Economic Watch

China | Pandemic Shaping the New Pattern of ODI

Jinyue Dong / Betty Huang / Le Xia

June 2021

China's ODI amid the Pandemic: Stabilizing or Collapsing?

The Covid-19 pandemic, which hit the world unexpectedly in 2020, has significantly transformed the global economy in a very short time. Global trade and investment were seriously dampened due to both the plummeting demand around the world and government-imposed travel restrictions. According to the estimates of UNCTAD, the global trade and direct investment contracted by -5.3% and -35% in 2020 respectively.

Among the countries, China stood out in terms of its excellent economic performance amid the Covid-19 Pandemic. Although it was the first country which witnessed a series of flare-ups, the timely and effective launch of anti-pandemic measures helped the country to restore its economic vigor soon. For 2020 as a whole, China's total value of international trade (exports + imports) grew by 1.9%, outperforming the global average and most of its peer.

Meanwhile, the picture of China's ODI in 2020 still remains vague due to the mixed information from different sources. China's Ministry of Commerce (MOFCOM) reported that the country's ODI amounted to USD 132.9 billion in 2020, modestly down by -2.9% from the 2019 reading of USD 136.9 billion. It suggests a welcome stabilization of China's ODI after a persistent fall of several years since 2016 when the authorities tightened regulations to clamp down capital flight and stabilize the RMB exchange rate. However, according to the American Enterprise Institute (AEI), a reputable US public policy think tank, China's ODI was trimmed by almost two-thirds to USD 30.5 billion in 2020, pointing to a collapse of the country's ODI amid the pandemic.

The discrepancy between AEI and MOFCOM reported figures existed in the past while has significantly widened in recent years. (Figure 1) A confluence of factors led to such a widening difference.

First of all, the official data (reported by MOFCOM) doesn't exclude the round-tripping ODI, which is Chinese capital channeled overseas as ODI via stopover locations with the goal to return (back into) China as FDI. The purpose of round-tripping ODI is to benefit from China's preferential terms for foreign investors or to circumvent certain restrictions applied to Chinese domestic capital. A number of existing studies state that the round-tripping ODI could account for 20-40% of China's total ODI.[1]

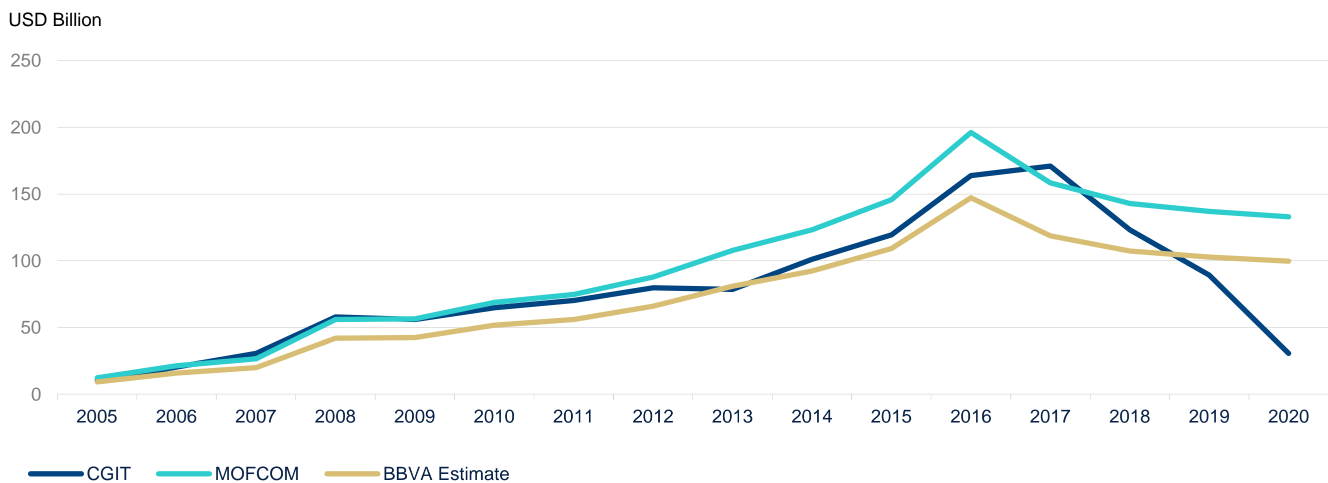
Second, the MOFCOM figures includes the reinvestment of retained profits by Chinese firms' overseas projects, which indeed constitutes an important part of total ODI, for example 31.2% as of 2019. But the reinvestment was not fully reflected in the AEI figures since it is deal-based.

1: For example , Geng Xiao (2004), People's Republic of China's Round-Tripping FDI: Scale, Causes and Implications, Latin America/Caribbean and Asia/Pacific Economics and Business Association, Working Paper No. 24, December 2004;
Garcia Herrero, Alicia, Le Xia and Carlos Casanova (2015): Chinese Outbound Foreign Direct Investment: How Much Goes Where after Round-tripping and Offshoring? BBVA Working Paper 15/17, June 2015, BBVA Research;
Damgaard, J, Elkjaer, T and N Johannesen (2019): "What Is Real and What Is Not in the Global FDI Network?", IMF Working Paper, December 2019.

Last but not least, the AEI database only includes the projects worth USD 100 million or above. However, due to the ever-mounting scrutiny pressure by other countries' authorities, in particular in the advanced countries including the USA, Japan and some European countries, Chinese firms deliberately managed the size of investment projects so as to circumvent the monitoring of other countries' authorities. As a result, the number of large-size projects disproportionally shrank even though the aggregate size of ODI only experienced a mild decline.

All in all, we reckon that the MOFCOM figures, after excluding the round-tripping part, might reflect the real picture of China's ODI better. We assume that the proportion of round-tripping ODI was 25% of China's total ODI and then adjust the series of MOFCOM. (Figure 1) The adjusted series is our estimate of China's ODI, which has a smaller gap with the AEI series relative to the original MOFCOM series. But just like the MOFCOM series, it stabilized somewhat during the period of 2019-2020 after a sharp fall from its 2016 peak.

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



Source: China Global Investment Tracker and BBVA Research

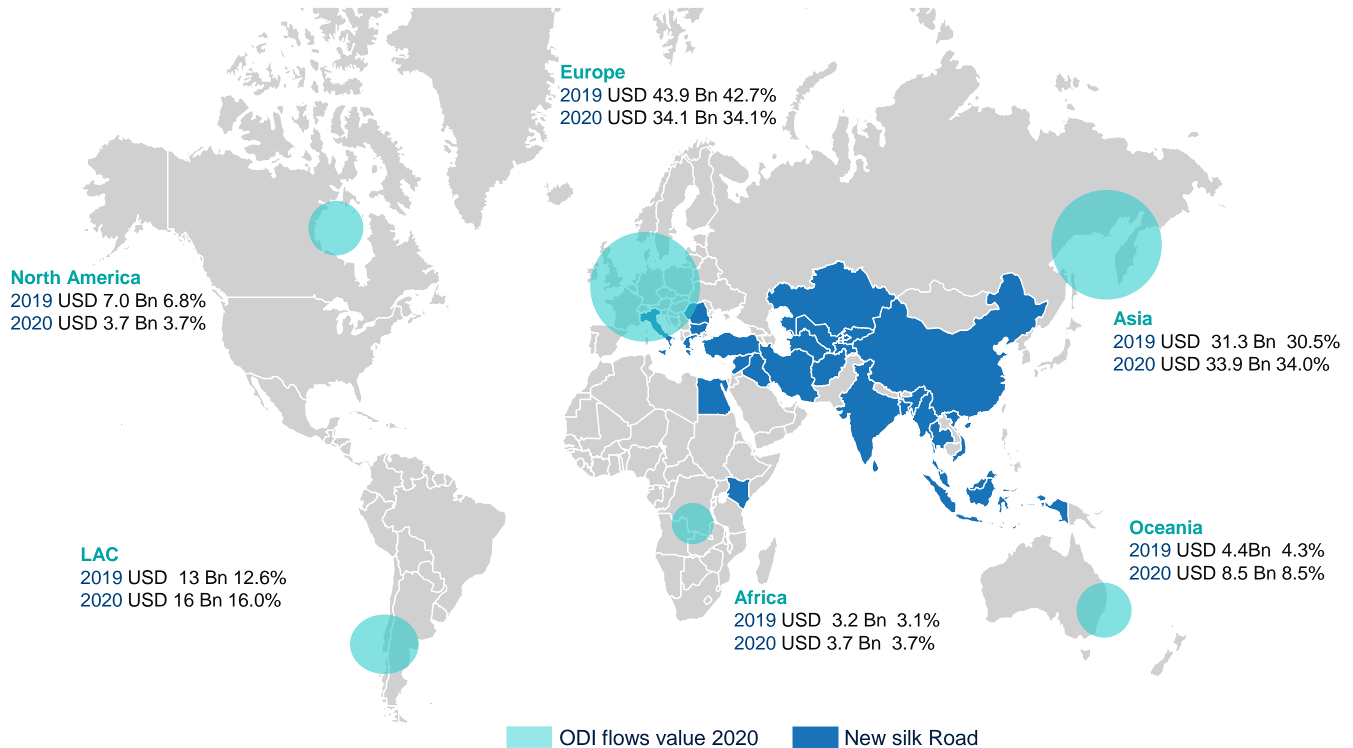
Redraw China's ODI footprint after adjustment

Another drawback of MOFCOM ODI data is the lack of adjustment for final destinations. In total, approximately 60% of China's total ODI flows to Hong Kong and some tax havens in the Caribbean, through which funds are expected to be channeled to their final destinations at a later stage. We use the similar methodology in one of our previous working papers to address the distortion of those tax havens and find the final destinations of Chinese ODI. (See our working paper: China's ODI: How much goes where after round-tripping and offshoring?)

The results show that the geographic distribution of China's ODI underwent nuanced changes during 2019-2020 (Figure 2). In particular, the North America, including both the US and Canada, used to be the leading recipient of China's ODI, which took in 53.1 billion USD in 2016, more than one-third of Chinese total ODI. However, China's investment to the North America plunged after China's relations with the US and Canada turned sour. In 2019 and 2020, China's ODI to North America only registered USD 7 billion and USD 3.7 billion respectively. Compared to the blow of the Covid-19 pandemic, the increasingly stringent regulations against China's investment constituted a much stronger headwind to China's investment.

The similar pattern was found in Europe, albeit to a less extent. China's ODI in Europe declined by -22.3% from USD 43.9 billion in 2019 to USD 34.1 billion in 2020. The European regulators have started to supervise China's investment in their countries with extra vigilance. As the China-Europe relations become sensitive now, it is certain that Chinese firms will reduce their investment in the Europe.

Figure 2 **DISTRIBUTION OF CHINESE ODI FLOWS** (2019 AND 2020)



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

In Asia, the ODI picked up slightly to USD 33.9 billion in 2020 from USD 31.3 billion in 2019, led by Pakistan, Thailand and Vietnam. Meanwhile, the investment in India and Indonesia slowed due to a second wave of Covid-19 and their slow process of vaccination. To our surprise, China's ODI in Oceania significantly increased in 2020, despite the recently deteriorating relations between China and Australia.

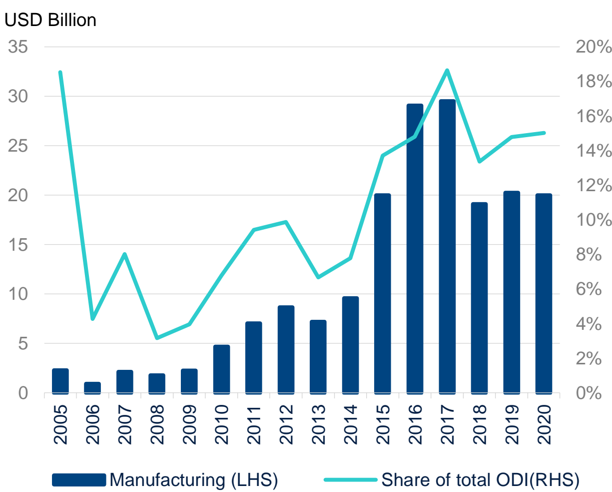
China's Investment in Latin American also picked up in 2020, with its share of total China's ODI increasing to 16% in 2020 from 12.6% in 2019. Among the countries, Chile is taking a led due to a big acquisition of electricity grids. The similar trend is also seen in Africa, where both the value and share as percentage of total ODI rose in 2020 mildly.

Manufacturing and infrastructure sectors continue to outpace other sectors

Across various sectors, manufacturing and infrastructure continued to take the lead in 2020. China's ODI in the manufacturing sector accounted for a large share of 15.1%, in line with the trend during 2015-2018. The infrastructure sector received USD 7.9 billion in 2020, including the subsectors such as construction and electricity, gas & water production and supply. China overseas construction projects were stable as the total value of newly-signed EPC contracts slightly dropped 1.8% yoy to USD $255.5 billion and about 80% of them were related to infrastructure. Commodity sector received USD 5.1 billion in investment in 2020, with the hydro and alternative energy subsectors seeing more activities than traditional energy such as coal and oil.,

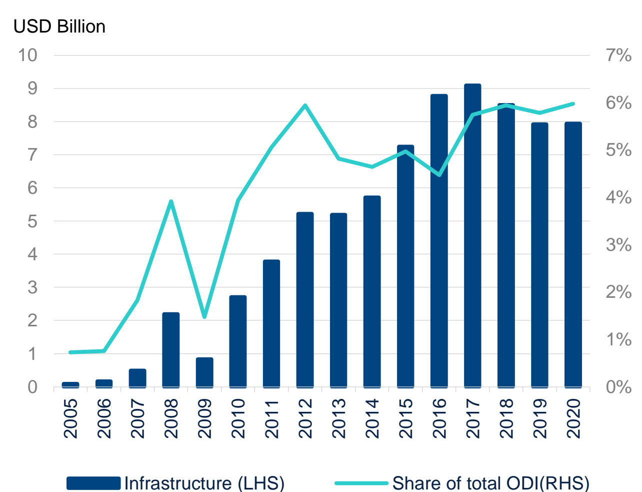
Over the past few years, several advanced countries started to perceive China's ODI in their high-tech sector as a potential threat to their leading position at the technological frontier and therefore imposed more limits on China's investment. However, the rise of Chinese own high-tech sector underpinned the ODI in other countries. In 2020 China's ODI in high-tech sector were up by 22.5% from 2019 to reach 6.7 billion USD, primarily including low-sensitive hardware manufacturing, software development, IT services etc.

Figure 3. **MANUFACTURING SECTOR CONTINUED TO DREW A LARGE SHARE**



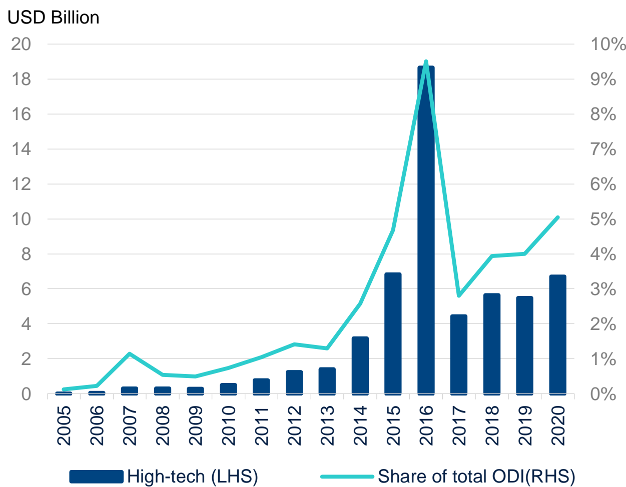
Source: CEIC and BBVA Research

Figure 4. **INFRASTRUCTURE WAS LED BY ELECTRICITY PRODUCTION AND SUPPLY**



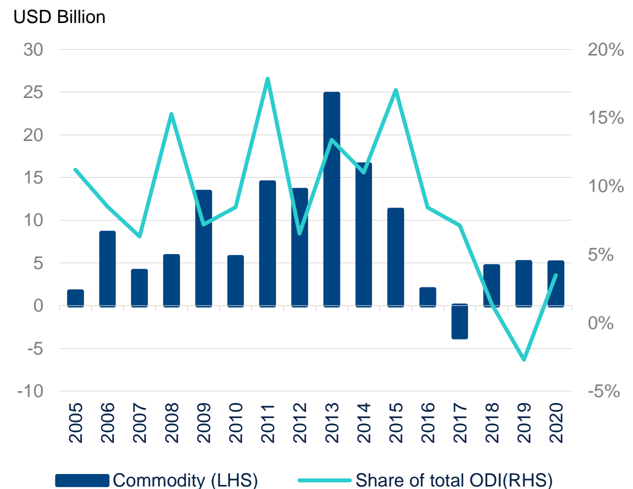
Source: BBVA Research and CEIC

Figure 5. **HIGH-TECH MAINLY IN LOW-SENSITIVE MANUFACTURING**



Source: CEIC and BBVA Research

Figure 6. **COMMODITY SECTOR WAS LED BY CLEAN ENERGY INVESTMENT**



Source: BBVA Research and CEIC

ODI will bottom out in 2021 but a big jump is unlikely

China's ODI proved to be resilient to knock-on impacts brought by the Covid-19 pandemic as well as China's soured relations with most of advanced countries. Therefore, we are cautiously optimistic about the performance of China's ODI in 2021. In projecting China's ODI, we adopted a bottom-up method in that we made our projections for a number of major sectors and then aggregated across them. We forecast that China's ODI will bottom out in 2021 to reach USD 104.7 billion, around 5% increase from its 2020 value.

First, ODI in the high-tech sector will continue to suffer from the advanced economies' enhanced scrutiny. Many economies, including the US and the EU enhanced their security scrutiny in 2020, primarily targeting Chinese technology investment in sensitive tech areas. In particular, the US expanded the scope of FDI scrutiny, promulgating Secure and Trusted Communications Networks Act on national security issue in March 2020; the EU Parliament also passed the Foreign Direct Investment Screening Regulation in March 2020, enhancing the FDI screening mechanism to avoid "sensitive" assets to be acquired or merged by foreign investors. Beyond these, UK, Canada, Australia, Japan, Russia and India etc. all tightened their FDI regulations on technology sector.

Second, ODI in overseas real estate, soccer club, entertainment and hotel etc. are under strict scrutiny of the Chinese authorities in a bid to regulate capital flight and maintain financial stability. Such restrictions are unlikely to be rolled back in the foreseeable future. Thus, we predict this sector will only maintain the current low growth rate in the next five years. These restrictions were announced in 2016-2017 when China's authorities took pains to curb massive capital exodus and stabilize the currency value.

Third, ODI in energy and commodity sector will gradually achieve the pre-Covid level in 2021 after the Covid-19 situation stabilizes in the target countries. The main target countries of China's energy and commodity ODI concentrate on emerging Asia, Africa and Latam America countries, due to their abundant natural resources. These investments are normally initiated by Chinese state-owned enterprise, which could rebound rapidly. When the border control releases together with the progress of vaccination, it is anticipated that energy sector ODI will go back to the pre-Covid level soon.

Fourth, manufacturing ODI will accelerate its pace to recover to the pre-Covid level. Based on the 2019 data, manufacturing ODI flow ranks number 2 in China's overall outward investment while its stock reached USD 200.1 billion, around 9.1% of total ODI stock. China's transition from "a manufacturer of quantity" to "manufacturer of quality" provides more opportunities of manufacturing overseas investment. There are some new developments of China's manufacturing ODI. The US tariffs on China also led to value chain diversification to circumvent the high export tariffs. In the medium to long term, lower labor costs in other emerging markets and fading comparative advantages of some specific sectors in China prompted Chinese enterprises to relocate their supply chain to ASEAN countries. (See our previous China Economic Watch: De-Sinicization of global value chain after Covid-19) That means, even without the Covid-19 pandemic or US tariffs, there will be a natural trend of global value chain relocation outside China. The recently signed multinational trade agreement such as RCEP (Regional Comprehensive Economic Partnership) will further speed up this process.

Finally, leasing and commercial service, which account for a large share of 30% of China's total ODI, is anticipated to recover to maintain its growth momentum at a faster pace than that of the pandemic time. China's leasing and commercial service ODI seems immune from the pandemic impact in 2020, which revved up to USD 41.79 billion at 17.5% growth. We anticipate the leasing and commercial ODI will further accelerate to 20% amid the global economic normalization.

In sum, in the short term, we have a cautiously positive view on Chinese ODI amid global recovery, but the performance varies across different sectors. In particular, we anticipate a stunning growth in leasing and commercial service, manufacturing, wholesale and retail trade sectors amid a gradual global economic normalization. After all, these sectors maintained the growth momentum even during the pandemic time. On the other hand, sectors of real estate, entertainment, hotel as well as high-tech will underperform, due to the tightening domestic regulation and the national security scrutiny of the advanced economies.

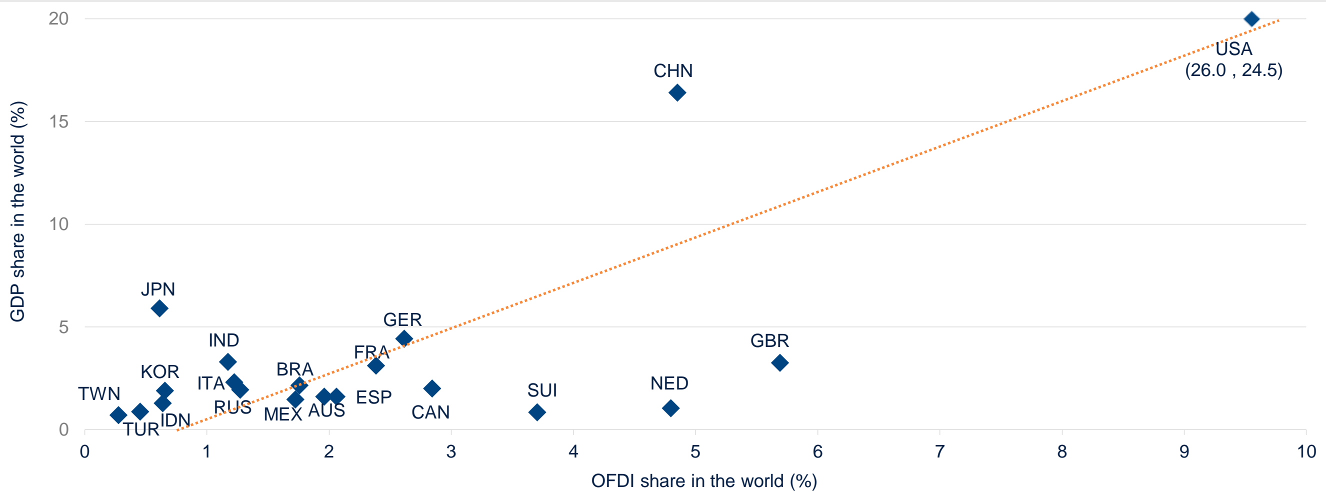
New features of China's ODI in the post pandemic era

Over the medium to long term, we hold an optimistic view of China's ODI. Compared to its share of global GDP, China's share of global ODI still has a lot of room to grow. (Figure 7) Moreover, despite the increase hostility of some advanced countries in high-tech scrutiny, China's ODI will benefit substantially from the authorities' policy supports on China's overseas investment, chief among them is the Belt and Road Initiatives. Under this framework, a number of newly established China-initiated institutions, including Silk Road Fund, Asian Infrastructure Investment Bank (AIIB), BRICS New Development Bank (NDB), China LAC Industrial Cooperation Investment Fund and the China-Latin America Infrastructure Fund, will play an increasingly important role.

We envisage that some new features of China's ODI will appear during the post-pandemic era. First, in response to the souring relations with advanced economies, the majority of China's ODI will pivot towards emerging economies. Comparatively, Asian emerging economies are likely to become the primary beneficiaries given their importance in terms of both economic and geopolitical positions. Second, the sustainability theme will become more important in

Chinas ODI. Even in the energy sector, China's investors' preferences will likely shift to renewable energy projects rather than the traditional ones. It is quite in line with China's authorities' promise to achieve a zero carbon emission by 2060. Last, SOEs will continue to be the main force in China's overseas investment. Compared to their private peers, China's SOEs are better suited to perform in a challenging environment. They can find overseas construction projects tied to the government's BRI strategy as well as get more favorable financing terms. The ODI of Chinese private firms will be suppressed by the authorities' persistent vigilance against capital outflows.

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



Source: UNCTAD, IMF and BBVA Research

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