

Assessment of the Key Political Risks of China's Overseas Direct Investment

Jian-Cong CHANG^{1,a,*}

¹Shanghai Jianqiao University, Office 8312, No. 1500 Kangqiao Road, Pudong New District, Post code: 201315, Shanghai, China

^ajiancongchang@gmail.com

*Corresponding author

Key words: China, overseas direct investment, political risks, social responsibility

Abstract: this paper introduces firstly the major political risks of China's overseas direct investment, analyzes the relevant affecting factors, assesses the causes for these political risks in consideration of the major systemic elements of the target countries and China, finally it develops a couple of strategies to reduce the political risks for China's overseas direct investment.

Introduction

In recent years, the international direct investments from China have been increasing markedly, accounting for 6.3 percent of global investment traffic in 2012. The "2012 Annual Statistical Bulletin of China's Overseas Direct Investment" issued jointly by China's Ministry of Commerce, National Bureau of Statistics, the State Administration of Foreign Exchange showed that, the net amount of China's overseas direct investment in 2012 accounted for \$ 87.8 billion, an increase by 17.6% compared to the previous year. From 2002 to 2012, China's overseas direct investment increased in average annual growth rate of 45% [1].

The World Investment Report 2013 published by UNCTAD showed that, global FDI flows reached \$1.39 trillion in 2012, with \$23.59 trillion of stock by the end of 2012 [2]. Based on the above report, China's outward FDI flows and stock in 2012 accounted for a share of 6.3% and 2.3% globally. China ranked 3rd among all economies in terms of outward FDI flows and 13th in terms of stock.

16,000 Chinese domestic investors had established about 22,000 overseas enterprises which are located in 179 countries (regions) worldwide [1]. However, over the same period the political risks in connection with the overseas Chinese investment have been remaining on an upward trend. Due to the large impact, the wide area of the influence and the strong destructive power of the political risks, the safety and interests of Chinese overseas investment are threatened seriously. To some extent, the risks restricted the development of China's economy. In the inconstant international political and economic environment, companies must develop rational preventive strategies to secure their overseas direct investment.

The Key Political Risks of China's Overseas Direct Investment

Political risk is a broad concept, yet there is still no generally recognized definition in the academia. From the perspective of overseas direct investment, political risk is usually considered as the political changes of the target country, the incoherence of the policy, geopolitical conflicts, nationalism and religious ideological conflicts, regional and local wars, bureaucracy and even terrorist attacks, as well as the possible damage to the local economy caused by the foreign

investors' behavior. Political risk is the largest and most unforeseeable risk for the overseas investment and may bring immeasurable harm to the enterprises. Political risk is a key factor affecting the success of overseas investment. Currently, the political risks faced by Chinese overseas enterprises mainly consist of the following factors.

The first factor is the government intervention, including the intervention by target country and the intervention by third-country. Due to the "China threat" theory and social ideological differences, Chinese enterprises have to face generally with formidable challenge of the government intervention in the target countries. Currently, the target country's government intervention has become a major political risk suffered by the Chinese enterprises in the developed world. In recent years, American and European countries often set restrictions on Chinese enterprises to enter sensitive sectors such as energy resources, high-tech industries etc. on the grounds of national security and state-owned background of Chinese overseas companies. Government intervention by the target country often led to investment failures of the Chinese enterprises. For example, the acquisition of the Unocal Oil Company by China National Offshore Oil Corporation (CNOOC) in 2005 had to be withdrawn as U.S. congressmen rejected the initiative on the pretext of threatened national security; in 2007, the acquisition of U.S. firm 3Com by Huawei in cooperation with Bain was blocked because the U.S. Committee on Foreign Investment imagined that it might harm the U.S. government information security; in 2009, Aluminum Corporation of China spent \$ 19.5 billion to acquire Rio Tinto Company of Australia, but it failed ultimately because of the Australian government's intervention. In 2010, 50 U.S. Congressmen prevented China's Angang to become major shareholder of the U.S. steel companies on the grounds that steel market would be looted and national security might be threatened by China.

The risk of government intervention by third country includes the risk of sanctions imposed directly by third country government and the risk of negative impact on decision making of the target country's government as well as the risk of uncertainty caused by the pressure or the lure given by the third country. Third country intervention risk occurs mainly in investment and cooperation in energy, such as petroleum, natural gas etc. For Chinese investment companies, the risk of sanctions imposed directly by third-country government comes mostly from the United States. If Chinese enterprises carry out economic activities with Iran, Sudan, North Korea – the so-called "axis of evil" by the U.S., they are likely to face with such kind of risk. The potential loss of the Chinese enterprises includes consequential damages due to the economic blockade of the target country by the U.S., cutting off the access to the U.S. market, or removal of the financing right in the U.S. [3]. In recent years, the development of oil fields by Chinese oil companies in Sudan and Iran was often intervened by the U.S. and other Western governments. In order to force Iran to abandon its nuclear program, the United States put embargo on Iranian oil sales in 2012. In January 2012, Chinese state-owned Zhuhai Zhenrong which had oil trade with Iran suffered economic sanctions imposed by the United States. With the intensification of international competition for resources, more and more frictions occur between countries, so that a third country (mostly economically advanced country) may take advantage of the political and economic dependence of the FDI target countries and force them to change the policies, in order to prevent investments by certain foreign companies. For instance, the construction of the oil pipeline between Daqing in China and Angarsk in Russia was repeatedly obstructed by the Japanese government, causing enormous damage in the initial investment.

The second factor is "nibbling" expropriation. Traditional expropriation risk is the risk of requisition, confiscation or nationalization of the foreign invested enterprises by the target country.

This kind of risk was prevalent from 1950s to 1970s. In recent years, public direct expropriation risk has been greatly reduced, but “nibbling” expropriation by way of indirect trade protection and corruption has been relatively increasing. The “nibbling” expropriation means that the FDI target country impedes the effective control of the enterprise assets of the foreign investors through surprise inspections, heavy fines and additional taxes, confiscation of property, restricting or canceling the rights of foreign investors, so as to constitute de facto expropriation. In the practice, government departments of some target countries’ frequently inspected Chinese enterprises in the name of checking tax evasion, smuggling, health and safety, and levied heavy fines and taxes, interfered with their production and business activities, and even confiscated the property of Chinese enterprises. Due to the hidden “nibbling” expropriation many Chinese companies suffered huge economic loss.

The third factor is the change in policy and law of the target countries that may cause economic losses of the foreign investors. There are mainly two situations in this respect: first, when the target countries need to protect the local industry and energy sectors, or when the business activities of foreign-invested enterprises threaten the local enterprises noticeable or potentially, they might change the existing policies and laws to restrict the business activities of transnational corporations; second, the continuity of the policy has to be broken if a new socio-economic situation arises. In recent years, Chinese companies that engaged in overseas oil investment have suffered such a political risk repeatedly. In October 2007 the Ecuadorian government announced to impose special oil gain levy on foreign oil companies. In May 2010, the Australian government announced tax reform program to levy resources excess profit duty up to 40% for all the non-renewable resources of energy, making PetroChina and Sinopec that engaged deeply in local business activities suffer large losses. Unrest occurs very often in the Middle East where China has large energy investment. Due to the shortage of the legal mechanism or frequent socio-economic changes there, discontinuity of policy and law happens from time to time. These target countries’ governments change policies and regulations to achieve political or economic goals, resulting in increasing political risk for Chinese overseas investment and damage to the interests of the Chinese invested enterprises.

The forth factor is the nationalist behavior. Currently, many overseas-funded enterprises pursue excessively the short-term economic interests without interest in establishing localized public relations. Further, these foreign companies do not care about local economic development, and hire only few local employees, resulting in great inconsistency between the booming business of the foreign-invested enterprises and slow local economic development. Lack of effective communication and coordination with the local government and the public, it is difficult for the Chinese enterprises to integrate into the local social and economic development of the target countries, thus many Chinese enterprises have similar aforementioned social image in the target countries and are consequently very susceptible to nationalism risks. As a result of religious beliefs, damaged economic interests, ideological differences etc., a number of various interest groups of the target countries may regard the investment of Chinese enterprises as economic invasion with adverse effect, and they even try to boycott against Chinese enterprises under certain conditions. In extreme case, violent attacks occurred against overseas Chinese companies. In recent years, looting cases aim at Chinese enterprises appeared in Spain, South Africa, Indonesia, Russia, the Philippines, Kyrgyzstan and some other countries, causing great losses to the Chinese companies.

The fifth factor is the effect of the terrorist attacks. Due to ideological, ethnic and religious conflicts, terrorists or religious extremists in some countries continuously make terrorist attacks in order to achieve their political and/or economic aspirations. After the "9.11", terrorist attacks

became a major threat on international direct investment projects. The international community made a lot of anti-terrorism efforts, however a solution for the complex international political, economic, religious and ethnic problems is still too far to seek. The terrorist activities resulting therefrom include kidnappings, assassinations and bombings etc on the foreigners [4]. In recent years, the local rebels and criminal gangs often kidnapped and attacked employees of China's natural resource exploiting enterprises in Africa, Asia and Latin America in order to accomplish their political purpose. The most dangerous countries in these areas are Iraq, Afghanistan, Pakistan, Nigeria, Ethiopia and Sudan. These terrorist activities became a serious threat to the life of the Chinese personnel and their enterprises property. On November 1st, 2009, the Copper Orange Buco of China's Zijin Mining Group in northern Peru suffered armed attacks, three local employees were killed and the mine facilities were burned. In 2012, more events in which Chinese workers were kidnapped or hijacked took place in Sudan, Egypt and some other countries. Chinese multinationals have become targets of terrorist attacks that threaten the safety of personnel of China's overseas enterprises seriously.

The sixth factor is the civil strife or civil war. Today the worsened relations between certain countries, power struggle as well as ethnic and religious conflicts in resource-rich areas lead to continuous unrest and war in the Middle East, Central Asia, North Africa etc. In these areas the rebels and local forces are getting more powerful, resulting in political instability, continuous civil unrest and violence, or even a civil war. Meanwhile, the strong involvement of Western countries for their own interests in these countries further exacerbated the intensity of the civil strife and civil war. The Chinese invested a lot in these areas, including natural resource exploitation, project contracting and infrastructure construction. The civil strife and war in these areas may lead to delay, interruption or even cancel of the Chinese investment projects. The enterprises that already invested in these areas might be faced with property damage, personal injury and other risks. Libya war that occurred in February 2011 was a typical example. Libya's civil war forced Chinese companies to withdraw all Chinese construction workers, break all investment projects including development cooperation in oil exploration. According to the announcement of the China National Petroleum Corporation (CNPC), the political unrest in the Middle East and North Africa led to termination of six large overseas project contracts of its subsidiary – the Great Wall Drilling Company – in Libya and Niger with revenue loss of \$ 1.2 billion, more than its loss in international financial crisis in 2009.

The Inherent Cause of the Political Risks of the Overseas Investment of China's Enterprises

Many countries are still not ready to accept the fact that a developing country has become an economic superpower worldwide for the first time in the history, so that overseas investment of Chinese enterprises may be viewed as economic invasion. Because of differences in ideology and social system, the government, non-governmental organizations and the mass media of the developed world have generally an incorrect view about the rapid development of China, and treat China's overseas investment as a potential threat. The rise of China's economy and the rapid increase in Chinese overseas investment made some countries worried, shocked and even panic. Certain Western countries deliberately smeared the image of China and described China's overseas investment as neo-colonialism, causing doubts and mistrust of many developing countries on China. Affected by the so-called "China threat" theory and a large number of overseas mergers and acquisitions made by Chinese enterprises in recent years, the governments and communities of some countries feared that Chinese companies would control their resources and advanced

technologies, and the tremendous amount of mergers and acquisitions by overseas Chinese companies would have a significant negative impact on local economic activities, therefore they tried to curb Chinese companies' investment activities for reasons of national interest. Additionally, with the expanding international influence of China and its increasing participation in international economic activities, the Western countries including the U.S. and the emerging countries including India and Russia tend to politicize the overseas investment of Chinese companies for political and economic interests, often make "national security" an excuse to interfere with the normal investment behavior of Chinese enterprises.

A very large proportion of China's overseas investment concentrated in the resource industries and its investment environment is not ideal. Till the end of 2012, the investment in mining sector accounted for 14.1 percent of China's total overseas direct investment [1]. Due to the long investment cycle and non-renewable characteristics of the resource industries, many countries tend to rank it as national strategic industries with high political sensitivity. Moreover, Chinese companies started overseas natural resource exploitation relatively late, so that almost all resource-rich countries and regions with good investment environment and mining conditions were occupied by developed countries, hence Chinese enterprises had to choose the regions without ideal investment environment. Chinese overseas direct investment in resource industries mostly located in the Middle East, Africa, Latin America and other politically riskier countries and regions where political turmoil, internal factionalism, religious conflicts, ethnic contradictions, civil war and terrorist incidents occur frequently. Some of the countries have a variety of conflicts with their neighbors due to border disputes. Due to the unbalanced distribution of resources and the large demand for strategic resources of China, the ethnic, racial and religious conflicts as well as frequent outbreaks of violence in the resource-rich countries such as Africa and Latin America did not block the expansion of Chinese investment in there. But consequently Chinese energy companies have to suffer huge political risk and often pay a heavy price for that. In addition, lack of sound legal system in those countries and regions, unforeseen adjustments in investment policies and regulations are often made by the local governments, causing adverse effect for the inward foreign direct investment.

State-owned enterprises are the main force in China's overseas direct investment. With the rapid development of China's economy, PetroChina, CNOOC, Sinopec, Chinalco, Shougang and some other large state-owned enterprises increased the intensity and scale of overseas investment. Due to political and cultural differences, in the view of the governments and the public of some FDI target countries, Chinese state-owned enterprises are completely controlled and strongly supported by the Chinese government, which means that the investment behavior of the Chinese state-owned enterprises is rather government action than enterprise market behavior, and it reflects the government's willingness. They even mistakenly believed that a large number of the overseas acquisitions by Chinese state-owned enterprises were a power expansion of China's government in the world, which will lead to greater impact of the China's government on the local enterprises of the target countries. Therefore some countries regarded Chinese overseas investments as a threat. In recent years, the United States, Japan, Russia etc intended to interfere with overseas M & A activities of China's natural resource-based enterprises. Oil, natural gas, iron ore and some other resources are essential for a country's economic development and directly related to a country's economic lifeline. Hence even the normal mergers and acquisitions of Chinese state-owned enterprises in the international market for their own resource needs were often interfered by some target countries, leading to many failed cross-border mergers and acquisitions.

Lack of research and information, some of the Chinese enterprises underestimated or ignored the political risk in the target countries. Due to the implementation of the "going out" strategy and the increasingly sharp domestic competition, a considerable number of private enterprises and SMEs also went abroad. These companies are generally short of the following competence factors: firstly, experience in overseas investment; secondly, research on the target country's political background; and thirdly, understanding of the political risks that may occur. Further, many of them don't have an effective mechanism of risk supervision and early warning management.

Some of the overseas investment enterprises from China are still short of the awareness of social responsibility. Actions to improve the welfare especially the employment rate of the local people in the target countries and achieve mutual benefit with the local community have already become an integral part of overseas investment made by large multinational companies from the West. However, some Chinese state-owned enterprises, especially natural resource-based enterprises are used to enjoying the privilege in China and short of the awareness of social responsibility, hence their business management concept is not good enough to built harmony with the local stakeholders in the target countries. Such Chinese companies often blindly pursued their own interests, ignoring the benefit of the local people, for instance they made effort only on the business development, but neglected the local pollution control, reduced the technical training of local staff to the minimum, employed so many technicians and engineers from China as possible. Such measures reduced the costs, but led to exacerbated interests conflict between the Chinese enterprises and local residents. In the view of the locals, they did not get the bonus out of the natural resource exploitation, the local employment opportunities were not increased by the Chinese companies and, what is more, the investment by Chinese enterprises brought environmental pollution.

Countermeasures for China's Overseas Investment Enterprises to Avoid the Political Risks

China's government shall improve political information service system and provide timely and authoritative political information services. Currently the reporting system about the political obstacles of different countries and "Country Investment Guide" have been brought into operation by the Ministry of Commerce, and the risk prevention mechanism of the "Country Risk Analysis Report" published by China Export & Credit Insurance Company has been activated to reduce the risk of China's overseas investment. These measures contributed on enterprises to deal with overseas political risks, but the effect is not enough. The Chinese embassies and consulates, business organizations, overseas enterprises, overseas branches should make efforts to collect, evaluate and publish the information about the political and economic situation, ethnic and religious conflicts etc of the crucial countries and regions, providing timely, accurate and authoritative information for Chinese enterprises. In addition, a specialized political risk rating agency must be set up to provide political risk analysis of different countries, evaluate the overseas investment behavior of the Chinese enterprises, forecast political risks for them, and help the Chinese enterprises to establish a reasonable risk management system to protect their overseas investment.

China must speed up the process to sign more bilateral investment protection agreements to enhance its legal binding force on the target countries. After the signing of a bilateral investment protection agreement, political risks of overseas investment made by the Chinese enterprises can be reduced through friendly negotiation with the target countries, court proceedings or submit the dispute to arbitration court to protect their legitimate rights and interests. At present, China's overseas direct investment has been spreading in over 170 countries and regions, but only about 130

bilateral investment protection agreements have been signed. Hence the Chinese enterprises have to deal with more political risks in the other circa 40 countries.

Chinese media must strengthen international communication to build a positive image for China's overseas investment enterprises. Due to the shortage of the global outreach of the Chinese media and the distorted propaganda of the Western media, many countries treated China's overseas investment as plunder of local resources and neo-colonialism. In this respect, China's government should strengthen media outreach to clarify the philosophy of China's peaceful rise. Efforts made by China should let the target countries understand that overseas investment is one of the practical needs of China's economic development, overseas investment is not a political act but a normal commercial activity, and it will benefit both sides. Meanwhile, the related Chinese enterprises should also invest in carrying out public diplomacy to actively increase targeted media exposure, and lobby the relevant government departments and social organizations to enhance their overall understandings of the business and investment projects of Chinese overseas enterprises.

The Chinese multinationals should buy political risk insurance to transfer part of the loss. Buying political risk insurance is a positive preventive measure implemented by multinational corporations to deal with political risks. Through such insurance the foreign investment enterprises can reduce the expected economic losses caused by political risks. Currently, there are both government-sponsored investment insurance agencies and commercial insurance companies that provide this kind of services. In response to the political risks of international investment, some foreign investment companies and insurance institutions have set up political risk insurance services, for instance the U.S. Overseas Private Investment Corporation, the North American Insurance Company, the Board of Trade MITI in Japan, the Export Credit Assurance Department in the UK, the Hames Credit Insurance Company in Germany etc. The internationally accepted overseas investment insurances are generally limited to the insurance of prohibiting foreign exchange, the insurance of nationalization or expropriation, the war insurance and business interruption insurance etc., and the insurance covers generally less than 90% of the investment amount [5]. Chinese overseas investment enterprises can also purchase political risk insurance from the above-mentioned insurance agencies of the industrialized countries. It should be noted that, although the scale of China's overseas direct investment has been increasing rapidly in recent years, yet the insurance coverage of China's insurance agents remains very low, limited to the insurance of political turmoil, foreign exchange restrictions, war and the government expropriation.

The Chinese enterprises should implement more flexible overseas investment strategies. The overseas Chinese enterprises suffered political risk mostly in natural resources and energy fields, and in most cases the investors in these fields are state-owned enterprises that have currently a disputed image in the world. Hence, for overseas investment in natural resources, energy and other sensitive industries, state-owned enterprises from China should choose the local large companies with positive goodwill in the target countries or the world multinationals to establish joint venture or cooperation connection. If an overseas investment is made by a joint venture of a state-owned enterprise from China and a local private company in the target country, or both enterprises participate in bidding as a group company, the likelihood that the local government takes restrictive measures against such a project will be decreased substantially. Joint venture or cooperation with world famous multinationals not only reduces the political risks, but also enables the Chinese companies benefit from the experience of the multinationals in overseas direct investment.

Finally, the Chinese overseas investment companies must take their social responsibility earnestly and actively contribute to the welfare of the local people in the target countries. If an overseas

investment company only focuses on its own business development and ignores its social responsibility in the target country, the local people will be dissatisfied with such an “economic invasion”, therefore this foreign company must suffer greater political risks. Hence, Chinese overseas investment enterprises should actively take the social responsibility and contribute substantially to the social welfare, employment improvement, environment protection of the target countries. For instance, the Chinese enterprises can help the target countries to build infrastructure, train local professionals and management personnel, create more jobs for local people, actively involved in a variety of social community work, effectively reduce environment pollution in production and integrate into the local culture actively to build harmony with the local community. These steps would help the Chinese enterprises to gain wide recognition and support of the local publics, reduce the likelihood of interference of the non-governmental groups and remove the hidden danger of nationalism and xenophobia.

References

- [1] Ministry of Commerce, National Bureau of Statistics, the State Administration of Foreign Exchange, 2012 Annual Statistical Bulletin of China's Overseas Direct Investment, China Statistics Press, Beijing, 2013, pp. 77-91.
- [2] UNCTAD (United Nations Conference on Trade and Development), World Investment Report 2013, United Nations press, Geneva and New York, 2014, pp. 2-8.
- [3] Tian Z., Risks and Countermeasures of China's Outbound Direct Investment in the Post-crisis Era, Contemporary Economic Research, 2010, pp. 10-15.
- [4] Zhang Q., The Identification and Prevention of the Overseas Direct Investment by China's Enterprises, International Economic Cooperation, 2010, pp. 4-6.
- [5] Zhang H., Diao L., Strategy of Transnational Merger of China's Resources Enterprises, Asia-Pacific Economies, 2010, pp. 13-15.