Fear the Dragon?
Chinese Foreign Direct Investment in Canada

TRADE, INVESTMENT POLICY, AND INTERNATIONAL COOPERATION
Preface

This report analyzes China’s foreign direct investment (FDI) in Canada. It considers the strategic drivers of this interest. Canada needs FDI, but Canadian politics (and therefore policy) may not be receptive to such investments for the reasons explored in this report. The report concludes with the consideration of how Canadian foreign investment policy might facilitate greater investment flows from China and help to deepen the growing bilateral trade and investment relationship.
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¹ These organizations do not necessarily endorse the research conclusions of this report.
Fear the Dragon? 
Chinese Foreign Direct Investment in Canada

At a Glance

- This report considers the opportunities and challenges associated with Chinese foreign direct investment (FDI) in Canada.
- The opportunities arise largely from Chinese demand for natural resources, which its domestic companies seek, in part, to serve through foreign direct investments.
- Two characteristics of Chinese foreign investments are especially problematic: the involvement of state-owned enterprises and the focus on natural resources.
- The current Canadian FDI regime exposes Chinese investments to uncertainty and political risk.
- Canada would attract higher Chinese investment under a more explicit regime that clearly lays out the requirements and is less subject to political interference.

This report considers the promise and challenges associated with Chinese foreign direct investment in Canada. The federal government is interested in diversifying Canada’s resource export markets. China, too, is looking to diversify its sources of resource imports. Thus, there is the potential for cooperation between the two nations. Yet the governance of Chinese companies will continue to present a challenge to Canada’s foreign direct investment (FDI) regime. The report explores how Canada’s FDI regime can be modified to encourage additional Chinese investment.

Drivers of Chinese Outward Foreign Direct Investment

China and Japan share the hallmarks of export-oriented countries with high savings rates. The two countries now account for about 55 per cent of the world’s foreign exchange reserves. China alone maintains almost US$3 trillion in foreign exchange reserves. In export-oriented countries with high savings rates, pressure builds to recycle foreign exchange, especially to avoid currency appreciation that may undermine the export-orientated approach to economic growth. One of the key drivers of China’s growing FDI position is simply that it has developed the financial resources to execute deals.

FDI Channelled Through State-Owned Enterprises

In the mid-1990s, China began consolidating its state-owned enterprises (SOEs). This consolidation led to the formation of companies such as Sinopec Group, China National Petroleum Corporation, and State Grid, which are now among the world’s largest corporations. These same corporations are now major players in China’s outward FDI.
A formal policy of global expansion, called the “Go Global” policy, has given these companies further impetus. The Chinese state promotes outward investments that:

- obtain resources or raw materials that are lacking within China, which the national economy requires for its development;
- stimulate the export of products, equipment, or technology in which China has a comparative advantage and labour service exports; and
- improve China’s technological research and development (R&D) capability and make use of internationally advanced technology, advanced management experience, and specialist human resources.

The first element, the search for raw materials lacking in China, has been the major factor in China’s outward FDI.¹

**HUNGER FOR RESOURCES**

China is a major producer of many resource commodities. It is the world’s largest producer of coal and is among the largest producers of iron ore, aluminum oxide, manganese, zinc, and gold. From 2000 to 2010, China had triple-digit rates of increases in the production of aluminum (441.8 per cent), cement (219.5 per cent), and steel (396.0 per cent). Yet in the same years, the value of China’s imports of iron ore increased 42.5 times, thermal coal 248 times, and copper 16.2 times. Even though China is a major producer of commodities, its demand outstrips its supply by a wide margin.

A key priority of Chinese FDI is to develop global supply chains in order to service domestic demand for resources. Not surprisingly, there is a focus on resource-rich countries. Indeed, scaling these Chinese investments to gross fixed capital formation (GFCF) in each country further emphasizes the importance of Chinese FDI in resource-rich countries. Chinese non-bond investment accounts for about 2.8 per cent of GFCF in Iran and 2.3 per cent in Australia. The point is that Chinese investments have the potential to be a significant part of capital formation in resource-rich economies.

¹ Freeman, China’s Outward Investments, 5.

**CHINA MEETS CANADA**

These drivers have naturally resulted in the consideration of Canada as a host for Chinese FDI. Yet relative to GFCF, China’s non-bond investment in Canada is only about a third of that in Australia.

The current majority Conservative federal government is quite clear on its intent to grow Canada’s resource sector and to diversify export markets. The aftermath of the U.S. decision to delay approval of the Keystone XL pipeline project restated this strategic goal.

Government support for the Northern Gateway pipeline project, and liquefied natural gas (LNG) facilities in northern British Columbia, revealed the goal again. The government is also interested in improving Canada’s overall attractiveness to FDI.

Part of the solution to Canada’s declining global FDI performance is to entertain more FDI in sectors that serve Chinese demand—namely resources. This would rebalance global FDI flows, which currently favour China. Not surprisingly, China’s foreign direct investments in Canada mirror China’s overall investments on two counts: very rapid growth and an emphasis on energy investments. We found that about half of China’s $14-billion current investments are in resources.

A review of recent Chinese FDI in Canada highlights the importance of resources. The deals confirm an emphasis on large-scale resource investments—more specifically, energy. Two large SOEs—Sinopec and PetroChina—have been most prominent. China Investment Corporation, China’s sovereign wealth fund, has also been active, most notably through its stake in Teck Resources, the largest Chinese investment in a Canadian miner. Minmetals and WISCO International have made smaller mining investments.

In most cases, Chinese companies have taken a minority position—likely to avoid the political problems of assuming control of resource projects. The only exceptions have been in cases where a company or a project has encountered financial difficulties and the Chinese have
taken larger stakes to ensure company or project viability. SOE investments dominate, but there are many smaller deals that do not attract the attention of regulators. A survey of Chinese investment intentions showed that 56 per cent of respondents were interested in setting up sales channels, while only 1 in 10 were interested in actual manufacturing in Canada. That suggests that most of the economic impacts from Chinese investments in Canada are found in the fewer and larger capital investments of large Chinese SOEs.

China has the potential to be the third-largest FDI investor in Canada before 2015, and could easily place second to the United States by 2020. But for that potential to be realized, Canada needs to re-evaluate its FDI regime.

**HOW WE SHOULD RESPOND**

There are two issues facing Chinese investments. One relates to the underlying governance of SOEs, especially from a Communist state. The second is the emphasis on resource investments. Both of these characteristics mean that Chinese investments are among the most politically sensitive.

Chinese investments in Canada are in our national interest. A more explicit regime that reduced arbitrary political interference would be better for those investments.

Currently, Canada manages foreign direct investments through the *Investment Canada Act*. This gives the federal industry minister the power to review large investments in order to determine “net benefit” to Canada. Canada’s track record for approving deals has been good. But the failure of BHP Billiton’s acquisition of the Potash Corporation of Saskatchewan clearly shows that significant investments can be easily scuttled through short-term political calculations.

In other words, the current regime adds costs to investments through political risk. As Chinese investments are, by their nature, highly political, they are most likely to face higher costs, related largely to political risk. High costs lead to fewer investments. The opaqueness of the review process makes it impossible to say how many investments are dissuaded.

Like Canada, Australia has a formal review process for FDI. However, the Australian review process seems more accommodative of Chinese investments through clearly stated conditions that make these investments politically palatable to the Australian public. The conditions relate to various aspects of ownership and governance.

We believe that Chinese investments in Canada are in the Canadian national interest. A more explicit regime that reduced arbitrary political interference would be better for Chinese investments in Canada. Specifically, we recommend the following:

- Organize the FDI regime around two clear tests: one related to the national interest and a second related to national security.

- Apply the national interest test in a way that requires the federal government to make the case that an investment is “contrary to the national interest” as opposed to the foreign investor having to demonstrate “net benefit”.

- Amend the *Investment Canada Act* to explicitly state that Canada has a national interest in companies operating on a commercial basis under the terms of Canadian commercial law.

- Improve the existing state-owned enterprise guidelines to include specific undertakings on arm’s length marketing requirements and prices benchmarked to international levels, similar to the Australian approach.

- Clarify specific security risks (corresponding to “three threats”) that are addressed through the security provisions of the Act and associated regulations and guidelines.

- Recognize the economic importance of resource mergers and acquisitions. Acknowledge the provincial capacity to safeguard domestic interests through control of the terms of resource extraction via leasing, licensing, royalty, and taxing powers.

- Continue to engage Chinese companies and make them aware of Canadian sensitivities and requirements (terms and conditions). Through practice, a “model” of Chinese investment in Canada that balances Chinese and Canadian interests will develop.
January 23, 2012, marked the beginning of the Chinese New Year—the Year of the Dragon. The dragon is a zodiac symbol that doubles as a representation of the Chinese nation. This is symbolically fitting, as China is clearly in the economic ascendancy among nations. The country controls a growing share of the world’s savings and investment. Since 2002, this investment has been increasingly spilling over from China into other countries, in the form of foreign direct investment (FDI). In the Year of the Dragon, the question confronting Canadian policy-makers is: Should the Chinese dragon be feared or welcomed?

This question is especially pertinent to a resource-rich country like Canada because so much of China’s overseas FDI is in resources. The Harper government’s China policy reflects the dichotomy of Canada’s relationship with China—a dichotomy between the shortcomings of Chinese governance and China as a source of economic growth. In the Conservatives’ first mandate, the emphasis was primarily on Chinese governance (specifically, human rights). Yet, since winning a majority in May 2011, the Conservative government has changed tack. The federal government is now interested in diversifying Canada’s resource export markets. China, too, is looking to diversify its sources of resource imports.

Thus, there is the potential for enhanced cooperation between the two nations. Recognizing this, the Harper government has re-initiated the Chrétien approach of high-profile trade missions to China. (The most recent took place in February 2012.) As with trade missions, numerous agreements were made—some indicative of genuine business; others, hope. The latter category includes the Foreign Investment Promotion and Protection Agreement (FIPA). Prior to the trade mission, Canada had 27 such bilateral agreements in force, 8 that had been recently concluded, and 13 in negotiation, for a total of 48.¹

The main point of FIPAs is to protect the property rights of foreign investors. That is arguably of greater importance to Canadian investors in China than to Chinese investors in Canada. Canada has well-established property rights and fair and transparent legal enforcement. The real issue for Chinese investors in Canada is the federal review of foreign investments under the Investment Canada Act (ICA). For Chinese investors in Canada,
the main issue is not protecting their investments after the fact, but whether Canada allows the investments to happen.

As seen in the prominent case of BHP Billiton Limited’s proposed acquisition of the Potash Corporation of Saskatchewan (2010), the political review process for high-profile foreign investments can be unpredictably politicized and can easily derail major foreign investments in Canada. In 2004, the Chinese company Minmetals aborted a friendly acquisition of the Canadian miner Noranda Inc. after political objections. The Chinese state-owned aluminum company CHINALCO went through a similar experience in Australia, in 2009, which led to the abandonment of a $19.5-billion bid to assume control of Australia’s mining giant, Rio Tinto. Chinese companies are now cautious in their pursuit of politically sensitive acquisitions.

Further, host country policy-makers recognize the difference between the source of control and the country of registration. For instance, China separates its investments from its Hong Kong Special Administrative Region. Hong Kong is effectively part of China and is often used as a platform for Chinese companies’ foreign investments. Greater China (which includes Hong Kong and Macao) is already the fifth-largest foreign direct investor in the world. Three of the four countries that have larger FDI positions than China are European Union (EU) members: the United Kingdom, Germany, and France. These countries maintain the lion’s share of their “foreign” direct investments in other EU countries. Stripping away these statistical anomalies reveals two countries driving genuinely cross-jurisdictional FDI: the United States, which has a large FDI stock built up over its decades-long global expansion; and new arrival, China.

Looking at the data in this way also highlights the challenge facing Canadian FDI policy in the coming years. Canada’s post-war foreign direct investment policy was fashioned largely with reference to the United States. The animating idea of Canadian inward FDI policy was the maintenance of Canadian control of corporate assets in the face of expanding U.S.-based multinationals.

As Canada has grown in confidence, the more restrictive aspects of the FDI regime have been relaxed, most notably in the replacement of the Foreign Investment Review Act (FIRA) with the Investment Canada Act in 1985. Numerous other agreements between Canada and the United States, such as the 1988 Free Trade Agreement (FTA) and the 1994 North American Free Trade Agreement (NAFTA), have tightened economic integration. More recently, Canada and the U.S. have worked together to establish a common security perimeter and regulatory harmonization. The U.S. and Canada have a similar culture and comparable democratic institutions. The same cannot be said for China. For this reason, the emergence of China is a key challenge facing future Canada FDI policy.

Canada may choose to ignore the Chinese dragon, although that approach is unlikely to be any more successful than ignoring the American “elephant” in previous times. Canada’s success in its relationship with the

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2 Grant, Burt, and Ai, Saskatchewan in the Spotlight.
3 All statistics are from the United Nations Conference on Trade and Development, 2011.
U.S. evolved from a realistic assessment of the Canadian national interest, followed by direct and frequent engagement. A similar approach now needs to be applied to China. As explored in this report, there is too much to gain from Chinese investment for Canada to allow the ambiguities of its current FDI regime to determine the outcome.

This report begins with a review of the key drivers of Chinese FDI and the position of Canada in the Chinese overseas FDI portfolio. It continues with an analysis of how Chinese investment relates to the Canadian national interest. It then explores some of the political problems with Chinese investments and how these are managed (or mismanaged) through the current FDI policy regime. Finally, the report concludes with reflections on how to get the most out of Chinese investment by reforming the Canadian FDI policy regime.
This chapter explores the key drivers of Chinese foreign direct investment and the pace of change. It positions Canada within the context of China’s broader globalization strategy. The chapter concludes with an analysis of the opportunities that this strategy presents to Canada.

A Chinese priority is the pursuit of FDI, largely to meet its burgeoning resource demands. Most of the barriers to that growth exist in the host countries, such as Canada. (The same is true when China is the host.) In terms of attracting Chinese FDI to Canada—China is the gas; Canada is the brake. Therefore, in the next chapter, we consider Canadian concerns that may lead to Canada wanting to put some limits on China’s FDI.

CHINA AS THE NEW JAPAN

China and Japan share the hallmarks of export-oriented countries with high savings rates. Those structural features lead to the buildup of foreign exchange reserves. Japan and China now account for about 55 per cent of the world’s foreign exchange reserves. China alone maintains almost US$3 trillion in foreign exchange reserves.\(^1\) In export-oriented countries with high savings rates, pressure builds to recycle foreign exchange, especially to avoid currency appreciation that may undermine the export-orientated approach to economic growth.

As with any substantial saver, there is an asset allocation decision for China. These decisions are initially made by the People’s Bank of China (PBOC) and China’s sovereign wealth fund, China Investment Corporation (CIC). As China maintains a sizeable trade surplus with the U.S., it naturally will want to export capital back to the United States to finance the trade gap. Not surprisingly, China is now the world’s largest holder of U.S.

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1. International Monetary Fund, *Currency Composition of Official Foreign Exchange Reserves*. 

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Treasuries (at over US$1 trillion), followed closely by Japan. Yet U.S. Treasuries are low-yielding instruments that expose China to considerable foreign exchange risk. Thus, in the last few years China has sought to reduce its exposure to U.S. Treasuries. In fact, 2012 is the first year in a generation that will see China actually reduce its stock of U.S. Treasuries, as it moves resources to support efforts to resolve the Euro financial crisis.

Both the PBOC and CIC have taken steps to diversify China’s investment portfolio. CIC has roughly US$400 billion in assets under management, which includes equity investments in U.S. financial companies (Blackstone Group, Morgan Stanley, and VISA) and Canada’s miner, Teck Resources. Meanwhile, the Bank of China has worked with Chinese banks to support the foreign expansion plans of Chinese enterprises.

**GO GLOBAL**

During the 1980s and 90s, there was an ongoing debate within China on outward investment policy. At the time, China had a problem with the financial health of state-owned enterprises, which were losing ground to private enterprises. The number of state-owned enterprises (SOEs) had declined steadily since 1978 and many SOEs were effectively bankrupt. (See Chart 1.) For a time, state banks kept many SOEs afloat, but this simply transferred bad assets onto the banking system. Therefore, China eventually favoured structural adjustments, allowing some SOEs to fail while restructuring others. In the mid-1990s, China began consolidating SOEs that led to the formation of companies such as Sinopec Group, China National Petroleum Corporation, and State Grid, which are now among the world’s largest corporations. (See Table 1.)

Concurrent with this corporate restructuring, East Asia experienced financial turmoil, culminating in the Asian financial crisis of 1997. At the time, China was understandably wary about liberalizing its policies in ways that would expose it to global financial forces. Yet the outward investment policy debate was eventually resolved in favour of those who supported a more aggressive development of Chinese-held foreign assets. This culminated in the adoption of the “Go Global” policy during the Communist Party’s Sixteenth Congress (2002).

China moves fast. Once the central government decides to move in a direction, China mobilizes its considerable resources extremely quickly. This is certainly the case with respect to China’s foreign direct investment position. In less than a decade, China moved from having modest outward FDI to a stock approaching US$600 billion. (See Chart 2.)

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The nominal responsibility for implementing the Go Global policy rests with the Ministry of Commerce (MOFCOM) and the National Development and Reform Commission (NDRC). Outward investment is promoted if it can be shown to:

- obtain resources or raw materials that are lacking within China, which the national economy requires for its development;
- stimulate the export of products, equipment, or technology in which China has a comparative advantage and labour service exports; and
- improve China’s technological research and development (R&D) capability and make use of internationally advanced technology, advanced management experience, and specialist human resources.4

Sectors encouraged for outward FDI include agriculture, forestry, animal husbandry and fisheries, natural resources, manufacturing, and services.

Yet the Go Global policy is not implemented in a highly centralized way because MOFCOM and the NDRC have only an indirect impact on Chinese companies’ FDI decisions. Of greater importance, the Go Global policy gives capital market regulators, financial institutions, and enterprises the “green light” to propose foreign projects and get them approved and financed. With the agreement of the PBOC, Chinese banks have provided financing to facilitate the outward expansion of Chinese firms, especially SOEs.

Significantly, Go Global provides a strong policy basis for SOEs to use retained earnings to fund projects that expand their global footprint. The new generation of Chinese multinational corporations have considerable resources to fund projects on their own account. For instance, in 2010, China National Petroleum Corporation reported “surplus reserves” equivalent to over US$110 billion.5

In 2012, the PBOC proposed further liberalization of inward and outward investment flows.6 The proposal is to open Chinese capital markets to foreign investors and to make it easier for Chinese companies to acquire foreign companies. If adopted, this policy may have a huge impact on China’s foreign direct investments, especially for its globally orientated SOEs.

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The role of SOEs is critical because they have the scale to be serious global players. The Chinese Central Government actually sees large, economically viable SOEs as a way of maintaining an element of central control of the economy.7 The post-1978 economic liberalization had greatly benefited coastal provinces and private enterprise. Since 2000, the Central Government has seen viable, centrally controlled SOEs as a buttress to growing provincial power. Now, these companies are viewed as “national global champions.” Their global expansion will help the Central Government (as their shareholder) and also serve national interests. Although those interests are varied, the list of China’s top foreign investors suggests that securing resources is the paramount priority. (See Table 2.)

6 Rabinovitch and Cookson, “China Outlines Plan to Loosen Capital Controls.”
7 Walter and Howie, Red Capitalism, 150.
A Hunger for Resources

China is a major producer of many resource commodities. It is the world’s largest producer of coal and is among the largest producers of iron ore, aluminum oxide, manganese, zinc, and gold. From 2000 to 2010, China had triple-digit rates of increases in the production of aluminum (441.8 per cent), cement (219.5 per cent), and steel (396.0 per cent).8 Yet, in the same years, the value of China’s imports of iron ore increased 42.5 times, thermal coal 248 times, and copper 16.2 times. Even though China is a major producer of commodities, its demand outstrips its supply by a wide margin.

Consider the oil situation.9 China became self-sufficient in oil by the mid-1960s and quickly became a net exporter of oil thereafter. Net exports were 36 million tonnes of oil equivalent (TOE) by 1985. Yet, by that point, China had more or less tapped out its domestic capacity. Subsequent additions to capacity were extremely difficult, and dependent on hard-to-develop fields in the interior and offshore. Meanwhile, oil demand increased dramatically in step with economic growth. In today’s China, every 1 per cent increase in GDP results in a 0.6 per cent increase in energy demand. Real annual GDP growth has been around 10 per cent since 1978. China’s oil demand has simply outstripped domestic capacity. (See Chart 3.) China is now the largest importer of oil in the world and is well on its way to challenging the United States as the top importer.

The same story is being replayed for a wide range of other commodities where China either has little capacity or insufficient capacity to meet rising domestic demand. China is at the epicentre of a seismic change in world commodity markets, which include fossil fuels, ores, minerals, and agricultural commodities. (See Chart 4.) In a matter of 30 years, China has gone from a marginal to a major player in virtually every traded commodity, usually as a significant importer.

The current trajectory of demand seems unlikely to continue as China relies less on domestic investment and more on consumption to spur growth. Yet China will continue to be a key source of demand for commodities. As an indication, in 2009, China’s car sales outpaced those of the U.S. for the first time. Even if China’s demand for resources moderates from its current torrid pace, China will continue to make an indelible stamp on world commodity markets.

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8 Tao, China: Is the Commodity Supercycle Behind Us? 2.
9 This section draws on Li, Ito, and Komiyama, Energy Demand and Supply Outlook in China, 2.
Given the growing appetite for resources, one might reasonably expect China’s resource demand to be reflected in its outward FDI portfolio. Given the shortcomings of MOFCOM statistical gathering techniques and the idiosyncrasies of Chinese FDI, it is difficult to construct an accurate portrayal of Chinese outward FDI.\textsuperscript{10} Derek Scissors of the Heritage Foundation has made an important contribution by reconstructing Chinese data to come closer to North American statistical standards.\textsuperscript{11} He focuses on the five-year period of 2006 to 2010.

Scissors calculates US$215.9 billion in “non-bond” outward investment during 2006–10, about US$2 billion less than MOFCOM statistics. In this period of expanding Chinese FDI, “energy and power” accounted for almost one-half of total outward FDI by Chinese firms. An additional 28 per cent went toward processing resources into metals. (See Chart 5.)

Scissors reckoning of the geographic distribution of outward investment also is of interest. (See Exhibit 1.) Chinese investments in Australia exceed those in the United States. Brazilian, Iranian, and Nigerian investments exceed those in Canada. Not surprisingly, there is a focus on resource-rich countries. Indeed, scaling these Chinese investments to gross fixed capital formation (GFCF) in each country further emphasizes the importance of Chinese FDI in resource-rich countries.\textsuperscript{12} Based on Scissors’ estimates and our own calculations, Chinese non-bond investment accounts for about 2.8 per cent of GFCF in Iran and 2.3 per cent in Australia. The point is that Chinese investments have the potential to be a significant part of capital formation in resource-rich economies. Yet relative to GFCF, China’s non-bond investment in Canada is only about one-third of that in Australia.

\textsuperscript{10} For instance, according to MOFCOM statistics, British Virgin Islands and Cayman Islands together account for over 10 per cent of the stock of FDI, likely for tax or incentive reasons (so-called round tripping where external investments are re-routed to China). China also does not use standard industrial classifications.

\textsuperscript{11} Scissors, \textit{China’s Investment Overseas in 2010}.

\textsuperscript{12} The Conference Board of Canada’s calculations are based on data from World Bank indicators.
CONCLUSION

This chapter argued that Chinese outward FDI (OFDI) is likely to increase, probably significantly, in the coming years. This argument is based on an accommodating Chinese policy toward OFDI (which is very likely to become even more liberal), enhanced financial resources, and the improving capabilities of large SOEs to execute foreign investments. Given that many of these investments are likely to be made in resources, Chinese companies will carefully examine resource-rich countries, such as Canada. The report now turns to the strategic considerations for Canada as it is faced with the prospect of more Chinese FDI.

Exhibit 1
China’s Non-Bond Overseas Investments, 2005–10
(key nations, US$ billions)

Source: Scissors.

CONCLUSION

This chapter argued that Chinese outward FDI (OFDI) is likely to increase, probably significantly, in the coming years. This argument is based on an accommodating Chinese policy toward OFDI (which is very likely to become even more liberal), enhanced financial resources, and the improving capabilities of large SOEs to execute foreign investments. Given that many of these investments are likely to be made in resources, Chinese companies will carefully examine resource-rich countries, such as Canada. The report now turns to the strategic considerations for Canada as it is faced with the prospect of more Chinese FDI.

Exhibit 1
China’s Non-Bond Overseas Investments, 2005–10
(key nations, US$ billions)

Source: Scissors.
CHAPTER 3

Chinese Investment: What Is in It for Canada?

Chapter Summary
- Canada has a stated policy to increase resource exports and diversify markets.
- Canada has lagged in its ability to attract FDI, which is related to overall productivity.
- Chinese FDI is desirable to both achieve resource policy goals and to improve Canada’s FDI attraction performance.
- China accounted for 44 per cent of the growth of Canadian inward FDI in the 2008 to 2010 period.
- The Chinese FDI that is likely to benefit Canada the most is large-scale investment by Chinese state-owned enterprises.

The current majority Conservative government is quite clear on its intent to grow Canada’s resource sector and to diversify export markets. This strategic goal was restated in the aftermath of the U.S. decision to delay approval of the Keystone XL pipeline project. It is revealed again in the government support for the Northern Gateway pipeline project and liquefied natural gas (LNG) facilities in northern British Columbia.

This chapter will consider the role that foreign direct investment in general, and Chinese investment specifically, play in the achievement of the Canadian national interest in resource development and market diversification as laid out in government policy.

INWARD FOREIGN DIRECT INVESTMENT: CRITICAL TO CANADA

The Conference Board of Canada has noted on numerous occasions that Canada’s FDI performance has lagged considerably in recent years. Canada’s share of global inward foreign direct investment flows dropped from 16 per cent in 1970 to 3 per cent in 2009. We benchmarked Canada against 15 peer countries in terms of stock of FDI as a share of GDP. In 1980, Canada ranked second among these countries. But, by 2009, Canada had slipped to ninth place. This decline is important because we also found a positive relationship between

2 The Conference Board of Canada, Hot Topics: Inward FDI Attraction.
capital stock and labour productivity. Foreign direct investment, especially for a medium-sized economy like Canada, is an important part of the capital stock.

A big part of the reason why Canada attracts relatively less global FDI is because China is attracting considerably more of global FDI flows. Inward FDI flows into China are driven largely by outsourced manufacturing, much of which is relocating on an extended basis to lower-cost China. China has abundant sources of labour, but lacks resources. So part of the solution to Canada’s declining relative FDI performance is to entertain more FDI in sectors that serve Chinese demand, namely resources. This would have the effect of rebalancing bilateral FDI flows, which currently favour China.

Integrative trade highlights the relationships between global investments and trade flows. Global supply chains increasingly determine trade flows and the value added through trade.

Between 2007 and 2011, Canada attracted an annual average of $54.6 billion in net foreign direct investment.3 It is important to note, however, that this investment is not distributed equally across the economy. Three sectors—manufacturing, mining and oil and gas extraction, and finance and insurance—account for over 65 per cent of the stock of foreign direct investment in Canada. (See Table 3.)

The Conference Board of Canada has also noted another trend—integrative trade. Integrative trade highlights the relationships between global investments and trade flows. It notes that global supply chains increasingly determine trade flows and the value that is added through trade.4 Foreign direct investment is part of the architecture of international trade. Companies route goods through their supply chains, adding value as they go. A country plugs into these networks by establishing nodes of supply through foreign direct investment. Canada has seen this dynamic in action through the Auto Pact, the FTA, and NAFTA—a virtuous cycle of liberalized trade creates the economies of scale for investment, and investments lead to more trade.

Canada has big plans for its resource sector. It is a clearly stated national interest. Canada needs foreign capital to realize those plans. Consider the oil sands as an outstanding example. According to the Canadian Energy Research Institute (CERI), Alberta’s oil sands contain 178 billion barrels of recoverable bitumen.5 However, bitumen recovery, processing, and transportation require billions of dollars of investment. CERI estimates aggregate oil sands investments over 15 years (2004–19) to be over $100 billion, with annual investments ranging from $3 billion to $6 billion. (See Chart 6.)

These investments are just for the oil sands. Overall investment in oil and gas extraction averaged almost $40 billion per annum in the 2007–11 period, while

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3 Statistics Canada, CANSIM, Table 376-0014.
4 Hodgson, Making Integrative Trade Real.
5 Timilsina, LeBlanc, and Walden, Economic Impacts of Alberta’s Oil Sands.
mining was almost $9 billion. Around $6 of investment in oil and gas translates into $1 of GDP per annum (about $5 per dollar of GDP for mining). GDP per employee in oil and gas is over $400,000 and around $128,000 in mining.

Although Canada generates sufficient savings to fund these investments, it is also desirable to have foreign involvement for two reasons. First, Canadian portfolios are already naturally weighted (through government revenues and stock market capitalization) toward resources. Foreign funding of resource development, therefore, helps reduce Canada’s national investment exposure to that asset class. Second, it makes sense to encourage companies with upstream (toward market) expertise to fund downstream development, as they are likely to do so in an efficient and effective way, often based on experience elsewhere.

In 2011, governments in Canada generated over $5 billion in corporate tax, over $1.1 billion in licences and fees, and over $18 billion in resource royalties from oil and gas companies.

### CHINA’S FOREIGN DIRECT INVESTMENT IN CANADA

Not surprisingly, China’s foreign direct investments in Canada mirror China’s overall investments on two counts: very rapid growth (see Table 4), and an emphasis on energy investments.

Statistics Canada maintains confidentiality protocols for data collection from firms that limit publication of any China data (before 2008) and sector distribution (post-2008). However, based on discussions with Statistics Canada for this report, we found that about half of China’s current investments are in resources. The level of Chinese direct investment was too low to report in 2007, yet continued to grow through the credit crisis when other investments stagnated. Indeed, China alone accounted for 44 per cent of the growth of FDI in the 2008 to 2010 period. Given the fundamentals that are driving China’s outward FDI, it seems reasonable to conclude that China will be the third-largest FDI investor in Canada before 2015, and could easily place second to the United States by 2020.

In order to get a better handle on recent Chinese investment, we analyzed deals announced since 2009. (See Table 5.) These large-scale investments attract press coverage. A few trends are noteworthy. To begin, the deals confirm an emphasis on large-scale resource

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7 Statistics Canada, CANSIM Table 180-0003.

8 Statistics Canada, CANSIM Table 380-0033.

9 Statistics Canada’s accounting of Chinese investment differs from Scissors’ “non-bond” investments. This shows that FDI numbers can vary significantly with computational methodologies.
<table>
<thead>
<tr>
<th>Deal</th>
<th>Size</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>PetroChina takes 20% stake in a Royal Dutch Shell PLC’s shale gas project in Groundbirch, B.C.</td>
<td>$1 billion</td>
<td>February 2012</td>
</tr>
<tr>
<td>Selwyn Resources completed a 50/50 joint venture with Yunnan Chihong Zinc &amp; Germanium</td>
<td>$100 million</td>
<td>February 2012</td>
</tr>
<tr>
<td>PetroChina has a proposed venture with Encana for 50% of their Cutbank Ridge natural gas assets</td>
<td>$5.4 billion</td>
<td>February 2012</td>
</tr>
<tr>
<td>Canaccord and China’s Eximbank intend to establish a $1 billion natural resource fund</td>
<td>To be determined</td>
<td>February 2012</td>
</tr>
<tr>
<td>PetroChina takes 100% controlling position of Mackay River and Dover oil sands (bought from Athabasca Oil Sands Corp.)</td>
<td>$680 million</td>
<td>January 2012</td>
</tr>
<tr>
<td>Winsway Cooking Coal Holding deal to purchase 100% of Grande Cache Coal Corp. Winsway will own 60%.</td>
<td>$590 million</td>
<td>November 2011</td>
</tr>
<tr>
<td>Sinopec acquires Calgary-based Daylight Energy</td>
<td>$2.2 billion</td>
<td>October 2011</td>
</tr>
<tr>
<td>Minmetals bid for Anvil</td>
<td>$1.3 billion</td>
<td>September 2011</td>
</tr>
<tr>
<td>Sichuan Bohong Industry announces deal to acquire auto parts maker West Cast Industries</td>
<td>$179 million</td>
<td>September 2011</td>
</tr>
<tr>
<td>WISCO International Resources invests in three Century Iron Mines’ projects for 40% in each project</td>
<td>$120 million</td>
<td>November 2011</td>
</tr>
<tr>
<td>China National Offshore Oil Corporation buys Opti Canada</td>
<td>$2.1 billion</td>
<td>July 2011</td>
</tr>
<tr>
<td>China Longyuan Power has acquired the rights to develop a 100 megawatt project in Ontario from Farm Owned Power</td>
<td>$260 million</td>
<td>July 2011</td>
</tr>
<tr>
<td>WISCO International Resources and Minmetals take stakes in Century Iron Ore Holdings</td>
<td>$73.1 million</td>
<td>May 2011</td>
</tr>
<tr>
<td>Sinopec invests in Enbridge Inc’s pipeline project</td>
<td>$100 million with 10 other investors</td>
<td>January 2011</td>
</tr>
<tr>
<td>Penn West Energy Trust enters into a joint venture with China Investment Corp. for 45% of oil sands properties</td>
<td>$1.23 billion</td>
<td>May 2010</td>
</tr>
<tr>
<td>State Grid International Development Ltd. purchased 10% in Quadra Mining Ltd. (QML) and 50% in Sierra Gorda project</td>
<td>$1.5 billion</td>
<td>May 2010</td>
</tr>
<tr>
<td>Sinopec buys 9% of Syncrude</td>
<td>$4.56 billion</td>
<td>April 2010</td>
</tr>
<tr>
<td>Jilin Jien Nickel and Goldbrook Ventures acquire Canadian Royalties Inc.</td>
<td>$192 million</td>
<td>January 2010</td>
</tr>
<tr>
<td>Sinopec purchases Swiss–Canadian company Addax Petroleum Corp.</td>
<td>$8.3 billion</td>
<td>2009</td>
</tr>
<tr>
<td>PetroChina agrees to buy a 60% stake in two undeveloped oil sands properties held by Athabasca Oil Sands Corp.</td>
<td>$1.9 billion</td>
<td>2009</td>
</tr>
<tr>
<td>Sinopec buys 10% stake (50% total) in Northern Lights Partnership from Total S.A.</td>
<td>not available</td>
<td>2009</td>
</tr>
<tr>
<td>China Investment Corp. purchases 17.2% of Teck Resources Ltd.</td>
<td>US$ 1.5 billion</td>
<td>2009</td>
</tr>
</tbody>
</table>

Source: The Conference Board of Canada.
Two large SOEs have been most prominent, Sinopec and PetroChina. China Investment Corporation, China’s sovereign wealth fund, has also been active, most notably through its stake in Teck Resources, the largest Chinese investment in a Canadian miner. Minmetals and WISCO International have made smaller mining investments.

Chinese government-controlled entities tend to have much larger, and fewer, investments than private or public companies and prefer greenfield investments.

In most cases, Chinese companies have taken a minority position, likely to avoid the political problems of assuming control of resource projects. The only exceptions have been in cases where a company or a project has encountered financial difficulties and the Chinese have taken larger stakes to ensure company or project viability. This explains PetroChina’s 100 per cent stake in the Mackay River and Dover oil sands project, which it acquired from Athabasca Oil Sands. This was also the case with Sinopec’s acquisition of Daylight Energy.

There are numerous other Chinese investments that are too small to warrant media coverage. To some extent, these smaller investments are a natural result of China’s outward orientation combined with a very significant number of Chinese immigrants to Canada. The 2011 Census will likely show that over 500,000 Canadians were born in China, which would make China the largest source of foreign-born Canadians.10 Thousands of these immigrants have entered Canada under economic class immigration. They will have business ties to China and therefore act as conduit for a wide range of investments into Canada from China. But most of these investments will be small scale, certainly well below the limit required for review under the *Investment Canada Act*.

An analysis of Chinese investment in the United States gives some idea of the likely shape of Chinese investments in Canada. (See Table 6.) Chinese government-controlled entities tend to have much larger, and fewer, investments than private or public companies. They tend to prefer greenfield investments to mergers and acquisitions. These features result in government-controlled entities accounting for 70 per cent of the investments, yet only just over 20 per cent of the deals. For the sample of deals considered in Table 8, government-controlled entities had an average deal size of US$142 million compared with US$25 million for private and public companies. This structure is likely to be similar to Canada, although the size of Chinese investment is greater in relationship to the entire economy.

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**Table 6**
Chinese Foreign Direct Investment in the United States, 2003–11
(number of deals; US$ billions)

<table>
<thead>
<tr>
<th>Number of deals</th>
<th>Greenfield</th>
<th>Per cent</th>
<th>M&amp;A</th>
<th>Per cent</th>
<th>Total</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government-controlled</td>
<td>40.0</td>
<td>29.0</td>
<td>30.0</td>
<td>23.0</td>
<td>70.0</td>
<td>26.0</td>
</tr>
<tr>
<td>Private and public</td>
<td>96.0</td>
<td>71.0</td>
<td>102.0</td>
<td>77.0</td>
<td>198.0</td>
<td>74.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>136.0</strong></td>
<td><strong>132.0</strong></td>
<td><strong>268.0</strong></td>
<td><strong>Total</strong></td>
<td><strong>268.0</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>US$ billions</th>
<th>Greenfield</th>
<th>Per cent</th>
<th>M&amp;A</th>
<th>Per cent</th>
<th>Total</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government-controlled</td>
<td>2.0</td>
<td>60.0</td>
<td>8.0</td>
<td>68.0</td>
<td>9.9</td>
<td>66.0</td>
</tr>
<tr>
<td>Private and public</td>
<td>1.3</td>
<td>40.0</td>
<td>3.8</td>
<td>32.0</td>
<td>5.1</td>
<td>34.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3.3</strong></td>
<td><strong>11.8</strong></td>
<td><strong>15.0</strong></td>
<td><strong>Total</strong></td>
<td><strong>15.0</strong></td>
<td></td>
</tr>
</tbody>
</table>

*Source: Hanemann, *Changing Patterns of Chinese Outward FDI*. 

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10 See Statistics Canada, *Immigration Population*. In 2006, China ranked second to the United Kingdom. Yet in the last five years covered by the 2006 Census, China had over six times as many immigrants to Canada as the United Kingdom. If that trend continues, then China will be the top source of foreign-born nationals in Canada.
Statistics Canada data do not reveal anything about these smaller investments. An Asia Pacific Foundation of Canada (APC) analysis of a survey of Chinese business’ global investment intentions helps fill the gap.11 The survey was conducted by the China Council for the Promotion of International Trade (CCPIT), between December 2009 and March 2010, and APC worked with CCPIT to extract findings for Canada.

Most of the 84 respondents that expressed interest in Canadian investments were small and medium-sized enterprises (50 per cent) and non-government controlled (86 per cent.). Over 76 per cent were manufacturing companies (as opposed to SOEs that tend to be resource-based). Following the pattern of the U.S., Chinese private and public company investment plans are considerably smaller than SOE investments (average $12 million versus $39 million for SOEs). The majority of Chinese companies planned to finance their investments in Canada within their companies (53 per cent), with about a quarter of respondents relying on Chinese banks.

The motivations behind Chinese investment plans for Canada are also revealing, especially their links to official Chinese government policy. (See Table 7.) The most prominent reason for investing in Canada was to take advantage of Go Global incentives. The second most important reason was to acquire technology, a stated goal of Go Global.

Other survey findings cast doubt as to the likely economic impacts for Canada of smaller private sector investments. Over half (56 per cent) of respondents were interested in setting up sales channels, while only 1 in 10 were interested in actual manufacturing in Canada. That would suggest that most of the economic impacts from Chinese investments in Canada can be found in the fewer, and larger, capital investments of large Chinese SOEs.

Table 7
Drivers for Chinese Investments in Canada, 2010–13
(n=84, percentage of respondents)

<table>
<thead>
<tr>
<th>Motivation</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Make Use of “Going Global” policy incentives</td>
<td>45.2</td>
</tr>
<tr>
<td>Acquire technology or managerial expertise</td>
<td>32.1</td>
</tr>
<tr>
<td>Acquire brands</td>
<td>26.2</td>
</tr>
<tr>
<td>Avoid Chinese market saturation</td>
<td>21.4</td>
</tr>
<tr>
<td>Take advantage of Canadian incentives</td>
<td>20.2</td>
</tr>
<tr>
<td>Avoid trade barriers</td>
<td>17.9</td>
</tr>
<tr>
<td>Lower production costs</td>
<td>16.7</td>
</tr>
<tr>
<td>Provide raw materials for domestic market</td>
<td>13.1</td>
</tr>
</tbody>
</table>

Sources: Asia Pacific Foundation; China Council for Promotion of International Trade.

CONCLUSION

The world is experiencing a fundamental change in the nature of FDI flows as China emerges as a major source of FDI with a special interest in resource development. Canada has a national interest in resource development and market diversification. Chinese investment fits the bill on both counts. In addition, Chinese FDI will help Canada regain a portion of its falling share of world FDI, which would contribute more broadly to the growth of employment and productivity gains.

As a first principle, Canada should welcome Chinese FDI. But Canada needs to be aware that it is in competition with other resource-rich jurisdictions for Chinese capital. These realities would appear to recommend an open approach to Chinese investment in Canada. Yet inward direct investment policy is about more than mere economic advantage. The next chapter explores the dimensions of Canada’s inward direct investment policy and how Chinese investments may challenge that policy.

11 Survey findings from Asia Pacific Foundation of Canada, China Goes Global, 4.
We have determined that Canada has an abundance of undeveloped resources that China needs. China has global-scale companies with well-developed supply chains that can add value to Canadian resources and channel them into the Chinese market. On the face of it, this is a marriage made in heaven. Yet, in this instance, heaven may have to wait.

The reason is that there are features of Chinese investment that are likely to challenge Canadian sensibilities as reflected in the current Canadian inward FDI policy and its execution.

**WHY A FOREIGN DIRECT INVESTMENT POLICY?**

In an earlier report, “Hollowing Out”—Myth and Reality: Corporate Takeovers in an Age of Transformation, we explored, in depth, the rationale for Canada’s foreign direct investment policy.¹ We noted management, financial, economic (market theories), and political/social theories that underlie Canadian concerns and drive Canadian FDI policy and practice. The market theories relate to business rationale and, specifically, how corporate value is created through mergers and acquisitions (M&As). The political/social theories are primarily about control and the nationality of control. China presents a unique, new challenge because there are questions regarding whether its state-owned enterprises operate on market or political principles.

¹ Grant and Bloom, “Hollowing Out,” Chapter 2.
Any foreign direct investment policy seeks to incorporate domestic political considerations into commercial decisions. This plays out in various ways. For instance, political power may be used to limit what we have called “negative corporate takeover effects” (CTEs).2 These are especially apparent in M&A deals where the acquirer is interested in enhancing corporate value by reorganizing corporate assets to better commercial use. This restructuring process may see corporate resources made redundant, resulting in disruptive changes in asset use and employment levels.

In “Hollowing Out,” we found that Canadian acquirers of business assets are very much the same as foreign acquirers in terms of the negative CTEs that follow M&As. Indeed, corporate transformations are ongoing in the Canadian economy and are certainly not limited to M&As. To be sure, large or otherwise prominent M&As are an event that occupies the politician’s mind—turning a commercial event into a political one. Nevertheless, Canada, rightly, does not maintain a general policy against corporate transformations, even if these happen to lead to redundancies in assets or jobs. There is a general acceptance that while individual corporate transformations may be disruptive, the processes of “creative destruction” are well served by the overall economy.

For these reasons, risk management through foreign direct investment policy rests on shaky, non-economic ground. There is little or no economic reason to target foreign investment activity, per se. There is no “market failure” that underlies the policy. On the contrary, the market works all too well. In this sense, foreign direct investment policy is really more about the “foreign-ness” of FDI than it is about the “investment.” Yet, it is important to recognize that foreign direct investment policy finds general support among the public. It may give Canadians a sense of some limited control in an otherwise turbulent market.

A concern specific to Chinese resource investments is that China will “lock up” resources to the exclusion of other markets. China could sell the resources it controls to Chinese end-users at below market prices or manage the supply to depress market prices where such market power exists (for example, potash or nickel). This is a legitimate concern, but this risk is manageable. Most resources in Canada are Crown resources—controlled by provinces through leasing, licensing, and royalty policies. If there is a desire to control the level or nature of foreign investment, leasing and licensing regimes could always be adjusted, as could royalty regimes. Moreover, a recent review of Chinese global resource investments and procurement arrangements conclude that their main effect was to diversify sources of supply and create more competition.3

To be sure, all global companies use foreign investments to develop their global supply chains. There is definitely “locking up” that occurs because the investment is tied into the company’s global supply chain. Chinese companies’ global supply chains happen to work to serve the Chinese end market. But we could say the same for Exxon’s supply chain, much of which is geared toward serving the United States end market.

Indeed, in a recent interview in Washington, DC, Prime Minister Harper lamented how existing foreign investments have locked Canada into a North American energy market. The prime minister said: “. . . we have taken a significant price hit by virtue of the fact that we are a captive supplier and that just does not make sense in terms of the broader interests of the Canadian economy.”4 He went on to suggest that this was a major reason why Canada is eager to approve pipelines to ship energy to the Asian market. Greater Chinese investments would be geared, in part, to filling those pipelines.

Another concern is reciprocity. China maintains a byzantine foreign direct investment approval process. Investment approvals occur at multiple levels (central, provincial, and even local) and officials have a wide degree of discretion with limited recourse for investors.5 Notwithstanding this, China has been extremely successful at attracting foreign investment under its terms. Canadian foreign investors may rightly suggest that it is easier for Chinese companies to invest in Canada than it is for Canadian companies to invest in China.

2 Grant and Bloom, “Hollowing Out,” Chapter 2, 51.
3 Moran, Chinese Foreign Direct Investment in Canada, 4.
4 Weese, Harper Determined to Get Canadian Oil to Asia.
5 See Nicolas, Doors Wide Shut.
Canada’s investment position in China is less than half of that of Chinese investment in Canada. But why should Canada harmonize its investment policies with China? If companies wish to do business in China, they will simply need to play by the local rules. Canada should be primarily concerned that its own rules reflect its national interest.

China and the U.S. are, perhaps, the two investor countries that generate the most fear and distrust in Canada (although even Australians could join the ranks of the “distrusted” if the deal in question is of sufficient size). In the case of the United States, the concern is that large corporate interests will easily swallow much smaller Canadian-owned companies. This explains why Canada retains sector foreign ownership restrictions in the areas of air transport, uranium mining, telecommunications and broadcasting, and financial services. These restrictions may be for security reasons and are undoubtedly targeted primarily at U.S. companies, as they would be most likely acquirers in these sectors.

Canadians generally become warmer toward Chinese investment the less it is concerned with control of existing operations and the more it is about new investments. In China’s case, the concern is more directly related to the relationship between Chinese corporate control and the Canadian national interest. There is lingering concern of political motivation behind the operations of Chinese SOEs. On the face of it, this concern is legitimate because the companies are governed by the state and the Chinese Communist Party. This leads to all sorts of speculation on the possible behaviour of Chinese companies, some of it well founded, but much of it based on fear of the unknown.

Under existing legislation, significant investments in Canada by Chinese companies are likely to be dealt with through the federal industry minister’s powers to review investments in excess of $330 million (for World Trade Organization members, 2012 limit) under the provisions of the Investment Canada Act (ICA). These reviews allow the minister to determine “net benefit” to Canada of proposed foreign investments across a wide range of factors. The Act does not specify how the minister is to weigh various factors, so the decision process is shrouded in secrecy and the minister has wide discretion. As the BHP Billiton case shows, the minister will sometime use that discretion when a foreign investment is judged as being politically sensitive.

**DEAR CHINA: WE HAVE TRUST ISSUES**

For Canada, China is as politically sensitive as it gets. The political concern starts with the nature of the Chinese regime, a non-democratic, Communist dictatorship for over seven decades. There is an inherent distrust of the regime among many Canadians and this is manifested in its investment relationship with Canada.

Consider, for example, recent polling data. In February 2012, Harris Decima polled Canadians on their attitudes toward Chinese investment. (See Chart 7.) Just 1 in 10 (10 per cent) respondents thought Chinese companies taking a majority controlling interest and/or taking over an existing Canadian-owned operation is a good thing. Canadians generally become warmer toward Chinese investment the less it is concerned with control of existing operations (especially Canadian operations) and the more it is about new investments. Yet even in the most positive case of greenfield investment, barely half of respondents think Chinese investment is a good or very good thing.

Canadians are generally of the view that it would be desirable to limit Chinese investments to greenfield opportunities. But that is not practical in a well-established market like Canada, especially for resource projects that may involve several players to share project risk. Oftentimes, a Chinese company may have the opportunity to acquire an existing interest, as was the case with PetroChina’s oil sands investments.

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6 Statistics Canada, CANSIM Table 376-0051. This difference in outward and inward investment position is likely due to a variety of legal and economic factors.

7 In May 2012, the Government of Canada announced its intention to increase the review limit to $1 billion.
To be fair, Canada is not alone in its concern about Chinese investments. In the process of calculating Chinese non-bond foreign investments, Scissors also considered the number of “troubled” Chinese investments. “Troubled” investments are those that regulators rejected or that partly or entirely fell apart. Of 309.5 billion (US$) in non-bond investments and construction projects, between 2006 and 2010, Scissors estimates that about 40 per cent (US$122.9 billion) were “troubled.” Investments in finance, real estate, energy, and metals were especially prone to delays because of concerns about Chinese involvement. The list of troubled investments involves a wide range of countries. (See Table 8.)

Still, Scissors allows that “Chinese firms have clearly learned; completing more transactions and suffering fewer problems of their own making.” Perhaps not of “their own making,” but there may still be problems managing the politics in the host country. Chinese companies may be more adept at executing deals over time, but they will continue to face resistance because of the perceived nature of Chinese firms or their home operating environment that host countries may find objectionable. It is therefore in Chinese companies’ interests to accommodate local political sensitivities when they invest abroad. Arguably, this was a major downfall of BHP Billiton’s approach to the acquisition of the Potash Corporation of Saskatchewan. BHP Billiton senior management simply underestimated the political resistance to the acquisition and therefore mismanaged the politics.

**CAPITALISM WITH CHINESE CHARACTERISTICS**

In “Hollowing Out,” we explored the relationships between corporate control and national interest. Canada has a national interest—wealth creation—in a market economy operating within the legal, fiscal, and regulatory strictures of governments. State-owned enterprises, in the form of Crown corporations, play a relatively small role in the economy in Canada. Like other Western countries, Canada practices a form of “economic secularism” that largely separates state from commerce.

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8 Scissors, China’s Investment Overseas in 2010, 3.
oil and gas reserves come under the direct control of large state entities in Iran, Saudi Arabia, Venezuela, Kuwait, and Russia.9

As long as these state-owned enterprises operate within their own borders, there is no problem because the country’s sovereignty aligns with the geographic scope of the companies. But, when these same companies operate overseas, there is concern that their commercial interests may become entangled with the political interests of their principal owners.

In “Hollowing Out,” we dissected the relationship between firm ownership, governance, and corporate decisions. We found little evidence that foreign (or even Canadian) companies pursue their home nation’s national interest in the course of executing business deals. To be sure, they may choose to integrate toward the home country following an acquisition, if the bulk of their operations are in the home country. Yet Canadian companies were more likely to have redundant operations that may be rationalized (i.e., sold or shut down) when they acquired other Canadian companies than were foreign companies acquiring in Canada.

It is difficult to say how the ownership–governance decision chain plays out with regard to Chinese SOEs in Canada. In terms of ownership, this report has already noted that the largest investments are by PetroChina, Sinopec, and Chinese Investment Corporation, with a smaller interest by Minmetals and State Grid (a non-listed SOE). These are among the world’s largest corporations with hundreds of billions of dollars of sales. (See Table 9.) In addition to these operating companies, the sovereign wealth fund China Investment Corporation has a 17 per cent stake in Teck Resources.

All the operating companies (with the exception of State Grid) issue shares on Chinese stock exchanges, yet are controlled through their state shareholder, the Chinese Central Government. Indeed as Walter and Howie argue, “China’s stock markets are not founded on the concept of private companies or private property; they are solely based on the interests of the Party . . . . they are a triumph of form over substance.”10 In China, the Communist Party controls the ownership of companies and their valuation, which is antithetical to the notion of valuation through a stock exchange.

The government manages its portfolio of shares through the state-owned Assets Supervision and Administration Commission (SASAC). The Communist Party maintains tight control of SASAC, operating it as a holding company for its interests. The Party manages the senior levels of management through the Communist Party Organization Department, the world’s largest human resources department. The Department appoints all senior figures in “China Inc.” It demonstrated its power in 2010, when it changed the leadership of China’s three largest oil companies.

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10 Walter and Howie, Red Capitalism, 142.
In the words of *The Economist*, executives at SOEs are “cadres first and company men second. They care more about pleasing their party bosses than about the global market.”

McGregor concurs with this assessment when he notes direct links between the managers of leading companies in China and the Communist Party high command. McGregor contends that the Communist Party maintains cells in major companies and holds shadow board meetings. The Party is directly involved in business management decisions.

In “*Hollowing Out,*” we noted that the rationale for a foreign direct investment regime depended heavily on the presumed alignment of corporate interests with the national interests of the home country. We were skeptical about the extent of this alignment and observed that corporations tend to pursue their interests based on corporate strategy. In a world of globalized capital flows, even the nationality of the shareholders and senior managers is unclear. For example, Potash Corporation of Saskatchewan was defended against takeover as a Canadian company. Yet the company is majority owned by foreigners and substantially operated by American senior executives.

In the case of China, there are few ambiguities. There is a genuine tight relationship between the state, the ownership of SOEs by the state, the Communist Party as the monopoly state power, and Communist Party control over the day-to-day operations of SOEs. To be sure, the heads of SOEs may try to build their power at the expense of the owners, much as senior executives in public companies may lose sight of shareholder value. There are ongoing debates between SASAC and the heads of SOEs on, for example, dividend policy. But there can be little doubt that the Communist Party is ultimately in control of SOEs.

**PLAYING THE CARDS WE’VE BEEN DEALT**

In some senses, the unvarnished nature of Chinese SOEs, as agents of the Chinese state, helps clarify Canada’s options. During the Cold War, the West’s relations with the Soviet Bloc were governed by a calculated national interest, so-called *Realpolitik*. The idea was to pursue the national interest free of moral overtones while recognizing the nature of competing governance systems. The Harper government may be returning to this approach as it downplays concern with Chinese human rights and places more emphasis on the advancement of Canada’s trade and investment interests.

Some may prefer a moral approach to Canada’s relationship with China. Others take the view that China is unlikely to change to a more democratic governance system based on pressure from Canada. One way to reconcile these different views is to hope that Chinese global economic engagement will lead to a more open China—a China that will liberalize politically through engagement with democratic countries.

Although many Canadians may find aspects of the Chinese regime distasteful, our trade relationship suggests that Canadians are willing to economically engage with China.

Canada already maintains a multibillion-dollar, two-way trade relationship with China. In 2009, China replaced Japan as Canada’s third-largest export market after the United States and the United Kingdom. Most of the export growth is based on commodities like canola, iron ore, and coal. China is Canada’s second-largest source of imports, shipping over $40 billion to Canada. Although many Canadians may find aspects of the Chinese regime distasteful, our trade relationship suggests that Canadians are willing to set aside differences and economically engage with China.

Given the extent of the trading relationship, is there any reason why Canada should recoil from a full investment relationship? Canada has a clear national interest in trading with China. That trade is dependent, to some extent, on Chinese SOE investments in the business infrastructure for trade flows. If we do not find it objectionable to trade with China, why would Canada not welcome Chinese investment?


WHAT ARE THE RISKS?

Presumably, a foreign direct investment regime is meant to manage risks to Canada’s national interests. Yet the governing legislation, the Investment Canada Act, is extremely vague on the nature of these risks.

Under its “purpose,” the Act states:

Recognizing that increased capital and technology benefits Canada, and recognizing the importance of protecting national security, the purposes of this Act are to provide for the review of significant investments in Canada by non-Canadians in a manner that encourages investment, economic growth and employment opportunities in Canada and to provide for the review of investments in Canada by non-Canadians that could be injurious to national security.14

Hence the Act recognizes the benefits of FDI and yet suggests that these investments require government review. The Act adds a political review process to investment decisions, so the idea that the Act “encourages” investment is questionable because it adds costs to the investment process. If it reduced costs in some way, then the Act might be considered to encourage investment. As for economic growth and employment opportunities, these are much broader policy objectives that are unlikely to be achieved through government review of individual investments. The Act does not constrain a government; a government can be as aggressive (or passive) as it wants. If a government chooses to apply the Act in an aggressive way, it could dissuade other new foreign investments from occurring.

Even if individual deals pass the industry minister’s review, the process itself may very well lead to lower levels of investment, growth, and employment than might otherwise have occurred. That is because it exposes investors to additional costs and political or decision process risk. Since the Act is not clear on what risks it is managing, it is impossible to say whether, on balance, the political risk it raises is less than the non-political or business risks it diminishes, or even whether it does diminish risk.

The Wilson Panel (a 2008 federal review of investment and competition policy) took umbrage with the Organisation for Economic Co-operation and Development (OECD) for “consistently rank[ing] Canada as having among the most restrictive barriers to foreign direct investment among industrialized nations.”15 The difference of opinion is based on Canada’s legal FDI regime rather than the way it has been implemented by successive Liberal and Conservative governments. Recent Canadian governments do, in fact, have a good track record of approving deals. But the Potash Corporation of Saskatchewan decision and the maintenance of “off limits” sectors support the OECD contention. The ICA allows for considerable political discretion. A future government less disposed to foreign investment could use the Act aggressively to impede foreign investments in Canada.

Since the Investment Canada Act is not clear on what risks it is managing, it is impossible to say whether the political risk it raises is less than other risks it diminishes.

Incremental improvement to the Act’s application to SOEs came with Industry Canada’s publication of guidelines on state-owned enterprises in 2008. The guidelines explicitly state a concern about state-owned enterprises operating under commercial principles. Industry Canada officials are instructed to consider “the corporate governance and reporting structure of the non-Canadian (entity). This examination will include whether the non-Canadian adheres to Canadian standards of corporate governance (including, for example, commitments to transparency and disclosure, independent members of the board of directors, independent audit committees and equitable treatment of shareholders), and to Canadian laws and practices. The examination will also cover how and the extent to which the non-Canadian is owned or controlled by a state.”16 However, these guidelines continue to operate within an opaque review process and are themselves not terribly specific about the governance structure that would be acceptable.


15 Government of Canada, Compete to Win. 29.

16 Industry Canada, Investment Canada Act.
Theoretically, the security provisions of the Act may be on firmer ground. Security is an actual risk. Canada maintains separate regulations to review investments under security criteria under the terms of the National Security Review of Investments Regulations (introduced in 2009). Yet these provisions merely require the industry ministry to consult with the public safety and the emergency preparedness minister to consider whether an investment could be injurious to national security. The regulations make no mention of the factors that go into such an assessment or even what constitutes a “national security” risk. The regulations are vague, only identifying 19 federal departments or agencies and provincial governments that may be involved in a security investigation. The regulations also note other investigation process requirements.

Under this legislative framework, the identification of political risk would appear of utmost importance in major deals. By “political risk,” we mean political discretion to intervene in deals based on their perceived popularity. Companies will structure deals to cover this political risk.

For instance, in March 2012, Glencore International plc. structured its $6.1-billion bid for commodity handler Viterra Inc. to include spinoffs of Canadian assets to Calgary-based Agrium Inc. and Winnipeg’s Richardson International Limited. The business press speculated that the deal was structured in this way merely to pass the Investment Canada review process. Indeed the federal Agriculture and Agri-Food Canada Minister, Gerry Ritz, issued a statement warning that the deal would have to pass the “net benefit” test.17

Yet, despite their efforts to manage political risk, foreign companies have no way of knowing how to pass such a test, since there are no explicit criteria for a successful investment in Canada other than “net benefit.” Prospective foreign investors are left to improvise deals that might satisfy the government of the day. This hardly seems like a rational way for a modern country to encourage foreign investment.

This issue is all the more relevant to China because, by definition, virtually all major Chinese investments are politically sensitive. Therefore, Chinese investors are at particular risk under a legislative framework that relies heavily on political judgements versus clear rules. We conclude that the current regime is most definitely a barrier to Chinese investment.

WHAT ABOUT THE AUSTRALIAN APPROACH?

In his statement on the Glencore-Viterra deal, Minister Ritz failed to mention that Viterra had easily passed Australia’s investment review when it acquired ABB Grain (formerly Australia’s version of the Canadian Wheat Board) for $1.4 billion in 2009. This raises the question: “Would Canada allow an Australian company to acquire the Wheat Board?”

The Australian example is pertinent. As we have shown, when it comes to competition for Chinese FDI, it is not Germany, France, or Italy that should concern Canada—it is resource-rich countries like Australia. Canadians may think that Australia is geographically advantaged, but that is not completely true. Both countries need to ship resources overseas. The shipping time from Vancouver to China is only two days longer than from Australia to China (15 days compared with 13 days).18 China gets most of its imported oil from the Middle East—again, much further removed than Canada.

According to Scissors, Australia attracts about three times as much Chinese FDI as Canada. Australia is extremely active in partnering with China to create the business models for infrastructure that act as a conduit for long-term trade relationships (for instance feedstock for liquefied natural gas facilities). (See Table 10).

This is what integrative trade is all about. Post-Chavez Venezuela may also prove to be a formidable competitor for Chinese heavy oil FDI. Even today, Venezuela attracts almost as much Chinese FDI as Canada, despite being farther away from China.

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17 Bloomberg, Glencore Finds Viterra.

18 Fordex Import Export Company Limited, Shipping Rates.
Like Canada, Australia has a formal review process for FDI. However, that review process seems more accommodative of Chinese investments through clearly stated conditions that make these investments politically palatable. As an example, Yanzhou Coal Mining Company has successfully closed two large acquisitions of Australian coal mining companies. (See box “Yes, With Conditions: Australia’s Approach to Chinese Mining Mergers and Acquisitions.”) The conditions relate to various aspects of ownership and governance. One suspects that a similar multibillion-dollar Chinese acquisition of a Canadian mining company would be a non-starter in the current political environment.

WHERE TO GO FROM HERE

To summarize the report’s argument, it is in the Canadian national interest to host Chinese investments, especially their large state-owned resource enterprises. But the upsides of these investments need to be offset by possible downsides related to state governance of SOEs and potential conflicts between Canada’s role as a producer versus China’s role as consumer. Given the differences in economic and political systems, Canada needs to ensure that China does not use its investment to undermine Canadian security.

The current FDI regime is not the ideal way of balancing the upsides and downsides of Chinese investments. As argued here, China raises considerable concern among the Canadian public, based largely on fear of the unknown. The use of an opaque, politically charged review process for such investments is not ideal because the fear of the unknown may colour a dispassionate analysis of net benefit. In the case of China, Canada is better served through a more explicit FDI regime that lays out the actual risks and how the regime manages the risks.

The risks fall into two categories: security and economic risks. In terms of security, Moran suggests that Canada can learn from the U.S. in terms of explicitly classifying security risks. He suggests three threats:19

1. monopolization of supply that may restrict Canada’s access to resources;
2. transference of sensitive technology; and
3. sabotage.

Moran rightly suggests that the actual threats to Canada from Chinese investment under these criteria are minimal. Yet, regardless of the current threat, a “three threat” framework would make the security provisions of foreign direct investment more explicit and transparent.

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Yes, With Conditions: Australia’s Approach to Chinese Mining Mergers and Acquisitions

Chinese resource investments are especially sensitive, a fact that Australia has been grappling with for over half a decade. The Chinese aluminum giant CHINALCO’s failed merger with Australia’s Rio Tinto (a $19.8-billion deal in 2009) demonstrated many of the pitfalls of Chinese state-owned enterprises’ investments through mergers and acquisitions.

Yet the Chinese coal company, Yanzhou Coal Mining Company Limited, has been successful in making two acquisitions: Felix Resources in 2009 ($3.2-billion deal) and a $2.2-billion merger with Gloucester Coal in March 2012. The latter deal created Australia’s largest listed coal firm, valued at $3 billion. Yanzhou’s Australian subsidiary, Yancoal, executed both deals.

The Foreign Investment Review Board, which operates under the auspices of the Australian Treasury, reviewed the Gloucester Coal deal. The Treasury’s conditions on the deal reveal much about its concerns. These included the following:1

- Yancoal needs to list on the Australian Securities Exchange.
- Yanzhou’s ownership would be reduced to less than a 70 per cent holding by the end of 2013.
- Yancoal would become an Australian incorporated and headquartered company, managed in Australia, using a predominately Australian management and sales team.
- Yanzhou would divest its ownership in the Syntech Resources and Premier Coal mines to 70 per cent by the end of 2014 and manage these mines through the listed Yancoal in the meantime.
- Yancoal, and its operating subsidiaries, would have at least two directors residing in Australia, one of whom will be independent of Yanzhou and its related entities.

The Chief Executive Officer and Chief Financial Officer of Yancoal would have their principal place of residence in Australia and the majority of Yancoal’s board meetings in any calendar year would be held in Australia.

Coal produced at the company’s Australian mines would be marketed on arm’s length terms with reference to international benchmarks and in line with market practices.

These are legally binding conditions under the authority granted by the Foreign Acquisitions and Takeovers Act of 1975. They clearly show that Chinese state-owned enterprises can be successful at mergers and acquisitions when they take a step toward domesticating the merged entity through local ownership and involvement in senior management. Also, the conditions demonstrate Australia’s need to put constraints on China’s interests as a consumer and balance this with Australia’s needs as a producer.

Even the Chinese government recognizes that it is important to consider local interests. A review of the failed CHINALCO-Rio Tinto deal for China’s State Council noted that CHINALCO did not do enough to allay the concerns of domestic stakeholders. “One important reason for blocking the vertical merger is conflict of interest; that is, when the major customer of Rio Tinto enters the board of directors, it will have certain rights to speak on product pricing which may harm the interests of Rio Tinto’s other shareholders.”2 Chinese state-owned enterprises are relatively new to managing these political sensitivities, but the Gloucester Coal deal shows there is a middle ground that allows state-owned capital while managing the national interest.

On economic risks, Canada needs to create a regime that “Canadianizes” Chinese company investments (through changes in governance) and ensures that companies operate on commercial principles, by separating operations from marketing, along the lines of the Australian approach.

Canada can do better. It is in competition with other jurisdictions that are very motivated to attract Chinese investments. Canadian governments will help our case if they:

- organize the FDI regime around two clear tests: one related to the national economic interest and a second related to national security;
- apply the national economic interest test in a way that requires the federal government to make the case that an investment is “contrary to the national interest” as opposed to the foreign investor having to demonstrate “net benefit”;20
- amend the Investment Canada Act to explicitly state that Canada has an economic national interest in companies operating on a commercial basis under the terms of Canadian commercial law;
- apply the national economic interest test in a way that requires the federal government to make the case that an investment is “contrary to the national interest” as opposed to the foreign investor having to demonstrate “net benefit”;20
- amend the Investment Canada Act to explicitly state that Canada has an economic national interest in companies operating on a commercial basis under the terms of Canadian commercial law;

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1 Swan, Foreign Investment Decision.
2 Garnaut, “China Clears Australia.”
improve the existing state-owned enterprise guidelines to include specific undertakings on arm’s length marketing requirements with prices benchmarked to international levels, along the lines of the Australian approach;
clarify specific security risks (for instance, “three threats”) that are addressed through the security provisions of the Act and associated regulations and guidelines;
recognize the economic importance of resource mergers and acquisitions and acknowledge the provincial capacity to safeguard domestic interests through control of the terms of resource extraction via leasing, licensing, royalty, and taxing powers;\(^1\) and
continue to engage Chinese companies and make them aware of Canadian sensitivities and requirements (terms and conditions). Through practice, a “model” of Chinese investment in Canada will develop that balances Chinese and Canadian interests.

\(^1\) We made a similar recommendation to the Government of Saskatchewan in relation to BHP Billiton’s acquisition of Potash Corporation of Saskatchewan. See Grant, Burt, and Ai, *Saskatchewan in the Spotlight*, 60.
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