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THE COMPETITIVE EDGE IN CHINA'S OVERSEAS INVESTMENTS: The Golden Hand of the State

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The state's role is key to the success of emerging economies' expanding investments. China's example presents a case in point: comparing its policies with those of Brazil and Korea illustrates a consistent advantage among other emerging markets and global economies. Using five phases of development, we demonstrate how broad public policies and specific support measures affect expansion.¹

In the last 30 years, emerging economies have shifted towards less restrictive outward foreign direct investment policies. China is a remarkable example of the dramatic shift that occurred—from outright restriction to enthusiastic promotion of investments abroad. The Chinese government's "Go Global" strat-

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Korea was an early adopter of liberalization and today Korea is one of the top investors amongst emerging economies.

The rise of the "Washington Consensus" marked a time of tectonic shifts across Latin America. Between 1995 and 2000, investment inflows into Brazil grew from \$4.9 billion to \$32.9 billion—far surpassing the growth of investments abroad in the same period.

The turn of the 21st century marked a period of soaring commodity prices, high growth rates, and the aggressive global expansion of emerging market multinational corporations.

Beijing followed the "Go Global" policy with several measures to assist domestic companies in developing a global strategy capitalizing on opportunities across local and international markets.

Outward investment has a positive impact on the competitiveness and performance of investing firms, and spillover effects to the home economy at large.

Internationalization enables firms to withstand competitive pressure from foreign firms in their domestic markets. As emerging economies become new centers for middle class growth, this competition is likely to become more intense.

egy set in motion a marked increase in outward investment by Chinese multinationals over the past 15 years. This strategy led to several specific measures and incentives aimed at facilitating investments abroad and promoting Chinese multinationals' competitiveness abroad.

This note examines investment policies of three emerging market countries, comparing the policies of the powerhouse that is China with those of Brazil, the largest investor from Latin America, and Korea, the second biggest investor from Asia.

Korea was an early adopter of liberalization, and today, the country's only requirement is prior notification and approval by a foreign-exchange bank. As a result, Korea is one of the top investors amongst emerging economies. In Latin America, most governments have not pro-

actively engaged in promotion policies, with the exception of Brazil. The latter encouraged investments abroad through financial support from the Brazilian National Development Bank (BNDES) to further internationalize Brazilian companies. Industrial-development policies and the proliferation of

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national champions turned Brazilian firms into serious competitors vis-à-vis the big international players.

1970s–1982: Latin America goes global

In Brazil, the seeds of international expansion were sown during the Juscelino Kubitschek (1956-1961) administration, which promoted protectionist policies to develop local industries, yet also opened the economy to foreign companies, especially in the global automobile industry. These economic forces incentivized small family companies to expand from regional centers into the entire domestic market to fend off foreign competition—paving the way for experiments in international expansion.

The “economic miracle” of the 1960s-70s encouraged many family-owned companies such as Odebrecht, Votorantim, Camargo Corrêa, Andrade Gutierrez, Tigre, and WEG to begin

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business operations abroad. Brazilian companies soon established operations in their “natural markets”—i.e., countries with a shared cultural affinity and/or a geographical proximity (Casanova and Kassum, 2014). Meanwhile, China and Korea were (comparatively) far behind. In Korea, from the 1970s to the mid-1980s, several regulations and conditions substantially constrained outward investment. China maintained the classic characteristics of a “closed country.” From 1979-1985, China had a few state-owned foreign trade companies, whose investment projects were highly regulated by the Ministry of Foreign Trade and only approved on a case-by-case basis. Except for a few projects in partnership with state-owned companies, foreign investment into China—not to mention investment abroad—was rare.

1983–1992: China opens up during Brazil Debt Crisis

In the 1980s, Brazil suffered a long period of economic stagnation triggered by the debt crisis. Hard-pressed by free falling sales at home, internationalization became the only viable option for companies to keep growing. Foreign markets became especially a lifeline for construction firms like Odebrecht, which already had infrastructure projects in Chile and Peru, and entered Africa in 1984.

During this period, swift and comprehensive institutional and political reforms signaled a major sea change in China—decentralizing power from the central government and propelling public institutions towards further transparency vis-à-vis market actors and international economic organizations. The central government established various transitional institutions to guide this policy innovation and experimentation. One important step in the process was the gradual reform of the agricultural sector and the partial liberalization of certain goods markets.

China broke ground by establishing new special economic zones. In the first four ones created in 1980 in the country’s southeastern coastal region, local governments could offer new tax benefits and other incentives to attract foreign investors and develop their own infrastructure without the approval of the central government. Chinese private business enterprises boomed in this region.

The special economic zones were strategic in that they led to an infusion of new capital, technology, and skills into parts of China’s economy, while protecting Chinese enterprises from international competition at home. State-owned enterprises also flourished against this backdrop. Only in the mid-1980s did China introduce a series of regulations *for* investments abroad, which established the principles and administrative processes governing the examination and approval of overseas investment by Chinese enterprises.

In 1992, Premier Deng Xiaoping delivered his “South speeches” during a tour of Southern China. In these speeches, he reassured the public that the current economic reforms would accelerate. He declared that the special economic zones were permanent and that the reforms would expand into the inland regions. In many ways, this was a landmark event, with the emphasis on “reform and opening” as the key mantra for what would follow in China: a cycle of economic prosperity, among other bedrock transformations.

Korea, which also had a history of state-led development, swiftly and openly embraced liberalization in response to a perceived demand for economic reforms in the early 1980s. Faced with increased production costs and a limited home market in addition to the need to secure access to natural resources, investments abroad were urgently needed. The government relaxed controls, including specific requirements on investors’ business experiences and host country conditions. For instance, the government removed the requirement for pre-approval of outward investment by the Bank of Korea and replaced it with a more flexible system, which further simplified over time. Subsequently, Korea’s investments abroad increased between 1983 and 1992 from \$169 to \$1,376 million, according to data from UNCTAD

1993-2003: The ‘Washington Consensus’ reign

The third phase of internationalization (1993-2002)—which emerged alongside the rise of the “Washington Consensus”—marked a time of tectonic shifts across Latin America. The IMF and World Bank encouraged (if not obliged) Latin American governments to abandon their import-substitution policies and to adopt pro-market strategies, including privatizing state-owned enterprises in the telecommunications, mining, energy, and transportation sectors.

In Brazil, the impact of this “competitive shock” was two-fold. The best-positioned Brazilian companies consolidated their domestic positions, pursued comparative advantages and foreign financing, and accelerated their international expansion (Casanova, 2009). Much of the Washington consensus also re-

volved around implementing a series of fiscal and monetary policy reforms. Policymakers were advised to loosen capital account restrictions and ensure that exchange rates would fluctuate in accordance with market forces. To do so, a new central banking regime was consolidated, which would use interest rates to control the value of a currency by setting an annual inflation target.

In Brazil, the exchange rate that resulted from regulating interest rates around a previously determined inflation target did not always secure favorable conditions for firms to invest abroad. However, by ending hyperinflation and creating more credibility around the currency's value, policymakers attracted more investments into the Brazilian economy. Between 1995 and 2000, investment inflows into Brazil grew from \$4.9 billion to \$32.9 billion—far surpassing the growth of investments abroad in the same period.

Meanwhile, China adopted several economic policy trends. Crucially, the central government implemented new trade regulations and laws, among them seven major rules released from 1988-1998 by the State Council and Ministry of Foreign Trade. These rules progressively instituted measures to support investing abroad, in line with the government's goal of nurturing national champions in strategic sectors. For instance, incentives took the form of export tax rebates or financial assistance for specifically targeted industries or large state-owned enterprises (SOEs) at the forefront of Chinese outward investment expansion. By 2001, China entered the WTO, thereby unleashing its foreign trade power as more foreign companies poured into China's market—this move, combined with the privatization of a number of SOEs, as well as the restructuring of the financial sector, enhanced China's credibility to foreign investors.

The 'Zou Chuqu' (or 'Go Global') policy that was introduced in 1999 to promote Chinese investments abroad is a notable example of China's commitment to internationalize its companies. Beijing was concerned about the dependence of the manufacturing sector on trade and was encouraged by the demands of entrepreneurs for a new, more sustainable, model of business expansion. A fundamental shift was underway: from attracting foreign investment to actively engaging in it. Throughout the 1990s, Korea actively promoted investment abroad as part of its broader industrial policy to increase firm competitiveness, especially regarding financing and support services. For example, the government implemented financial support for Korean firms investing abroad to facilitate foreign exchange transactions and enhance overseas investment and export credit insurance.

2003-2014: Emerging Markets Golden Decade: China 'Go Global' policy and Brazil's BNDS supports Brazilian companies

The turn of the 21st century marked a period of soaring commodity prices, high growth rates, and the aggressive global expansion of emerging market multinational corporations

(eMNCs), notably through the acquisition of foreign firms and assets. Natural resource-based companies such as Brazil's Vale and Petrobras benefitted from this phase in particular; their strong cash position permitted large-scale acquisitions in both advanced and emerging markets.

In the same period, Chinese political and economic institutions sought to sustain soaring growth rates by amending the constitution to include guarantees on private property in 2004, and enacting a law on private property in 2007. Reforms such as these implicitly recognized the role of private business in the transformation of China's economy. At the same time, the preferential tax rates for foreign enterprises investing in China disappeared. The government increasingly encouraged Chinese enterprises to pursue overseas investments and extend manufacturing beyond their home bases in China.

The government followed the "Go Global" policy with several measures to assist domestic companies in developing

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a global strategy capitalizing on opportunities across local and international markets. These measures improved support policies for investments abroad, streamlined approval procedures, simplified application requirements, relaxed restrictions on foreign exchange, and provided various types of assistance. Critical financial support measures included easier access to finance, interest-subsidized loans for investment in priority sectors and industries, subsidies in the context of aid programs, and tax incentives. Equally significant was the administrative, financial and commercial support of institutions such as The Ministry of Commerce (MOFCOM), the National Development and Reform Commission, the China Export and Import Bank, the China Development Bank (CDB) and the China Export and Credit Insurance Corporation. These changes in attitude to investments abroad and its support policy resulted in dramatic increases in outward investment, with flows in 2014-2015 ten times their level in 2005, making China the third-largest investor in the world today. In the process, though China had not yet become a net capital exporter (as Korea did), the gap between inward and outward investment was substantially reduced. For Korea, the "Golden Decade" included a surge in investments abroad that has continued virtually unabated. From 2000 to 2015, Korean investment outflows increased more than sevenfold. In 2007, Korea reaffirmed its stance by adopting the Policy for Supporting Korean Firms to Invest Abroad and creating the Committee for Global Business Operation chaired by the prime minister. The Korea Trade and Investment Agency (KOTRA), the Korea Export Import Bank and a number of government-related organizations provided integral support. Today, Korea is a net exporter of capital: its outward flows exceed its inward flows. It figures among the top 15 international investors in the world and is the second most active international investor among the E20 emerging economies.

In Brazil, this period was marked by high growth rates, increased public investments in infrastructure, and social policies that contributed to wage growth. The government gave tax cuts and other incentives to companies that took advantage of the domestic market expansion to make foreign investments, especially in high-value sectors. The payroll cut was the most significant tax benefit, given to companies in 50 economic categories. This amounted to a significant loss of government income (on the order of \$100 billion between 2011 and 2015).²

The government also earmarked an unprecedented amount of funds for public banks to subsidize loans for Brazilian firms engaged in foreign investments. The reduction of the benchmark interest rate facilitated the expansion of subsidized loans (TJLP: TJLP: “Taxa de Juros de Longo Prazo”, or

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Long-Term Interest Rates). Between 2005 and 2013, the SELIC³ dropped from 19.75% to 7.12%—its lowest recent point. Subsidized rates became less fiscally onerous, even as loans grew in value. By 2016, the BNDES had about \$250 billion in outstanding TJLP loans (BNDES, 2016),⁴ an amount that enabled the expansion of highly strategic sectors such as energy, transportation and telecommunications.

Brazil has struggled to reconcile its policies towards investments abroad with its commitment to attracting foreign investment. The country’s extraordinarily high interest rates created a negative trade-off between inflation targeting (for inward investment) and growth (for both economic activity and investments abroad). Even during the “Golden Years,” the central bank limited fund allocation to public banks to subsidize foreign investments.⁵

Support for investments abroad was therefore restricted to tax incentives for strategic exporting sectors and subsidized loans to companies that made foreign investments. These policies became less effective over time as the cost of these loans coupled with the reduction of government income limited the federal government’s discretionary spending

capabilities. Political headwinds exacerbated this trend as nondiscretionary spending grew and successive governing coalitions failed to make the reforms necessary to fiscally secure promotion of investments abroad.

2015-Present: New Times for Emerging Markets

As commodity prices collapsed towards the end of 2014, emerging markets faced less buoyant economic growth relative to the previous period. In Brazil, the decline was amplified by the political crisis that involved several major national industry champions of the country, muddying the waters for support for investments abroad. Concerned by the downward pressure on the yuan, also known as the renminbi, and the risk of destabilization resulting from the significant capital outflows registered in 2015 and 2016, Chinese authorities increased scrutiny and tightened regulations on capital outflows, including closer monitoring of Chinese firms’ M&As overseas in fall 2016. In addition to foreign exchange and destabilization concerns, authorities also feared that some recent acquisitions in the past two years, especially by private companies, were mainly motivated by the desire to transfer money abroad—in particular, when the acquired firm falls outside the buyer’s core area of business.

As part of their move to rein in capital outflows, authorities announced stricter approval requirements for M&A deals worth more than \$10 billion (or \$1 billion if the acquisition falls outside the investor’s core business area). They also restricted real estate purchases abroad by State-Owned Enterprises for more than \$1 billion. In August 2017, China’s State Council issued “guidelines on overseas investment” that formalized the fall 2016 announcements and clarified a number of issues. The guidelines classified overseas investments into three main categories, in line with the national economic and strategic interests of China: 1) encouraged investments; 2) restricted investments; and 3) prohibited investments.

Restricted investments include, among others, real estate, hotels, entertainment, and sport clubs—industries in which Chinese authorities flagged a number of deals questioning their economic rationale. Additionally, outdated industries and projects in countries with no diplomatic relations with China or in chaotic regions have also been targeted for restriction. Prohibited investments include investments in gambling and “lewd industries” as well as those that provide access to sensitive sectors such as core military. On the other hand, firms are encouraged to actively engage in investments that promote the Belt and Road Initiative (in particular in infrastructure and connectivity projects), as well as investments that “strengthen cooperation with overseas high-tech and advanced manufacturing companies.” They are especially encouraged to establish R&D centers abroad. For encouraged investments, the Chinese government intends to adopt a number of measures to provide further incentives in taxes, exchange rates, insurance, customs and other benefits.

2. The original law, which was passed in 2011, included benefits for only 15 sectors. This grew to 56 sectors due to political pressure. Originally, federal law in Brazil required executives to contribute 20% of worker’s wages to the social security fund (INSS). This was reformed. The new tax obligation is calculated differentially (depending on sector) as a percentage of total revenue (varying depending on sector), but that excludes external revenue. The exclusion of external revenue has provided an incentive to companies to invest abroad.

3. i.e. Special Clearance and Escrow System. The SELIC rate, the Brazilian Central Bank’s overnight rate, is the basic interest rate used by banks to determine their own lending rates.

4. The total value in real of these loans: \$513 billion reals. See BNDES at: http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes_pt/Galerias/Arquivos/empresa/download/2015_captacoes_tesouro.pdf.

5. The high interest rates in Brazil also made financing abroad cheaper. During the period, firms in Brazil received large amounts of loans from their overseas subsidiaries; such intercompany loans reduce the value of country’s outward investment flows as per the methodology of the IMF Balance of Payments Manual.

Likewise, leveraged buy-outs by Chinese firms may be more difficult to undertake, as Chinese authorities appear to tighten public financing policies. Such policies had previously enabled a number of firms, especially government owned SOEs, to gain access to subsidized financing despite high debt ratios. The leverage ratio of SOEs increased from about 140 in 2007 to 170 in 2016, peaking close to 180 in 2012, 50% higher than in 2003.

The People's Bank of China introduced a number of steps to reduce these market risks, including changes to its Macro Prudential Assessment (MPA) risk-tool in order to control rising leverage in the country's financial system. The government also reduced its explicit support for SOEs to encourage healthier financing. Given that overseas acquisitions were largely credit-fueled; these restrictions will dampen the appetite of Chinese companies—especially government-backed firms—for large-scale acquisitions.

While the full impact of these new rules and guidelines on China's capital outflows remains to be seen, in the first

half of 2017, the value of outbound M&As has already decreased 13% relative to the previous semester, and 50% relative to the same semester in 2016, according to data from the S&P Capital IQ database. This reflects the chilling effect of increased scrutiny on mega-deals, which combined with reduced access to financing (not to mention an outright ban in certain sectors), will likely depress the growth in the value of Chinese outbound M&As. At the same time, the increased transparency and support for "encouraged deals" under the new guidelines are bound to facilitate such transactions. In this latter case, however, the obstacle lies not in China but on the receiving end—i.e. with the host country governments, some of which are already wary of Chinese investment in their high-tech industries. The "clarifications" brought about by the guidelines will likely not assuage those fears.

The rationale for government support to investments abroad

China and Korea both experienced sequential expansion of investments abroad: first through the relaxation of foreign investment controls and/or prohibitions coupled with administrative reforms to streamline approval procedures, then, second, through active and direct assistance (whether knowledge-based, financial or otherwise). Korea began policies promoting investments abroad earlier than China, but the latter has become very active. Strong policy support was instrumental to the surge in investments abroad from both countries. Support in Brazil has been less pro-active and consistent than in China or Korea, a divergence that partly explains their performance.

Opponents of investments abroad point to the tension between the local investment needs of emerging economies and the cost of capital directed for outward investment, as well as to potential negative impact on jobs, exports and tax revenues. Nevertheless, outward investment has a positive impact on the competitiveness and performance of

investing firms, and spillover effects to the home economy at large. A key question is whether emerging market multinationals can do without internationalization. Internationalization enables firms to withstand competitive pressure from foreign firms in their domestic markets. As emerging economies become new centers for middle class growth, this competition is likely to become more intense. Outward investment may be a way for emerging market multinationals to access overseas markets, develop new products and acquire global brand recognition. As established multinationals (often from developed economies) are eyeing the increasingly large and prosperous consumer markets of emerging economies, investments abroad are central for emerging market multinationals seeking to protect or increase their domestic market position. While maintaining a price advantage, emerging market multinationals have improved their position among global brands.

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In the current knowledge-based economy, technology and innovation are crucial determinants of success and progress. Short-term economic parameters do not exclusively determine policies regarding investments abroad; in some cases, long-term strategic considerations, as well as geo-political factors, play an important role.

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