

# RECORD FLOWS AND GROWING IMBALANCES

Chinese Investment in Europe in 2016

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## Chinese Investment in Europe in 2016

**Thilo Hanemann | Mikko Huotari**

- China's global outbound foreign direct investment (OFDI) jumped to almost USD 200 billion in 2016, an increase so great that Chinese policymakers are now seeking to slow the pace of outbound investment expansion.
- The European Union (EU) continues to be a favorite destination for Chinese investors, with more than EUR 35 billion of completed OFDI transactions in 2016, an increase of 77 per cent from 2015. This stands in contrast with a further drop in investment by European firms in China.
- Chinese investors are eyeing a broad range of industries, but showed particularly strong interest in technology and advanced manufacturing assets in 2016. Real estate investment, on the other hand, dropped sharply compared to 2015.
- Chinese OFDI shifted to "core" European economies in 2016. Germany and the United Kingdom accounted for more than half of total incoming Chinese investment last year.
- The growing imbalance in two-way FDI flows, persisting asymmetries in market access, and growing Chinese acquisitions of advanced technology and infrastructure assets have spurred heated debates in Germany and other nations about related risks.
- While the fundamentals suggest that Chinese outbound investment in Europe should remain high in the coming years, political uncertainty arises from Chinese capital controls as well as from changing attitudes toward Chinese investment among European policymakers, regulators and the broader public.

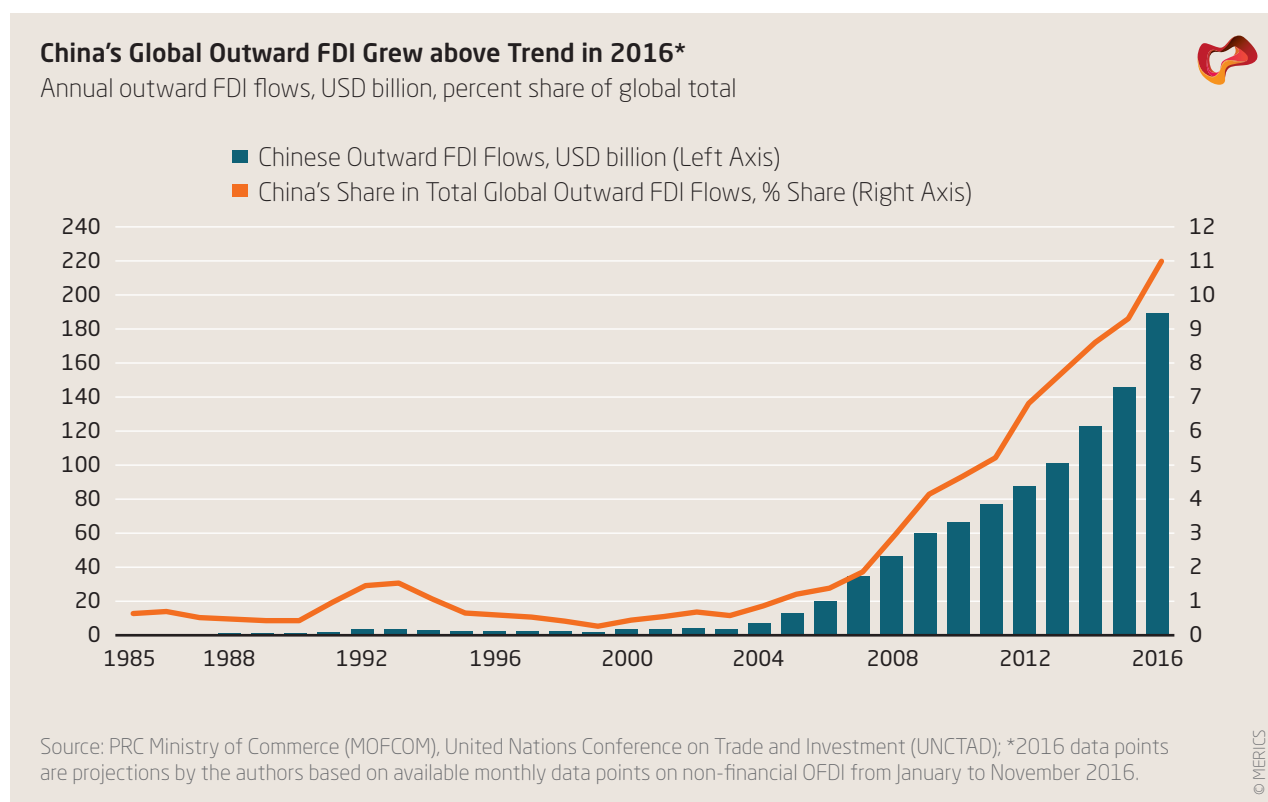
Foreign direct investment (FDI) has become an increasingly important part of the EU-China economic relationship. European companies have invested hundreds of billions of euros into the Chinese economy since the 1980s and have made big bets on China's transition to a new consumption-, service- and technology-driven economy. Chinese investment in Europe was relatively limited in past decades but has grown exponentially in recent years, creating new opportunities for Europe, but also concerns. Rhodium Group and the Mercator Institute for China Studies (MERICS) have supported European policymakers in understanding and assessing the implications of growing Chinese investment through an in-depth study released in 2015 and an update on Chinese investment patterns in Europe in 2016. This update reviews the patterns of Chinese FDI in Europe in 2016 and related policy discussions.

## CHINA'S GLOBAL OUTBOUND INVESTMENT FURTHER ACCELERATED IN 2016, MAKING CHINESE LEADERS NERVOUS

China's global outward FDI has been on an impressive growth trajectory for the past decade, with an annual average growth rate of 30 per cent from 2005-2015. In 2016, Chinese outbound investment grew faster than this historical rate. The acceleration was driven by greater incentives for corporations to diversify in the face of a slowing domestic economy, financial stress and devaluation pressure on the Chinese currency. Official full-year data is not yet available, but we estimate that Chinese outward FDI came close to USD 200 billion in 2016, a 40 per cent increase compared to 2015. This cements China's role as one of the top direct investor nations globally.

The rapid growth of global investment activity by Chinese companies has made Chinese leaders nervous and has triggered a re-tightening of administrative controls to crack down on certain types of transactions. In early 2016, the central bank first informally reached out to banks and local bureaucrats and asked them to increase their scrutiny of outbound investments. In November, the key agencies involved in China's OFDI regime implemented even more stringent reviews for certain outbound FDI transactions with the goal of cracking down on illegitimate transactions. The tightening of controls is a response to growing capital outflows under China's balance of payments, which are draining China's foreign currency reserves and putting increasing downward pressure on the Chinese currency.

Figure 1



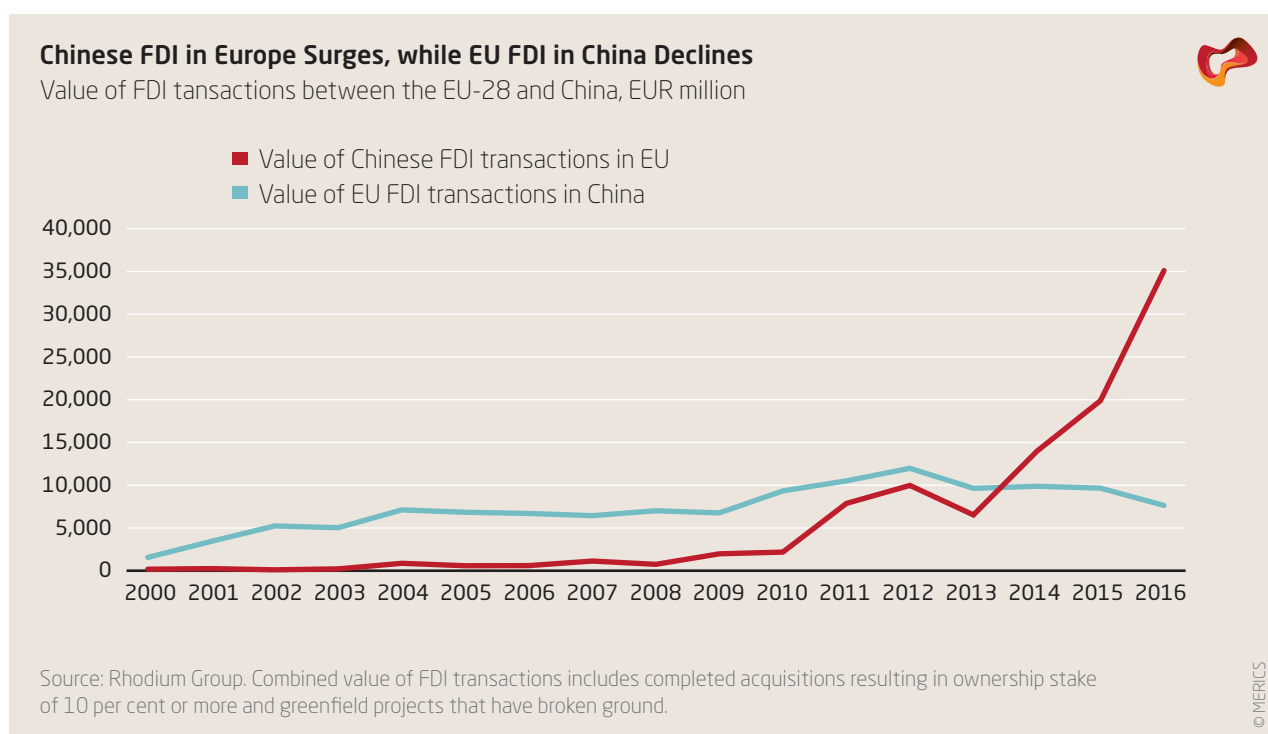
## CHINESE INVESTMENT IN EUROPE REACHED A NEW ALL-TIME HIGH WHILE EUROPEAN FDI IN CHINA DECLINED FURTHER

Europe has emerged as a key destination for Chinese OFDI. In 2016, Chinese companies invested EUR 35 billion in the European Union (EU), a 77% increase from last year. Compared to 2015, when a large part of Chinese OFDI was accounted for by ChemChina's EUR 7 billion acquisition of Italian tire producer Pirelli, the deal mix was more widely dispersed and buoyed by medium-sized deals. The biggest transactions were the EUR 6.7 billion investment in Finnish gaming company

Supercell by a Tencent-led consortium; Midea's acquisition of German robotics company KUKA for EUR 4.4 billion; a 49% stake by a Chinese consortium in UK data center operator Global Switch for EUR 2.8 billion; HNA's acquisition of aircraft leasing firm Avolon for EUR 2.3 billion; Beijing Enterprises' purchase of Germany's EEW Energy for EUR 1.4 billion; Ctrip's EUR 1.6 billion acquisition of British travel platform Skyscanner; and Shandong Ruyi Technology's EUR 1.3 billion investment in French fashion company SMCP Group. Privately owned companies accounted for 74 per cent of total Chinese investment, a significant increase compared to just 30 per cent in 2015.

In contrast to this sustained rise in Chinese investment in the EU, European companies have become more hesitant to invest in China. The value of EU FDI transactions in China continued to decrease for the fourth consecutive year to only EUR 8 billion in 2016, which is less than one third of the combined value of all Chinese investments in Europe. In addition to slowing economic growth, looming overcapacities and lower margins in the Chinese market, these imbalances are also a result of persisting formal and informal market access barriers for foreign companies in China. The growing gap in two-way investment flows is fueling European perceptions of a fundamental lack of "reciprocity" between the EU and China. Language demanding greater reciprocity has now become common in conversations with China across many EU member states, as well as in Brussels.

Figure 2



### ADVANCED MANUFACTURING AND SERVICES ARE NOW DRIVING CHINESE INVESTMENT ACTIVITY, TRIGGERING EUROPEAN DEBATES ABOUT SAFEGUARDING CRITICAL TECHNOLOGY

The distribution of Chinese direct investment in 2016 shows that investors are driven by pressure to upgrade technology, brands and other strategic assets, as well as incentives to diversify globally and reduce over-exposure to a slowing Chinese economy. Similar to last year, advanced manufacturing assets account for more than one third of the total Chinese deal value in the EU, with a particular focus on machinery (KUKA and KraussMaffei Group). Other sectors that received greater interest than last year include information and communication technology (Global Switch, Skyscanner and Supercell); energy (mostly attributable to renewable energy investments such as Meerwind); utilities, transportation and infrastructure (Avolon, EEW Energy and Piraeus Port Authority); and entertainment (Odeon & UCI, MP & Silva). The biggest loser in comparison to 2015

was real estate, which may partially reflect the beginning of a crackdown on financial outbound investment by Chinese authorities.

Growing Chinese interest in the advanced manufacturing and services sectors further fueled European debate about potential risks from inbound Chinese investment. For one, Chinese interest is growing particularly rapidly in sectors that remain restricted to foreign investors back in China (for example entertainment or utilities and infrastructure), which has further amplified the political salience of unequal market access between European and Chinese markets.

Secondly, the growth of Chinese acquisitions of high-technology assets combined with new industrial policy plans has elicited fresh concerns about the sale of core industrial technology to Chinese buyers. The release of major new Chinese industrial policy plans (see MERICS Paper on China No. 2 “Made in China 2025”) that promulgate overseas M&A as a way of upgrading Chinese technology and ultimately displacing foreign companies both in China and globally have created new awareness of the potential long-term risks of such transactions for Europe’s industrial base. Officials in Berlin, Paris, Brussels and other European capitals have woken up to the potential implications of such scenarios and are discussing different options to address concerns about the potential long-term consequences of industrial policy, subsidies and other strategic state interventions.

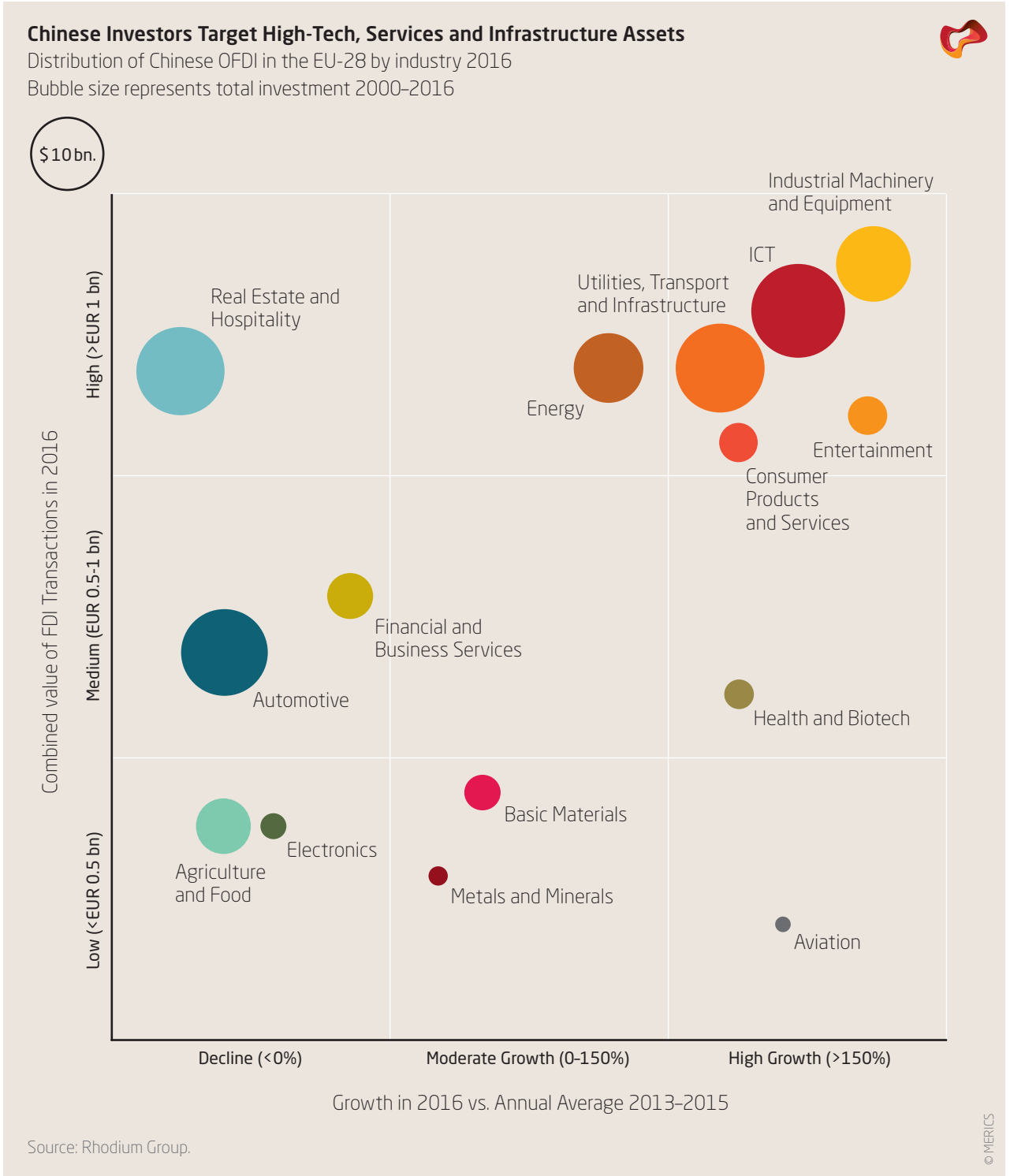
Finally, high-tech acquisitions and investments in infrastructure have also nudged forward European debates about the national security implications of Chinese investment. Foreign ownership can bring specific national security threats and security concerns are therefore considered legitimate exceptions to the general openness to external investment in the EU. Chinese investment elicits specific concerns because of its geopolitical position as a non-ally and a rapidly developing military power, its unique political system, state ownership in the economy and other characteristics. Specific transactions (Aixtron, Lumiled) highlighted that growing Chinese interest in technology assets translates into a greater spectrum of potentially concerning transactions due to the duality of purpose of certain technologies for both civil and military use. In addition to technology, the security debate also increasingly extends to “critical infrastructure”, as Chinese investors continue to acquire stakes in energy and electricity grids, power plants, ports and other transportation and communication infrastructure (see China General Nuclear Company’s investment in the Hinkley Point nuclear power plant, the sale of a stake in British data center operator Global Switch to a Chinese consortium or State Grid’s failed investment plans in Belgium).

Procedural hiccups (Aixtron, Hinkley Point) and emerging interest in greater transatlantic and international coordination on Chinese technology acquisitions underscore that the current system of fragmented national investment screening regimes is increasingly ill-equipped for addressing risks and providing certainty for Chinese and other foreign investors. Individual countries such as the UK and Germany have already begun to explore changes to their national investment screening regimes. There are also proposals in Brussels to better coordinate on foreign investments in critical national infrastructure (see the EU Commission’s new China strategy paper), but diverging national interests and security assessments (see, for example, Greece’s embracing of Chinese investment in the Port of Piraeus and electricity operator ADMIE) make a pan-European security screening regime unlikely.

## **CHINESE INVESTMENT SHIFTED BACK TO “CORE” EUROPEAN ECONOMIES**

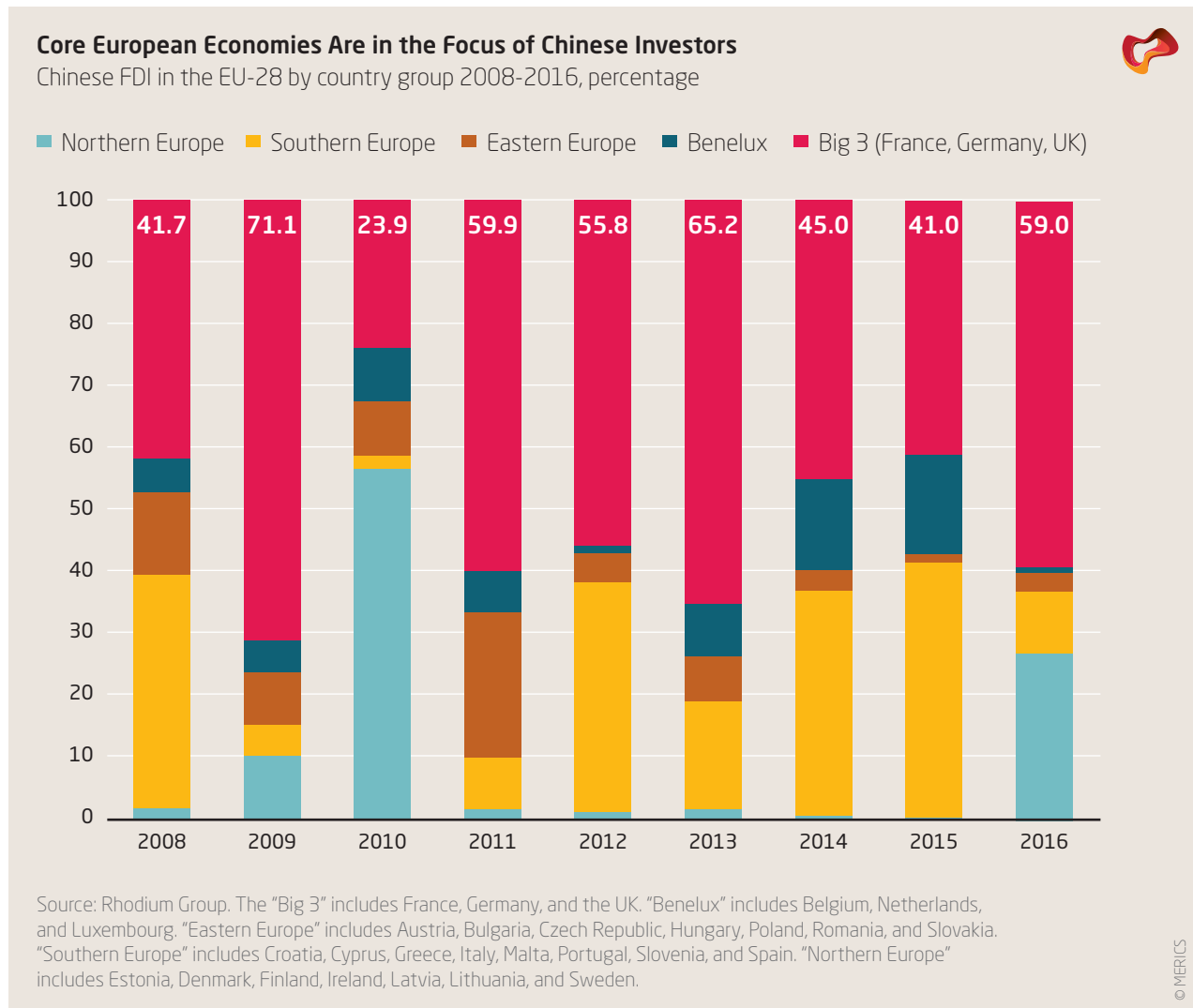
After a period of large-scale investment in Southern European economies, Chinese investors re-focused on the “Big Three” European economies (Germany, the UK, and France) in 2016. Germany (EUR 11 billion) and the UK (EUR 7.8 billion) together accounted for more than half (53 per cent) of the total investment value last year. The group of Northern countries came in second place due to Tencent’s EUR 6.7 billion investment in Finland’s Supercell and HNA group’s acquisition of Irish aircraft leaser Avolon. Southern Europe experienced continuing interest (with sizable investments in Italy, Portugal and Greece) with the Port of Piraeus and MP & Silva being the two largest transactions. Chinese investment in the Benelux states declined from the levels seen in previous years.

Chinese investment in Eastern Europe remains limited as newly announced projects, for instance in the Czech financial industry, materialize slowly despite the “16+1” (China plus 15 CEE



countries) format and Chinese promises of “Belt and Road” investments. While investment remains low, those promises are posing new challenges to European internal cohesion and external diplomacy. There are signs that European member states are compromising on European principles to accommodate Chinese investment (see investigation into procurement for the planned Hungarian section of a Budapest-Belgrade railway link). Chinese financing promises are also beginning to change the external policy calculations of member states and thereby diminish the EU’s ability to speak with one voice in important foreign policy areas (for instance after the South China Sea arbitration decision).

Figure 4



### GERMANY WAS THE KEY RECIPIENT OF CHINESE FDI IN EUROPE AND PROVIDES GOOD EXAMPLES OF CONCOMITANT POLICY DEBATES

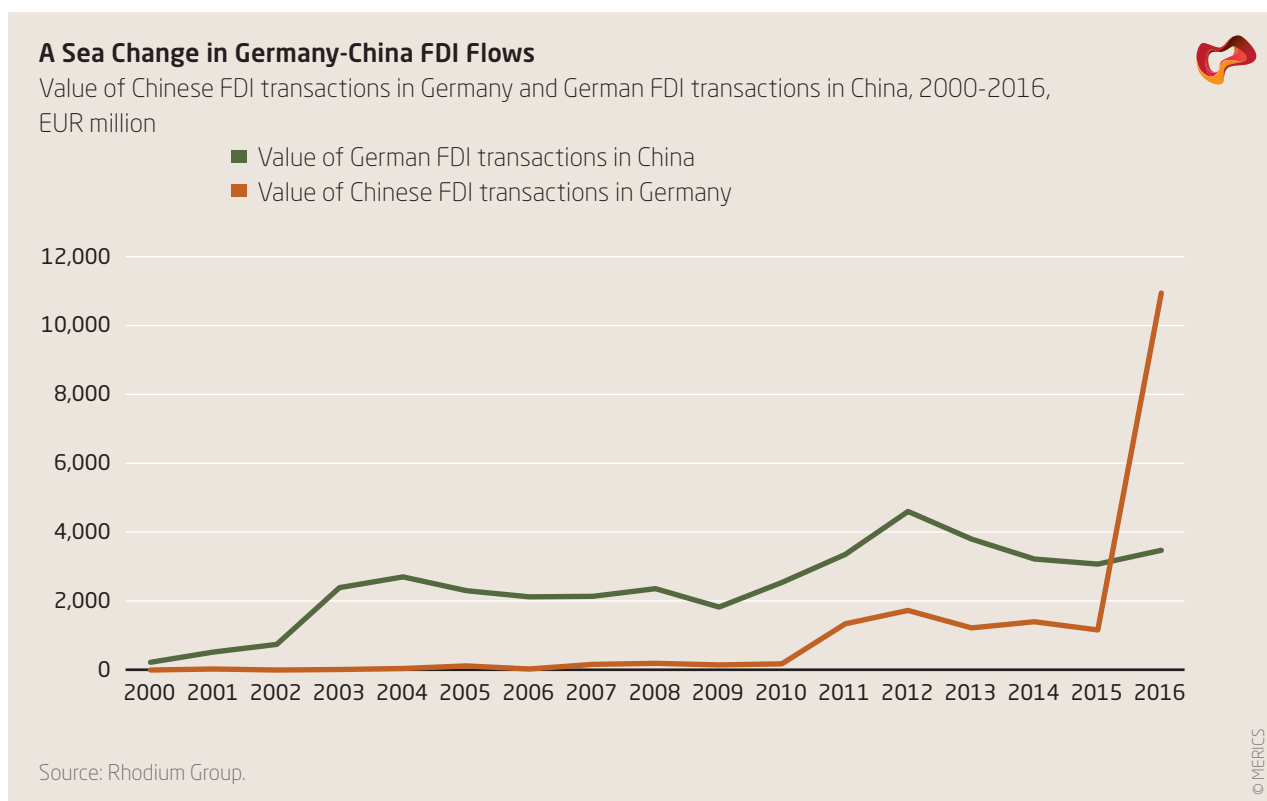
Germany took an outsized role in attracting Chinese investment in 2016. With EUR 11 billion of completed deals, it was the largest recipient of Chinese FDI, accounting for 31 per cent of total Chinese investment in Europe. The largest transactions were Midea's acquisition of robotics maker KUKA (EUR 4.4 billion); Beijing Enterprises' acquisition of waste incineration and power generation company EEW Energy (EUR 1.4 billion); CIC's investment in German property group BGP (EUR 1 billion); and China National Chemical Corporation's acquisition of industrial machinery maker KraussMaffei Group (EUR 925 million). This big increase also meant that, for the first time, annual Chinese FDI flows into Germany were greater than German FDI flows into China.

The sea change in two-way FDI dynamics has taken Germany to the forefront of major policy debates related to Chinese investment. With Germany being the largest investor in China and its biggest trading partner in Europe, Berlin was traditionally inclined to pursue a non-confrontational approach in its economic diplomacy toward China. Yet leading government officials took a more outspoken stance in 2016. The rapid increase of technology acquisitions, and especially the Midea-KUKA takeover, has spurred heated debates about the sale of critical technology to a country with industrial policies that aim at replacing German market shares in the future. The German ambassador to China and other officials have also ratcheted up public criticism of market barriers and an uneven playing field for foreign businesses in China. Finally, the German government



has shown more teeth in reviewing Chinese acquisitions for potential national security threats, withdrawing, for instance, its initial approval of a Chinese takeover in the semiconductor industry (Aixtron), which was later cancelled after the U.S. government blocked the sale of the company's U.S. assets. Taken together, these developments have burdened the bilateral diplomatic agendas over recent months and have contributed to a new realism in German-Chinese economic relations. However, the German political and business elites continue to be highly divided whether, and if so what specific changes to the government's traditionally open approach to foreign investment are necessary.

Figure 5



### CHINESE CAPITAL CONTROLS AND EUROPEAN POLITICAL BACKLASH THREATEN THE FURTHER EXPANSION OF CHINESE FDI IN EUROPE

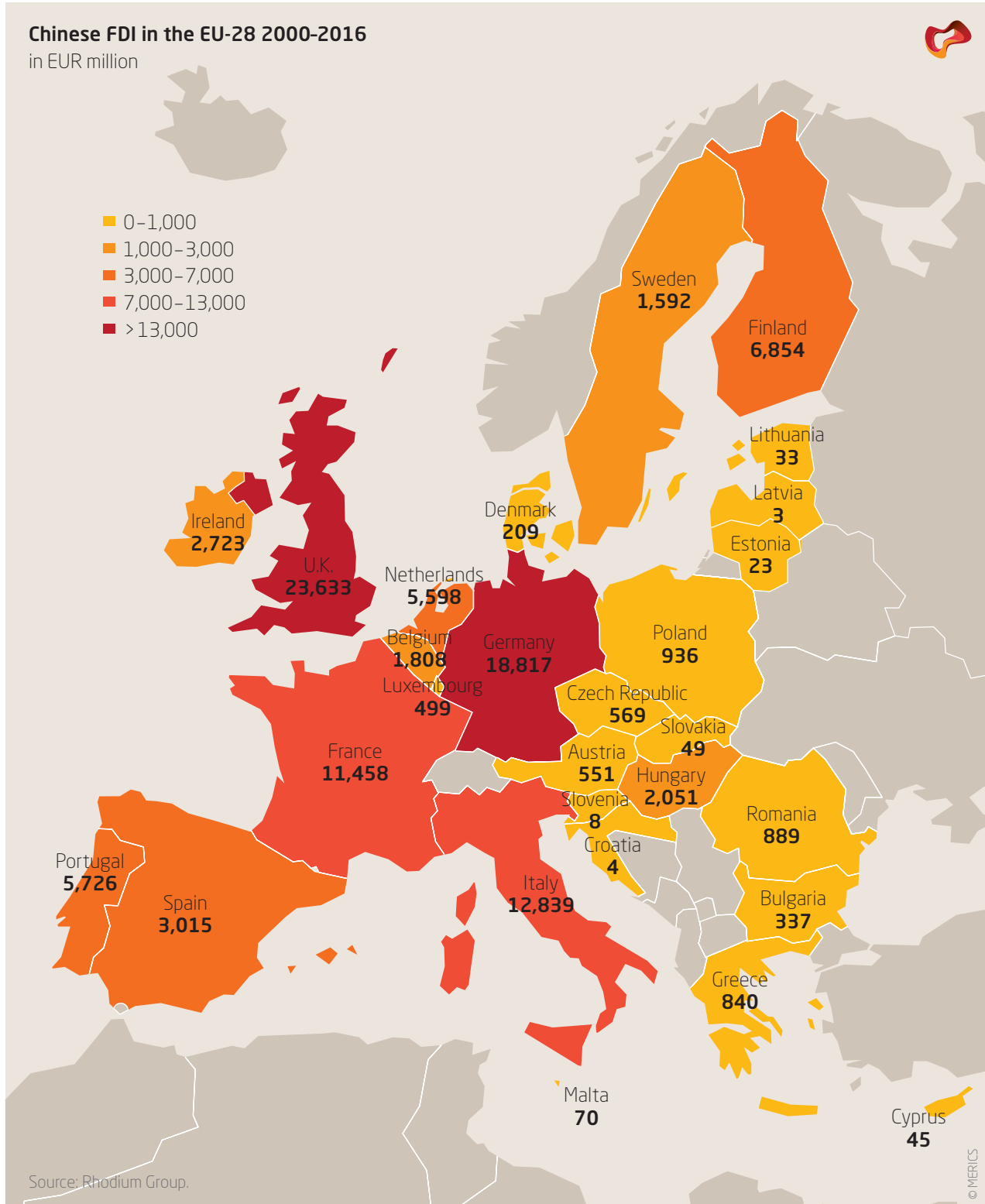
The structural drivers of the expansion of Chinese outbound FDI remain in place and will further gain momentum in the coming years. However, several developments suggest that China's global OFDI bonanza will not repeat itself in 2017.

As discussed above, growing concerns about capital outflows forced Chinese regulators to backtrack on certain aspects of OFDI liberalization and re-tighten the review of outbound investments. While these rules seem to be temporary and aimed at better filtering out illegitimate transactions, their implementation and reception by market participants is unclear, which creates uncertainty about the near- and medium-term trajectory of outbound FDI from China.

The second important unknown is the political reaction in Europe. Media coverage of Chinese acquisitions has increased substantially, which incentivizes politicians to politicize transactions and increases the probability of populist kneejerk reactions to Chinese deals. More importantly, persistently high levels of Chinese investment in Europe, combined with lack of progress in market and inward FDI reforms, has increased European awareness of the real security and economic risks associated with Chinese investment, which could result in new legislation to tighten investment reviews across Europe to address those concerns. Both the growing likelihood of politicization and a potential tightening of investment regimes pose risks to the further expansion of Chinese companies in Europe.

The single most important determinant of political reactions to Chinese investment in Europe will be China's behavior and reform progress. The only way to ensure that the European business community, government leaders and the broader public view growing Chinese investment in Europe as a win-win situation is for China to make real progress on reforms that increase the role of markets and level the playing field for foreign companies in China. A breakthrough in bilateral investment agreement negotiations would also be a powerful signal. If China continues to disappoint on internal and external reforms, a more pronounced backlash against Chinese investment in Europe seems inevitable.

Figure 6



**Imprint**

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