Economic Watch

China | Overseas Direct Investment Pivoting to Global South

Betty Huang / Le Xia

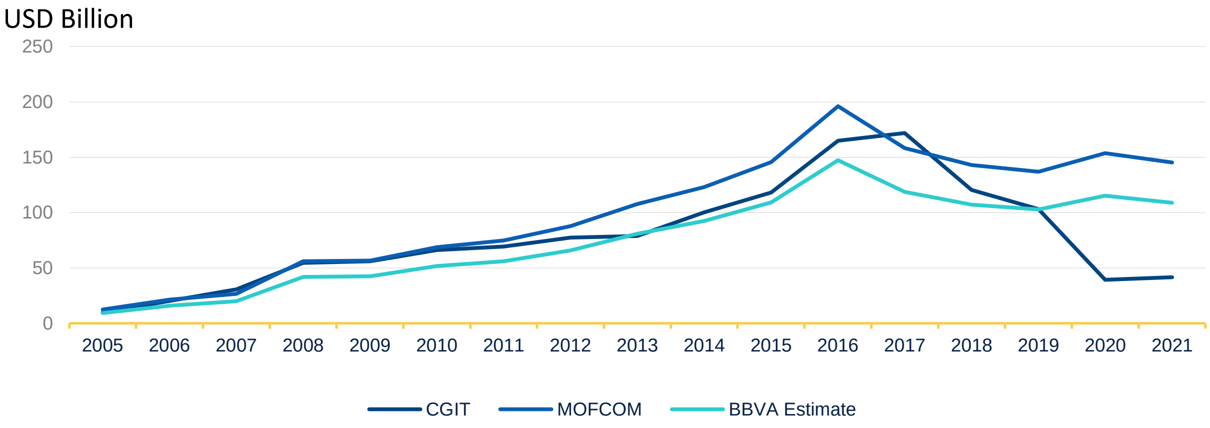
July 12, 2022

Chinese ODI stagnated in 2021 despite global recovery

With the majority of countries in the world deciding to live with the coronavirus, global FDI flows showed a knee-jerk rebound in 2021 after the dip caused by the pandemic in 2020. According to the UNCTAD, the global FDI rose by 77% to an estimated $1.65 trillion last year, from $929 billion in 2020, even surpassing its pre-pandemic level. Developed economies saw the biggest rise (which accounted for nearly 75% of total increase), while developing economies, especially the least developed ones, saw a relatively modest recovery. Driven by favorable long-term financing conditions, recovery stimulus packages, and overseas investment programs such as China's One Belt One Road (OBOR) Initiatives, investors' confidence was strong in the infrastructure sector last year. Meanwhile, investors' confidence in global value chains remained weak due to rising geopolitical uncertainties.

China's overseas direct investment (ODI) has experienced several years of slowdown and stagnation since its value reached a historical high in 2016. In 2021, the country's anti-Covid measures, including strict cross-border travel controls, the substantial reduction of flight numbers, and unbearably long quarantine requirements, all weighed on ODI deal making through the year. As a consequence, the aggregate value of China's ODI failed to synchronize with the global recovery over the same period. (Figure 1)

Figure 1 **CHINA's ODI ESTIMATES BY AEI, MOFCOM AND BBVA**



Source: China Global Investment Tracker (AEI), MOFCOM and BBVA Research

It is noted that our estimate of China's ODI is mainly based on two important sources: China's Ministry of Commerce (MOFCOM) and China Global Investment Tracker (CGIT) reported by the American Enterprise Institute (AEI). As shown in figure 1, there exists a remarkable discrepancy between the figures reported by these two sources. We use some algorithms to adjust them and to come up with our own estimate, which, we believe, is much less subject to the biases caused by round-tripping ODI as well as unreported smaller transactions, and therefore can better reflect the real pattern of China's ODI. Moreover, our algorithms also allow us to find real final destinations for China's ODI, rather than a number of entrepôts including Hong Kong and some tax havens in the Caribbean as reported by MOFCOM. (Please refer to our previous report for our adjustment algorithms: China_Pandemic Shaping the New Pattern of ODI and China's ODI: How much goes where after round-tripping and offshoring?)

Mapping ODI footprints: pivoting to global south is ongoing

The geographic distribution of China's ODI underwent significant changes over the past few years (Figure 2). A discernible trend is that it is pivoting to global south countries in Latin America and Africa given that most advanced countries enhanced their regulations or discriminations against fund flows from China, which partially reflected the rising geopolitical uncertainties between China and the US. Moreover, In Emerging Asia, the relatively slower vaccination progress could have temporarily held up China's investment in 2021. All in all, this "Pivot to Global South" phenomenon is likely to persist in the foreseeable future as we believe that the ongoing competition between China and the US is structural and cannot be reversed in a short time.

North America, including both the US and Canada, which was once the leading recipient of China's money, shared a slim slice of China's total ODI (2020: 2.9%; 2021: 3.7%) over the past couple of years. This is in stark contrast with the pattern in 2016 when North America accounted for one-third of China's total ODI. In addition to the blow of the pandemic, the increasing suspicion and stringent regulations against China's investment constitutes other important drivers of the shrinking market share. Currently, the Committee on Foreign Investment in the United States (CFIUS) reviews have become the biggest regulatory barrier to Chinese investment. Moreover, the Foreign Investment Risk Review Modernization Act (FIRRMA) was put into practice in 2020, which further expanded the scope of CFIUS and allowed it to focus on more sectors. These regulatory constraints have substantially slowed the pace of Chinese investment to the US, especially in the areas of infrastructures, advanced technologies, healthcare, raw materials etc.

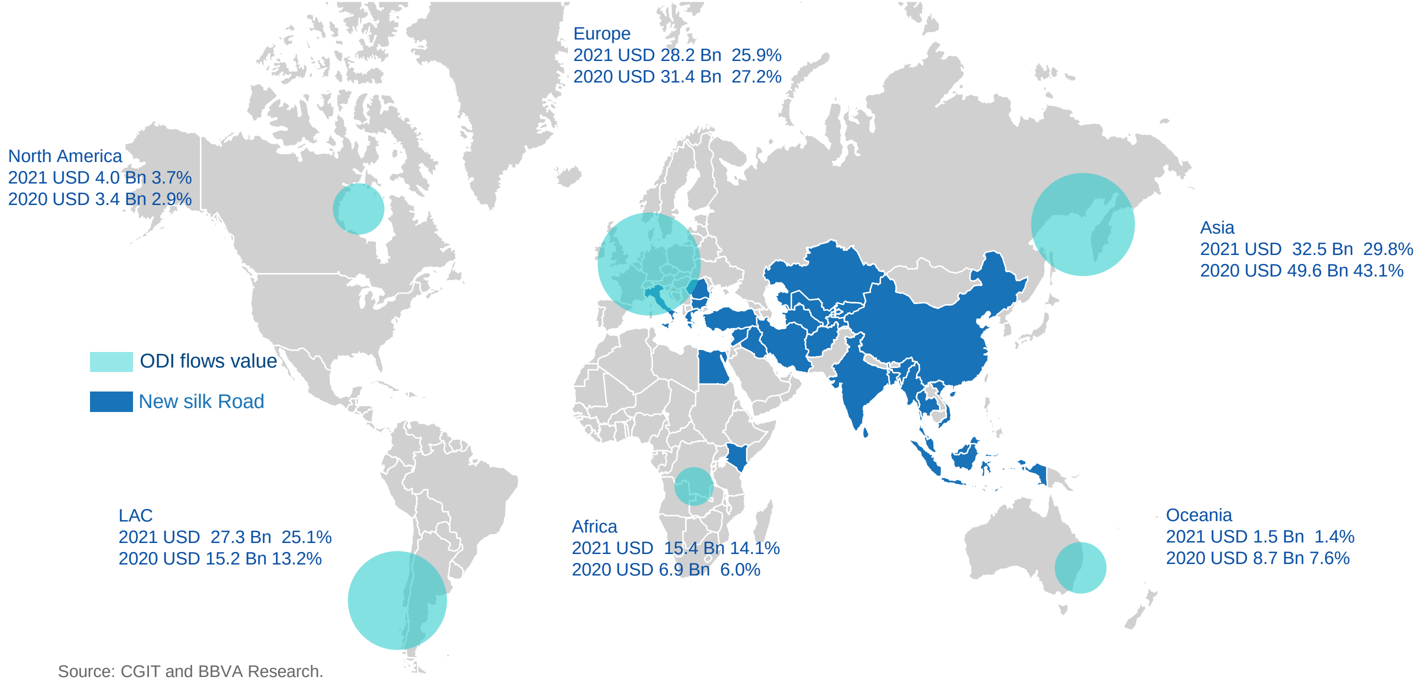
A similar decline was also found in Oceania. The worsening relation between China and Australia over the past few years, which was almost for no reason, has translated into a remarkable decline in bilateral trade and investment. In 2021, China's investment in Oceania declined to USD 1.5 billion (versus USD 8.7 billion in 2020), a mere 1.4% of China's total ODI (versus 7.6% in 2020).

China's direct investments in Europe are increasingly faced by screening requirements, which witnessed a further decline to USD 28.2 billion in 2021 from USD 31.4 billion in 2020 while the market share declined from 27.2% to 25.9% accordingly. Europe continued to be one of important destinations for China's investment, due in part to the fact that European authorities haven't turned their foreign investment screening mechanisms and regulations to a pure political game just as in the US. Therefore, there are still opportunities for the Chinese investors which desire to achieve the synergy or technology development in their own sectors. For example, Germany continues to be an attractive destination for Chinese funds. German authorities are still welcome to the Greenfield investment from China although they tightened scrutiny on foreign investment in the high-tech and data-related sectors.

Asia continued to be the top destination for China's investment although a decline in both total value and market share was registered in 2021. China's ODI to the rest of Asia shrank to USD 32.5 billion in 2021 from USD 49.6 billion in 2020 while its market share declined to 29.8% from 43.1% over the same period. Three factors stood behind the decline: (I) due to the relatively slower progress of vaccination, most of Asian countries were implementing strict social distance and border control policies through 2021, which unavoidably led to less cross-border investment activities; (ii) Hong Kong, the most important entrepôts of China's ODI to other Asia countries, has been implementing strict traveler controls since early 2020; and (iii) some country-specific factors, for example, the worsening relation between China and India, hold back China's ODI as well.

In 2021 China's ODI made its biggest gain in Latin America and Africa where China's capital can find ample opportunities in the energy and infrastructure sectors. More importantly, China's funds are generally welcomed in these regions as the host countries are striving to get out of the economic downturn. In 2021, China's investment in Latin America accelerated to USD 27.3 billion from USD 15.2 billion in the previous year, almost doubling its market share. The increase was led by investment in Brazil with an aggregate USD 12.4 billion, thanks to the big investment in the oil sector, followed by Colombia (USD 8.3 billion), Chile (USD 2.2 billion) and Mexico (USD 1.8 billion). Meanwhile, the investment in Africa amounted to USD 15.4 billion in 2021, more than doubling the value of USD 6.9 billion registered in 2020. Accordingly, the market share of Africa significantly rose to 14.1% in 2021 from the previous 6.0%. Despite the pandemic, China's investment continued flowing to Africa, motivated by the strategic importance of their economic complementarities. Africa is endowed with abundant mineral and agricultural resources. They also need China's money to develop their own infrastructure including energy, transportation etc.

Figure 2 **GEOGRAPHICAL DISTRIBUTION OF CHINESE ODI FLOWS** (2020 and 2021)


Europe
2021 USD 28.2 Bn 25.9%
2020 USD 31.4 Bn 27.2%
North America
2021 USD 4.0 Bn 3.7%
2020 USD 3.4 Bn 2.9%
Asia
2021 USD 32.5 Bn 29.8%
2020 USD 49.6 Bn 43.1%
ODI flows value
New silk Road
LAC
2021 USD 27.3 Bn 25.1%
2020 USD 15.2 Bn 13.2%
Africa
2021 USD 15.4 Bn 14.1%
2020 USD 6.9 Bn 6.0%
Oceania
2021 USD 1.5 Bn 1.4%
2020 USD 8.7 Bn 7.6%

Source: CGIT and BBVA Research.

Note: The bubbles are indicative and do not exactly represent the size of ODI flows and stocks.
Source: AEI, MOFCOM and BBVA Research

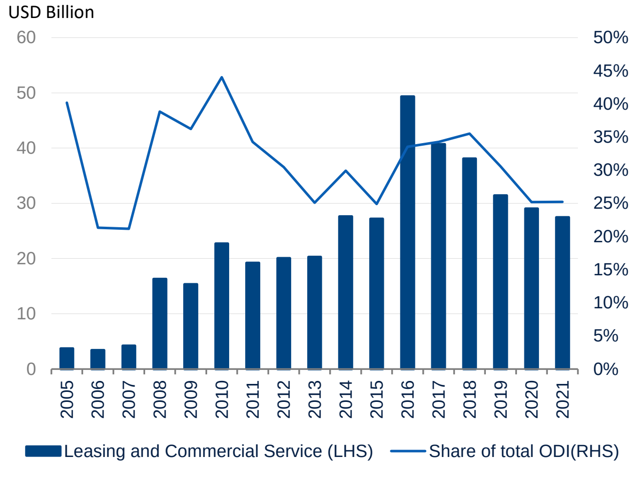
Energy and manufacturing sectors accounting for the lion's share

Across various sectors, the leasing and commercial service sector (USD 27.5 billion), manufacturing sector (USD 13.8 billion) and wholesale & retail trade sectors (USD 13.2 billion) were the top areas for Chinese ODI, accounting for almost half of China's total ODI, followed by the transport and infrastructure (USD 11.7 billion) and high-tech (USD 5.6 billion) sectors.

In 2021 the leasing and commercial service sector accounts for more than 25% of China's total ODI, broadly in line with the previous year's share although the total value of investment slightly decreased to USD 27.5 billion (versus USD 29.0 billion in 2020). (Figure 3) It is noted that the investment in the energy sector is in fact included in this category. According to our estimation, the investment flowing to the energy sector amounted to USD 25.5 billion in 2021, slightly up from USD 24.8 billion in 2020. Benefiting from China's authorities' efforts to push forward the global carbon neutrality promise, the investment in clean energies such as hydro and alternative energy were more active than that in traditional energy, e.g. coal and oil.

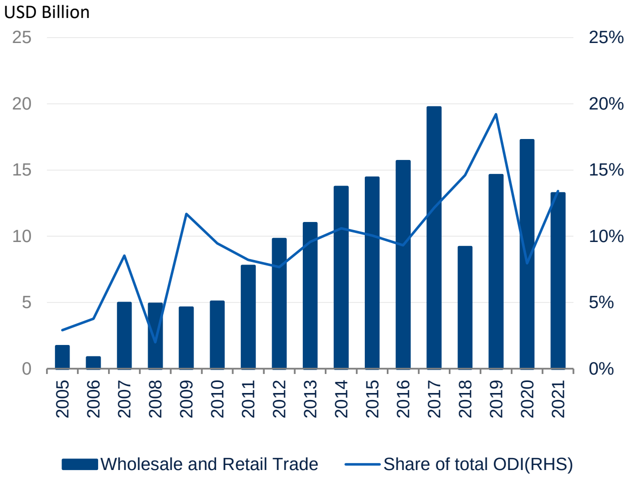
Both the total value and the shares of manufacturing and wholesale & retail trade sectors diminished in 2021. China's ODI in the manufacturing sector amounted to USD 13.8 billion (12.7% of China's total ODI), down from USD 19.4 billion (16.8% of China's total ODI) in the previous year. The pandemic seemed to have slowed the pace of relocating China's manufacturing capacity in other countries. Also, the retail trade sectors saw a decline of ODI to USD 13.2 billion in 2021 from USD 17.2 billion in 2020. At the same time, the increasingly tightened regulations in advanced countries prevented Chinese investors from acquiring advanced technologies via firms' M&A. These regulations seriously affected high-tech sector investment as well. In 2021 China's ODI in high-tech sector was down by 18.0% from 2020 to USD 5.6 billion, mainly including low-sensitive hardware manufacturing, software development, IT services etc. (Figure 4-6)

Figure 3. **LEASING AND COMMERCIAL SERVICE SECTOR WERE THE TOP AREA FOR CHINESE ODI**



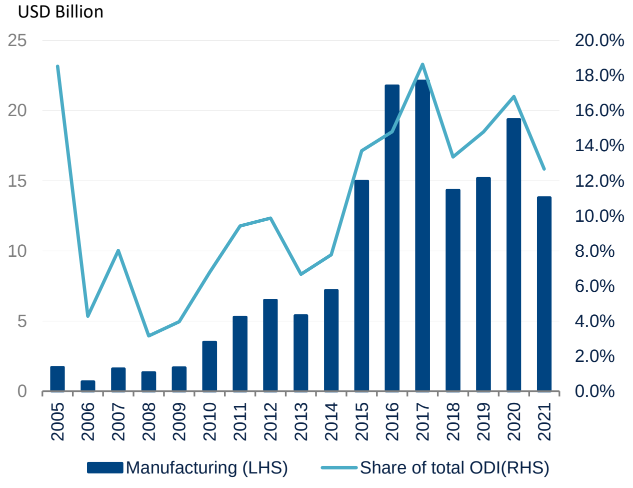
Source: CEIC and BBVA Research

Figure 4. **WHOLESALE AND RETAIL TRADE DIMINISHED IN 2021**



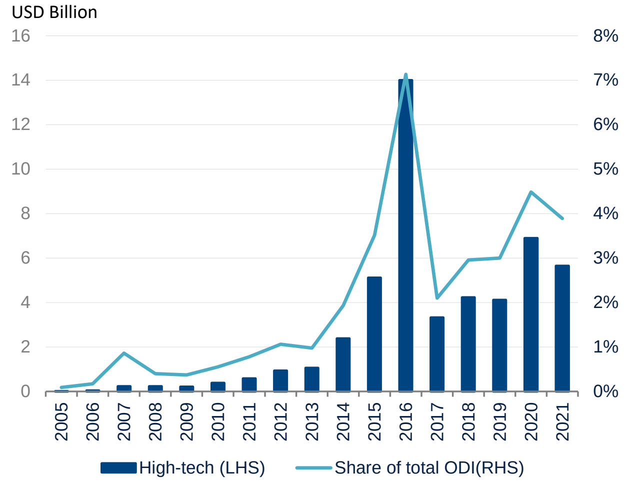
Source: BBVA Research and CEIC

Figure 5. **MANUFACTURING SECTOR CONTINUED TO DREW A LARGE SHARE**



Source: CEIC and BBVA Research

Figure 6. **HIGH TECH SECTOR FACES HEADWINDS FROM TIGHTER REGULATION**



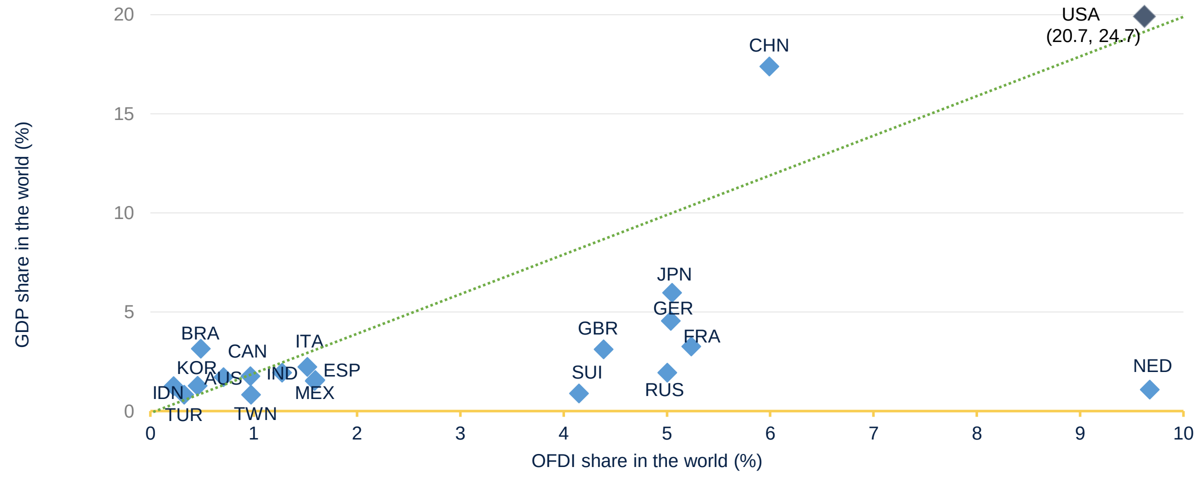
Source: BBVA Research and CEIC

Prospect of China’s ODI: a grim 2022 but recovery in the pipeline

The outlook for China’s ODI remains grim for this year due to a number of headwinds, chief among which include both the US monetary policy tightening and China’s “Zero Covid” policy. After several tranquil decades, inflation comes back to haunt the global economy again. Under the shocks of global supply bottlenecks and spiked energy prices caused by Russia’s invasion into the Ukraine, headline inflation climbed up to above 8% in most of the advanced countries across the Atlantic in the mid-year. Unabated inflation pressure has already prompted the major central banks including the US Fed, the ECB and BOE to accelerate their pace of monetary policy tightening. The fast monetary policy tightening doesn’t bode well for China’s ODI given the majority of investments are still financed by a handful of internationalized currencies such as the USD and Euro. Synchronized policy tightening of the central banks in advanced countries will not only lead to high financing costs but also add to currency volatilities in emerging markets, both of which are likely to hamper China’s overseas investment activities. Overall, the financial vulnerabilities in many emerging markets are still on the rise, as evidenced by the recent example of Sri Lanka’s country default and social unrest. Chinese investors have to think twice before they make the decision to invest overseas, in particular those countries appearing to be fragile. Moreover, China’s authorities’ obsession with the “Zero Covid” policy also thwarts the country’s cross-border investment as the country’s unbearably long quarantine requirements for international travelers lead to numerous postponements of business trips,

We expect the total value of China’s ODI in this year to hover around its level of 2020-2021 given that both tight global monetary conditions and China’s “Zero Covid” policy are likely to last for quite some time. Notwithstanding the short-term gloomy outlook, we have good reasons to be sanguine about its performance over the long run. First and foremost, China’s share of global ODI is still disproportionately lower than its share of global GDP, which constitutes a structural problem to be addressed in the long run. (Figure 7)

Figure 7 **CHINA'S SHARE OF GLOBAL STOCK ODI STILL HAS ROOM TO GROW**



Source: UNCTAD, IMF and BBVA Research

Ironically, the outbreak of the Russia-Ukraine war might inject additional incentives for China to continuously expand its share of global ODI. Indeed, due to its rising tensions with the US, China's authorities proactively deployed certain measures over the past few years, to secure energy and food supplies under adverse scenarios. Thanks to the authorities' efforts, China hasn't been seriously affected by the energy and food shortage faced by many other countries. However, given that the US-China rivalry is likely to last for the foreseeable future, China's authorities will put the security of energy and food supply on the top of their list in the coming decades. That being said, China will seek to deepen their cooperation with those friendly and resource-rich countries, mainly through ODI, to solve these problems.

In addition, an important lesson China draws from the Russia-Ukraine war is that a country's national foreign reserves could become hostile countries' target under certain circumstances. As part of financial fractions imposed on Russia, the Biden administration resolutely froze Russia's foreign reserves. China has a gigantic size of foreign reserves, USD 3.13 trillion as of May 2022, about one-third of which is directly invested in the US treasury bonds. Russia's lesson is likely to urge China's authorities to further reduce their exposure to the US financial markets and orient part of foreign reserves to other investment areas. Apparently, increasing ODI in friendly countries is one of the important options for this diversification plan of foreign reserves.

Another driving factor of China's ODI might be associated with the ongoing supply chain relocation process. As early as the later stage of the Trump administration, the US government started to pursue the decoupling from China in a number of sectors. Punitive tariffs, technology embargos as well as market access limitations, all of which are regular weapons for the US government against China now, have created more barriers for China's producers and increased the competition edge of other emerging markets. Just as many multinational enterprises, Chinese enterprises actively move part of their production capacity to other emerging markets in the form of ODI, so as to circumvent the US trade barriers and take advantage of good business conditions in host countries. We expect that this trend will continue after the world, in particular China itself, normalizes from the Covid-19 pandemic.

In sum, China’s ODI has ample room to grow over the long run. In terms of destinations, the trend of pivoting to global south countries will persist in the coming years. In these emerging markets, China could secure its energy and food supply through more investment in related sectors. Chinese enterprises are able to take advantage of cheap labor and land in these countries to relocate their production capacities. Moreover, China will continue to cooperate with these countries in infrastructure investment under its flagship One Belt One Road Initiatives.

DISCLAIMER

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Any estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

With regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. Reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process is prohibited, except in cases where it is legally permitted or expressly authorised by BBVA on its website www.bbvaresearch.com.

ENQUIRIES TO:
BBVA Research: 95/F, International Commerce Center, One Austin Road, Hong Kong
Tel. +2582 3111 / Fax +852-2587-9717
bbvaresearch@bbva.com www.bbvaresearch.com