December 16th 2007

Published as:
Morck, Randall, Bernard Yeung & Minyuan Zhao. 2009. China's New Multinationals: Policy Implications for Host Countries. In Randall Morck & Taehoon Youn, eds. *The Market For Corporate Control: Comparative Perspectives*. Korea Development

China's New Multinationals:
Policy Implications for Host Countries

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The authors are grateful for helpful comments from William Allen, Jun Huang, Tom Pugel, Alan Rugman, Myles Shaver, Jordan Siegel, Changqi Wu, participants at the Korea Development Institute's conference on "The Market For Corporate Control: Comparative Perspectives". This paper recapitulates findings regarding outward FDI from China described in Morck, Yeung, and Zhao (2007) and then explores policy options potential host economies of that FDI might consider.

China's outward foreign direct investment (FDI) is smaller than generally realized and mainly into tax havens and emerging markets. Because this FDI is largely by large State controlled enterprises (SCEs) with government sanctioned monopolies, access to credit from State controlled banks, and access to equity markets, we propose that free cash flow problems at Chinese SCEs may be driving inefficient outward FDI. However, we also concede that Chinese SCEs' histories may provide them genuine advantages, in e.g. routinized mature industries and politically corrupt host countries. Given these observations, we then weigh the pros and cons of various ways potential host countries might modulate the inflow of Chinese FDI. All these options have serious downsides, but might nonetheless be viable policy options in some countries under some circumstances.

1. Introduction

Successful mergers and acquisitions (M&A) in general, and successful cross-border ones in particular (also called outward foreign direct investment or outward FDI), succeed if the acquirer brings something new and valuable to the target firm. Often, this is a new technology, or more efficient ways to apply an existing technology. Sometimes, the acquirer is more efficiently run, and brings higher standards of governance to the target's operations. In other cases, a merger can create new avenues for tax avoidance. Popular arguments that multinationals go abroad to exploit workers more vigorously, build monopolies more openly, or degrade the environment more freely all lack support in the data. But spreading technology and improving managerial efficiency are the two most vaunted real contributions multinationals make to their local host economies, and substantial empirical evidence supports both.

Headlines have recently trumpeted a spate of foreign takeovers by large Chinese enterprises – Haier, Lenovo, TCL, CNPC (China National Petroleum Corporation), and CNOOC (China National Offshore Oil Corporation). After reviewing the evidence, we conclude the answer is "none of the above" explanations apply clearly to most transactions. Here we provide a non-technical explanation of a series of research findings first presented in Morck, Yeung, and Zhao (2007) that show China's enterprises'

current outward FDI not fitting the mold of past successful foreign M&A. Of course, international business recalls numerous examples of ultimately unsuccessful foreign M&A driven by factors other than economic fundamentals. Various economic and psychological factors – empire-building or free cash flow problems – explain much ultimately value-decreasing M&A, both domestic and foreign. These transactions are driven by false signals in the economy, by the interests of top corporate insiders rather than their firms, and perhaps even by outright errors.

Morck, Yeung and Zhao (2007) show that China's current outward FDI fits the pattern of some of these explanations. In particular, high profile M&A transactions likely boost the careers of the Party officials in charge of the acquiring enterprises, virtually all of which are directly or indirectly controlled by the State. Free cash flow problems may also play an important role, for Chinese state-controlled enterprises (SCEs) have broad access to cheap credit from state-controlled banks, enthusiastic backers of their borrowers' foreign takeovers. Nevertheless, China's outward FDI may also have genuine economic purposes that simply do not apply to M&A by multinationals based in fully developed economies.

To examine thee issues, sections 2 and 3 summarize the main empirical findings of Morck, Yeung and Zhao (2007) – basic stylized facts about China's outward FDI and likely economic forces underlying it. Both sections also elaborate on key points that likely have public policy implications. Section 4 considers economic and political implications of this capital flow for the economies receiving it; and then discusses public policy options that might merit consideration in those host economies. Section 5 concludes.

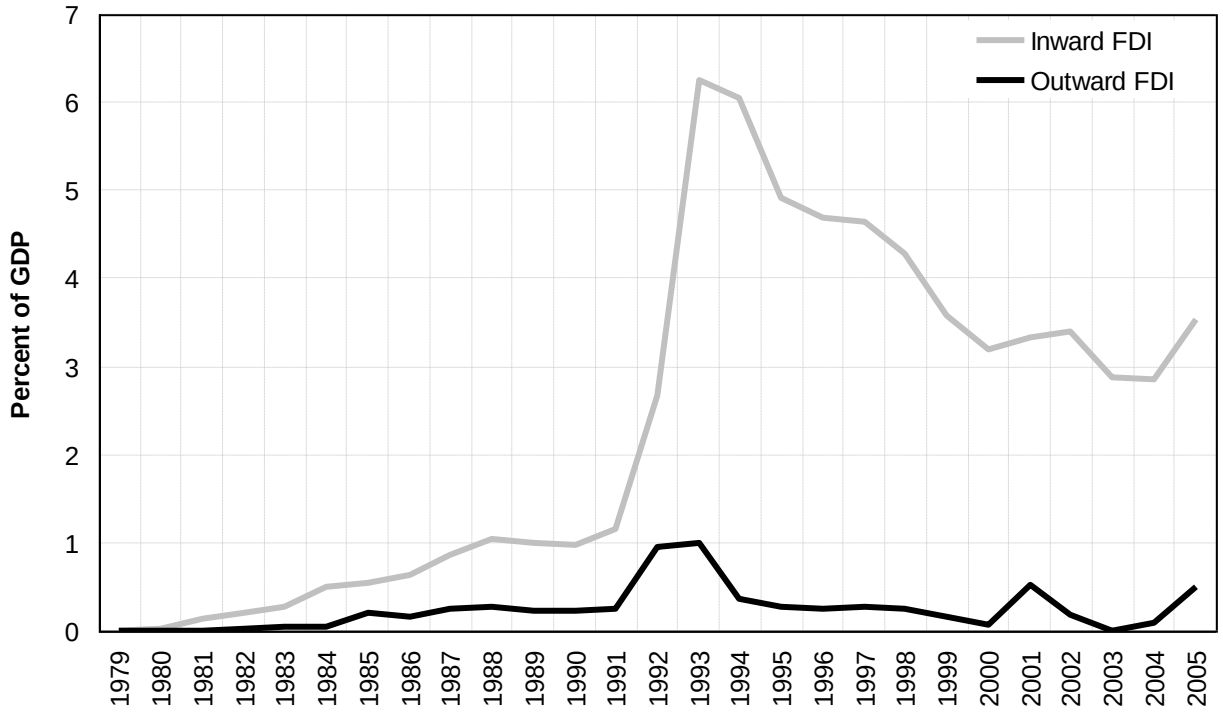
2. Some Stylized Facts about China's Outward FDI

This section summarizes findings in Morck, Yeung, and Zhao (2007), who assemble a considerable array of statistics to place China's current FDI in context – both within China and internationally. The key points they uncover are each granted a subsection.

2.1 China's outward FDI has grown a lot, but still remains quite small

Outward FDI by China's non-financial enterprises grew from negligible levels in the 1970s to over $17.6 billion in 2006. This is impressive, but the accumulated totals remain tiny given the country's 2006 GDP, which the IMF puts at nearly $10 trillion (adjusted to purchasing power parity). Figure 1 shows China's outward FDI growing little as a fraction of the economy's size. Rather, inward FDI – foreign firms buying corporate assets in China, exploded after the 1978 opening, though it subsequently receded.

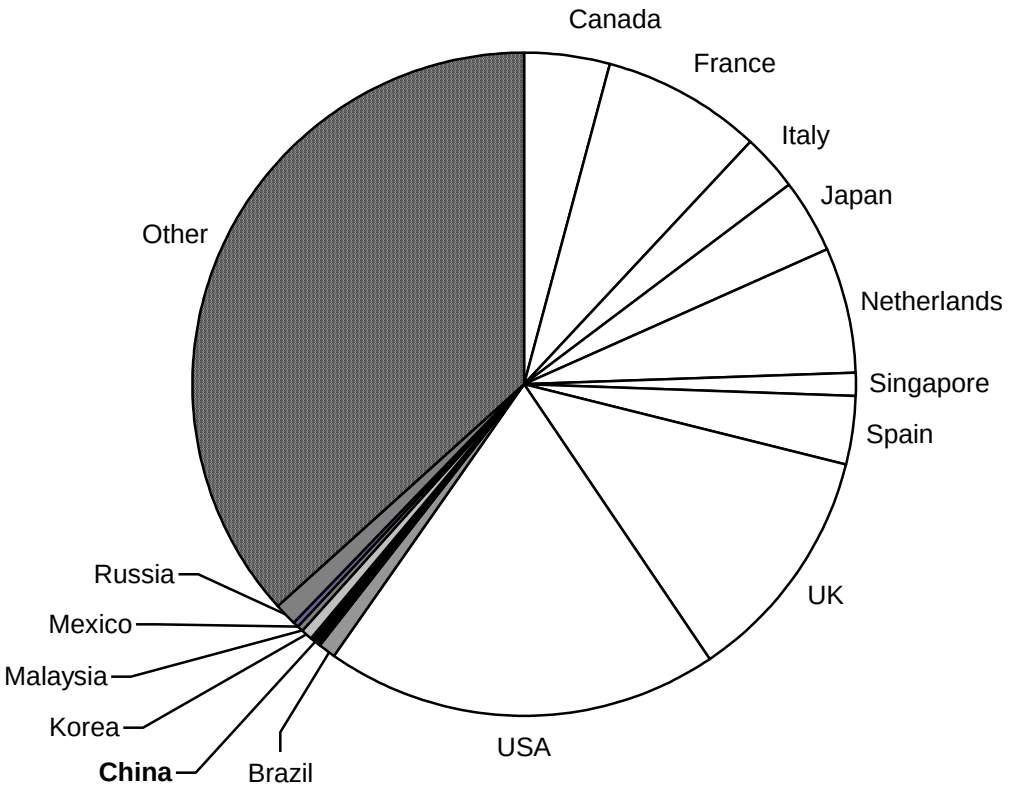
Figure 1. FDI Flows Into and Out of China, Fractions of Gross Domestic Product



Source: World Bank WDI Database.

Perhaps more importantly, Figure 2 shows the total miniscule in the context of global FDI. Foreign assets held by China's enterprises accounts for only 0.7% of the global total in 2006 – far smaller than comparable numbers for the major developed economies and small even in comparison to the city-state of Singapore. The total for China, $75 billion, is only about twice that for Korean enterprises, $36.5 billion, despite China's much larger total GDP.

Figure 2. Outward Foreign Direct Investment Stocks
Accumulated foreign assets held by enterprises based in each country, as share of global total.



Source: World Investment Report and World Investment Report of UNCTAD, Chinese Ministry of Commerce, various years. Figure for Canada is an estimate interpolated from prior years' data.

2.2 Most of China's Outward FDI flows to other developing economies

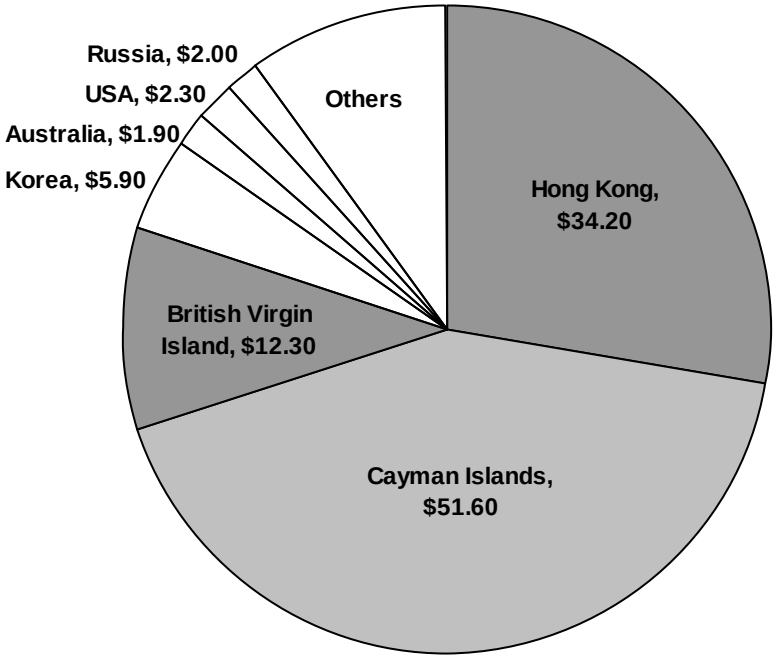
When Chinese enterprises bid for major firms in developed economies – Lenovo's acquisition of IBM's personal computer unit and Minmetals' bid for Noranda – they make headlines worldwide. But these transactions turn out to quite atypical, for China's outward FDI disproportionately targets firms the developing world – notably in Asia and Africa. In 2006, these hosted over 60% of new Chinese FDI projects, while the developed world attracted only one third of the total.

Before we delve into the geographical distribution of Chinese foreign takeovers, some caveats merit clarification. The raw data, as illustrated in Panel A of Figure 3, are problematic for several reasons.

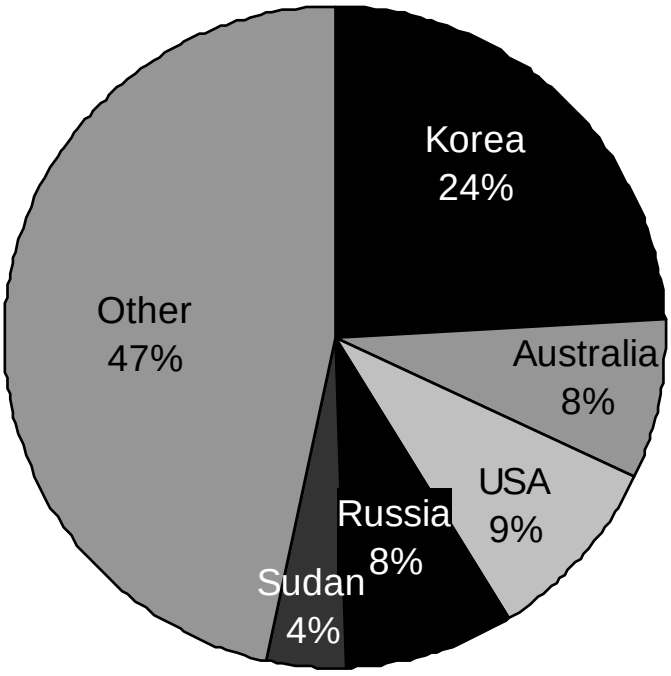
Figure 3. Host Economies to Chinese Foreign Investment, By Value

Total Chinese Outward FDI in top seven destination economies, in billions of US dollars, 2006.

Panel A. Including Hong Kong and Tax Havens



Panel B. Excluding Hong Kong and Tax Havens



Source: China FDI Statistics Report, Ministry of Commerce and China Statistics Bureau.

First, the Hong Kong figures are problematic. Many Hong Kong acquisitions by Chinese SCEs are surely genuine FDI, but some are also motivated by tax considerations. Prior to 2007, Hong Kong-based ventures operating on the mainland enjoyed tax benefits unavailable to purely local enterprises. Some funds likely flowed to Hong Kong only to rebound back into China. Also, much Chinese investment in Hong Kong may well have been en route to other economies via Hong Kong. Business partners in the developed world might, for example, be more comfortable dealing with a Hong Kong based entity subject to Hong Kong courts, even if the capital and control are really mainland Chinese.

Second, much of China's outward foreign direct investment is into countries known primarily as tax havens. These are usually microstates that attract foreign investment by offering opportunities to hide taxable income from firms' home country governments. Since most of the enterprises contributing to China's outward FDI flow are state controlled, their reluctance to contribute to the Chinese government's coffers is perhaps puzzling. One possibility is that these enterprises are operated in the interests of the senior bureaucrats who manage them, more than in the interests of average Chinese taxpayers. Lipton and Sachs (1990) document massive *spontaneous privatization* in early stages of privatization programs in Eastern Europe – bureaucrats "privatize" (steal) state-owned capital, leaving little for formal privatization programs to dispose of. We are unable to confirm or exclude the hypothesis that the top insiders of some Chinese firms might be moving wealth into tax havens to place it under their personal control.

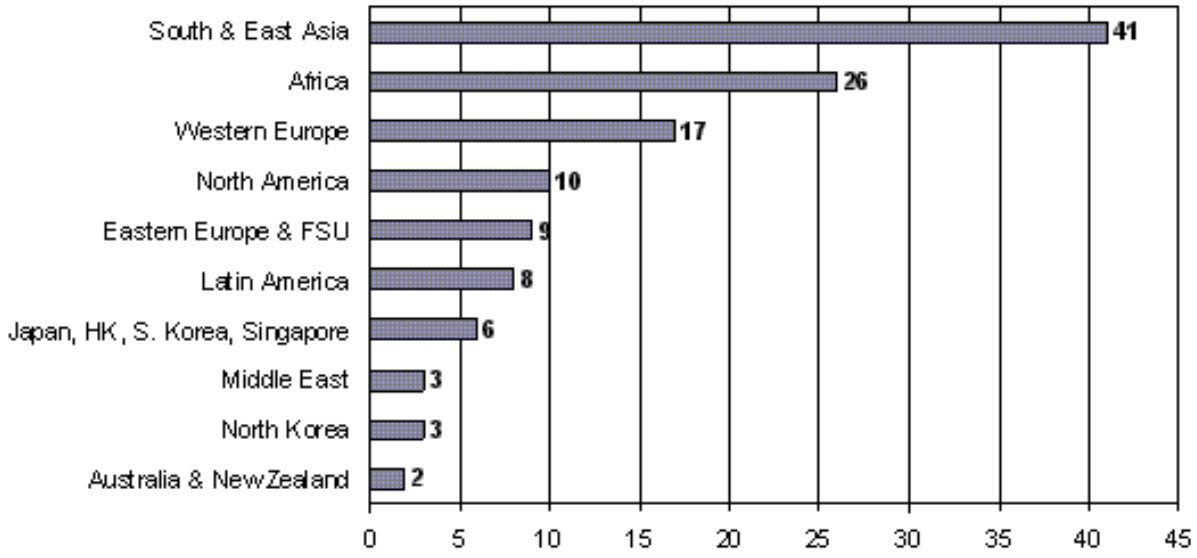
The dollar figures for these top FDI destinations are thus not entirely reliable as measures of Chinese ownership of productive assets in those economies. Certainly, some mainland businesses invest in some, particularly Hong Kong, to gain convenient access to trade and financing opportunities. Thus, dropping all FDI into Hong Kong, and even into many tax havens, may be seriously overcorrecting.

Dropping specialized tax havens, like the Cayman Islands and the British Virgin Islands, reveals the pattern in Panel B – which is more likely the true distribution. Korea, Russia, and the Sudan now figure much more prominently. Among developed economies, only the United States and Australia are prominent. The Ministry of Commerce breaks Chinese outward FDI down by continent of destination reporting Asia, Latin America and Africa as receiving 63.9%, 26.3% and 3.4%, respectively, of

accumulated Chinese outward FDI at the end of 2006; but North American and Europe each hosting less than 3%. Again, the Asian and Latin American figures must be adjusted downward to account for tax-induced FDI into Hong Kong and Caribbean tax havens, but the adjusted totals for North America and Europe relatively remain small – less than 15% of the total, and some of the European destinations may also be tax haven microstates.

Another metric – the *count* of FDI projects by Chinese enterprises into each country or area – reveals a similar pattern, illustrated in Figure 4.

Figure 4. Host Economies to Chinese Foreign Investment, By Number
Number of Chinese Outward FDI projects in top seven destination economies, in 2006.



Source: FIAS/MIGA Firm Survey, World Bank

But, peering through this statistical haze, it does look like Chinese outward FDI is disproportionately into other emerging economies – other parts of Asia and Africa in particular, at least in recent years. (The 2006 data are similar to figures for 2004 and 2005). This differs starkly from typical patterns of outward FDI by multinationals based in developed economies, in which generally flows to other developed economies.

2.3 Most of China's Outward FDI is by Large, Listed State Controlled Monopolies

The top thirty foreign investors from China are ranked in Table 1 by outward FDI in 2004, 2005, and 2006. Three features stand out.

First, investors in Chinese stocks will recognize most of the names in Table 1. Almost all the major players in outward FDI are either listed or control a listed subsidiary. Public shareholders' equity capital seems to be financing, in part at least, foreign acquisitions.

Table 1: Top Thirty Foreign Investors Based in China, Ranked by Outward FDI

	2004	2005	2006
1	China Mobile	China National Petroleum Corp.	China Petrochemical Corp.
2	China National Petroleum Corp.	China National Offshore Oil Corp.	China National Petroleum Corp.
3	China National Offshore Oil Corp.	China Mobile	China National Offshore Oil Corp.
4	China Resources (Holding) Co.	China Resources (Holding) Co.	China Resources (Holdings) Co.
5	COSCO	COSCO	China Mobile
6	CITIC	SINOPEC	COSCO
7	SINOPEC	CITIC	CITIC
8	China Telecom	China Merchant Group	China Nat. Cereals, Oils & Foodstuffs
9	Guangdong & Hong Kong Inv.	China Nat. Cereal, Oil & Foodstuff	China Merchants Group
10	China Merchant Group	China State Construction Corp.	Sinochem
11	China NetCom	China National Aviation	China State Constr. & Engineering
12	China State Construction Corp.	China Telecom	China National Aviation
13	Lenovo Holding	SinoChem	China Telecom
14	China National Aviation	China NetCom	China Shipping
15	China Power Investment	China Shipping	China NetCom
16	China Minmetals	Guangdong & Hong Kong Inv.	GDH Limited
17	SinoChem	Shanghai Automotive Ind.Corp.	China Power Investment
18	China Nat. Cereal, Oil & Foodstuff	Shum Yip Holding Company	Shanghai Automotive Ind. Corp.
19	China Shipping	Lenovo Holding	China National Chemical Corp.
20	Sino Transportation Group	China Power Investment	China Minmetals Corporation
21	Shanghai Automotive Ind.Corp.	China Minmetals	Lenovo
22	China Huaneng Group	Sino Transportation Group	Shum Yip Holdings
23	Beijing Orient Electrics Group	TCL	China Nat. Foreign Trade Transp.
24	China World Best Group	Beijing Orient Electrics Group	Huawei Technologies
25	TCL Group	China Huaneng Group	Shanghai Baosteel
26	Guangdong Hangyun Group	China Poly	China Huaneng Group
27	Shanghai Baosteel	Shanghai Baosteel	SinoSteel Corporation
28	Beijing Jade Bird Group	China Shou Gang Group	China Poly Group Corporation
29	China Nonferrous Metal Mining Group	China Nonferrous Metal Mining Group	China Nonferrous Metal Mining & Const.
30	China Road and Bridge Corp.	China North Industrial Group	Haier Group

Source: China FDI Statistics Report, Ministry of Commerce and China Statistics Bureau

Second, with the lonely (and possibly debatable) exceptions of Lenovo and Huawei, all China's FDI heavyweights are overtly Party controlled. (Another possible exception, the Haier Group, is a collective.) China's SCE sector is itself highly concentrated. In 2005, the top ten national SOEs made over 75% of the sector's total profits. The other 159 contributed the rest. Eight of the ten most profitable SCEs appear in Table 1 – so SCEs' earnings also seem to be financing China's outward FDI. Private-sector firms may conduct outward FDI; but the scale is too small to register.

Third, virtually every one of the SCEs in Table 1 has a State-enforced monopoly in some key industry, such as natural resources or telecommunications. Chinese SCEs typically do not compete with each other. For instance, China National Petroleum has a monopoly on most aspects of the oil and gas industry within China, while China National Offshore Oil has a monopoly on key offshore oil and gas operations. These monopoly market positions are enduring reminders of China's socialist past, and their ability to charge what the market can bear means Chinese consumers are also likely footing the bill for the country's outward FDI by paying higher than market prices.

3. What Motivates China's Outward FDI?

China's outward FDI is primarily by very large, monopolistic SCEs with access to public equity capital. It seems unlikely that these enterprises might bring superior technology or managerial efficiency to companies like IBM or Noranda. Nor do these contributions spring to mind in China National Offshore Oil Co.'s bid for Unocal, Shanghai Automotive Industry's takeover of Ssangyong, China National Petroleum's purchase of PetroKazakhstan, Haier's bid for Maytag Appliances, TCL's purchase of Alcatel's cell-phone business … .These companies currently do not appear to be superbly efficient or creative in the world league.

3.1 Some Popular Explanations

So what motivates China's outward FDI flow? Tax savings, or hiding funds as a first step towards corporate managers' liberating them from their companies, can surely explain FDI into tax havens. But what of the rest? The popular press is not short of explanations. Unquestionably, the foreign investment could not be occurring without State and Party encouragement. The policy goals motivating that encouragement are less clear, though several candidates arise in most news coverage of Chinese SCEs' foreign M&A bids.

3.1.1 China's Foreign Currency Reserves.

First, China has accumulated over $1.4 trillion in gold and foreign currency reserves, the latter mainly denominated in US dollars. This treasure hoard was apparently built up largely incidentally, as China sought to prop up a weakening US dollar in world currency markets and maintain a fixed exchange rate between the US dollar and Chinese yuan. China's US dollar reserves have mainly been recycled back into American government debt instruments, enabling the United States to sustain the ballooning deficits necessary to cut taxes, enhance medical entitlements to senior citizens, and sustain armies in Iraq and Afghanistan. Unfortunately, US government debt pays a rather low return, and may generate large losses for China if, as now seems likely, the yuan will have to appreciate against the US dollar. The fundamental unsustainability of this flow is thus becoming increasingly evident to top Party officials, so China is seeking alternative ways of investing its foreign currency reserves.

For this reason, the China Investment Corporation (CIC) was established in September 2007 to reinvest China's foreign reserves. With US $200 billion in capital, CIC has already invested US$3 billion in the Blackstone Group, a US private equity firm. Earlier, China raised its Qualified Domestic Institutional Investors (QDII) quota to US$42.17 billion. The QDII program authorizes commercial banks, fund management firms and insurance companies to invest in overseas financial products. Both programs, in part at least, seem designed to reallocate the Chinese government's foreign asset portfolio into investments whose values might survive a collapse of the dollar relative to the yuan – in part at least.

Table 2 compares the CIC to other major sovereign investment funds, showing the Chinese government to control the sixth largest in the world.

Table 2. Sovereign Investment Funds

Sovereign investment funds are ranked by assets. Each fund's founding date, major source of revenues (other than investment returns), and assets per citizen are also reported.

Rank	Country	Sovereign Investment Fund	Assets US$ M	Since	Origin	*Assets per citizen*
1	UAE	ADIA Abu Dhabi Investment Authority	$875	1976	Oil	$1,5M
2	Singapore	GIC Government of Singapore Investment.	$330	1981	Other	$100,000
3	Norway	GPF Government Pension Fund of Norway	$315	1990	Oil	$71,000
4	Saudi Arabia	Kingdom of Saudi Arabia	$300	?	Oil	$11,500[a]
5	Kuwait	KIA Kuwait Investment Authority	$250	1953	Oil	$250,000
6	China	CIC China Investment Company Ltd	$200	2007	Forex	$151
7	Russia	SFRF Stabilization Fund of the Russian Federation	$141	2004	Oil	$1,000
8	Singapore	Temasek Holdings	$115	1974	Other	$30,300
9	Australia	FFMA Australian Government Future Fund	$51	2004	Other	$2,400
10	Qatar	QIA Qatar Investment Authority	$50	2000	Oil	$250,000
11	United States	APFC Alaska Permanent Fund	$40	1976	Oil	$61,000
12	Libya	Libyan Arab People's Jamahiriya	$40	2007	Oil	$7,200
13	Brunei	BIA Brunei Investment Agency	$30	1983	Oil	$90,100
14	Korea	KIC Korea Investment Corporation	$20	2005	Forex	$417
15	Malaysia	KN Khazanah Nasional	$18	1993	Oil	$658
16	Kazakhstan	KNF Kazakhstan National Fund	$18	2000	Oil	$1,170
17	Canada	AIM Alberta Heritage Fund	$17	1976	Oil	$4,800[b]
18	Taiwan	NSF National Stabilisation Fund	$15	2000	Forex	$652
19	Iran	OSF Oil Stabilisation Fund	$13	1999	Oil	$174

a. Date of founding ambiguous.
b. Citizens of Alaska only.
c. Citizens of Alberta only.
Source: Morck (2008).

We are somewhat uncomfortable with this logic, despite its near litany status. China's countryside remains impoverished. Vast reaches of the country desperately need roads, bridged, schools, and hospitals. It seems inconceivable that China's leaders, concerned as they are with stability and harmony, have not considered spending their foreign currency reserves importing materials, technology, and expertise to diffuse these time bombs. Buying up the shares of foreign joint stock companies seems untenable in the face of these alternative possibilities.

3.1.2 Acquiring Technology

Second, some commentators suggest that China is strategically acquiring foreign firms to acquire technology. This stands one of the usual economic explanations of outward FDI on its head. Caves (1983) and others argue that multinationals develop technological edges in their home markets and then create value by applying their superior technologies to the operations of foreign firms they acquire. The reason the technologically advanced firm typically takes over the less advanced one is that continuous innovation is needed to maintain a technological edge, and that the management team that first established the new technology is best positioned to sustain the pace of innovation necessary to stay ahead of rivals.

Firms might also invest abroad to gain knowledge not available in their home markets (Cantwell 1989). Thus, technologically advanced regions can attract knowledge-seeking foreign direct investments from abroad – see e.g., Kogut and Chang (1991), Chung & Alcacer (2002), others. Thus, Japanese and Taiwanese companies are alleged to have "listening posts" in Silicon Valley. IN a similar vein, Chinese firms eager to acquire intangible assets – like advanced technology or market information – might undertake cross-border acquisitions to gain a footholds in countries where those intangibles are to be found. The specific target company may thus be almost irrelevant. For example, TCL's acquisition of Thomson was almost certainly motivated, in part at least, by a need to gain access to European and North American markets.

3.1.3 The Great Game

Another popular explanation is that China's leaders may be using M&A as an arm of foreign policy – part of what historians of political scientists call "The Great Game". In this view, China's leaders are orchestrating the purchase of strategic raw materials and technology to further China's quest for global influence. Chinese SCEs are encouraged to purchase oil and gas fields, mines, and key technologies so that, in some future era of global turmoil, these resources will be firmly under Chinese control.

This view attributes a remarkable naivety to China's political elite. China's leaders surely understand that legal ownership of oil fields and mines means little if local warlords, ideologues, or

populists nationalize them. Just ask executives at any major American oil company to list off the foreign oil fields it owned in the 1950s, and which government seized them when. Unless China is prepared to embark on military adventures abroad, this sort of investment would be money down the drain in turbulent eras. And if military actions were in the cards, titular ownership of the resources would seem almost redundant. China would be better off buying such raw material as it needs on the open market, stockpiling any resources that might be cut off by geopolitical instability, and using its wealth for more sensible investments. Of course, political elites have shown remarkable naivety elsewhere and at other times.

3.1.4 For internal consumption only …

Another possibility is that Party leaders are gaining political points from Chinese nationalists by overtly demonstrating that China is "in the game" globally. Enhancing national pride grants the Party legitimacy in the eyes of many Chinese, whose education includes numerous incidents of foreigners oppressing, exploiting, and humiliating China. Corporate executives – and the Party officials and SCE bankers who aid them – are thus seen restoring China's honor as a true economic power. They may well gain political influence and status unattainable by other means.

Nationalism is a tricky reality for economists. Before we dismiss the possibility that Chinese popular opinion might support politicians who waste government money on inefficient FDI, we should recall that consumers, in the United States and elsewhere, support politicians who promise them higher prices and less choice by erecting trade barriers. As Veblen (1904) put it: "By force of [a] happy knack of clannish fancy, the common man is enabled to feel that he has some sort of metaphysical share in the gains which accrue to businessmen who are citizens of the same 'commonwealth'." It grates on trained economists, but we ignore such feelings at our peril.

3.2 Free Cash Flow Problems

To sum up, we find the above rationales for China's outward FDI inadequate in terms of economics, though some may serve as political motivations. We therefore propose an alternative perspective: namely that China's outward FDI may be largely driven by the self-interest of senior bureaucrats running its greatest SCEs. Past empirical work shows that a substantial fraction of US domestic M&A activity also serves no apparent economic purpose for the acquiring firms, but plays nicely into the self-interest of their top executives.

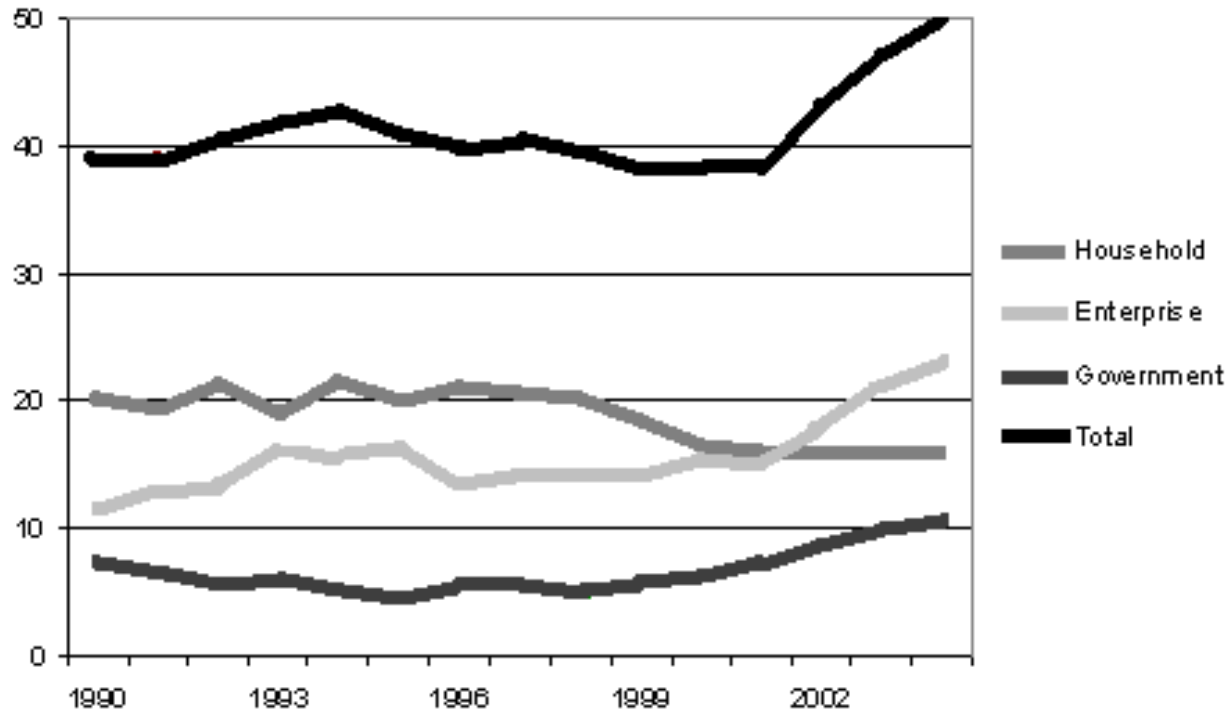
Free cash flow problems are widely recognized as a major generator of economically unjustifiable M&A activity in developed economies (Jensen, 1986). Firms with access to cash flows substantially in excess of their profitable investment opportunities should, in theory, pay dividends roughly equal to that excess, their so-called *free cash flow*, less a sensible reserve to meet occasional shortfalls. In practice, most firms in such positions pay low to average dividends and funnel their free cash flow into unprofitable investments – they over-expand, over-diversify across lines of businesses and internationally, and undertake economically senseless corporate takeovers. All of these strategies, though deleterious to firm valuations, stroke the egos of powerful CEOs, secure their control, reduce their career risk, and justify expanded CEO compensation.

We propose that many Chinese SCEs and this substantial fraction of large American firms, are governed by analogous forces. As noted above, China's largest SCEs have access to public equity markets, can charge their customers state-enforced monopoly prices, and have high cash flows from their ongoing operations. Access to public equity markets is rationed by the State, inducing large and persistent overvaluations of Chinese A shares – the class of shares available to domestic investors whose savings are denominated in the nonconvertible yuan. State-enforced monopolies free SCEs of competitive pressure to cut prices, allowing their earnings to swell. It would be remarkable if SCEs in such situation did not display free cash flow problems. Indeed, several features of the current Chinese economy virtually guarantee abundant free cash flow problems.

3.2.1. High savings

Savings fund investment, and China's savings rate is persistently and remarkably high. Figure 5 shows China's total savings as a percent of GDP, and also breaks the total into savings by households, enterprises, and governments. Even as household savings declined slightly, enterprise savings (retained earnings) are growing rapidly and now constitute the most important category of Chinese savings., Retained earnings surpassed household savings by about 2000, and have dominated ever since.

Figure 5. China's Savings Rate and its Breakdown by Sector

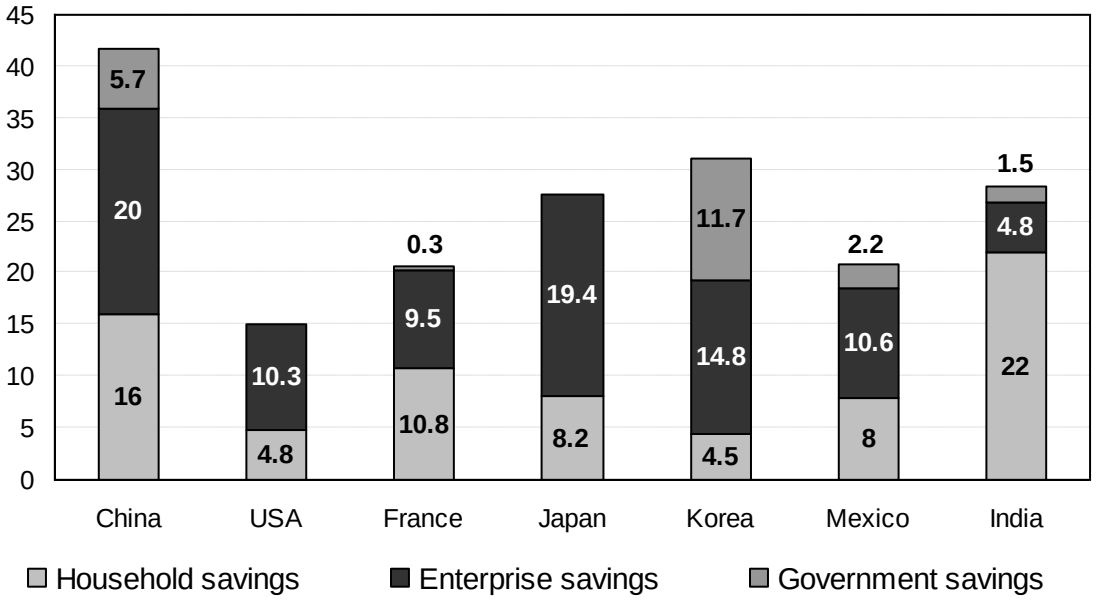


Source: IMF World Economic Outlook, September 2005

Figure 6 shows that this situation is highly unusual internationally by comparing China's savings rates and their sectoral breakdown to those of other countries.[1] Clearly, China's household, enterprise, and government savings exceed those of other countries by substantial margin.

[1] Note that the total savings rates in Tables 4 and 5 are not fully comparable because they are from two difference sources.

Figure 6. Savings Rates and Breakdowns by Sector, Compared



Data source: Kuijs (2006, Table 4).

In 2006, China's 159 central government SOEs earned a total profit of about ￥755 billion, an 18 percent increase over the previous year. These SCEs can direct their abundant savings into outward FDI transactions if their top political mangers so wish. Figure 6 reveals that China's enterprise savings to be among the highest in the world, and comparable to Japan's. Bank involvement in Japanese corporate governance is thought to induce excessive earnings retentions (Morck & Nakamura, 2000). If enterprises do not plow their retained earnings into economically sound expansions, a high enterprise savings rate is conducive to magnified free cash flow problems (Jensen, 1986).

3.2.2 China's Banking System

Chinese household savings flow almost entirely into a deposit banking system monopolized by SCEs. The reasons for Chinese households' high savings are well known: mortgages, consumer credit, and student loans are largely unavailable (though this is now beginning to change), so education, consumer durables, and housing require advance savings. China's state pension and medical coverage is rudimentary at best. These services, when they were provided at all under communism, were the responsibility of SCEs and

communes, not the State. In the years after 1978, even the barefoot doctors found other work. Thus, Chinese save for their old age and to pay medical bills.

What do banks do with household savings? Consumer loans, including mortgages are only starting to take root. Most state-controlled banks, it would appear, lend their depositors' money to SCEs – presumably to finance outward FDI among other things. China's banks are growing in sophistication, but it seems likely that political pressure and connections still govern the allocation of bank credit to some extent. If state-controlled banks recycle household savings indiscriminately into loans to SCEs, a high household savings rate is also conducive to free cash flow problems

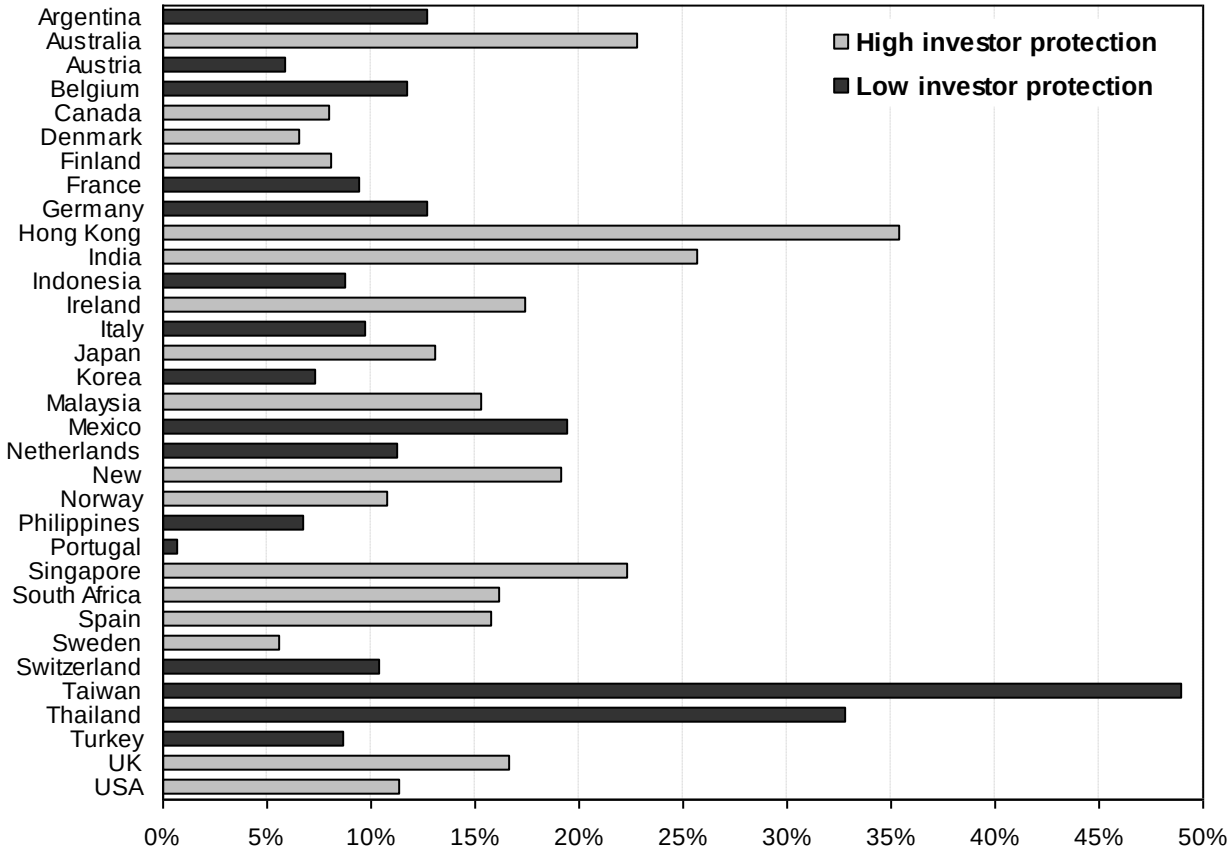
3.2.3 Weak Shareholder Rights

Corporate finance theory has companies paying dividends approximately equal to their free cash flows, but empirical studies suggest actual dividends are often substantially lower. Jensen (1986) argues that information asymmetry problems make "profitable" investments hard for shareholders to identify, forcing them to trust managers to do this. Since managers cannot be monitored costlessly, an agency problem ensues with managers diverting free cash flow into projects that increase managers' utility but erode shareholder wealth.

La Porta, *et al.* (2000) show that sound legal protection for investors is associated with higher dividends, and that legal systems less at the service of investors let insiders excessively retain earnings for empire-building. Free cash flow problems are thus worse in economies where public shareholders have less power and top corporate insiders have more. Dividends levels are thus an indicator of shareholders' power to curb gree cash flow problems. Figure 7 summarizes their findings.

Figure 7. Dividend Policies and Shareholder Rights

Countries are classified as providing above or below median legal rights to public shareholder of listed companies vive vie insiders. Firms pay higher dividends in countries that empower public shareholders. For definitions and details, see la Porta et al. (2000).



Source: La Porta et al. (2000).

China (along with other major transition economies) is not included in their study. Although top insiders are occasionally charged with 'corruption' in China, such charges are widely seen as selectively laid against insiders who recently exhibited political disloyalty Their correlation to the severity of actual shareholder rights violations is widely panned. It seems likely that Chinese public shareholders have little clout when it comes to forcing listed SCEs to disgorge their free cash flow by hiking dividends.

Consistent with this, the SCEs, responsible for most of China's outward FDI, are particularly dividend-averse. According to the Shanghai and Shenzhen stock exchanges, over half of the listed SOEs pay no dividends, despite high earnings. For example, the most profitable SOE in Table 1, China National

Petroleum Corp., realized 2005 net profits of ¥133.36 billion, but distributed only one percent of that, a mere ¥1.49 billion, to shareholders.

Outward FDI builds particularly impressive corporate empires, spanning continents, and so is an especially plausible utility-enhancing use of retained earnings in the eyes of top insiders. Of course, China's weak financial system might also induce SCEs to hold more cash internally to save up for profitable investments (Khanna, 2000). And outward FDI might be an economically rational response to an overregulated domestic environment (Lewin & Witt, 2007). These arguments may hold for purely private enterprises, they have less traction with the large SOEs in Table 1. These have access to public equity capital, loans from state-controlled banks, and probably state coffers too. Weak shareholder rights allowing suboptimal dividends and inducing free cash flow problems that manifest as economically inefficient outward FDI must be considered a serious hypothesis.

This situation seems to be changing, but slowly. The Chinese Securities Regulatory Commission (CSRC) seems concerned that listed SCEs pay inadequate dividends, evidenced by a series of rulings since 2004. Companies with positive profits, but no dividends for three consecutive years, must provide "explanations" or risk legal actions; and companies with dividend payouts below 20% of after-tax profits are ineligible for debt refinancing. Because of these changes, many Chinese companies raised dividends to precisely equal to the 20% minimum. Beginning in 2008, SOEs will also be required to pay dividends on shares owned directly by the government (at present they do not). Dividends for firms in energy, telecommunications, and tobacco industries are to be ten percent of their profits; for those in steel, transport, electronics, trade and construction, dividends are to be five percent of profits. Dividends are to be waived (for now) for firms in defense and science. Whether this approximates efficient payout ratios is anyone's guess.

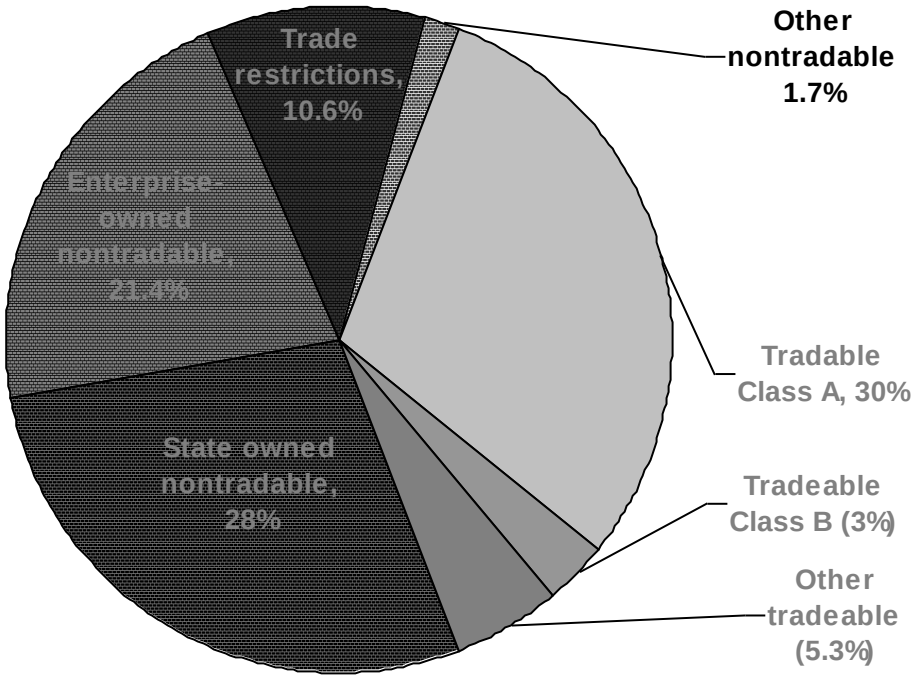
3.2.4 Odd Shareholders

Unless shareholders are utterly powerless, firms whose shareholders are more concerned about efficient management should feel at least some pressure to operate more efficiently. China's system of multiple

officially segregated equity classes relegates controlling ownership of most listed Chinese firms to shareholders who, until recently at least, have little to gain from efficient corporate decisions.

Figure 8. Equity Classes and their Ownership

Average ownership structure across population of 1,381 Chinese listings, Dec. 2005. *Non-tradable shares* are inalienable without official permission. Most are voted by state and party organs directly, or via other state controlled enterprises. Tradable A shares are available to Chinese residents in yuan (China's nonconvertible currency). Tradable B shares can only be traded for foreign currency, and so are mainly held by foreigners. Most other tradable shares are H shares, trading in Hong Kong in that economy's currency and again, mainly held by Hong Kong residents and foreigners.



Source. Morck et al. (2007).

Figure 8 provides a snapshot of the average ownership structure across the population of 1,381 listed companies at the end of 2005. Of all the shares outstanding, fully 65.9% are designated as *non-tradable shares*. These are inalienable – they can be neither bought nor sold. Until 2005, this proscription was absolute; now it can be circumvented – but only with explicit permission from various state-owned assets authorities. Nontradable shares are voted, directly or indirectly, by the Chinese State, the Party, their organs, or other levels of government. Indirect stakes are typically controlled through other SCEs or state-managed investment funds. These shares locks in Party control of all major enterprises, including

all major listed ones, by giving Party loyalists majority voting power in all significant shareholder meetings.

The figure likely understates state voting power, as state investment funds also hold tradable shares, and cross-shareholding by SOEs are prevalent.[2] Its major implication is that the typical listed Chinese firm is still state controlled, in that the vast majority of its shares are voted by state and Party representatives. These controlling shareholders may have interests quite different from those of small savers buying tradable shares as investments and hoping for maximal value creation and efficient dividend payments. Second, as mentioned above, many listed firms do not pay dividends on non-tradable shares directly to the state, even if they pay dividends on other classes of tradable and non-tradable shares. Naturally, vested interests within the state organs see a high dividend as undesirable because retained earnings are 100% under their control, while dividends accrue primarily, or even entirely, to others. Chinese firms' typical share ownership structures thus further magnify the likelihood and likely costs of free cash flow problems.

3.2.5 Parallel Party and Shareholder Corporate Governance Structures

Corporate governance reformers in China stress the need for independent directors, echoing the recommendations of Sarbanes Oxley in the United States. We doubt that independent directors would have any effect at all unless they are independent of the State and the Party, and unfazed by either. Such directors are likely still somewhat rare in China.

But more importantly, the board of directors, its chairman, and the company's CEO are not necessarily the real decision makers in Chinese listed companies. Just as China is ruled by parallel state and Party governing bodies, each listed firm, parallel to this familiar governance structure, also has a Party Committee headed by the firm's Party Secretary. Sometimes these parallel structures overlap, or even coincide entirely, but sometimes they do not. Where they are partially or completely disjoint, the Party apparatus appears to take precedence. In the large SOEs, the Party Secretary heavily influences, or

[2] This discussion draws on Morck, Yeung and Zhao (2005) and on Morck, Yeung and Zhao (2007).

even directly controls, the appointment of top executives and directors, often simply relaying orders from the Communist Party of China's Organizational Department, and exercises a leading role in the company.

A firm's Party Committee and Party Secretary are, of course, not elected by its shareholders; whomever they are, but appointed by the Communist Party. Thus, even if nontradable shares were to become tradable, and savers demanding competitive returns on their investments constituted a majority of their shareholders, Chinese listed firms would still not necessarily be governed to create value and disburse returns to shareholders.

The ultimate function of the Party Committee and Party Secretary may change as corporate governance reforms occur, but this remains unclear. For example, whether listed companies' managers might someday report to shareholders, rather than the Party, is debated. At present, the Party Committee monitors and evaluates corporate executives, determining their prospects for career advancement. The CEOs of the largest 53 national SOEs are appointed directly by the China Communist Party's Organizational Department. The other senior management positions are mostly appointed by the State-Owned Assets Supervision and Administration Commission (SASAC), which is directed by the State Council. Similar patterns hold for the local SOEs.[3]

The full extent of State and Party influence over corporate management is rendered obvious with examples of top executive turnover. PetroChina, a subsidiary of China National Petroleum Corporation, trades on both the New York Stock Exchange (NYSE) and the Hong Kong Stock Exchange (HKSE). In April 2003, Mr. Li Yizhong, then Chairmen of the Board of CNPC, was appointed to the SASAC and replaced by Mr. Chen Tonghai, a former State Planning Commission official. In October 2003, Mr. Wei Liucheng, then CEO, Chairman of the Board, and Party Secretary of CNOOC, was appointed Governor of Hainan Province. In November 2004, the top managers of the three largest telecommunication companies in China – China Mobile, China Telecom and China Unicom – exchanged positions almost overnight

[3] *Caijing*, Volume 174, December 11, 2006

without prior notice to public shareholders[4]. In short, executive positions in listed firms are filled by State and Party bureaucrats and are seen as steps in the career of a successful civil servant.

The current parallel corporate governance structure is unlikely to reward top managers who honestly admit that investment opportunities are limited and advocate disbursing excess earnings to shareholders. Unpaid dividends are, of course, corporate savings, for if earnings beyond profitable investment needs were disbursed to shareholders, they would show up either as consumption and household investment goods (e.g., houses, cars), or as additional household savings (bank deposits or portfolio investments). For Party officials who have real control, but little personal stake in their company's long-term economic performance, underwriting unprofitable, but politically important, projects is likely sound strategy for career advancement in both Party and State bureaucracies – so-called "image projects" (形象工程) and "political achievement project" (政绩工程). High retained earnings can also finance featherbedding, the creation or preservation of artificial jobs where politically necessary – and thus preserve "harmony" (和谐) and provide "stability" (稳定) – two social objectives highly valued by Party leaders – by keeping unemployment low. They can also finance overt symbols of power and grandeur, such as "national champion" SOEs taking over companies in foreign countries.

3.2.6 Capital Allocation in China

Outside capital allocation in China remains highly politicized, and economically inefficient. To access public equity, firms must obtain government approval. Although this technically requires meeting an array of financial tests, in practice SCEs appear to pass these hurdles by organizing subsidiaries with the appropriate earnings and other financial ratios. The subsidiary then lists, regardless of the financial condition of the SCE parent or its other subsidiaries.

[4] Interestingly, the Party Committee and its members are usually not mentioned in IPO prospectuses when theses SCEs are listed abroad (or in Hong Kong). Thus, when the Bank of China announced its global offering in 2006, the only Party-related position listed in the prospectus was the Secretary of the Party Discipline Committee, a relatively low-ranking position.

China's banks are the critical providers of outside capital to SCEs without listed subsidiaries, and likely to many with access to public equity. The banking business is dominated by the "Big Four" state-controlled banks – the Bank of China (BOC), Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), and Agricultural Bank of China (ABC). These provide about three-quarters of all commercial loans and hold just over half of all banking assets as of the end of 2005 (Thomas and Ji, 2004).

Household savings and idle corporate retained earnings both appear as bank deposits, which the banks recycled as loans – mainly to SCEs. Thus, the *Financial Statistics Yearbook* (2005), published by the People's Bank of China, lists 73% of short-term bank loans between 2001 and 2004 as made to SCEs. Whether this is because of political pressure or Chinese bankers' inability to evaluate risks in private sector firms is unclear (Tsai, 2002). Or, bankers may assume greater creditworthiness of SCEs by inferring state loan guarantees – if so, evidence of continuing soft budget constraints at SCEs. Regardless, even SOEs that merely hoard earnings as bank deposits, without actually initiating foreign acquisitions, join households in financing the outward FDI of other SCEs.

Biasing capital allocation towards SCEs is not justified by the fundamentals. Rather, the OECD concludes in 2005 that private firms responsible for most of China's growth, accounting for 59.2% of total value added.[5] .Table 3 summarizes.

[5] See the table in Chapter 2, *Economic Survey of China*, Paris: OECD, September 16, 2005. The survey defines private enterprises as those controlled by individuals or legal persons, in contrast to "state-controlled" and "collectively controlled" enterprises. This may confound SCEs controlled by other SCEs (legal persons) with true private enterprise.

Table 3. Productivity of Private and State Controlled Chinese Enterprises

The private sector outpaces the public sector

Per cent of value added by firm ownership

	1998	1999	2000	2001	2002	2003	Change
Non-farm business sector							
Private sector	43	45.3	47.7	51.8	54.6	57.1	14.1
Public sector	57	54.7	52.3	48.2	45.4	42.9	-14.1
State-controlled	40.5	40.1	39.6	37.1	35.2	34.1	-6.4
Collectively controlled	16.5	14.7	12.7	11.2	10.1	8.8	-7.7
Total (79 per cent of GDP)	100	100	100	100	100	100	
Economy-wide							
Private sector	50.4	51.5	52.8	55.5	57.4	59.2	8.8
Public sector	49.6	48.5	47.2	44.5	42.6	40.8	-8.8
State-controlled	36.9	37.1	37.3	35.7	34.6	33.7	-3.2
Collectively controlled	12.7	11.3	10	8.8	8	7.1	-5.6
Total (100 per cent of GDP)	100	100	100	100	100	100	

Source : National Bureau of Statistics and OECD estimates.

Source: Table in Chapter 2, Economic Survey of China, Paris: OECD, September 16, 2005. The survey defines private enterprises as those controlled by individuals or legal persons, in contrast to "state-controlled" and "collectively controlled" enterprises. This may confound SCEs controlled by other SCEs (legal persons) with true private enterprise.

These high productivity private businesses appear bound by hard capital constraints, for most finance their growth either internally (from retimed earnings) or informally (Allen *et al*., 2005). Ayyagari *et al.* (2007, Table 7) shows that firms with bank loans subsequently post elevated sales, but not productivity growth, while those relying on internal or informal financing post slower sales growth, but stronger productivity growth. Dollar and Wei (2007) find, even after years of reform, state-owned firms significantly lagging in returns on capital compared to domestic private enterprises and foreign-owned firms. This is consistent with China's banking system channeling savings to firms with limited capabilities and few profitable investment opportunities, virtually guaranteeing free cash flow problems. Some of these funds may end up backing high profile outward FDI. .

3.3 Redeeming Grace?

We do not argue that all outward FDI from China is unjustified. We just caution that the current parameters of governance and bank lending suggest a high likelihood of over-allocation of capital to

SCEs, inducing Jensen's (1986) free cash flow problems that waste the economy's capital. Meanwhile, private companies with plausibly more promising investment opportunities lack capital.

Notably, these issues are not unnoticed in China. The rationale and efficiency of SCEs going abroad are discussed in Chinese newspapers, academic journals, and some high-profile economic forums.[6] Advocates argue that FDI can be a long learning process for Chinese enterprises. Those arguing for patience point to the Japan's unprofitable wave of outward FDI in the 1980s and urge Chinese firms to learn from their experience.

But another possibility is that Chinese FDI really does make economic sense. Perhaps some Chinese SCEs really do have edges that can translate into advantages in foreign markets sufficient to justify FDI.

3.3.1 Internalization: Political wiles as an intangible asset

As noted above, the standard view of why FDI can add value is that it raises returns to corporate investment in research and development (R&D), brand creation, and other ventures with large fixed costs. These sorts of investments have higher returns if applied to larger scale operations. But these sorts of investments yield intangible assets – consumer awareness, innovative processes, and the like – and intangibles are difficult to buy and sell. Selling brand names risks their debasement, and selling technology risks losing property rights over key innovations. Such risks limit scale of application by restricting intangibles to one firm. Multinational expansion provides an "out" from this conundrum by letting a single firm operate on a global scale (Buckley & Casson 1976), and empirical work validates this hypothesis (Morck and Yeung, 1991, 1992.) This solution is called *internalization* because, by keeping productivity enhancements internal to the company, it captures the higher returns of larger scale operations while avoiding the risk of intellectual property rights misappropriation.

[6] Specifically, these issues were debated at the annual "International Forum on Chinese Companies Going Global" conferences in Beijing in 2006 and 2007, organized jointly by the Ministry of Commerce and UNCTAD.

At first glance, this perspective offers little justification for outward FDI by Chinese SCEs – few of which have the requisite sorts of reputational or technological edges. If anything, this view recommends FDI by China's high productivity purely private firms, which is not observed. It also recommends FDI into countries with large markets that can better contribute to economies of scale and scope in the use of such productivity enhancements. This too is not observed, for the targets of China's outward FDI are mainly in Southeast Asia and Africa, not Europe, Japan, or North America.

But perhaps the concept of an intangible asset needs broadening before we dismiss Chinese outward FDI as driven by agency problems. China's vast but highly regionalized domestic markets may school Chinese managers in catering to large and complex customer bases. Chinese firms also, of necessity, know how to do business in a "relationship economy". They are familiar with corruption, and with enforcing informal agreements with corrupt officials. Relevant institutional knowledge can also be an intangible asset (Rugman & Verbeke, 1992; Rugman, 1996). Perhaps these sorts of intangible assets provide Chinese SCEs with enough of an advantage to justify outward FDI on occasion, just as R&D or advertising justify FDI by OECD-based firms.

This modified internalization perspective arguably better explains recent Chinese outward FDI. Many of the Asian and African countries targeted by Chinese FDI have chronically weak institutions. Huang *et al.* (2004) show that most ASEAN economies have high level of direct state intervention, insecure property rights protection, and opaque corporate governance. These institutional deficiencies impede capital market development (La Porta *et al*., 1997; 1998), and raise costs of capital for local firms (Morck *et al*., 2005).

For Western and Japanese multinationals, corrupt or otherwise dysfunctional institutions in these countries constitute risk. In contrast, Chinese firms routinely deal with burdensome regulations and opaque political constraints. Perkins (2005) shows that past experience in certain institutional environments significantly predicts survival when a firm invests in another such environment. Such capabilities become an intangible asset that might make FDI into like environments far more profitable for Chinese companies than for other foreign firms.

This modified internalization theory thus posits that Chinese SOEs have developed sophisticated measures that help them operate despite endemic government interference and related problems. By expanding into economies with similar institutional environments, they can achieve large returns on these past investments. In 2005, PetroKazakhstan, a Canadian owned concern with operations primarily in Kazakhstan, found itself unable to enforce its previous agreements with a Kazakh government bent on expropriation. The state-owned CNPC stepped in and bought out PetroKazakhstan for $4.2 billion. PetroKazakhstan's investors were exited with some capital intact and CNPC was able to enforce contracts and property rights where a private sector Canadian firm could not.

3.3.2 Who is the boss, and why?

In a typical FDI venture, the firm that develops the intangible asset – the technological or advertising heavy firm – is the acquirer, and retains control to protect its property rights over that asset. Grossman and Hart (1980) argue that control should reside with the party whose non-contractible effort is more important in creating value for firm.

In the traditional FDI setting with the acquirer from a developed country, this party is the firm that initially produced the critical intangible asset. A new technology must be updated continuously, or risks eclipse by advances elsewhere. A brand name made valuable by a reputation for high quality must be safeguarded by continual rigorous quality control. Failure to keep pace with the expanding technology frontier or to safeguard the value of a brand name courts disaster, and the Chinese manufacturing firm typically lacks the ability to contract and monitor the foreign firms' performance in these dimensions.

The foreign firm, in contrast, can monitor and control the Chinese production operation, at least to a considerable extent. Thus, in a typical inward FDI investment into China, a foreign firm with a technological edge or a brand name acquires physical assets in China that help it produce for Chinese or global markets.

However, this logic need not apply in all cases. IBM saw PCs becoming commoditized, with rapidly evaporating profit margin. While technology advances continue to affect key components, actual

PC assembly becomes routine, which made technology maintenance and upgrading more contractible and less critical. The terms of competition tilted towards production cost and quality control. In this setting, actions by the managers of the Chinese assembly plants became important enough to justify Lenovo taking control of IBM's PC unit. Conceivably, similar logic induced TCL's takeover of Thomson's TV and DVD businesses in Europe and elsewhere.

More generally, in maturing industries, intensifying price competition in increasingly standardized products renders manufacturing quality more important than cutting edge R&D, and rigorous cost control more important than brand name recognition. In such circumstances, a reversal of roles becomes rational: the production unit takes over the R&D or brand-building unit because its non-contractible effort becomes more important in creating value.

Perhaps these sorts of rationales are behind some recent high-profile cases of Chinese manufacturing firms acquiring firms in rich countries in mature or rapidly maturing industries – Lenovo's acquisition of IBM's PC manufacturing unit and Haier's bid for Maytag.

4. Being a Good Host

We have shown that China's outward FDI is not all that large. The positive reasons described in Section 3.3. not withstanding, the data in Table 1 and in Section 3.2 suggest that much of China's outward FDI is conducted by SCEs with unique savings patterns, share structures, governance structures and elevated cash flows. It may also be motivated by nationalism.

Given this, how should prospective host country governments welcome Chinese FDI? The United States government intervened to quash the Chinese takeover of Unocal, and in 2007 Canada enacted government approval mechanisms to screen all takeovers of Canadian firms by foreign SCEs. Although not explicitly aimed at Chinese acquirers, the Minmetals bid for Noranda was conspicuous in public debate over the initiative. Is such a cool welcome justified?

4.1 Shareholder Rights

"Shareholder rights" advocates understandably demur. Shareholders, if one accepts the logic of an unfettered free market, should be free to sell their shares to the highest bidder – and if this turns out to be a Chinese SCE, such is life. Maximizing the shareholder wealth means permitting competitive offers by all interested bidders.

This logic is erroneous, for it misunderstands the role of shareholder valuation maximization in corporate governance. Finance theory argues that good governance corresponds to shareholder valuation maximization because, in an efficient and transparent stock market, higher valuations are barometers of more efficient resource allocation. The ultimate objective of good governance is efficient use of the country's resources – natural, human, and financial – to sustain and increase living standards. Shareholder valuation is important, not on its own accord, but because it is an often useful means to this more fundamental end.

But where this connection is frayed, the validity of shareholder valuation maximization is undermined. Thus, in an opaque stock market, where share prices are driven up and down by noise trader sentiment, shareholder valuation becomes economically senseless (Morck, Yeung, and Yu, 2000). Similarly, in a profoundly corrupt economy, where high share prices reflect controlling shareholders political influence rather than their management abilities, shareholder value is undermined as a valid barometer of good governance (Fisman, 2001). Shareholder valuation maximization is an 'instrument', not an 'end', of sound public policy.

If entrusting the governance of a Korean firm's corporate assets to the managers of a Chinese SCE acquirer would not improve the efficiency with which those assets are used, that the Chinese SCE can pay a high takeover premium cannot be used to justify the economic fundamentals of the transaction. Although the Korean target firm's current shareholders would be enriched, nothing guarantees that this outweighs the present value of the welfare losses the new inefficient management would impose on the Korean economy. This negative assessment is more relevant if a large firm in a limited size market is

being acquired. When the market is large and non-performance of the acquired firm will lead to quick sculling by competitors, the negative assessment is less relevant.

Freedom to buy and sell shares is restricted in many cases – insider trading, trading to manipulate stock prices, etc. Where broader public policy objectives come into conflict with shareholders' freedom to trade, governments have not been shy about restricting the latter. The main argument against restrictions on takeovers is that corporate M&A is a useful mechanism for replacing less by more efficient managers, and empirical work shows that this does occur (Morck, Shleifer, and Vishny, 1988, 1989).

If bidders rely on excess free cash – rather than greater relative efficiency – to take over target firms, this undermines an otherwise socially useful function of takeovers (Jensen, 1986).

4.2 State Vetting of Foreign Takeovers?

The above reasoning, or some facsimile of it, is often used to justify state-enforced restrictions on takeovers – foreign and domestic. But this is a difficult course for several reasons.

First, blanket proscriptions of all takeover activity are likely undesirable. Takeovers replace inefficient managers and spread technology. Some, at least, are socially useful. This means takeover restrictions have to be selective, permitting government officials a degree of discretion. This is the route followed by Canada in the wake of Minmetals' bid for Noranda – takeovers by SCEs must be reviewed by government officials before being allowed to proceed.

But this politicizes corporate takeovers. For example, if the Canadian government forbade a Chinese SCE from taking over a particular target firm, Beijing might 'retaliate' in some other forum – for example by withholding support in a trade negotiation important to Canada, or by promoting an alternative candidate for a chair on the United Nations Security Council. This makes discretionary restrictions troublesome.

Politicizing corporate takeovers is also undesirable from a purely domestic perspective. The most enthusiastic proponents of legal restrictions on takeovers are often the inefficient managers whom the raider would replace. State anti-takeover laws in the United States appear driven by the lobbying activity

of this special interest (Miller 2000). This is a form of political rent-seeking, as described by Krueger (1974). Canada established its Canada's Foreign Investment Review Agency in the 1970s to pick and choose FDI takeovers, and rent-seeking soon grew to absurd intensity levels. The economic effects were almost certainly negative, for government officials proved no better at picking winners in takeovers than in picking winners for industrial policy subsidies. As Murphy et al. (1993) show, rent-seeking typically misallocates resources and undermines economic growth. Sound public policy discourages rent-seeking wherever possible. The Canadian foreign takeover restrictions were eliminated in the 1980; and are now generally regarded (by serious economists at least) as a significant policy error (Safarian, 1993; Rugman, 1996).

Can takeover restrictions be selective, but not discretionary? For example, might Canada have simply forbidden all takeovers by SCEs? But here definitional issues arise, for the line between SCEs and private enterprise is not always clear. Is Airbus an SCE? What about a public sector pension fund, like CalPERs? Or a private equity fund, like BlackStone, reinvesting the money of a public sector entity?

Can these definitional ambiguities be sidestepped somehow? The United States seeks to do this with its "national security" test for FDI takeovers. In 1988, in response to heavy lobbying by the executives of the flagging Fairchild Semiconductor to block a takeover bid by Fujitsu, the American Congress passed the Exon-Florio Amendment of 1988 which forbids foreign takeovers of US firms that present "unacceptable risks to national security" (Liebeler and Lash, 1996). Although this circumvents definitional ambiguities, it resurrects the problems of politicizing takeover proscriptions.

Perhaps there is some clever way through this morass, but no country has yet mapped it out, much less implemented a working model. However, a key virtue of emulating the approach of the United States is that the US Commerce Department is unlikely ever to use such policies adopted by other countries as evidence of protectionism. Policies that deviate from the US approach, in contrast, invite attack by American trade negotiators. However, relatively immunity to America charges of protectionism does not make a policy efficient – only expedient.

4.3. Takeover defenses

If the government cannot vet takeovers, perhaps we should let target firms block bidders' advances more easily? Numerous devices to do this have been used in many different countries.[7] *Poison pills* (which selectively dilute raiders' equity stakes) and *staggered boards* (typically, a third of directors are elected each year for three year terms) are popular in the United States. *Dual class shares* (insiders shares' carry multiple votes per share) are popular in Canada and Sweden; *golden shares* (a single golden share carries veto rights) are common in the Netherlands. *Voting caps* (shares in excess of e.g. 20% stakes become non-voting shares) are also in place in many large Canadian firms. *Crossholdings* (numerous small intercorporate equity stakes that sum to control blocks in all the participating firms) stymie takeovers in Japan.[8] Unfortunately, takeover barriers are now fairly unambiguously linked to corporate insider entrenchment problems (Gompers, Ishii and Metrick, 2003; Westin et al. 2004; Bebchuk and Cohen, 2005).

If the target firm's mangers erect these barriers to block socially undesirable takeovers, such as those launched by foreign SCEs with free cash flow problems, but lower them to permit takeovers that would expand the scope of a technological innovation or permit the replacement of inefficient management, all would be well (Comment and Schwert, 1995). Technology-driven M&A might still occur; since these do not threaten the target's insiders; but it is difficult to see why inefficient target firm managers would cooperate in their own ouster (Shleifer and Vishny, 1997; Bebchuk, 2002). So-called *golden parachutes* (side payments to target managers) might induce inefficient target managers to step aside and permit a takeover by a better managed firm; but acquirers with excess free cash flow problems, as well as those with profits from superior management, can offer side payments – so the generosity of side-payments need not track the economic efficiency of takeovers (Hartzell et al. 2004).

Thus, allowing firm-level takeover defenses under the control of the prospective target's insiders relieves undesirable pressures on public servants, but seems unlikely to provide economically efficient

[7] For an overview of takeover defenses in the United States, see Weston et al. (2004), chapter 19.
[8] For more detail on these takeover defenses and how they came to be prominent in different countries, see the relevant country chapters of Morck (2005). On the US, see Shleifer and Vishny (1997)

selectivity. But there may be ways of countering the negative effects of takeover restrictions. For example, more and more powerful institutional investors might fill the breach, for example, by forcing management changes in contested board elections at shareholder meetings, or by threatening to sue obviously underperforming officers, directors, and controlling shareholder (Gompers and Metrick, 2003; but see also Romano, 1993).

This logic implies a careful public policy choice as to which takeover defenses to permit and which to avoid. For instance, voting caps need not block alternative ways of pressing inefficient mangers to either change their ways or step aside if they leave institutional investors' collective voting power at annual meetings intact, while blocking takeover bids by any single shareholder. Poison pills might be defensible too, though not if they can be nullified by the target firm's management in return for side payments (golden parachutes) (Hartzell et al. 2004). Poison pills revocable by a shareholder vote, rather than by the target's management might be viable, though little evidence exists as these devices are rare. Staggered boards, dual class shares, and other takeover defenses that prevent both takeovers and successful activism by institutional investors are undesirable because they protect incumbents' positions and limit institutional investors' potential power (Bebchuk, 2002; Bebchuk and Cohen, 2005).

4.4 Local Heroes

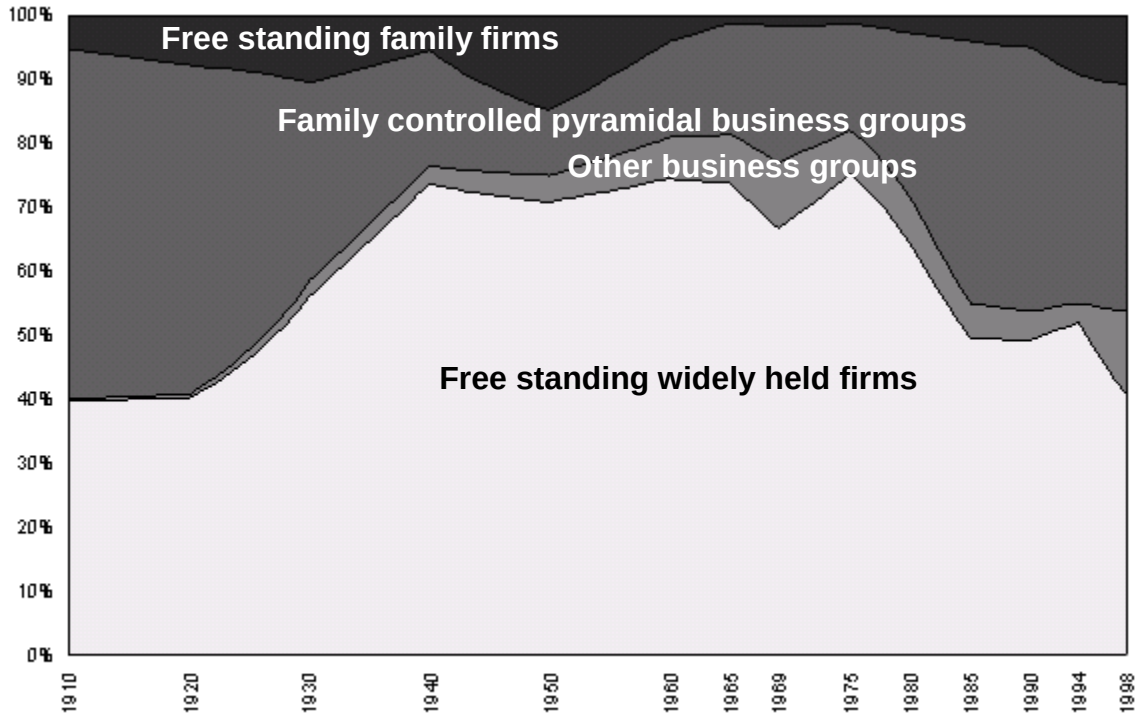
Another possibility is to entrust corporate governance to locals with deep pockets. Local champions might acquire control blocks in important firms to preclude socially undesirable foreign takeovers. As long as these local champions arranged takeovers that spread technology and organized the ouster of inefficient managers, all would be well. In Korea, this path might expand the great chaebol groups into such champions – defenders of Korean control over Korean business.

Unfortunately, controlling shareholders in general and wealthy families in particular are now fairly clearly associated with a range of corporate governance problems (Nenova, 2003; Dyck and Zingales, 2004; Djankov et al., 2005). Controlling shareholders, especially if their control is enhanced by the sort of pyramidal ownership structures characteristic of the great chaebol groups, appear to derive

important private benefits from operating the many firms they control inefficiently (Morck, Wolfenzon, and Yeung, 2005). In this sense, the cure might not dominate the disease. If the controlling shareholders cannot provide efficient corporate governance in general, why should they provide an efficient vetting of takeover bids?

History also argues against this option. In the 1970s, Canada's pyramidal business groups presented themselves as champions of national sovereignty amid a wave of popular concern about American takeovers. Large family-controlled business groups played dominant roles in Canadian industrialization in the late 19th and early 20th centuries. In subsequent decades, they steadily shrank as a fraction of the large business sector until the 1970s. At that point, amid a wave of economic nationalism, they dramatically expanded, adding new listed firms to their existing tiers, and adding whole new tiers of listed firms. Figure 9 summarizes.

Figure 9. The Expansion of Canadian Pyramidal Groups in the 1970s
Control over the 100 largest Canadian businesses, weighted by assets, through the 20th century.



Source: Morck, Percy, Tian, and Yeung (2005).

Placing control blocks with pyramidal groups did effectively preclude foreign takeovers, unless the relevant group's controlling shareholder cooperated. But by the 1980s, firms in the business groups run by old moneyed families were clear performance laggards (Morck, Stangeland, and Yeung, 2000), and their low productivity may well have damaged the overall competitiveness of the Canadian economy (Morck, Percy, Tian, and Yeung. 2005). A policy of entrusting corporate governance to a tiny elite presumes implausible degrees of both ability and selflessness on the part of that elite

4.5 Do nothing

Public policy makers contemplating regulations restricting FDI should seriously contemplate the option of doing nothing, even in the face of obviously inefficient transfers of control to foreigners. While this cannot be justified in the name of shareholder rights, it might be as the lesser of evils. The downsides of government vetting agencies, takeover defenses under the control of incumbent managers, and overly entrusting corporate governance to elite families are undeniable. Perhaps they eclipse the costs of an occasional bid by a "wrong" Chinese SCE.

First, the physical assets of the target company are unlikely to move. Factories (and jobs) remain in Korea even if the CEO resides in Shanghai, rather than Seoul. Mines, machines, buildings, and people are hard to transport, and foreign ownership usually does not transfer real economic activity abroad. Head office functions, and their spin-off industries like accounting and corporate law firms, might move, but blue collar jobs are tied to immobile assets. American hotels, acquired by cash-flushed Japanese firms in the 1980s at astronomical prices, were sold back to Americans in the 1990s at fire sale prices. As long as the Japanese did not damage the hotels physically (in fact they renovated extensively), it is hard to see how this sort of FDI harmed America. Perhaps foreign host country governments should let Chinese FDI follow the same course – though Chinese communist bureaucrats admittedly might cause more damage by mismanaging Korean firms than Japanese *sararimanu* caused in the United States. .

Second, the assumption that Chinese takeovers are inefficient and driven by free cash flow problems may not always be defensible. We have advanced an economically rational explanation of

Chinese firms acquiring Maytag and IBM's PC production wing. Perhaps there are other instances in which Chinese managerial teams might have genuine advantages that genuinely justify outward FDI.

The skills in handling cumbersome institutions that successful Chinese SCE managers must accumulate may constitute a sustainable 'edge' over other foreign managers, and even over domestic managers, in countries with endemic corruption. But the argument is also problematic if we turn to Shanghai Automotive Industrial Corporation (SAIC) acquiring SsangYong Motor in 2004. Korea is a more institutionally developed economy, and innovation remains quite important in auto making.

The 'do nothing' option clearly applies most easily to Chinese outward FDI in countries that receive relatively little of it. So far, Chinese-owned assets account for a very small fraction of the Korean economy, although Korea is one of the major host countries of Chinese SCEs' outward FDI. But if the surge of Chinese FDI into Korea continues, the downsides of entrusting the governance of Korean businesses to privileged but not necessarily efficient Chinese SCEs would be harder to ignore.

Permitting the Chinese government and Communist Party to control large swathes of the big business sector in Korea is not only economically undesirable, but might also be politically unsustainable in Korea for (at least) reasons. First, Chinese controlled Korean companies would almost certainly lobby Korean officials, just as Korean firms do. But the Chinese-controlled firms are creatures of a foreign government, and Koreans might fear that their lobbying might be driven by Beijing's foreign policy objectives, and thus might compromise Korean sovereignty.. Although overt lobbying too overtly aligned with Chinese official interests is unlikely to prevail, subtler forms of lobbying on issues that remain out of the headlines might be a genuine concern. Second, the Korean electorate is unlikely to allow it. Nationalism is a political reality in most countries, and many Koreans are likely to feel uncomfortable granting Chinese SCEs too much economic power and political influence. Consequently, Korean politicians may end up seeking the least economically damaging of the above restriction options.

With chaebol groups already unpopular, and their intrinsic governance problems counting against their serving as nationalist champions, the workable options would appear to include an overt restriction on takeovers by foreign state-controlled entities, a national security test that foreign takeovers must pass,

or more liberal use of firm-level anti-takeover defenses that leave institutional investors free to act, such as voting caps and poison pills..

5. Conclusion

Despite the media buzz, China's outward FDI is still relatively tiny relative to its GDP, even compared to those of other developing countries. However, this FDI is mostly acquisitions in neighboring Asian countries and resource-rich parts of Africa by cash flush Chinese SCEs with domestic monopolies and preferential access to capital. We argue that their insiders are likely to use retained earnings to fund investments that advance their careers as bureaucrats, like "flagship" projects overseas, rather than investments with high economic returns in the long run. Much of China's outward FDI may thus result from free cash flow problems in its large SCEs. China's outward FDI may be justified politically as instilling national pride, but only as long as China's taxpayers, savers, and consumers continue to foot the ultimate bills.

But, standard economic rationales for FDI may also take unexpected new turns in China, and may provide real economic justification for some of China's outward FDI. The internalization theory of FDI, appropriately reinterpreted, posits that Chinese SCEs' vast experience in navigating complex bureaucracies, might carry over to countries with similar institutional environments. Also, in certain maturing industries, outward FDI from China, even into advanced economies, might make economic sense. This ownership inversion, derived from Grossman and Hart (1986), argues that, as efficient production, rather than ongoing innovation, becomes the locus of competition, those best able to control production costs and quality control should own residual claims.

The above perspectives are all consistent with the stylized facts we observe, and are not mutually exclusive. Each may explain some part of Chinese outward FDI. Prospective host country governments may be subjected to pressure to limit or proscribe takeovers of their domestic firms by Chinese SCEs. Since many of these takeovers may be inefficient, such policies are not readily dismissed.

Allowing individual firms to erect takeover defenses is one such option, and may be defensible if it leaves unaffected alternative checks on inefficient management, such as institutional investors. A government agency to vet takeover by entities under the control of foreign governments is another option, as is the American 'national security test' on foreign takeovers. Expanding pyramidal business groups to pre-empt takeovers is likely the least desirable option, for this almost certainly restricts the influence of institutional investors and promotes a range of other governance problems.

But each of the various ways takeovers might be vetted, restricted, blocked, or banned has offsetting costs. These are likely to differ in different countries, and the best public policy option is consequently also likely different across countries.

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