving large shares of Chinese outward investment. SOEs acting as agents of the Chinese government will undermine national sovereignty of the host country. Such concerns are magnified by China's opaque political system and the 2006 decision to expand the roles of SOEs in sectors considered critical to China's national and economic security. Another concern is over investors' willingness to abide by host countries' regulatory regimes, one that has been amplified by recent reports of cyber-attacks on government and enterprise networks traced back to the Chinese military. I return to these issues below.

National security concerns aside, there is plenty of evidence to support the contention that while Chinese investing enterprises have commercial objectives similar to those of other multinationals, they are on steep learning curves in understanding and abiding by rules of the road in international business and host country regulatory regimes. Evidence of learning can be found in a survey of nearly 20 Chinese overseas investments, which showed that while early investments in natural resources may have been intended to direct supplies to the home market, the majority of recent investments aim to expand global supplies in response to world market prices.[27] The opaque governance of the Chinese parents of affiliates investing abroad is a problem and reports of aggressive hacking into the systems of western companies do not help. As Chinese enterprises gain more international experience and profile, however, it is likely that market pressures and pressures from informed and vigilant national regulators will encourage greater transparency and alignment with best international practice.

Taking these concerns together, the increasingly intense regulatory scrutiny suggests extra efforts are needed by Chinese investors to demonstrate their intention to meet host country concerns. Enterprises in technologically sensitive businesses such as telecommunications face particularly intense scrutiny in the United States and United Kingdom. Besides CIFIUS

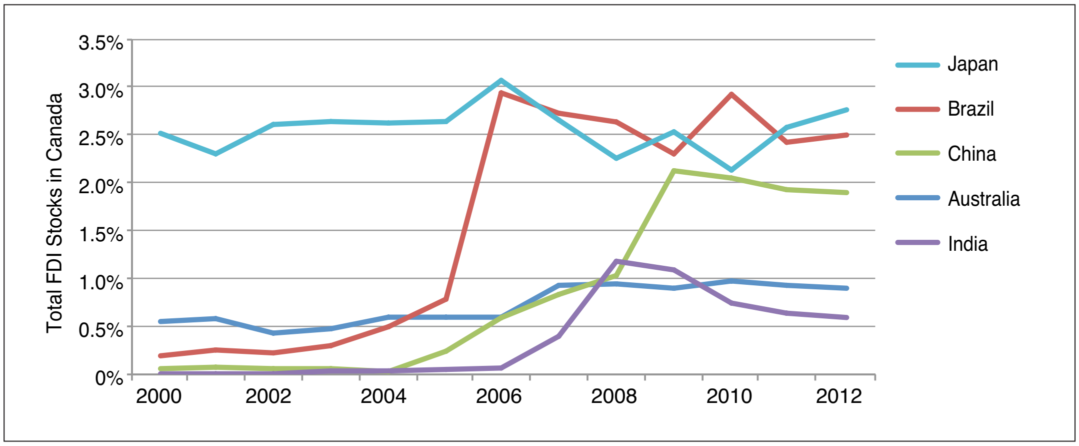
[27] Theodore H. Moran, "China's Strategy to Secure Natural Resources: Risks, Dangers and Opportunities," *Policy Analyses in International Economics* 92, (Washington, D.C.: Peterson Institute for International Economics, July 2010).

scrutiny, companies such as Huawei and ZTE have been studied by the U.S. House Committee on Intelligence, whose chair released a critical report in late 2012 alleging that those companies were complicit in bribery and corruption, and requested an FBI investigation.[28] Chinese media and regulatory pressures on Apple's Chinese operations in April 2013 suggested tit-for-tat behaviour, which adds to unease.

CHINESE ENTERPRISES INVESTING IN CANADA

Large-scale Chinese investment in Canada is a relatively recent phenomenon and, according to Canadian statistics, accounted for less than two per cent of the total inward stock in 2012. Historically, of course, American investment accounts for the dominant share of Canada's FDI stock, but that has declined in relative terms from 61 per cent of the total in 2000 to 51 per cent in 2012. The U.S. is followed by Japan and, since 2004, Brazil whose shares are both less than three per cent (Figure 4). The Heritage Foundation's Investment Tracker, which measures transactions over $100 million, reports that Australia ranks as China's top destination for transactions recorded between Jan. 1, 2005 and June 30, 2013, with Canada ranked third after the United States and Australia. By the end of that period, Chinese inflows to Australia totalled US$59.2 billion, followed closely by the United States (US$57.8 billion), Canada (US$37.6 billion), Brazil (US$28.2 billion) and Indonesia (US$25.8 billion). The sectoral breakdown of China's global investments is dominated by energy and power, accounting for nearly half (47 per cent) of the total, followed by metals at 23 per cent and finance at less than 10 per cent.[29]

FIGURE 4: FDI STOCKS IN CANADA, BY INVESTING COUNTRY, 2000-2012



Source: http://www5.statcan.gc.ca/cansim/a26?lang=eng&retrLang=eng&id=3760051&paSer=&pattern=&stByVal=1&p1=1&p2=-1&tabMode=dataTable&csid=, Statistics Canada, Table 376-0051. International investment position, Canadian direct investment abroad and foreign direct investment in Canada, by country.

[28] CBC News, "Huawei corruption allegations given to FBI," October 10, 2012, http://www.cbc.ca/news/business/story/2012/10/10/pol-huawei-information-turned-over-to-fbi.html.

[29] Derek Scissors, "China's Steady Global Investment: American Choices," *Issue Brief* 3990 (Washington, D.C.: The Heritage Foundation, July 16, 2013), 3.

Statistical information on the sectoral breakdown of Chinese investments in Canada is limited to what can be gleaned from public sources. As in Australia, natural-resource sectors have attracted a large number of relatively large investments, mainly by SOEs (Table 4), mostly in western Canada. A number of transactions through intermediaries and tax havens are not included in the official statistics. Nor are investments in which the Chinese entity acquires an equity stake of less than 10 per cent. Historically, some large investments, such as Sinopec's 2009 investment in the Northern Lights Project, CNOOC Ltd.'s 2011 acquisition of insolvent OPTI and CIC's 2009 investment in Teck Resources, have been uncontroversial, as was Sinopec's 2009 acquisition of a nine per cent share of Syncrude (which was similar in size to the Shuanghui-Smithfield transaction in the United States).

TABLE 4: MAJOR CHINESE INVESTMENTS IN CANADA, 2005 TO PRESENT

Year	Investor	Investment	Province (City)	Per cent Share	SOE?	Value ($ millions)
OIL & GAS						
2009	Sinopec	Northen Lights	AB (Calgary)	10	Yes	N/A
	CNPC	Venerex	AB (Calgary)	100	Yes	499
	PetroChina	Athabasca Oil Sands Corp.*	AB (Calgary)	60	Yes	1,900
2010	Sinopec	Syncrude	AB (Calgary)	9	Yes	4,657
	China Investment Corporation (CIC)	Peace River	AB (Calgary)	45	Yes	702
	CIC	Penn West Energy Trust, Joint Venture	AB (Calgary)	45	Yes	1,230
2011	CNOOC	OPTI	AB (Calgary)	100	Yes	1,997
	Sinopec	Daylight Energy Limited	AB (Calgary)	100	Yes	2,000
	CNOOC	Northern Cross (Yukon) Limited	AB (Calgary)	N/A	Yes	N/A
	Sinopec	Enbridge Inc.	ON (Toronto)	N/A	Yes	100
2012	PetroChina	Athabasca Oil Sands Corp.*	AB (Calgary)	100	Yes	680
	CNOOC	Nexen	AB (Calgary)	100	Yes	15,100 (est.)
	PetroChina	Royal Dutch Shell PLC*	BC (Groundbirch)	20	Yes	1,000
	PetroChina	Encana*	AB (Calgary)	Failed	Yes	5,400

Sources: Michael Grant, "Fear the Dragon? Chinese Foreign Direct Investment in Canada," (Ottawa: The Conference Board of Canada, June 2012); and various newspapers and public websites.

[a] *Jointly with Telus and Bell.*

* *Investment in properties and projects instead of the entire company.*

TABLE 4: MAJOR CHINESE INVESTMENTS IN CANADA, 2005 TO PRESENT (cont'd)

Year	Investor	Investment	Province (City)	Per cent Share	SOE?	Value ($ millions)
MINING						
2005	Jinchuan Group	Gobimin	ON (Toronto)	10	Yes	3
	China Minmetal Corp.	Noranda	ON (Toronto)	Failed	Yes	6,000
2007	Aluminum Corporation of China	Peru Copper	BC (Vancouver)	100	Yes	792
2008	Jinduicheng Molybdenum Group Mining Corporation	Yukon Zinc. Corp	BC (Vancouver)	N/A	Yes	102
	Jinchuan Group	Tyler Resources	AB (Calgary)	100	Yes	197
	Wuhan Iron and Steel Co. Ltd.	Consolidated Thompson Iron Mines	ON (Toronto)	20	Yes	302
2009	CIC	Teck Resources	BC (Vancouver)	17	Yes	1,558
	Ningbo Sunhu Chemical Products Co., Ltd.	Royal Nickel Corporation	ON (Toronto)	15.6	No	22
	Jilin Jien Nickel	Victory Nickel	ON (Toronto)	14.7	No	N/A
	Industry Co., Ltd.					
	CIC	SouthGobi Resources	BC (Vancouver)	N/A	Yes	500
	Shougang Corp.	Canadian Kailuan Dehua Mines	BC (Vancouver)	25	Yes	23
	CRCC and Tongling Nonferrous Metals	Corriente Resources Inc.	BC (Richmond)	100	Yes	648
2010	Zijin Mining Group Co., Ltd.	Intercitic Minerals	ON (Toronto)	19	No	19
	Tongling Nonferrous Metals	Canada Zinc Metals	BC (Vancouver)	13	Yes	18
	Jilin Jien Nickel Industry Co., Ltd.	Canada Royalties	QC (Montreal)	75	No	192
2011	Baoshan Iron and Steel Co., Ltd.	Noront Resources	ON (Toronto)	9.9	Yes	17
	China Minmetal Corp. and	Century Iron Ore Holdings	ON (Toronto)	30	Yes	73
	WISCO International Res.					
	WISCO International Resources	Century Iron Ore Holdings*	ON (Toronto)	40	Yes	120
	Winsway Coking Coal Holding with Marubeni Corp.	Grande Cache Coal Corp	AB (Calgary)	60	No	590
2012	Hebei Iron & Steel Group	Alderon Iron Ore Corp.	QC (Montreal)	19.9	No	194
	Western Mining Group Co. Ltd.	Inter-Citic Minerals Inc.	ON (Toronto)	100	No	250
	Yunan Chihong Zinc & Germanium	Selwyn Resources, joint venture	BC (Vancouver)	50	Yes	100
OTHER						
2008	Wuhan Liren	Windfields, Solar and Renewable Energy Corp.	ON	N/A	No	N/A
	Huawei Technologies	N/A, open office (greenfield)	ON (Toronto)	100	No	N/A
2009	Huawei Technologies	N/A, R&D center (greenfield)	ON (Ottawa)	100	No	N/A
	ICBC	Bank of East Asia (Canada)	Canada	70	Yes	N/A
	Zhongchuan Mining Corps.	N/A	SK	N/A	No	N/A
2010	State Grid International Development Ltd.	Quadra Mining Ltd.	BC (Vancouver)	10	Yes	1,500
2011	Bank of China	N/A, open office	Canada	100	Yes	N/A
	Huawei Technologies	N/A, joint innovation center [a]	Canada	50	No	N/A
	Longyuan Power	Farm Owned Power (Melancthon)	ON	100	Yes	260
	iSoftStone Holdings Ltd	Abovenet International	ON (Toronto)	100	No	N/A
	Bohong Group	Wescast Industries Inc.	ON (Toronto)	100	No	245
	Unistrong Science & Technology Co. Ltd.	Hemisphere GNSS Inc.	AB (Calgary)	100	No	15

Sources: Michael Grant, "Fear the Dragon? Chinese Foreign Direct Investment in Canada," (Ottawa: The Conference Board of Canada, June 2012); and various newspapers and public websites.

[a] *Jointly with Telus and Bell.*

* *Investment in properties and projects instead of the entire company.*

China Minmetals' 2004 bid for publicly traded Noranda, Canada's largest mining firm and a major zinc and copper producer, was more troubled. Despite the endorsement of the bid by Noranda's largest shareholder, it drew a storm of controversy about a "government proposing to run a mining firm" and criticism of Canadian firms for having failed to bid first. Minmetals withdrew its bid in 2005 when Noranda did a stock swap with its Falconbridge subsidiary that raised the potential deal price closer to full value. In 2006, Falconbridge was acquired by the Anglo-Swiss mining giant Xstrata.

Since 2008, a variety of smaller transactions have occurred, including greenfield investments, by private and state firms in manufacturing, transportation and telecommunications, but most acquisitions have been concentrated in natural-resource sectors. This pattern can be compared with official statistics up to 2012 on the sectoral patterns of total foreign investment as reported by national sources in Canada, the United States and Australia (Table 5). In Canada, investments reported in natural resources and petroleum were slightly smaller than those in "management of companies and enterprises," trailed by finance. Both sectors saw growth at similar rates of 13 per cent over the period. In the United States, manufacturing, retail trade and finance dominate the picture, while in Australia, mineral exploration and development and "real estate" dominate inflows (similar stock data were not available) followed by manufacturing and services. These differences should not be a surprise as they reflect each country's comparative advantage.

TABLE 5: TOTAL STOCKS OF INWARD INVESTMENT BY INDUSTRY, CANADA, UNITED STATES AND AUSTRALIA

a. Canada, 2000-2012, by % share

Industry	2000	2005	2011	2012
Mining and oil and gas extraction	6.26	10.95	13.24	12.67
Petroleum and coal products manufacturing	1.85	2.79	5.04	4.84
Chemical manufacturing	3.03	3.53	2.68	2.63
Primary metal manufacturing	0.88	0.76	3.62	3.34
Transportation equipment manufacturing	4.08	2.56	2.22	1.95
Wholesale trade	6.50	6.93	5.13	5.06
Retail trade	2.62	2.61	3.27	3.16
Finance and insurance	7.75	9.50	10.16	8.96
Management of companies and enterprises	4.97	11.83	13.75	12.80
Information and communication technologies (ICT)	5.96	2.45	1.74	1.46

Source: Statistics Canada, CANSIM 0376-0052, "International investment position, Canadian direct investment abroad and foreign direct investment in Canada, by country," http://www5.statcan.gc.ca/cansim/a26?lang=eng&retrLang=eng&id=3760051&paSer=&pattern=&stByVal=1&p1=1&p2=-1&tabMode=dataTable&csid=.

b. United States, 2000-2011, by % share

Industry	2000	2005	2011
Manufacturing	38.23	30.59	32.90
Wholesale trade	13.84	14.41	12.17
Retail trade	2.12	1.89	1.98
Information	11.68	6.28	5.77
Banking	5.11	7.97	6.01
Finance and insurance	13.29	13.13	14.79
Real estate and rental and leasing	3.98	2.29	1.90
Professional, scientific, and technical services	2.43	3.15	3.46
Other industries	9.31	20.29	21.02

Source: U.S. Bureau of Economic Analysis, http://www.bea.gov/international/di1fdibal.htm. Position on a historical-cost basis, financial flows without current-cost adjustment, and income without current-cost adjustment.

c. Australia, 2008-2011, by % share

Industry	2008	2009	2010	2011
Agriculture, forestry & fishing	1.53	1.67	0.78	2.11
Finance & insurance	6.00	3.01	7.78	2.67
Manufacturing	10.54	11.64	8.44	17.29
Mineral exploration & development	49.97	57.97	31.07	30.26
Resource processing	0.99	0.77	1.47	0.18
Services	17.46	10.03	26.89	12.31
Tourism	0.58	0.51	0.08	0.55
Real estate	12.91	14.33	23.50	34.63

Source: http://www.firb.gov.au/content/publications.asp, Foreign Investment Review Board, Annual reports.

Notes: Shares in panels a, b and c total 100 per cent.

** FIRB reports only flow data. Entries for Canada and United States use stock data.*

CANADIAN POLICY AND REGULATION

The advantages that FDI offers host countries include portfolio diversification using foreign capital, access to the technologies and international supply chains of foreign firms, and increased domestic competition from them — all factors that contribute to faster growth and more efficient use of resources. If that were all there were to it, there would be few constraints on commercial decisions.

Many argue that it is in the national interest to seek foreign capital to develop Alberta's oilsands. The Canadian Energy Research Institute (CERI) has estimated that more than $100 billion will be required for oilsands investments in the 2004–19 period.[30] This is on top of the $40-billion overall investment in oil and gas extraction in the 2007–11 period and the $9 billion in mining. As Grant points out, these investments were largely funded by Canadian savings and heavily expose domestic portfolios as a result. Foreign funding can diversify these risks.

[30] Michael Grant, "Fear the Dragon? Chinese Foreign Direct Investment in Canada," (Ottawa: The Conference Board of Canada, June 2012), 11-12.

Weighed against these benefits of inward FDI are three main policy concerns about Chinese investment: enterprise ownership, asymmetric access for Canadian firms to the Chinese market and national security concerns. Several other more implicit concerns include lack of trust, foreignness and concerns about unfair competition. All of these concerns have been analyzed carefully in Bergevin and Schwanen, Cornish, Grant, Moran, and Assaf and McGillis[31] and are summarized here.

Ownership

Ownership is an important issue in a number of countries including Canada. Concerns about politically driven decisions need checks against actual behaviour. The behaviour of China's largest enterprises (mostly SOEs, so far) is largely consistent with that of multinationals seeking to access new markets, natural resources and the acquisition of technologies and brands. It is important to realize that the policy environment at home is changing; home markets are increasingly competitive — ones in which they must compete successfully or die — which can mean that foreign operations are the only way to expand their businesses. Indeed, as China's growth slows in the years ahead, China's large enterprises are even more likely to pursue additional offshore markets.

Cornish[32] has argued, and as the earlier description of CNOOC Ltd. illustrates, SOE boards and management focus exclusively on the company's interests; to serve those interests they must conform to stock-exchange and host-country rules and regulations. Market pressures on buyer-seller relationships provide a more cogent interpretation of their behaviour. At the same time, as new arrivals in international markets, managers are still learning the rules of the road, which differ radically from those in the close (but evolving) business-government relationships at home. In its quest for Nexen, CNOOC Ltd. invested heavily in the approval process, committing to allocate half of the board and management positions to Canadians, invest in Nexen's assets, make Calgary the headquarters for CNOOC operations in Central and North America, run the company by commercial principles, and maintain Nexen's high profile for corporate social responsibility. Hill & Knowlton managed the public face of the transaction and the demonstration of the company's ability to meet the net-benefit test. Nexen shareholders overwhelmingly approved the proposal and CFIUS cleared the transaction involving U.S. assets, albeit with restrictions on assets in the Gulf of Mexico, whose details are not publicly available.

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[31] Philippe Bergevin and Daniel Schwanen, "Reforming the Investment Canada Act: Walk More Softly, Carry a Bigger Stick," *Commentary, International Economic Policy* 337, (Toronto: CD Howe Institute, December 2011); Cornish, "Behaviour of Chinese"; Grant, "Fear the Dragon?"; Theodore H. Moran, "Chinese Foreign Direct Investment in Canada: Threat or Opportunity?" (Ottawa: Canadian Council of Chief Executives, March 2012); Dany H. Assaf and Rory R. McGillis, "Foreign Direct Investment and the National Interest: A Way Forward," *IRPP Study* 40 (April 2013), http://archive.irpp.org/pubs/IRPPstudy/IRPP_Study_no40.pdf.

[32] Cornish, "Behaviour of Chinese."

It is worth noting that available information on the terms of financing for the $15.1-billion cash offer for Nexen indicate a consortium of five Chinese and 15 international banks (including BMO and Scotiabank) provided $6-billion bridge loans at the rate of LIBOR plus 80 points, and up-front fees of 25 basis points. While the full funding profile had not been publicly disclosed at the time of writing, it is expected that it will closely resemble the package assembled for the earlier Unocal bid but with less financing from the parent.[33]

Asymmetry in Market Access

Asymmetry in market access is an issue in many countries. Framing it as a problem of reciprocity, as has happened in Canada, is misleading as the latter term refers to an attribute of much broader trade negotiations based on comparative advantage. The real concern is that access for Canadian firms to China's market should be equivalent to what is offered Chinese firms entering Canada. This is a reasonable general principle, but China is still building its institutions to regulate FDI — and the two countries have different sources of comparative advantage.

National Security

The third issue is national security. Most countries screen foreign investments for risks to national security, but the interpretations and tests are highly variable and have varying degrees of opacity. The U.S. regime carried out by CFIUS is relatively transparent with consideration of seven identifiable factors.[34] Canada's regime is relatively opaque reflecting a variety of views. There are some conflicting corporate views where some see ownership of natural-resource enterprises as a strategic issue while others argue that foreign investments in natural resources, where Canada remains the ultimate owner, do not pose a strategic threat. Moran[35] proposes three national security issues for which investment screening makes sense: market dominance of supply that penalizes the host country; transferring technology that harms host-country interests; or engaging in sabotage or espionage. These are serious concerns. Is restricting investment the most effective way to address them? This is a blunt instrument that denies Canadians access to foreign capital and international supply chains. Canadian regulators should be enforcing our own regimes for oversight of safety, environment, labour laws and financial transparency and soundness. The Office of the Superintendent of Financial Institutions (OFSI), for example, closely supervises all banks operating in Canada, including the Chinese-owned Schedule 2 banks. Canada's natural resources are owned by the provinces and provincial governments oversee the leasing, licensing and royalty regimes for such resources. These resources cannot be moved abroad without official permission. Our rules and regulations, and their enforcement, should reflect our national interests.

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[33] Sources include: interviews with Toronto-based Canadian banks; and Charlie Zhu and Umesh Desai, "China's CNOOC may tap bond, loan markets for Nexen bid," Reuters Hong Kong, July 27, 2012, http://www.theglobeandmail.com/report-on-business/international-business/asian-pacific-business/chinas-cnooc-may-tap-bond-loan-markets-for-nexen-bid/article4443823/.

[34] See Bergevin and Schwanen, "Reforming the Investment," 12.

[35] Moran, "Chinese Foreign Direct."

As to concerns that SOEs and their affiliates take orders from government owners to tie up supplies for their own use, Moran[36] has documented an evolution in the behaviour of natural-resource-seeking SOEs from that of seeking to secure supplies for Chinese use (as Japanese investors sought to do in the 1970s and '80s) to investing in production for international markets. It should also be recalled that Industry Canada requires SOEs to operate on a commercial basis. Nor is there any transport infrastructure available to export significant quantities of oil and gas to Asia. Even if there were, exports would have to satisfy the National Energy Board's net surplus tests.

FUTURE TRENDS AND THEIR IMPLICATIONS FOR CANADIAN POLICY

Re-evaluating the Existing Regime

Canada is a country in need of international capital to fully realize its comparative advantage based on abundant natural resources. China is a major potential source of capital from both private and state enterprises. The Canadian government's December 2012 policy statement, added to the existing opaque net-benefits and national-security tests, has raised the risks in several ways that the development of the oilsands resource will be underfunded.[37] First, the policy increases the cost of capital and reduces potential investor interest by increasing the uncertainties about approval of the transaction. A related issue is that the net-benefits test raises transactions costs relative to alternative locations in countries with more transparent processes and less uncertainty. It is impossible to value proposals that are withdrawn before the approval process — and Industry Canada does not publish statistics on proposals that are withdrawn during the approval process. Second, the size restrictions introduced in December 2012 will discourage private-equity investors for whom exit strategies are a key dimension of their high-risk investment decisions. Large players provide potential exit channels and if they decline in number so will the potential value of such investments. Those firms likely to suffer most from reduced funding, paradoxically, will be emerging players whose viability and pace of development could be undermined by perceptions among potential investors of "political whim" in Canada. Third, restrictions on investments by large firms reduce market discipline and the threat of takeover for Canadian-owned enterprises by shielding them from potential takeovers that are attracted by poor managerial performance.

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[36] Moran, "China's Strategy."

[37] The Prime Minister's statement on foreign investment on December 7, 2012 focused primarily on SOEs with particular emphasis on oilsands investments. "…[A]ll investments are not equal," he said. " … Canadians have not spent years reducing the ownership of sectors of the economy by our own governments, only to see them bought and controlled by foreign governments instead." He went on to declare that future control of oilsands businesses by SOEs would be permitted "only in exceptional circumstance" and that SOEs bidding for Canadian businesses will face strengthened scrutiny with respect to such factors as the degree of control or influence on the acquired Canadian business, on the industry and "the extent to which the foreign government in question is likely to exercise control or influence over the acquiring SOE." The thresholds for review were also adjusted. (Prime Minister of Canada's Office, "Statement by the Prime Minister of Canada on foreign investment," December 7, 2012, www.pm.gc.ca)

Canada's ambiguous net-benefits test and national security review process are also vulnerable to politicization. Both put the onus of proof on the investor rather than on the reviewing minister. While vagueness and uncertainty may increase the leverage of Canadian authorities, it reduces foreign investment and leaves open the possibility of politicized decisions that protect Canadian firms from foreign competition. Comparison with the Australian regime shows striking differences in the threshold for reviews, the transparency of the tests applied (Australia provides a transparent list of the factors it takes into account), the transparency of the minister's decision (the Australian minister provides a transparent public explanation), and accountability (the onus is on the Australian government to explain why it will not allow a transaction).[38] In contrast, Canada's screening applies to all new FDI, its net benefit test is subjective, opaque and interventionist; reasons for decision are not necessarily made public and the onus is on the investor to show net benefits.

There are key implications for policy, as Bergevin and Schwanen, Cornish, Grant, Moran and Assaf and McGillis have argued. Canada should revise its review regime in a number of ways: the economic and national security tests should be clearer about the factors under review (such as Moran's three national security threats); SOE guidelines should clarify performance expectations; and the onus should shift to the federal government to show why the investment does not satisfy the national interest, further adding to transparency.

The policy emphasis on ownership means that Canadians have failed to make use of other policy tools. More emphasis on *behaviour* would mean taking more responsibility for the knowledge and skills of Canadian regulators. Canada has well-established regulatory regimes ranging from competition policy to regulation of firm behaviour with respect to financial soundness, labour laws and worker safety, and environmental protection. It may be that Canadian regulators need to increase their understanding of the business and policy environments of the home countries of firms investing in Canada, including SOEs from China, but also firms from Brazil, India, Russia and even Mexico. With more expertise, regulators could improve their capabilities to monitor foreign-firm behaviour and any undertakings they may have provided to Industry Canada. Canadian educational institutions should offer training programs on these regulatory regimes to foreign executives — activities that are well established in some U.S. business and technical schools. As well, Canadian officials should be working with foreign officials to identify each government's expectations of foreign-firm behaviour and to evaluate how such firms are treated. In the case of China, such activity could build directly on the *China-Canada Complementarities Study* completed by officials and published in 2012.

Re-evaluating Canadian Policy Assumptions

The other key policy issue is Canadian assumptions about Chinese enterprises. Such assumptions are becoming dated as China's policy regimes evolve. Three main changes are underway as China's new leaders push economic reforms leading to eventual opening of China's capital account. First, the FDI regime is changing. Not only is the old restrictive FDI regime inconsistent with the new growth model, particularly in services and high-tech manufacturing, but competition resulting from a more liberal regime will create pressures on

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[38] Bergevin and Schwanen, "Reforming the Investment," 9.

the large state monopolies in energy and finance. Second, China has now built the institutions needed to regulate inward FDI, having adopted a competition policy, a negative list approach (in which everything beyond a designated list of exceptions is allowed), and an FDI screening body aimed at national security concerns. Third, foreign concerns about asymmetric market access now matter to Chinese enterprises which have more to lose in their efforts to fulfill ambitions abroad than by a continuation of the current restrictive and internally inconsistent approaches at home.[39] The decisions to proceed with the stalled negotiation of a China-U.S. bilateral investment treaty (BIT) and an experiment to liberalize existing FDI rules as part of the Shanghai Pilot Free Trade Zone will push things along.

As noted earlier, Chinese outward FDI (OFDI) will increase inexorably in the years ahead. If the current six per cent outward-FDI stock relative to China's GDP[40] were to be maintained for the rest of this decade, by 2020 — when China's GDP will have doubled to around $14 trillion according to projections by Goldman Sachs — the outward-FDI stock could be $700 billion, which would be similar to stocks accumulated over much longer periods by Canada and Japan. More bullish estimates put GDP in 2020 at $20 trillion and the OFDI stock at least $1 trillion, possibly $2 trillion,[41] which would still be one-quarter to one-half the U.S. total today.

In Canada, the Chinese OFDI stock measured by Statistics Canada more than doubled between 2008 and 2012, from $5.6 billion to $12 billion,[42] increasing Canada's share of China's total OFDI to more than two per cent. Note that this happened at a time when the shares of the other major investing countries in Figure 4 were static or declining. The stock in Canada will at least double again in 2013 with the inclusion of the CNOOC-Nexen transaction, to nearly five per cent of the total. Even if Canada's share continued at two per cent to 2020, it would total $40 billion — or about 40 per cent of what CERI has estimated to be the financing needs for the period.

Chinese firms are on a learning curve, not only with respect to reforms in markets and corporate governance at home, but with respect to the regimes governing international business in host countries such as Canada. In response, the federal government should build upon its recent *China-Canada Complementarities Study*, in which officials from both countries worked together on seven sectors where both sides have interests and growth opportunities, to identify complementarities as well as issues that need to be addressed. For example, in natural resources, the study recognized that:

> "To take advantage of complementarities in this sector, further improvements could be made in the clarity, efficiency and predictability of inward investment-related regulations, the compatibility of certification systems and the expediency of approval process on goods such as equipment."[43]

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[39] Thilo Hanemann and Beibei Bao, "A New Momentum for FDI Reforms in China" (New York: Rhodium Group, August 28, 2013), http://rhg.com/notes/a-new-momentum-for-fdi-reforms-China.

[40] This ratio compares with the global average in which OFDI/GDP is 33 per cent. In per capita terms it was $175 per Chinese compared to a global average of $2,900 (see: Rosen and Hanemann, *Open Door?*, 18).

[41] Rosen and Hanemann, *Open Door?*, 18.

[42] Statistics Canada, CANSIM 03760051.

[43] See: Government of Canada, Department of Foreign Affairs, Trade and Development, *China-Canada Complementarities Study*, 2012, http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/china-chine/index.aspx?lang=eng.

Officials from both countries should continue to meet periodically for mutual discussions that follow up on such issues.

Or will Ottawa reject Chinese suitors? Increasingly they will come in the form of non-SOE investors seeking to add Canadian assets to their supply chains, to acquire technology and expand markets using Canada as a base for North America or the Western Hemisphere. Such transactions could be very much in the national interest and are trends that should be encouraged.

Yet Canada continues to send mixed messages, placing obstacles in the path of SOE investors through the exceptional-circumstances test introduced in December 2012, while deepening the two-way economic relationship with the signing of the Foreign Investment Promotion and Protection Agreement (FIPA) in September 2012 that provides investors in both countries more assurance about the future safety of their assets.[44] Building on the *China-Canada Complementarities Study* would be a wise investment in better understanding each government's objectives, encouraging high standards of corporate governance and interpreting policy and institutional differences to find mutually acceptable solutions.

Canada needs a simpler, more transparent policy framework that focuses mainly on national security issues. It should be transparent and focus on investor *behaviour* rather than ownership through competent and well-informed regulatory oversight. The basic issue with China is one of bridging differences between economic systems, a process that should be guided by the principle of mutual learning. The end goal should be to improve competitiveness and contribute to the development of both sending and receiving countries.

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[44] For the time being, however, national consultations required for implementation of the FIPA have been stalled by objections from aboriginal groups objecting to the consultation process.

About the Author

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