Chapter 2 Japan growing with Asia's development – Asia –Pacific framework toward sustainable growth

Section 1 : Asia increasing its presence in the world

3. China's outward investment that is enhancing its presence in the world

(1) Trend of China's outward direct investment

(A) Expanding China's outward investment

China has been increasing foreign direct investment and developing domestically utilizing foreign capital and technologies. Recently, there is a strong trend that Chinese companies are increasing their overseas direct investment supported by their accumulated capital and improved technologies through their growth. In 2008 when the global financial crisis occurred, China's outward direct investment (flow base) was $55.9 billion, which is a 1.9-fold increase from $26.5 billion of 2007 (see Figure 2-1-3-1).

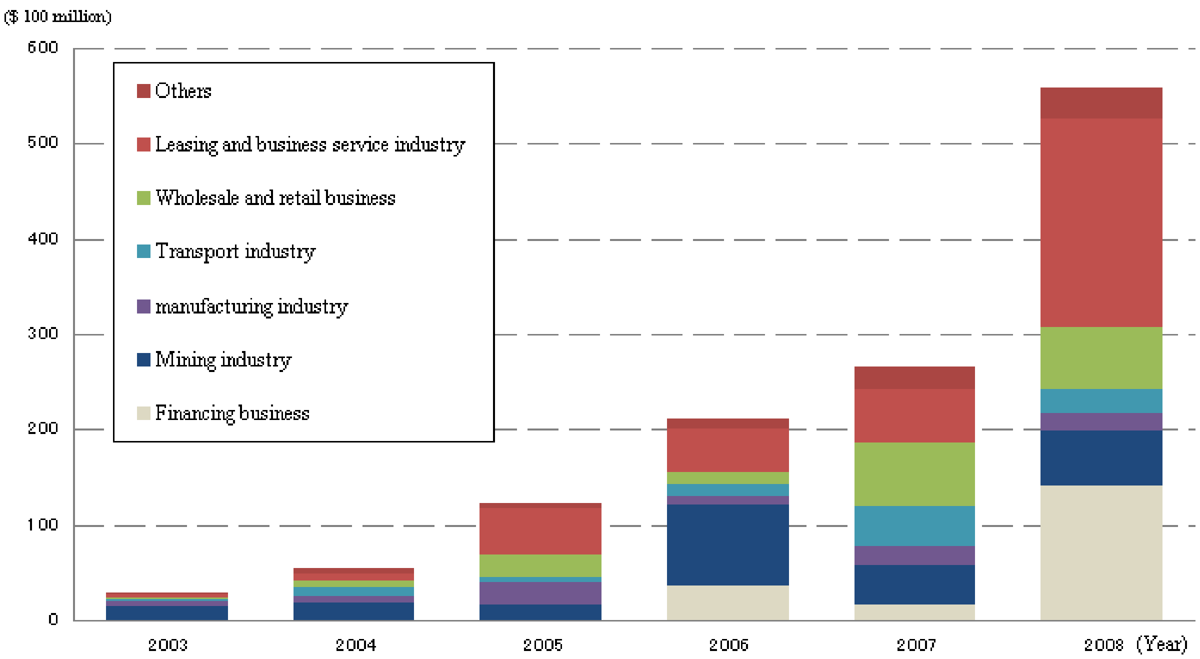
Increase of the outward direct investment is supported by domestic factors; the drive to secure the resource reserve that can satisfy the medium-to-long term growth of China; China's increasing trade surplus which gained momentum after its participation to WTO in the end of 2001; the pressure for the appreciation of yuan brought about by the expansion of investment and the massive capital inflows; the surge of excess liquidity in the domestic markets. In addition, the investment environment that observed the drastic decline in prices of overseas investment target assets (stocks, real estate properties and resources) is further spurring the overseas expansion of the government and companies.

The breakdown of outward direct investment by sector shows that mainly the outward direct investment in the mining industry has been enlarging since 2003 and notable projects are particularly the large-scale projects by the government trying to obtain resources. Companies with largest outstanding outward direct investment balance in China in the end of 2008 are mostly resource-related national companies such as China National Petroleum Corporation (CNPC), China Petroleum and Chemical Corporation (SINOPEC) and Alminum Corporation of China[5].

After the global financial crisis, taking the drop of prices of overseas investment target assets as an opportunity to purchase overseas company, the acquisitions of companies are also increasing intending to obtain technology and management know-how, brand and sales networks.

2-1-3-1 Trends in Direct Investment by Industry in China (Flow)

[5] Mika Takehara (2009) "BICHIKUTO SHISANBAISHUNIYORU SHIGEN (GENBUTSU) KAKUHOO KASOKUSURU CHUGOKU"(Japan Oil, gas and Metals national Corporation website)



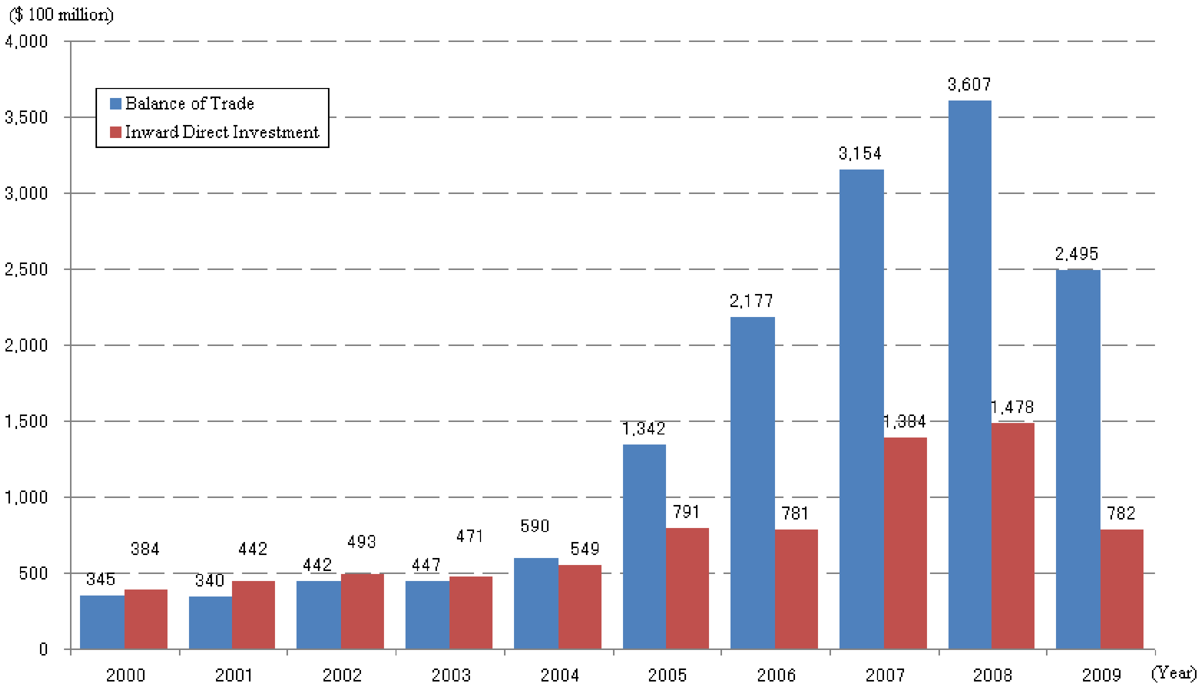
Note: The graph does not include data of financing business before 2006.
Source: CEIC Database

(B) Growing China's overseas investment supported by enlarged foreign exchange reserve

The development of the China's economy is a precondition for the increasing overseas expansion by Chinese companies. Another factor that is supporting the trend is the surge of trade surplus which is unique to China. Along with the participation to WTO in the end of 2001, production transfer from overseas to China has been accelerated and the trade surplus kept expanding till 2008 (see Figure 2-1-3-2). Consequently, the ratio of the current balance to nominal GDP increased from a 1% level of prior to WTO participation to 10% in 2008 substantially exceeding that of Japan. Simultaneously, surplus on capital balance continues due to the factors such as the increased direct investment in China. This resulted in a structure that stably creates "Twin surplus" in balance of payments (see Figure 2-1-3-3).

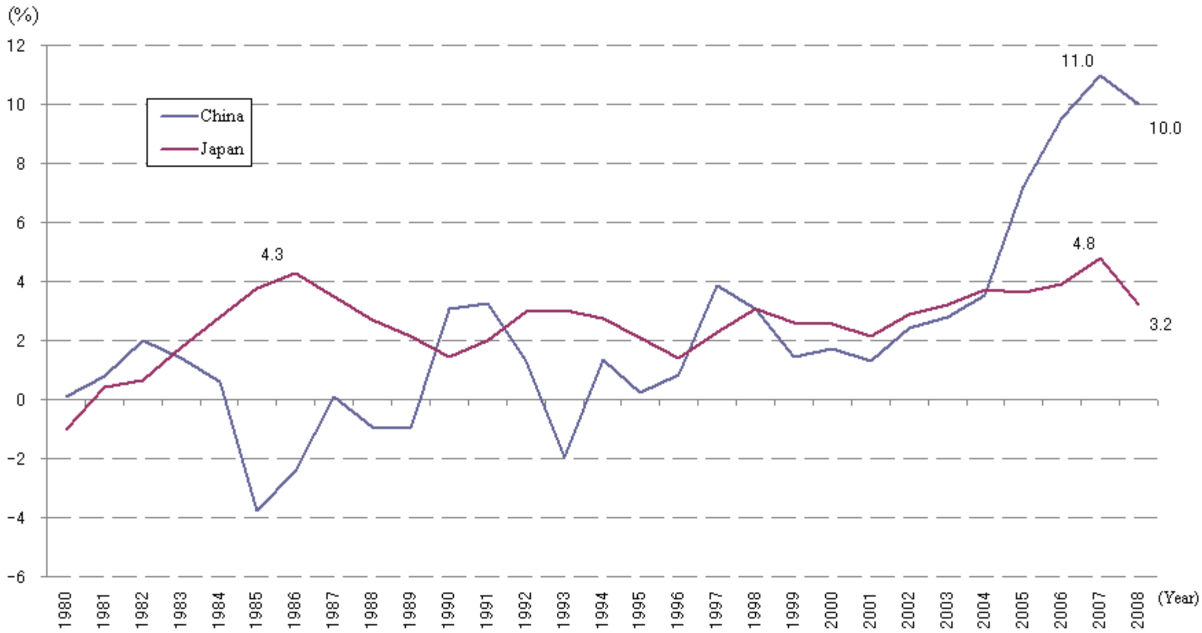
Trade surplus and surplus on current account have been pressuring China to appreciate yuan. However, considering the influence over the export industries that generate employment, the Chinese government has been stabilizing exchange rates through market intervention. For the intervention, commercial banks purchase foreign currencies from companies and the central banks acquires them from commercial banks to accumulate foreign exchange reserves. As a result, the money supply of yuan is increasing. China is in the condition that would invite asset bubble for real estate properties and stocks as the liquidity in domestic markets increases.

2-1-3-2 Balance of Trade and Inward Direct Investment for China



Source:CEIC Database

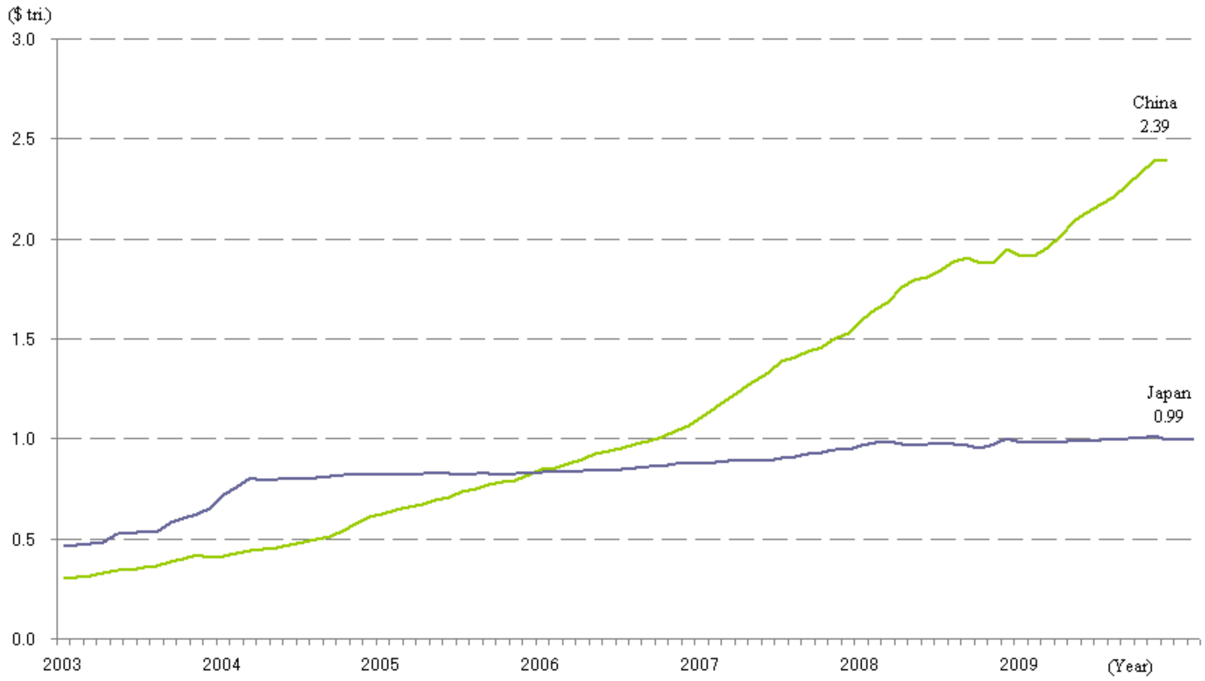
2-1-3-3 Trends in Capital Account Balance between Japan and China as Proportion of GDP



Source: IMF "World Economic Outlook,April 2010"

Furthermore, China became the world largest foreign currency holder superseding Japan in 2006 (see Figure 2-1-3-4). One of the contributing factors for the large-scale outward investments is that China gained a position to comfortably implement the significant relaxation of regulations on foreign currency procurement.

2-1-3-4 Trends in Chinese Foreign Reserves



Source: CEIC Database

(C) Chinese companies outward investment supported by China's monetary relaxation policy

One of the factors to promote the international expansion of Chinese companies is China's monetary relaxation policy. The credit easing measures were intended to extend loans to mainly small-to-medium exporting companies. However, the measures also have made the financing environment for large national companies relatively relaxed and this environment is supporting their vigorous outward investment. Furthermore, the amount of new loans in China exceeded 9.5 yuan in 2009 which is much higher than the government's annual target of 5 trillion yuan (see Figure 2-1-3-5). Some people view that capital was reinvested in real estate properties and stocks instead of underperformed exporting companies and generated asset bubble[6].

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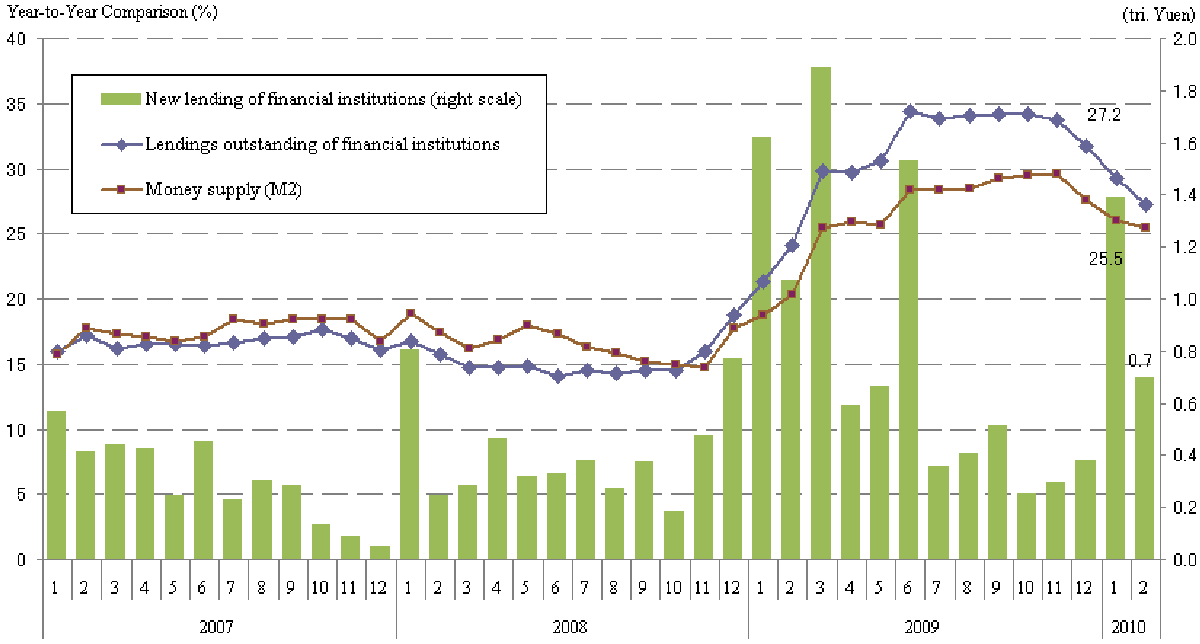
6 Mika Takehara (2009) "BICHIKUTO SHISANBAISHUNIYORU SHIGEN (GENBUTSU) KAKUHOO KASOKUSURU CHUGOKU" (Japan Oil, gas and Metals national Corporation website)

2-1-3-5 Trends in Financial Institution Lending and Money Supply in China



Source: CEIC Database

(C) China's outward investment "Going Out" policy that accelerates investments

The expansion of China's outward direct investment is supported by the surge of demand for energy resources and raw materials to meet the economy expansion. Since China's domestic supply is insufficient to satisfy the demand, the supply shortage is becoming severe. Therefore, the Chinese government has been promoting companies' participation, investment and companies acquisition related to overseas resource development trying to secure resources.

Furthermore, to nurture multinational companies with international competitiveness, China is conducting outward direct investment such as M&A aiming to acquire technologies to fill the technological gap with developed countries. There is technical disparity between China and developed countries and China is short of technical staff.

Moreover, there are other factors that contributed for the expansion of China's outward direct investment such as the dissolution of excessive production capacity and the globalization of domestic market. In addition, to solve these issues, the Chinese government established "Going Out" policy to promote the overseas expansion. China's outward investment policy, "Going Out" was proposed in the 10th Five-Year Plan (2001 to 2005) for the first time and inherited in the 11th Five-Year Plan (2006 to 2010). The third plenary session of the 11th National People's Congress held on March 5, 2010 posted the execution of "Going Out" strategy as a part of 2010 policy guideline and emphasized the followings: (i) Promotion of production transfer to overseas, (ii) Support of mergers and acquisitions and encouragement of the mutual cooperation for resource use in foreign markets, and (iii) Obtaining orders for overseas construction projects and improvement of quality of overseas Chinese labor. The Chinese government has made announcement for series of measures to support the expansion of outward direct investment such as the preferential treatment of tax and loan, the simplification of various assessment and approval procedure, the facilitation of legal system, and the relaxation of regulations on the use of foreign currencies.

(a) Support through taxation system

The Chinese government applies higher export drawback rate and provides export tariff exemption to the companies that are engaged in outward direct investment; establishing a factory, processing and assembling Chinese raw materials and parts overseas and increasing Chinese exports.

(b) Financial support

The support mostly includes loans and credit guarantee. For example, the government provides prime rate loans to businesses that export raw material and parts from China to process and assemble them overseas and full exemption of interest rates of loans to some resource development projects.

(c) Authorization procedure

Authorization procedure was simplified and the number of application documents was reduced. After the submission of the application of outward investment project, the company certificate for outward direct invest is supposed to be issued within three business days if there is no special issues.

(d) Foreign currency procurement

China's State Administration of Foreign Exchange made an announcement on the foreign currency control for the loans extended by Chinese companies to overseas borrowers on June 2009. It relaxed the regulations on the loans to overseas subsidiaries that had been permitted only to multinational companies. Moreover, in July 2009, it released the foreign exchange control regulations for outward direct investment to promoted deregulation. For example, the sources of capital that companies are allowed to use for outward direct investment was expanded from only own capital to foreign currency denominated-loans, foreign currencies exchanged with yuan and profit gained from outward direct investment. Moreover, the requirement for foreign exchange control method for outward direct investment was changed from advance assessment to ex post facto registration. Besides the above, China's overseas expansion "Going Out" policy has been promoted through various measures such as each local government's own support programs.

(2) China's effort to secure resources

The Chinese government consider that the stable energy supply is crucial to realize sustainable economic growth and has been particularly promoting outward direct investment by resource-related companies.

Immediately after the global financial crisis, while resource countries were having trouble in financing due to their deteriorated balance sheet affected by the declined resource prices, the Chinese government had summit meetings with Venezuela, Russia and Brazil in February 2009 and made agreements on "Loan For Oil". The basic scheme is that policy banks including China Development Bank and The Export-Import Bank of China provide loans to oil producing countries while China's state-owned oil company and state-owned oil companies of the partner countries seals a long-term oil sales contract. The reimbursement of loans will be offset with the payment to the crude oil exports to China. Later, China has concluded similar contracts with Kazakhstan and Turkmenistan and the total contract amount reached $45.5 billion.

China is the world largest foreign currency holder and also owns the largest amount of U.S. national bonds in the world. While there is mounting concern for the devaluation of U.S. bonds and the depreciation of U.S. dollar, some view that China's series of Loan For Oil (Gas) arrangements sealed with resource countries (see Table 2-1-3-6) were a part of China's effort to diversify their financial asset management[7].

Meanwhile, China's oil imports have been rapidly expanding since it turned into an oil net importer in 1993. In 2009, its oil imports exceeded domestic production (see Figure 2-1-3-7). Moreover, the oil import ratio is forecasted to grow from current some 50% to some 80% by 2030[8]. In addition, China is one of the largest iron ore producers. Although the production volume of iron ore is high, the iron content is low. Therefore, the production does not satisfy its demand and China is also dependent on imports (see Figure 2-1-3-8).

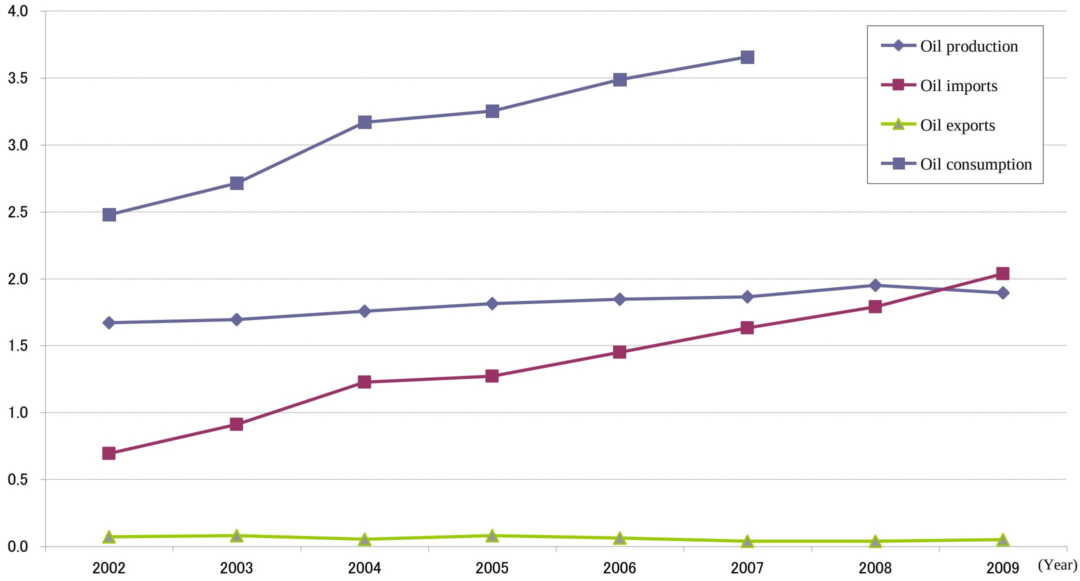
2-1-3-6 Major Loans for Oil (Gas) from China Following Financial Crisis

Oil Producer	Time of Agreement	Financing Bank	Financing contract / Borrower / Loan	Long-term supply deal	Note
Venezuela	Feb-09	China Development Bank	The amount of contribution for Joint Investment Fund of China and Venezuela has been increased from 4 billion to 8 billion dollars.	Crude oil purchase agreement Venezuela：PDVSA China：CNPC Quantity：80,000 to 200,000 b/d	Joint project of heavy-oil development with CNPC and PDVSA / Agreement on reserve estimation of 5 mature oilfields
Russia	Feb-09	China Development Bank	Rosnest：15 billion dollars Transneft：10 billion dollars Total of financing：25 billion dollars	Crude oil purchase agreement Russia：Rosneft China：CNPC （For 30 years from Y2011：300,000 b/d）	CNPC made an agreement with Transineft on construction and operations of a branch channel of the pacific crude pipeline to China
Brazil	Feb-09	China Development Bank	Petrobras：10 billion dollars Brazilian National Economic and Social Development Bank（BNDES）：800 million dollars Total of financing：10.8 billion dollars	Crude oil purchase agreement Brazil：Petrobras China：Sinopec （Y2009 ：150,000 b/d, For 19 years from Y2010：200,000 b/d）	Sinopec is negotiating with Petrobras on rights for the interests of 2 drilling districts offshore of Brazil.
Kazakhstan	Apr-09	The Export-Import Bank of China	Financing：1.7 billion dollars	Joint asset purchase Kazakhstan：Kazmunaigaz China：CNPC (CNPC has obtained 49% of ownership of Mangistaumunaigas for 3.3 billion dollars.)	-
Turkmenistan	Jun-09	China Development Bank	Financing：4 billion dollars	Natural gas purchase agreement Turkmenistan：Turkmengas China：CNPC (For 30 years from Y2010：max.40 billion m3/year）	-
Ecuador	Jul-09	China Development Bank	Financing：1 billion dollars	Crude oil purchase agreement (100,000 b/d for 2 years）	-

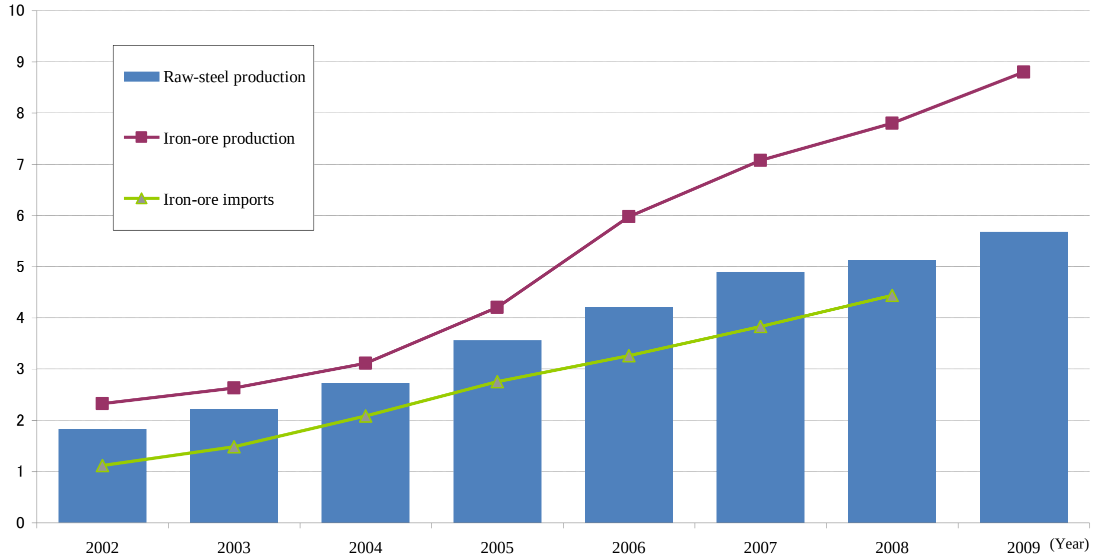
Mika Takehara (2009) "Doru kara shigen e, kin-yu kikigono chuugokuni okeru sekiyu sigen kakuhono ugoki (From Dollar to Resources – China's Trend to Secure Petroleum Resources after the Financial Crisis)"

[7] It was reported that China had increased its holding ratio of short-term U.S. Treasury Bills (of which maturity is less than a year) from 3% of the end of August 2008 to 26% in the end of May 2009.

[8] IEA (2009) "World Energy Outlook 2009"



Source: CEIC Database



Source: CEIC Database

By obtaining recourses, China is also willing to increase the reserve of crude oil and mineral resources. In 2001, China announced to build “National Petroleum Reserve” in the 10th Five-Year Plan (2001 to 2005) approved by National People’s Congress. Since then, the government has been promoting the construction of the reserve in three phases. The first phase national petroleum reserve of [9]4 bases (total reserve capacity: 16.40 million kL, about 103.00 million barrel) was currently completed. In June 2009, there was an announcement on the second phase national petroleum reserve plan to construct 8 bases (total reserve capacity: 26.80 million kL, about 168 million barrel) with 30.0 billion yuan (about $4.4 billion) by 2015.

[9]The plan is to establish a reserve of 70.00 million kL (440.00 million barrel) by 2020. (Mika Takehara “BICHIKUTO SHISANBAISHUNIYORU SHIGEN (GENBUTSU) KAKUHOO KASOKUSURU CHUGOKU”)

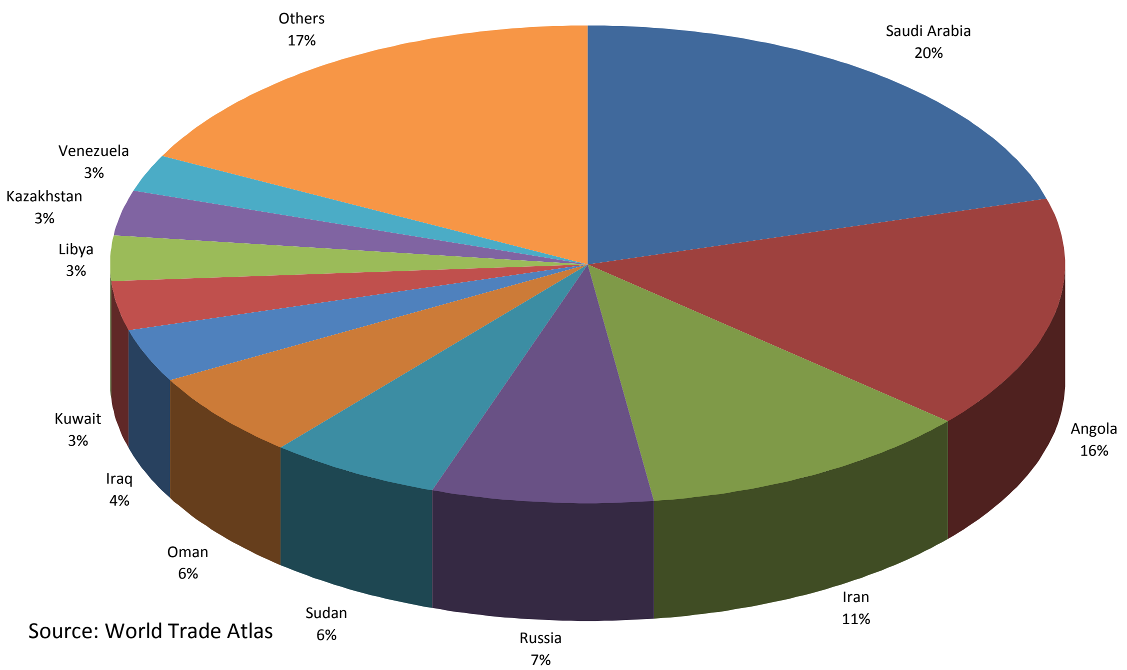
Moreover, as for mineral resources, Ministry of Land and Resources of the People's Republic of China announced a national mineral resources plan (2008 to 2015) in January 2009 and revealed its policy to promote the strategic reserve of copper, chrome, manganese, tungsten and rare-earth metal.

Furthermore, China's crude oil imports in 2008 was some 3.60 million barrel per day (some 500,000 ton per day) (see Figure 2-1-3-9) and about 80% is imported through the Strait of Malacca. Considering the safety of travel of Very Large Crude Oil Carrier (VLCC) with deep draft, the Chinese government is proceeding with the petroleum procurement diversify project that uses land transportation (pipelines and railroads) through Russia and Kazakhstan for the stable energy supply.

(3) Chinese companies' global strategies that promote the acquisition of overseas technologies and brands

One of characteristics of China's outward direct investment in developed countries is China's purpose of the investment which targets to obtain technologies and management know-how, brand, sales networks. Since 2000, Chinese makers have been increasing M&A against large companies in developed countries to acquire technologies and brands (see Table 2-1-3-10). In 2004, China gained attention of the world accomplishing series of large-scale acquisitions such as the acquisition of IBM's personal computer business by a personal computer maker, Renovo, and the procurement of French company's TV and mobile phone business by an electronic appliances maker, TLC. However, it is not easy to adopt locally enforced worker's protection practices, laws and regulations. There is a case that underperformance of overseas business adversary affected the business of group as a whole. With another case, a Chinese maker could not obtain a certificate from the government of the country that the maker has advanced. Under these circumstances, some Chinese makers were force to review some overseas expansion plans

2-1-3-9 Countries Producing Chinese Oil (Weight Base, 2008)



Source: World Trade Atlas

After the global financial crisis, Chinese companies regained its momentum to acquire foreign companies due to declined prices of overseas investment target asses. Especially the move of automobile industry is outstanding; Geely Automobile purchased an automobile part maker in Australia and then signed an agreement with Ford Motor Company for its purchase of Volvo of Sweden.

(4) Launch of Chinese government fund

(A) Establishment of China Investment Corporation (CIC)

China's world largest foreign exchange reserve was mainly invested in the U.S. national bonds assuming their safety and liquidity by State Administration of Foreign Exchange. Due to the increasing foreign exchange risk and other factors, to diversity the investment targets, China Investment Corporation (CIC) was established as China's Sovereign Wealth Fund (SWF) with $200.0 billion of capital in September 2007 (see Table 2-1-3-11). CIC also aims to support companies' outward investment.

2-1-3-10 Recent Chinese Investments

Year	Outline
2004	TLC established a joint venture, TCL & THOMSON ELECTRONICS, with Thomson (France), integrating TV / DVD manufacturing sectors of both sides. The capital of the new company is 430 million euro, and TCL has 67% of the ownership.
	TCL set up a joint venture of cell phone project with Alcatel, a leading telecommunication company in France, in October 2004. The capital of the new venture is 100 million euro, and TCL obtained 55% of its ownership. The venture has been dissolved in May 2005.
	Shanghai Automotive Industry Corporation obtained 48.92% of the ownership of SsangYong Motor Company, a car maker in South Korea, for 5.74 million dollars. However, SsangYong Motor Company was failed in 2009.
	Lenovo announced the acquisition of PC sector of IBM. Lenovo paid 1.25 billion dollars in cash and stocks, and paid estimated approx. 500 million dollars for taking over the sector. The total amount of its investment was approx. 1.75 billion dollars.
2005	Nanjing Automobile Corporation bought MG Rover in UK for estimated 50 million pounds.
	Haier tried acquiring Maytag Corporation, a home appliance maker in US, but failed because of high price offered by Maytag. Eventually, Whirlpool Corporation acquired it for 2.7 billion dollars.
2008	Huawei Technologies tried to acquire 3Com, a telecommunication equipment manufacturer in US, jointly with Bain Capital Partners, an investment company in US. However, it failed because the US government refused to give permission.
	Zhuzhou CSR Times Electric Co.,Ltd, a manufacturer of electric parts for railroad-vehicles, acquired 75% of ownership of Dynex Power Inc., a semiconductor maker in Canada, for 16.72 million Canadian dollars.
2009	Beijing West Industry that is capitalized by Shougang Group and Tempo Group etc. acquired brake and suspension sector of Delphi, a leading automotive parts manufacturer in US.
	Haier Group invested approx. 50 million dollars to Fisher & Paykel, a major appliance manufacturing company in New Zealand, and acquired 20% of its ownership.
	Geely Automobile acquired DSI, an automotive parts maker in Australia, for 70 million Australian dollars.
	Sichuan Tengzhong Heavy Industrial Machinery Company Ltd made a tentative agreement with GM in US on acquisition of its "Hummer" section.

Source: Bank of Tokyo-Mitsubishi UFJ, Economic Research Office "Keizai review No2009-20 (Economic Review No2009-20)"

The targets of CIC are "Separation of politics and business activities (Separation of the government and the company)", "Self-management" and "Commercially driven". It is a limited liability company established based on the Corporation Law, however, all board members are government officials.

Investment strategies of CIC are: (i) Portfolio investment in capital market, (ii) Strategic investment such as overseas energy and raw materials, and (iii) Support to Chinese companies' overseas M&A strategies. However, investment policy has not been clarified. Other countries, mainly developed countries, speculate and express their alarm that it could be the implementation of government strategy.

Although it was made in May 2007 prior to the establishment of CIC, the investment in the largest private equity fund in the U.S. , the Blackstone Group LP, was $3.0 billion (investment stake: 10%) with the conditions of no voting right and 4 years of lock up period. It was a pure financial investment that expects the growth of Blackstone and there was no resistance in the U.S. However, due to the large evaluation loss caused by the drop of share price of Blackstone, the criticism in China is growing. Lately, China's outward direct investment which had been focusing the securement of resources is diversifying into various areas including finance such as the participation of purchase of bad-loans owned by American financial organizations.

(B) China's SWF that the world expresses its alarm

SWF of the Middle East and Singapore made a large-scale investment to purchase the stocks of Merrill Lynch & Co., Inc and SWF started gaining attention of the world around 2007 (see Table 2-1-3-12). Compared to Kuwait Investment authority, the world-oldest SWF with 55 years of history in Kuwait, China's CIC is quite new. The assets under management (capital) of China's CIC are $200.0 billion and it is less than one thirds of the size of Abu Dhabi Investment Authority of $625.0 billion. An advisory body for the U.S. Congress, "The United States - China Economic and Security Review Commission" showed its concern over China's dictatorial single-party political system run by Communist Party of China. It also mentioned about the slow progress on CIC's management system facilitation and pointed out that CIC's investment policy and investment behavior cannot be verified. The comission held "Hearing on the Implications of Sovereign Wealth Fund Investments for National Security" focusing on China's SWF in February 2008.

2-1-3-11 China SWF Investments

Time of Investment	Investment Destination	Investment Field	Amount of Investment
22-May-07	Blackstone	PE Fund	3 billion US dollars
28-Nov-07	China Railway	Railways	100 million US dollars
19-Mar-07	Visa	Finance	200 million US dollars
16-Oct-08	Blackstone	PE Fund	250 million US dollars
—	Tesco	Retail	—
16-Jun-09	Goodman	REIT	200 million Australian dollars
3-Jul-09	Teck Resources	Resource	1.5 billion US dollars
17-Jul-09	BBMG	Real Estate	25 million US dollars
17-Jul-09	CITIC Capital	PE Fund	2 billion Hong Kong dollars
22-Jul-09	Diageo	Alcoholic Beverage	221 million punds
22-Sep-09	Noble	Trading Company	850 million US dollars
23-Sep-09	Bumi	Resource	2.75 billion US dollars

Source: Materials by Daiwa Institute of Research / News reports

(C) SWF with massive capital and fear for management intervention by the government

According to IMF[10], following the size of world foreign exchange reserve of $5.6 trillion, the total size of SWF of $1.9 trillion to $2.9 trillion already exceeded the size of hedge funds of $1 to $1.5 trillion. It is expected to accumulate $800.0 to $900.0 billion of foreign currency assets per year mainly in emerging countries. Partially due to the global imbalance, SWC was born taking advantage of wealth/foreign currencies accumulated in resource countries, mainly oil producing countries, and

[10] By "Global Financial Stability Report, Oct.2007"

emerging Asian countries. It has a function to reflux the wealth to the world, however, it also holds some latent problems.

One is uncertainty about SWF's investment management. Besides some exemptions, the information on SWF's investment size and details is not disclosed at all. There is concern that the speculation over SWF's investment would amplify the fluctuation of prices. Moreover, there is fear that SWF which is a government organization would have significant influence over the management of companies through its investment. Some pointed out the possibilities that SWF may execute its power to influence the investment target to provide favorable treatment to a company of the country and it may threaten the security of country which accepted the investment. In light of the above, IMF[11] recommends SWF to set up its own code of conduct and improve the transparency of the investment.

2-1-3-12 Major Global SWF

Country	Name	100 million of dollars	fiscal resource
Abu Dhabi	Abu Dhabi Investment Authority	8,750	Crude oil
Norway	The National Insurance Scheme Fund	3,580	Crude oil
Saudi Arabia	Saudi Arabian Monetary Agency	3,200	Crude oil
Kuwait	Kuwait Investment Authority	2,500	Crude oil
China	China Investment Corp.	2,000	Foreign currency reserves
Russia	Reserve Fund	1,200	Crude oil
Hong Kong	Hong Kong Monetary Authority Investment Portfolio	1,100	Foreign currency reserves
Singapore	Temasek Holdings	1,080	Financial surplus
Singapore	Government of Singapore Investment Corporation	1,000	Foreign currency reserves
Qatar	Qatar Investment Authority	700	Natural gas

Source: Nikkei Business Publications, Inc (2008) "Seihukei fando nyumon (Introduction of Sovereign Wealth Fun

[11] In October 11, 2008, International Monetary and Financial Committee (IMFC) of International Monetary Fund (IMF) approved "Generally Accepted Principles and Practices (GAPP) - Santiago Principles", codes of conduct which was presented by International Working Group of Sovereign Wealth Funds (IWG).