GLOBALISATION OUTLOOK

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SUMMARY

- It is time that the West, and Europe in particular, thinks and acts more strategically about China and its impact on the global political economy

- Chinese investment in Europe continues apace - much of it directed at the acquisition of know-how and strategic industries rather than development capital. The investment pattern meshes with the 'Made in China 2025' plan.

- The Chinese model where major corporations are never free from the long arm of the state and act in the national interest is a disrupter of the financialized, shareholder focused Western economic model

- While it is not yet clear whether China's model is sustainable, in the short term the West needs to evaluate how its economic model that separates commercial interests from national/regional interests can compete effectively with a state directed and protectionist Chinese economic model

- It is time to tackle the question of how to deal with care with Chinese investment in Europe to maintain cooperation while prevent it becoming the world's biggest Trojan horse that will eventually undermine Europe from within.

A BOON OR A TROJAN HORSE?

Total Chinese investment in Europe now exceeds 300 billion Euros

China continues to invest heavily in Europe. There are different views as to the precise amount of annual Chinese Foreign Direct Investment (FDI) in Europe. Estimates vary widely largely reflecting different methodologies. One estimate (Rhodium Group) puts it at around 30 billion Euros in 2017. Another (Baker Mackenzie) puts it at nearly double that when looking at all investments that can ultimately be traced back to China. Whatever the number, it is a significant amount that has grown from something of the order of 2 billion Euros invested in 2010. The amount of investment remains significant even after a Chinese government crackdown on highly leveraged companies.

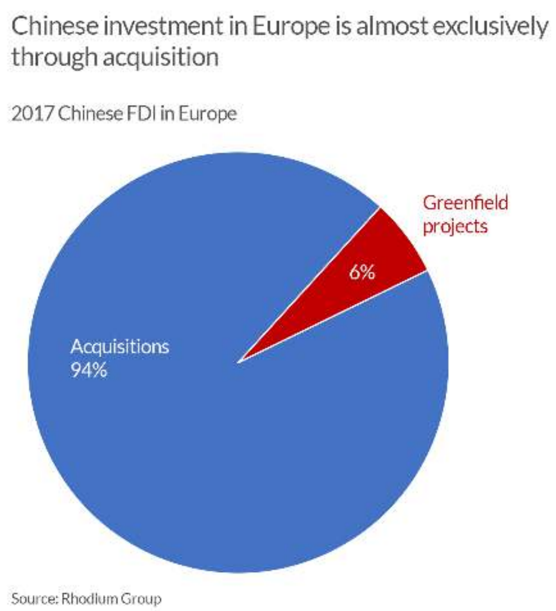
It is estimated that total Chinese investment in Europe now exceeds 300 billion Euros.

These levels of investment have raised questions about whether Chinese FDI is a net positive or a longer-term threat to Europe. Is it manna from heaven or the world's biggest ever Trojan Horse? While corridor chatter about the issue proceeds apace, there seems little in the way of an agreed policy as to how Chinese investment should be handled.

HOW IS CHINA INVESTING?

Does Chinese investment help European development?

Or is it a route to technology transfer and control of essential infrastructure?



Most Chinese investment in Europe is in the form of acquisition activity (figure) rather than development capital invested in greenfield projects.

By and large, acquisitions are focused on automotive, real estate, food and agriculture, energy, infrastructure, and technology.

This pattern meshes with the 'Made in China 2025' plan suggesting that investments are strategically directed.

Technology acquisitions are one way of achieving technology transfer to allow China rapidly to catch up and overtake Western technology know-how. Infrastructure investments will put China at the very heart of the proper functioning of European states (see box). In neither case do European governments or companies have the same level of access to the Chinese market.

It is our view that this amount of FDI flowing from China into Europe is not the result of China having more financial resources to invest than are available in Europe. Rather they are due to differences in how project finance is evaluated.

Neither do we believe that the issues will be resolved, in geopolitical terms, by fighting for more access to the Chinese market – the most talked about 'solution' to the asymmetrical investment flows.

Our objective in this newsletter is to highlight some the structural issues that between the Western and Chinese models and which should be the subject of much more public discussion than is currently the case.

Chinese investment goes to the very heart of the functioning of European states.

European energy infrastructure is the single largest target of Chinese investment. It represents a full 28% of all Chinese investments in Europe over the past five years. In spite of recent entry of privately owned enterprises, 60-70% of Chinese energy investment in Europe still comes from state owned enterprises or sovereign wealth funds.

Target countries have also become more diversified. After initial investments in larger, Northern European markets, investments have now spread to southern and, to a lesser extent, central Europe, benefiting from privatization programmes often imposed on countries like Greece and Portugal as part of the bailout conditions during the Eurozone crisis that made strategically important assets available at affordable prices.

Investments have been both in fossil fuel and renewable energy and suggest aims that span technology acquisition as well as energy security.

Such a level of investment in essential infrastructure should, and do, raise significant concerns about national security. This is all the more relevant as electricity systems become increasingly digitized and therefore subject to interference from abroad.

There seems little doubt that such investments are politically guided and strategically thought out to give China commercial, technological and political advantage. They mesh with the 'Made in China 2025' plan.

THE GREAT DISSOCIATION

European investment is directed at shareholder interests.

A core issue is the dissociation in the West between business/financial interests and the national/regional interest.

Chinese investments are made in the national interest.

According to Milton Friedman (whom we have previously labeled as the economist who has done most damage to Western societies), companies' only concern should be the maximization of profit and shareholder value while operating within the current rules. This has become the guiding light of the Western economic model. And it is corrosive.

To look at its effects, let us look at the production of cobalt – an essential element for electric batteries.

China already controls over 80% of the world's cobalt production. In March of this year, mining company Glencore agreed to sell a chunk of its cobalt production to China's GEM. Glencore's CEO was also quoted as saying that if Chinese investors were to make a bid for the whole company, he would accept if the price was right for shareholders.

It is unimaginable that this could happen the other way around – a major Chinese company being allowed to sell itself to a US or European corporation in an area as strategically important as the production of a metal that is essential to an electricity-powered future.

European authorities remain supine in the face of Chinese expansionism

Yet authorities at both the national and EU level remain supine. They remain wedded to an extreme non-interventionist economic model that can have negative geopolitical implications in a world where China has explicitly rejected such a model in favour of a state-directed capitalist model where corporate interests and the national interest meld and are expected to work in concert.

> '*A large proportion of Chinese investments in Europe comes from state-owned enterprises. Their motives may not always be guided purely by commercial objectives but are plausibly shaped by China's national interests…Chinese private companies are also intertwined with China's state capitalist system through their dependence on a network of state-controlled financial vehicles.*'
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> Editorial: Chinese investments in Europe's energy sector: Risks and opportunities? Energy Policy 101 (2017) 644–648

The Chinese economic model acts as a great disruptor

In business terms this is the equivalent of a new market entrant causing disruption through a new business model that upends previous structures and assumptions. In such situations, one has to adapt, somehow, or go out of business. Adapting does not necessarily mean aping the new business model. But change becomes essential for survival.

THE FINANCIALISED ECONOMY

China uses its excess capacity to make overseas investments, skirt around WTO dumping rules, and support its Belt and Road initiative

The West does not invest in infrastructure due to high required returns rather than lack of resources

A further structural difference between China and Europe is the way that return on investment is evaluated in a financialized economy.
It is well known that China currently suffers from significant production over-capacity. The Western approach to such a situation would be to cut over-capacity (and then some) to maximise profitability and shareholder returns.

China has taken a different approach. It is using its over-capacity to develop the Belt and Road initiative through which it is already seducing EU countries, primarily in Eastern Europe, into its sphere of influence. A process that is facilitated by (i) a shrinking EU budget that threatens to decrease financial transfers to Eastern Europe and (ii) ever-growing differences in political attitudes between Northern European countries and those in Eastern and Southern Europe.

When evaluated as part of an economy with significant over-capacity, projects become much easier to finance (they can simply be considered as additional contributions to established fixed costs) than when they are evaluated on a project-by-project basis with high expected returns and a low appetite for investments that only generate long-term returns.

The net result is that ever more project finance will come from China rather than from Europe – even though many European economies have plenty of money floating around looking for investment opportunities.

Of course, it is not clear how long such an approach to project finance can last. Chinese mining investments in the Congo have already turned sour and China is starting to restrict access to finance to minimize the chances of excessive and ill thought out investments.

DEBT BONDAGE

"Debt is such a powerful tool, it is such a useful tool, it's much better than colonialism ever was because you can keep control without having an army, without having a whole administration."

Susan George

Finally, there is the issue of debt.

China holds some three and a half trillion in foreign exchange reserves of which at least a quarter are estimated to be held in Euro-denominated assets. In addition, a proportion of project finance provided by China is in the form of debt.

China positions its Euro holdings as a vote of confidence in European economies. However, as African countries are finding out, such levels of debt also place countries in debt bondage to a foreign power that is, rightly, primarily concerned with pursuing its own interests. When such investments are clearly controlled, directly or indirectly, by the Chinese state, they cannot be judged exclusively on a financial basis. They could, over time, play a substantial role in the projection of political power – potentially being used to bend debtor nations to the creditor's political will.

There is good reason why, in 1933, JM Keynes exhorted nations to *"above all, let finance be primarily national."* Wise words long since forgotten in the world of hyper-globalisation.

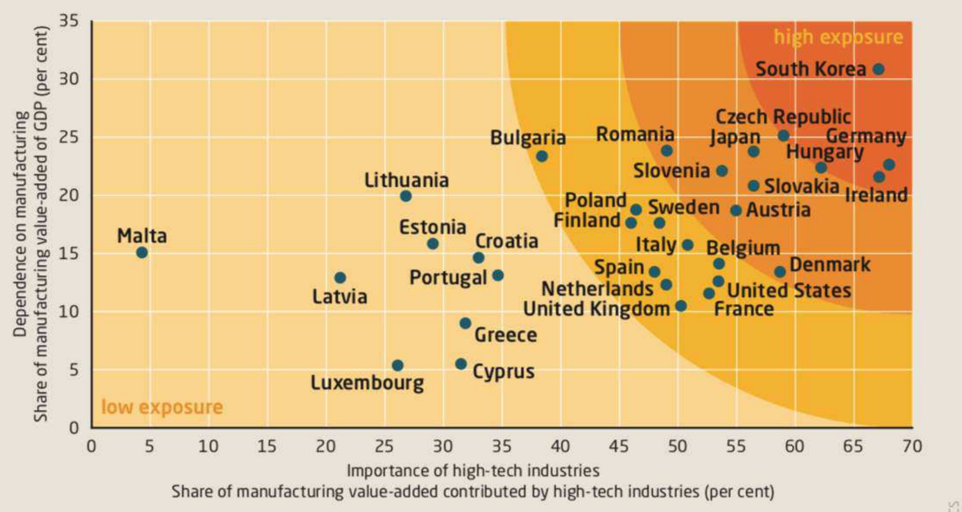
A DIVIDED EUROPE

Some of the concerns that we raise in this paper about Chinese investment in Europe are not new. What has not been much talked about, however, is how the Western open, privatized economy focused almost exclusively on investor interests can withstand the disruption from the new Chinese economic model.

China's rhetoric in defence of open trade bears no resemblance to its policies or actions.

Even more worrying is that Europe seems to be aligning itself with China and against the US in supposedly defending a globalized trading economy. Yet Europe and the US share fundamental values and similar economic structures. China's practices, on the other hand, are directly opposed to its rhetoric. The 'Made in China 2025' initiative explicitly calls for actions that infringe WTO rules on local substitution.

Under Pressure: Industrialised countries will feel the heat of Made in China 2025
Vulnerability of select industrial countries to Made in China 2025



Source: MERICS

Europe is also divided. A European Commission initiative to screen Chinese investments in Europe has run into objections from some countries hungry for FDI to help their short-term financial issues as well as corporate interests focused on their own narrow interests seemingly to the exclusion of all else. As a result, there is no effective European response to the China disruption except for pleas for opening up the Chinese market.

Europe needs to do a better job of screening Chinese investments in its markets.

TIME TO RESPOND

We have outlined here the many ways in which China acts as a disrupter for the Western economic model. The question is - how best to respond?

One response is to try to 'level the playing field'. The West has already tried something similar when it admitted China to the WTO in the hope that it would lead China to follow the Western economic and political model. That gamble has failed spectacularly.

China cannot afford to open up its market to Western corporations without undermining its state-directed model of capitalism

In addition, China cannot afford to open up its markets. Allowing Western companies to operate unfettered in the Chinese market would undermine its model of state-directed capitalism. It's not going to happen any time soon. And even if it does happen, it is unlikely to happen in ways we have come to expect with our Western mindsets.

Investors should be wary of Western companies whose future depends on significant growth in the Chinese market.

Investors should be wary of those Western companies whose future success is highly dependent on growing access to the Chinese market. A recent statement by Idaho-based Micron Technology stated: *"The activities by the Chinese government may restrict us from participating in the China market or may prevent us from competing effectively with Chinese companies."*

What is amazing about this statement is not its content but that it has taken management this long to understand such a fundamental issue.

An alternative approach would be to mimic China's state-directed model. That would mean abandoning many core Western values. It is not clear that we are either prepared to do that or could actually achieve it even if we tried.

The response therefore needs to contain five elements:

- Recognising China as a competitive disruptor to the Western economic model (which could be a good thing if it stimulates improvement)

- Acting to fix the exploitable weaknesses in the current Western model

- Recognising that we need a new set of world trading rules that can apply to all rather than the current Western-driven rules system that cannot apply to China's economic model – and hence will not be followed

- Thinking strategically and having the tools to act strategically in vetting Chinese investments in Europe

- Ensuring that the Western alliance sticks together in the face of disruption and not letting short-term disagreements and clumsy diplomacy fracture that all-important coalition

It may be that China's model will change over time towards a more open economy. But let's not hold our breath. And let us not wait any longer to take action. It may already be too late. According to Ely Ratner, a former official in the Obama administration *"The time we really needed this was a few years back."* Yet the Obama administration sat on its hands.

Absent decisive action, Europe risks being squeezed between a stronger US and China's new economic model.

It's not just about trade. What we are seeing is competition between two fundamentally different models of the political economy. A divided Europe unable to either think strategically or act effectively risks being squeezed between the stronger Western economic model represented by the US and the new state-directed model emerging in China.