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# China Market Trends

# Foreign Investment in China: Some Upcoming Challenges

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This is the fourth in a series of articles for the Canada China Business Forum on regional aspects of China's development, based on Chreod's ongoing work since 1988 in providing research and advisory services to public- and private-sector investors active in China.

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## Recent Trends

China was the largest recipient of private direct foreign investment (DFI) in the world in 1993. Contracted foreign investment soared to US\$110 billion while actual DFI rose to US\$26 billion (please see Figure 1). In addition, in 1993, China was the largest recipient of World Bank funding, totalling US\$3.17 billion (FY92/93), more than

2.5 times the amount received in 1991 (US\$1.173 billion).

Despite the slowdown this year in contracted DFI, down 44% year-on-year in the first five months of 1994 to US\$32 billion, there is still considerable interest in foreign investment into China from many parts of the world.

For example:

- while DFI in the first five months was down 33% year-on-year in Guangdong Prov-

ince, Western investment was up nearly 50%

- since the regularization of diplomatic relations two years ago, China has become the second-largest target of South Korean DFI after Indonesia
- although Japan is now only the fourth-largest foreign investor in China (after Hong Kong, Taiwan, and the U.S.), the Nomura Research Institute predicts that a major surge in Japanese investment is about to occur

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## Source and Targets of Recent DFI

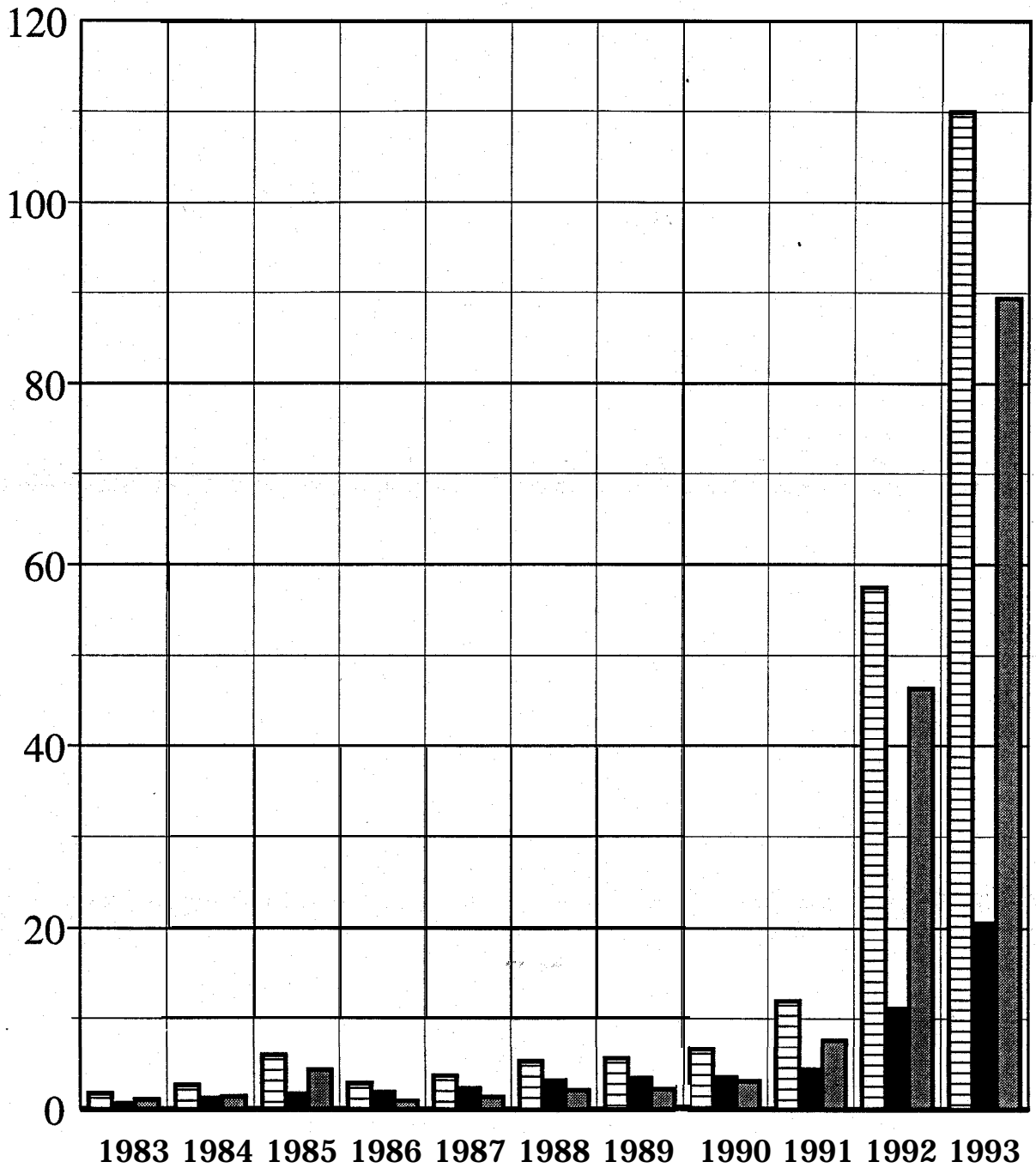
Where is DFI going? Where is it coming from? Answering these questions is difficult, for the following reasons:




1. Many "foreign" investments are in fact made by Chinese enterprises with corporate shells in Hong Kong.

The World Bank estimates that as much as 20% of DFI in China may in fact be from these "fake foreign-devil" firms that are seeking tax concessions and other forms of preferential treatment accorded to foreign investors; these investments are very rarely, if ever, announced, and local governments obviously have no desire to advertise them if they are aware of the origin of such investments.

2. One of the reasons that there is such a large spread between "contracted" and "actual" DFI in China is that many government agencies and SOEs interpret "contracted" investment very loosely to include "letters of intent" that are

Figure 1  
DFI to China (US\$billion)



 contracted     
  actual     
  balance

Source: China State Statistical Bureau 1992,  
EIU 31 May 94

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not at all binding, yet show foreign interest in a particular market.

3. Although diminishing as a result of the recent clamp-down on speculation, there is a "grey" market in virtually every sector of which we are aware in China; this "grey" market relies to a large extent on "connections," and is completely outside of legal or taxation frameworks. Deals are concocted that provide for rapid ROIs through informal channels; if eventually identified by authorities, investors hope that they will have pulled out their original investments and returns long before. There are many such deals in China, none of which are announced and all of which are very difficult to identify.

Of greater interest than these generally small-scale, speculative investments are those announced openly by major foreign firms, especially those that are publicly listed and therefore accountable to host-country shareholders for their actions. These kinds of DFI generally involve large sums, and indicate a serious attempt to establish in China in order to become competitive re-exporters and/or providers to the domestic market. This higher-quality DFI is also of greatest interest to government authorities as they seek to promote China as a viable destination for serious investment.

We recently undertook an internal study to identify what kinds of credible information might be available on

growing DFI and foreign competition in China. The study was conducted through desktop research for the period from 1 October 1993 to 26 July 1994, i.e., the end of the DFI boom of 1993 and the first half of 1994 during which DFI value has declined in China.

An exhaustive check was conducted of 13 international sources of information on foreign investment and long-term debt-financing plans, including international news wires, generally reputable journals, and the World Bank and Asian Development Bank (a major gap, readily apparent in the figures, is the virtual absence of publicly announced investments during this period from Taiwan and Hong Kong, the major sources of DFI over the past decade; we assume that a wider data search to include local sources would identify a number of additional investments from these key locations).

Two hundred announcements of major actual or proposed DFIs were identified. Many of these announcements came from large, publicly traded companies (such as General Motors, Ciba Geigy, BASF, Hutchison Whampoa, Matsushita, and Northern Telecom).

As shown in Figure 2, most announced DFIs (17.8%) had no specific target province yet identified (a lot of these were announcements of intentions to invest, largely by American firms).

The greatest percentage of DFIs with announced locations is in Shanghai (14.4%), followed by Guangdong (13.3%) and Beijing (9.4%). Jiangsu Province had 7.2%

while Sichuan, Shandong, and Tianjin had from 4 to 6%. This shows the growing shift in DFI away from South China, particularly into the Yangtze Delta Region.

The majority of announced DFIs were from Europe (27.2%, led by Germany and France), followed by the U.S. (25%) and Japan (17.8%). Multilaterals, Canada, and Hong Kong each accounted for around 7% of announced DFIs, followed by Korea and Switzerland (please see Figure 3).

China's DFI base is clearly broadening beyond its historic base of Hong Kong and Taiwan.

The range in quality of DFI from countries of origin is instructive. Only 31% of announced DFIs from Canada were either joint ventures, direct foreign ownerships, or expansions of existing investments (i.e., the rest were either announcements of intentions to invest or Letters of Intent) compared to 71% for France, 41% for Germany, 74% for Japan, 63% for Korea, and 53% for the U.S.

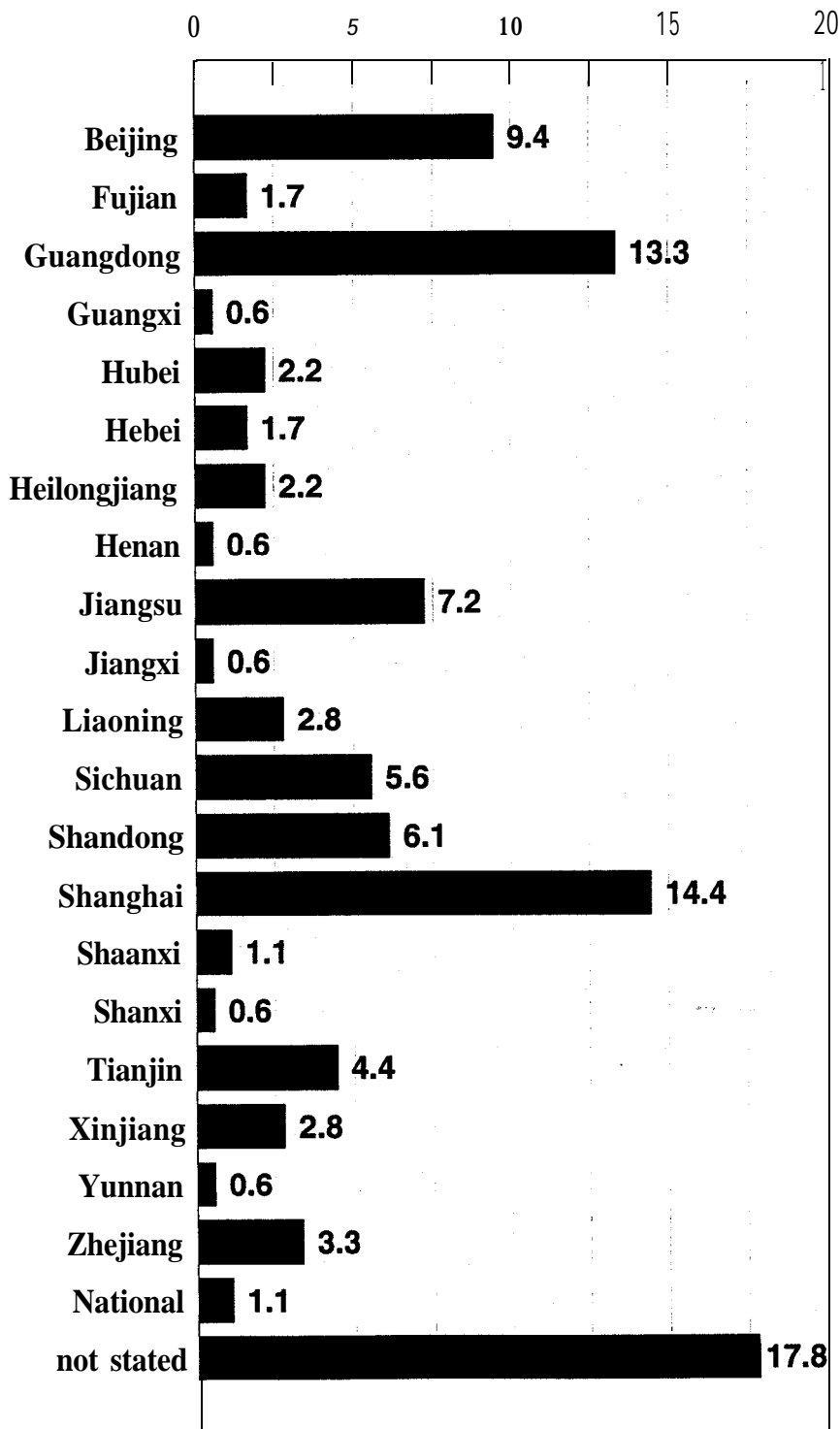
Figure 4 shows these announced DFIs by sector of investment.

The largest DFI concentrations are in food and beverage products (indicating that serious foreign investors are increasingly locating in China to serve growing domestic demand), followed by communications equipment (again, mostly for domestic consumption), automobile and transport products, and household goods.

A relatively significant number of investments was announced in sectors only recently opened to foreign investment: build-operate-

Figure 2

## Provincial Targets of Sampled DFI (%)



source: Chreod Ltd.

transfer (BOT) transport, oil and gas exploration, power BOTs, and financial services. There were also notable investments in telecommunications systems, largely fibre-optics networks.

### Major Issues Affecting DFI

Competitive North American firms seeking to invest in China – or to provide services to foreign investors – need to be aware of the following major issues that will affect DFI in the next couple of years:

1. Continuing DFI – although likely more cyclical – by new and existing investors into China (the rate of DFI is expected to increase once China joins GATT/WTO, perhaps as soon as the end of this year).
2. The need to better understand locational implications of investment decisions as the comparative advantages of the relatively few Special Economic Zones and preferential trade areas – the historic locations for DFI since the commencement of market reforms – are quickly eroded by the central government's recent shift to foster foreign investment throughout much of the country.
3. The opening-up of new sectors to DFI that have major regional implications, such as BOT projects in the transport, infrastructure, power, and domestic housing sectors.
4. The need to understand the rapid qualitative and quantitative shifts among regional

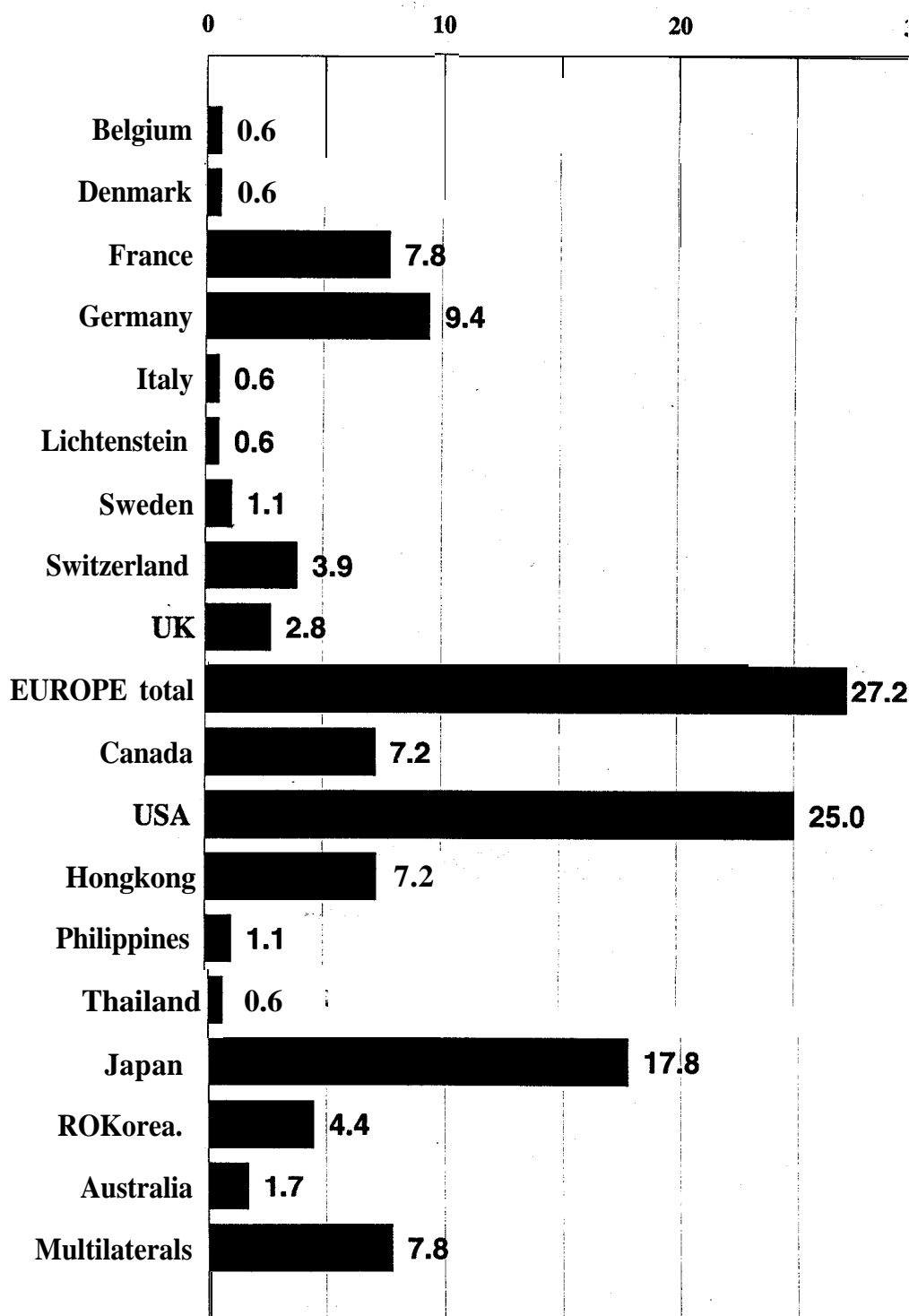
markets, including market saturation levels that are possibly being approached in certain areas in some sectors (e.g., high-end retail in Shanghai).

5. In spite of market reforms, the continuing importance of centrally generated Five Year Plans (FYPs) in guiding the type and location of investment in many key sectors open (or about to be opened) to DFI.

6. The huge demand for project financing in China. There has been a dramatic decrease in the percentage of actual to contracted DFI in China since 1986 from 66% to last year's 19%. This leaves an accumulated backlog in actual investment of almost US\$160 billion to meet obligations contracted since 1983. Even though much of this gap will likely never be filled, if only half is to be actually invested, requirements will largely need to be met through project financing from international capital markets that are becoming very demanding in their assessments of China project risk.

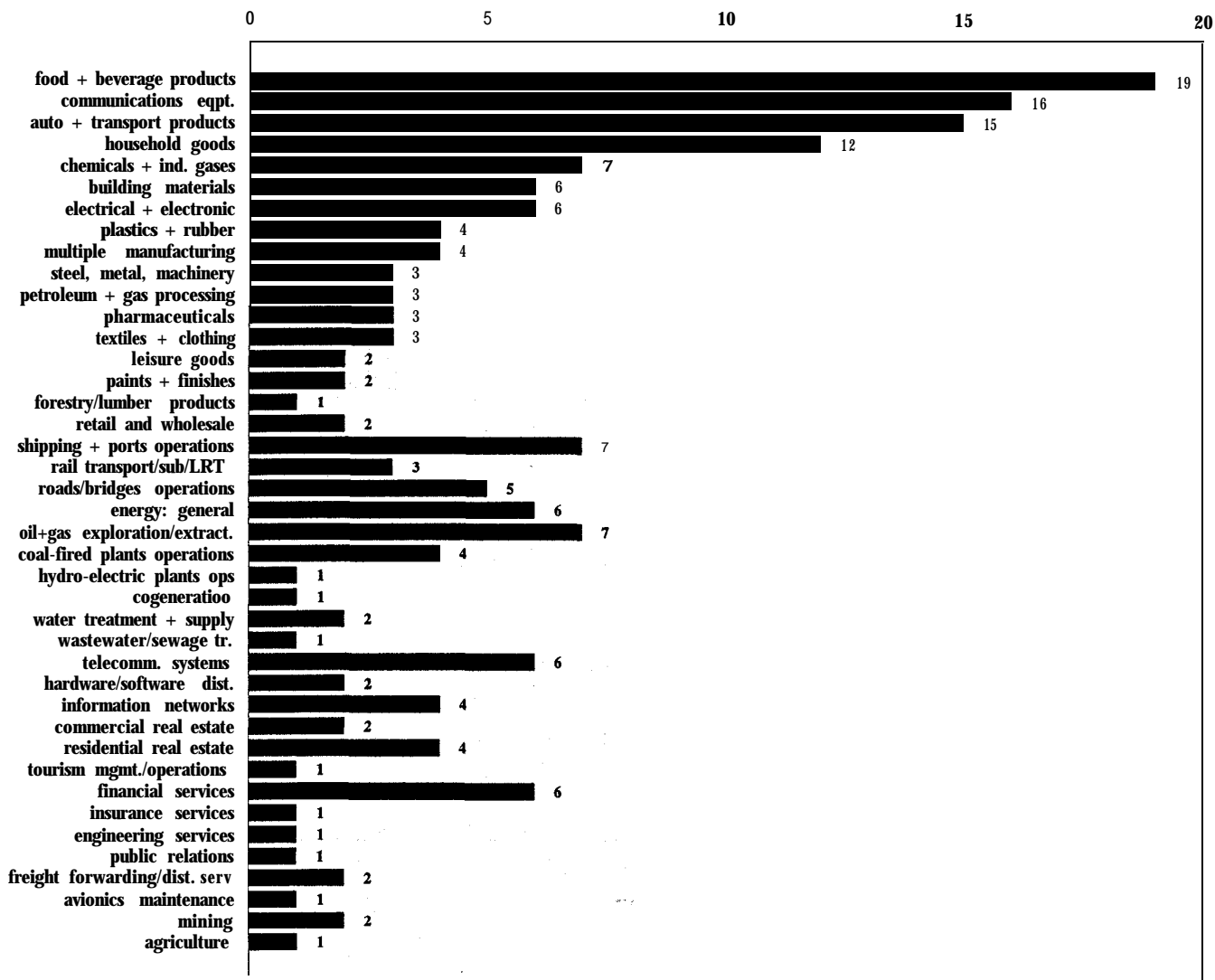
Figure 3

### Country of Origin of Sampled DFI (% of projects)



source: Chreod Ltd.

Figure 4  
Sectoral Targets of Sampled DFI  
(# of projects)



SOURCE: Chreod Ltd.

Despite the significant dismantling of the command economy in China since the start of reforms, the role of FYPs is still strong. It is still exceedingly difficult to introduce, for example, a new capital project into provincial or municipal development plans if it is not included in

the current or pending FYP. Government financing and credit allocation, particularly for capital projects, continues to be based largely on the FYPs; in periods of tight credit, it is very difficult to induce governments or state-owned enterprises to seek approvals for increasing

limited discretionary spending to co-finance "unplanned" initiatives, however profitable.

The scope of FYPs remains pervasive: despite market reforms, the culture of "target-oriented thinking within government (especially at middle levels where cadres have been schooled for dec-

ades in Soviet-styled central planning, and where the immediate benefits of market reform may be less obvious) will take a long time to change. What this means for foreign investors is that development initiatives are programmed both sectorally and spatially to a relatively fine degree of detail, often well in advance.

To the outside investor, this situation could appear to be quite advantageous in that "shopping lists" for investment ostensibly exist. However, there are two major difficulties with FYPs for most foreign investors:

1. Although overall directions (and some specific targets) are now well publicized, it is still quite difficult for foreigners to obtain complete or even partial copies of the FYPs.
2. There is often fierce competition both sectorally and cross-sectorally for individual projects that occasionally have little commercial merit, but are politically desirable for a number of reasons. It is not uncommon to have government agencies promoting these select projects without foreign investors being aware of other approved projects that may be more commercially attractive: the same applies, to varying degrees, to initiatives for which bilateral or multilateral funding is being sought.

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### The Need for Smarter Money

One of the most difficult problems facing foreign investors who have committed, or

are about to commit, to the Chinese market is securing sufficient low-cost project financing. This is quickly becoming a major issue for many firms, particularly given the severe contraction in domestic credit available to both local and foreign borrowers, recent constraints on domestic lending to foreign firms (especially in the industrial and real estate sectors) and a growing concern among government authorities over the perceived overvaluation of foreign technology inputs into equity joint ventures.

While emerging market project financing worldwide was almost negligible in the late 1980s (most was done by equity investment occasionally guaranteed by export credit agencies, and through multilateral and bilateral debt and grant packages). last year, an estimated US\$120 billion in non- or limited-recourse project loans was issued by commercial banks, mostly through syndications. Given recent trends, it is very likely that most large project financing in China, with the possible exceptions of large equity investments from some cash-rich Asian- investors, will be conducted through a mix of routes including multilateral and export credit agency participation in seed co-financing of projects and risk guarantees, followed by commercial lending for bridge financing. This combination could provide a sufficient basis for proponents to seek investment-grade ratings for subsequent private and/or public placements of project equity and debt, especially if guaranteed by government-sponsored ITICs. Project

financing in China will invariably become much more complex, involving a wider range of players with often different and changing risk assessment criteria. Given the rapid state of flux in project risk in many parts of China — and the growing competition in Asia for capital — due diligence preparation will need to become much more stringent.

The slackened pace of direct, and portfolio investment this year from abroad suggests that the country has reached a new plateau: it is no longer the "flavour of the month" for speculative and short-term gain — or for politically 'appropriate' yet unfocused foreign aid — and it is unlikely to become so again. The market reforms introduced in the past decade have already started to have their greatest incremental impacts in most regions and sectors within China. Despite occasional bumps along the road, governments' control of macro-economic tools to mitigate some of the less favourable impacts has improved dramatically in the past five years.

Most of China's major regions are now entering a period of market consolidation in which both domestic and foreign capital and technology will need to be matched with greater precision to regional development priorities, many of which represent significant business opportunities. This means that future public and private foreign investment, either in equity or debt, must become much "smarter money" than in the recent past. ■