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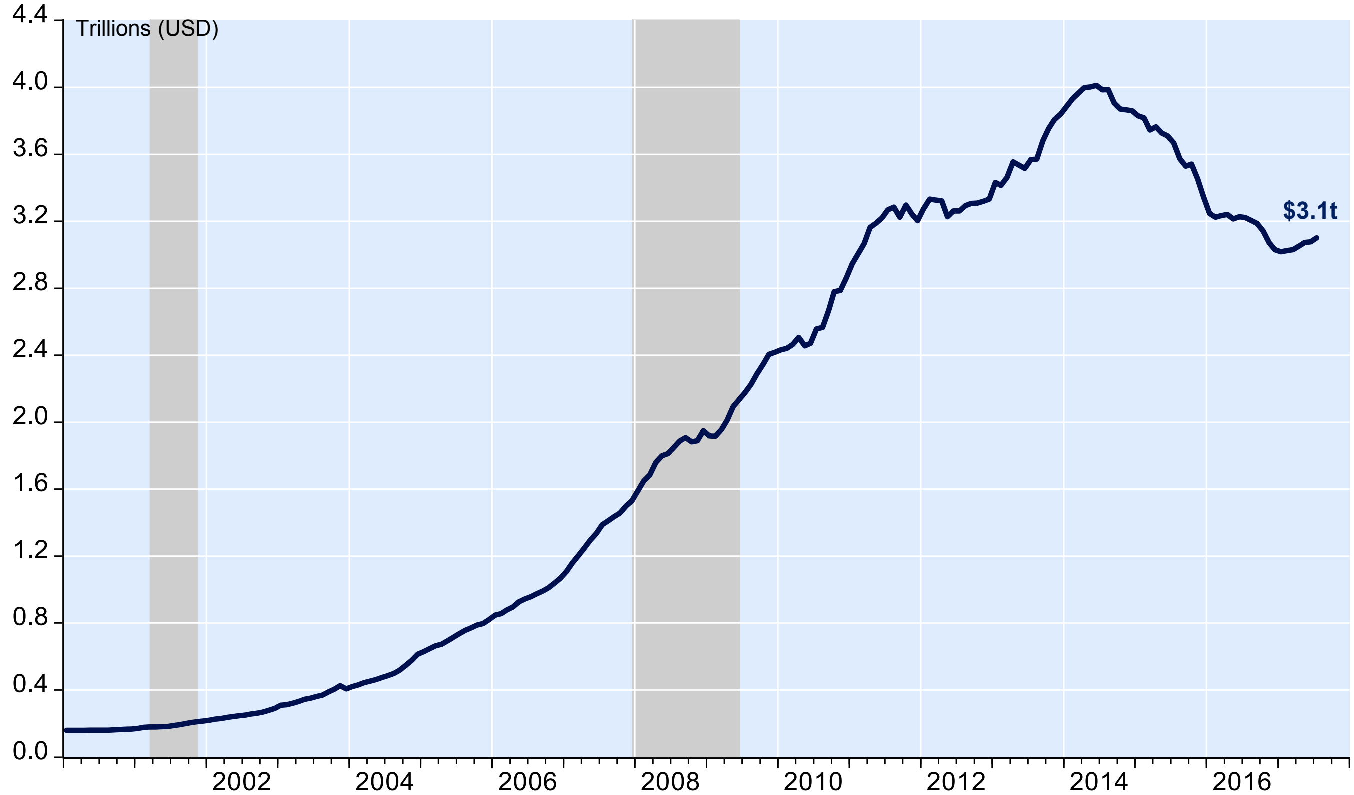
The story behind China's crackdown on outbound investments

Introduction

China considers its foreign exchange reserves to be a vital shield against potential economic headwinds. This is why, when the reserves fell to just under $3 trillion last January from a peak of $4 trillion in June 2014, alarm bells went off throughout the government.

China: Perspective on foreign exchange reserves

Total reserves excluding gold



NBF Economics and Strategy (data via FRED)

This led to the introduction of much stricter controls on money leaving the country and increased regulatory scrutiny of all proposed major offshore investments. The government reportedly suspected that some privately owned corporations were deliberately overpaying for international assets as a way of moving funds out of China. Of particular concern was what the government considered to be speculative investments in the real estate, sports and entertainment sectors.

The new measures have, for the time being, reversed the decades-long decline of state-owned enterprises in the Chinese economy and stopped the decrease of its foreign exchange reserves.

The Chinese government officially classifies investments: good, bad or ugly

- **Banned:** core military technology, gambling, sex industry, investments contrary to national security
- **Restricted:** property, hotels, film production, entertainment, sports, obsolete equipment, investments that contravene environmental standards
- **Encouraged:** investments that further the Belt and Road framework, enhance China's technical standards, research and development, oil and mining exploration, agriculture and fishing.[1] Or otherwise stated, any investment that advances China's geopolitical and economic strength.
- China's preferred investment strategy is geared to two objectives: 1) Investing in ports, railways, power plants and other infrastructure that expands its geopolitical influence and provides an outlet for spare industrial capacity; and 2) Investing in areas such as pharmaceuticals, robotics, computer chips and electric cars which allows it to make a play for market dominance in crucial value-added sectors.

Tighter capital controls have also been imposed on individuals

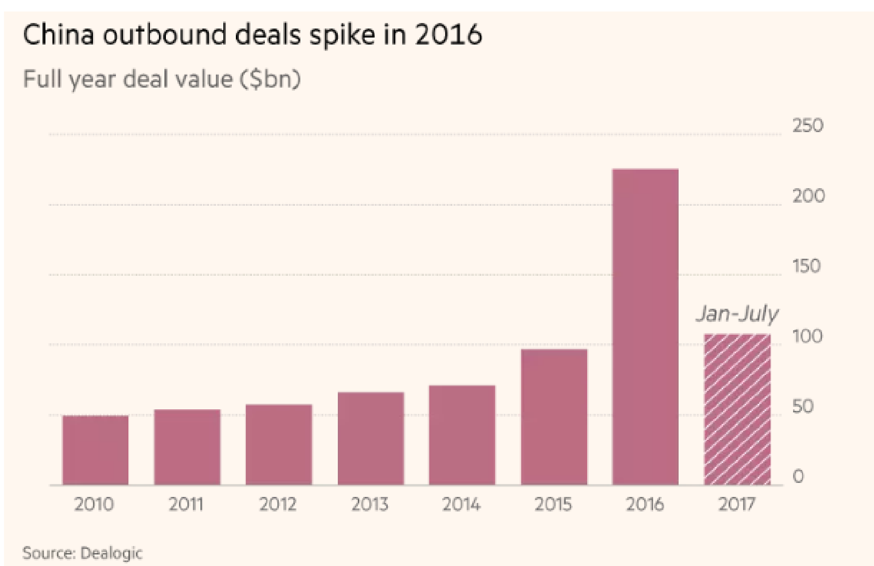
Rules stipulating that Chinese citizens could convert no more than the equivalent of US$50,000 annually in foreign currency and that these funds could not be used to purchase real estate abroad have traditionally not been rigorously enforced. This may be changing.

The government imposed new requirements in early 2017. Before, converting yuan to foreign currency could be done electronically. Now, Chinese banks demand official documentation stating the reasons for the exchange.[2] The tighter restrictions include requiring people to sign a pledge that their foreign currency quotas will not be used to purchase property offshore.[3]

The government recently also issued an official ban against buyers of foreign currency sharing their quotas with others. Technically speaking, this was already illegal. However, it had long been a common practice.[4] While the very rich will still have access to channels for stealthily transferring money overseas, upper- and middle-class Chinese could find it much more difficult to invest abroad if these controls are enforced more rigorously.

Significant decline in outbound investment

Not surprisingly, after a record year in 2016, outward foreign direct investment fell 41.8% in the first eight months of this year.[5]



Source: "Chinese crackdown on dealmakers reflects Xi power play," Financial Times, August 9, 2017

[1] "China Codifies Crackdown on 'Irrational' Outbound Investment," Bloomberg, August 18, 2017
[2] "New Chinese money rules threaten tide of foreign buyers in Canada," The Globe and Mail, January 4, 2017
[3] "China's Army of Global Homebuyers Is Suddenly Short on Cash," Bloomberg, January 26, 2017
[4] "China Inc. hits brakes on foreign property investment," Financial Times, February 16, 2017
[5] "China's foreign investment plunges after official curbs," Associated Press, September 14, 2017

Learning from Japan's mistakes

One of the driving factors behind China's crackdown on capital outflows is an effort to avoid repeating Japan's mistakes. As Japan rose to economic prominence in the 1980s, its companies splurged on U.S. real estate and other trophy assets that resulted in major losses. This was one of the factors that led to the epic bust of the early 90s and the following decade of virtually no growth. The fear that some Chinese companies were going down the same path as their Japanese counterparts are highlighted by the following two examples:

- The Dalian Wanda Group of China paid $3.5 billion in 2016 for Legendary Entertainment, the Hollywood studio. It has since produced several money-losing films. This has been compared to Sony's ill-fated 1989 purchase of Columbia Pictures for $3.4 billion, most of which was written off a few years later.
- China's Anbang Insurance Group purchase of several buildings in Manhattan, including the Waldorf Astoria Hotel for close to $2 billion in 2014, is reminiscent of Japan-based Mitsubishi Estates' 1989 $1.4-billion deal to acquire 80% of Rockefeller Plaza. Five years later Mitsubishi was forced to sell the Plaza at a $600 million loss to stave off bankruptcy.[6]

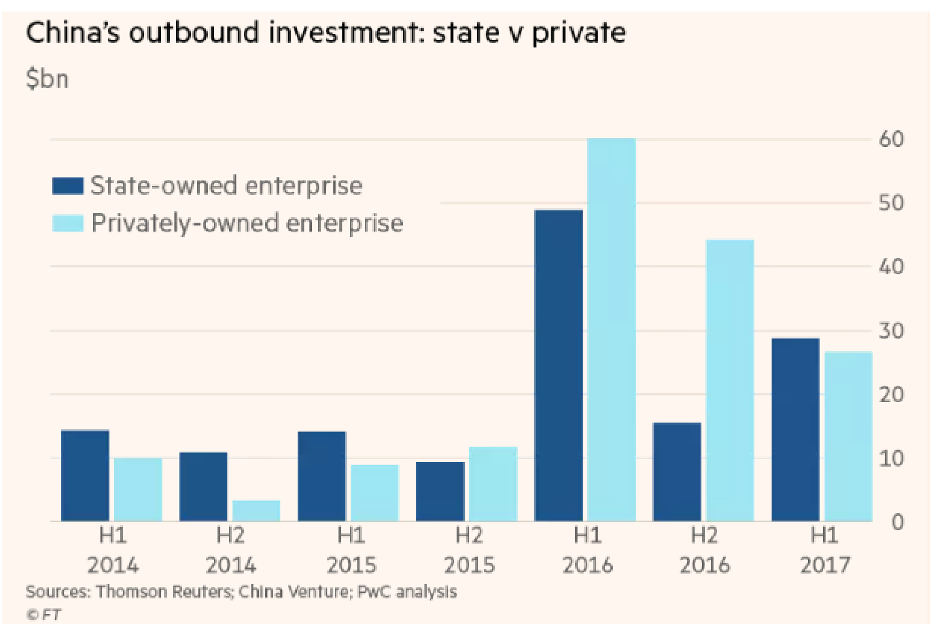
A study commissioned by the Chinese government strongly recommended that the global buying spree by some of the nation's biggest private companies be curtailed to avoid going the way of Japan.

The government wholeheartedly agreed with these recommendations and soon after warned the private sector's most aggressive dealmakers in 2016 to scale back their foreign activities. A particularly strong message was sent last June with the arrest of Wu Xiaohui, Chairman and CEO of Anbang Insurance Group. He has not been seen since.

Guo Guangchang, the chairman of Fosun International, who presided over the purchases of Club Med and Cirque du Soleil, appears to have received the message loud and clear as well. He publicly stated: "The recent scrutiny on overseas investments and financial irregularities is necessary, timely and can eradicate a lot of irrational investment." He added: "If we do not take measures, foreigners will see us as 'silly money."

The return of state-owned enterprises

After seeing its share of overseas investment go from low single digits a decade ago to nearly 50% in 2016, the government's new policy has caused privately owned companies to lose ground. **Since the government announced tighter capital controls in early 2017, state-owned enterprises have accounted for 60% of outbound investments.**

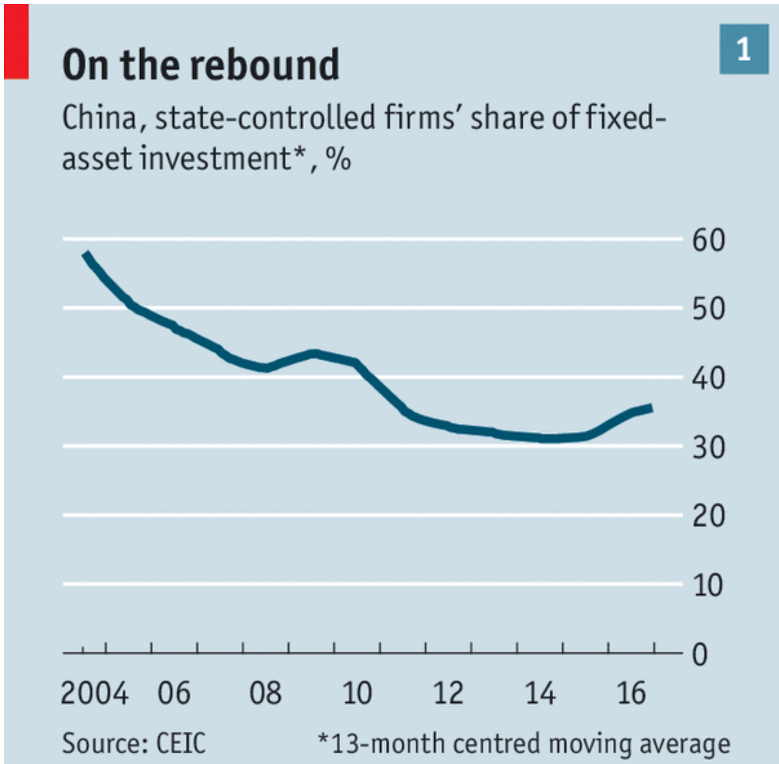


Source: "State-led companies back on top in China's outbound M&A rankings," Financial Times, September 3, 2017

[6] "A Chinese Echo of 1980s Japan," The Wall Street Journal, July 25, 2017

State-owned enterprises also gaining ground domestically

Reversing a decades-long trend, state-owned enterprises have outpaced their private-sector counterparts in terms of domestic investment since 2015.



Source: "Reform of China's ailing state-owned firms is emboldening them," The Economist, July 22, 2017.

One of the less publicized reasons behind the crackdown on outbound investments is that the government viewed the growing influence of many large private-sector corporations as a threat to its firm control of the economy. **The lack of an independent judiciary and the recent crackdown on Bitcoin is further proof that China does not look kindly upon entities developing powers independent of the government.**

The growing backlash against Chinese acquisitions

As part of its tighter control on outbound investments, China plans to redirect capital towards the worldwide purchase of more strategic assets in the areas of infrastructure, natural resources, IT and advanced manufacturing. However, these plans have run up against increased resistance from the United States and Europe.

United States

U.S. President Donald Trump recently blocked a Chinese investor from buying Lattice Semiconductor over concerns that the investor was linked to the Chinese military. The fact that China does not permit U.S. companies to purchase similar Chinese IT companies was another reason for the decision.

Accusations of intellectual property theft are another major source of tension. A recent report by the U.S. Commerce Department estimated the annual value of the theft of U.S. intellectual property at as much as $600 billion. The report named China as the main culprit.

The combination of Chinese restrictions on outbound investments and greater U.S. scrutiny of proposed Chinese takeovers has reduced the value of announced investments by Chinese firms in the United States by nearly 70% so far this year compared with the same period in 2016.[7]

[7] Dealogic, September 2017

European Union

The European Union has proposed giving governments significantly increased power to block foreign takeovers. As in the United States, there are mounting complaints that Chinese buyers are free to make almost any acquisition in Europe while Europeans are prevented from making similar purchases in China.

In June, the German parliament amended legislation to allow authorities to stop non-EU companies from acquiring more than 25% of a German firm on national security grounds. Further, the government can now review the security-related implications of a foreign takeover for up to five years after a deal has been completed, compared with the previous three-month period.[8]

Conclusion

The combination of substantial capital flight, the risk of unwise international investments and misgivings over the growing influence of privately owned companies have led China to implement strict measures to both reduce and redirect outbound investments.

Greater government involvement in the Chinese economy has had the following repercussions:

- A greater role for state-owned enterprises. Going forward, investors looking for joint-venture partners in China might find it less risky from a political perspective to partner with state-owned enterprises.
- Purchases by Chinese companies of real estate, hotels, entertainment and sports clubs abroad have fallen by more than 80% in the first six months of this year. This is likely the beginning of a long-term trend.
- The Chinese government's push for firms to invest abroad in strategic sectors such as IT, robotics, agriculture and infrastructure will be met with more and more resistance from countries not wanting to lose their strategic assets. The fact that foreign companies are mostly prevented from purchasing Chinese assets only strengthens this resistance.

Key factor to watch

Will tighter capital controls on individuals make it more difficult for them to invest in foreign residential real estate, or will they just exploit new loopholes to get their money out of the country? The answer to this question could impact the residential real estate markets of major cities in certain Western countries, including Canada.

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[8] "Paths diverge for Chinese firms chasing overseas assets," South China Morning Post, September 18, 2017

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