China Becomes Brazil's Single Largest Investor: Where Next?

Introduction

About 600 years ago, Admiral Zheng He attempted to "go abroad" on expeditions with his fleet. History has it that he sailed as far as the eastern shores of Africa. Today, China's fleet of investors have not only reached Africa but are now leaving their commercial footprints everywhere in the world. Along the way, Chinese companies have conquered major obstacles in their quest for investments in far-flung countries.

Overseas direct investment by Chinese companies increased dramatically from $5.5bn in 2004 to $59bn in 2010. Chinese officials predict that this figure will reach $100bn by 2013.

In 2009, 15% of China's overseas investments was being directed to Latin America. A year later, a whopping $10bn – by some accounts perhaps an even higher amount - was invested in Brazil alone, up from $92m the year before. Such investments are part of a slow but hugely important trend. Newly crowned the second-largest economy in the world – eclipsing Japan – China is gradually stepping up, and diversifying, its investments internationally. With its huge natural resources, land, and infrastructure development opportunities, South America has become a particular focus for hungry Chinese investors.

Interestingly, China's involvement is not only as an investor. In 2010 Chinese banks extended over $10bn in loans to leading Brazilian companies doing business with China in strategic industries.

Evolution of investment targets

Just as it has done during the past decade, Chinese companies are hungrily snapping up raw materials and related assets worldwide. With the full backing of Chinese banks, they are also already beginning to invest in more sustainable areas such as manufacturing and infrastructure. Not only are Chinese companies are becoming increasingly competitive and sophisticated, but Chinese banks are also offering attractive financing terms to assist with their endeavours overseas. At a time when credit is tight globally, these two factors are enabling PRC investors to make substantial forays into Latin America. Manufacturing and infrastructure projects along with natural resources acquisitions are being rolled our around the region, including in Brazil.

One driving factor behind the direction of China's outbound investments to date is a deliberate attempt to reduce its economic – and, to some extent, political – dependence on the U.S. This policy is a priority for the Chinese leadership. It also serves as a hedge against the uncertain long-term economic prospects of the developed world.

The impact of this policy is being felt acutely in Brazil. During the past decade, Brazilians were primarily concerned with providing commodities to industrial powers like China. However, in the past year, substantive Chinese investments have been put in place. For instance, Wuhan Iron and Steel (**WISCO**) paid $400m for a stake in a mining company owned by Brazilian industrialist Eike Batista. WISCO is also planning to build a huge steel mill at the Acu Port complex near Rio de Janeiro.

For several years, Chinese railway construction companies have been operating in neighboring countries in central and southeast Asia. Over the past 12 months, they have also signed contracts in such diverse places as the Ukraine, Turkey and Argentina. In Brazil, Chinese companies have not restricted their activities to laying rail lines, but are now also trying to sell their own high-speed rail equipment. The first such customer could be the planned high-speed rail line between São Paulo and Rio de Janeiro.

Two key factors have made these developments possible:

- Firstly, China has produced a generation of companies manufacturing capital goods that are competitive internationally. They offer developing countries new trains, power stations, mining machinery and telecommunications equipment of sufficient quality at prices that are often well below those of their multinational competitors.

- Secondly, the Chinese banks have been mobilized behind these businesses to provide financial backing. At the end 2010, Vale, the Brazilian company operating a giant iron ore mine in the Amazon, announced that it had signed a $1.23bn credit line with two banks to finance the purchase of 12 cargo ships from a Chinese shipyard, for use in transporting iron ore between the two countries. In addition, Chinese banks have lent $10bn to Petrobras, the Brazilian oil company, in exchange for a decade of oil shipments to China. This last example showcases the interrelated nature of China's investment regime and raw materials acquisition policy.

International Impact

If Chinese investment does indeed help to stimulate a growth cycle in other parts of the developing world, as many people hope, then it may also serve as a tonic for a subdued global economy; particularly since some leading countries face the risk of a double-dip recession. The combination of Chinese domestic demand for goods and booming international investment is one reason behind Brazil's robust growth rate of 6.2% from the second quarter of 2010 through to the end of the first quarter of 2011.

However, China's push to 'go global' is likely to herald an era of intense competition between foreign multinationals and state-owned Chinese companies. Protectionist domestic market access rules, couple with strong financial backing to invest overseas, are likely to fuel accusations that Chinese companies are not playing on a level field. For example, in many sectors, current Chinese rules and regulations require foreign companies to partner and share technology with a local counterpart in order to enter the Chinese market. These policies have long been criticized by developed countries such as the U.S., most recently in the forum of the WTO. With increasing competition coming from Chinese companies in foreign markets, companies such GE and Siemens - which operate in sectors where China is becoming a fierce competitor, such as power equipment and railways – have had no choice but to speak up. However, developing nations are often reluctant to voice their complaints too loudly, for fear of being locked out of the enormous Chinese market.

If full economic integration with other developing countries is to become a reality, it will require sophisticated and delicate management by Beijing. There is a very real risk that China's commercial activities in emerging markets will provoke a backlash, especially if China's exports of manufactured goods maintain such rapid growth.

There are already plenty of warning signs. For instance, there has been widespread criticism of the behavior of Chinese companies in Africa. India has also tried to reduce its use of Chinese power equipment in favor of goods made by local producers. New Delhi went as far as blocking Huawei - the Chinese maker of telecom equipment - from the Indian market in 2010. The U.S. took similar action against the same company earlier this year.

In Brazil, there is concern about fresh competition in other Latin American markets: many Brazilian exporters of manufactured goods to the region feel threatened by lower-priced Chinese products. If their local markets become saturated, Brazilian businesses are likely to become increasingly critical of the new ties to China.

During the course of the next decade, China's outbound investment strategy will no doubt provide a huge boost both to the country itself and to the global economy. Yet a wave of protectionism abroad could halt the process if Chinese companies are not sufficiently sensitive to their target investment destinations. Beijing will need to work hard to ensure that its new partners do not feel steamrolled, and that the backlash does not spread. Chinese companies will need to learn the complications as well as the benefits associated with assimilating into local economies, just as foreign investors have had to do for their investments in the PRC over the past three decades.

It is now China's turn to show what it can do internationally. China has much to offer to the rest of world at a time when its economic and financial prowess could be most helpful. To protect their long-term interests and ensure success, however, Chinese companies will need to invest not only in the resources they need, but also into the local economies themselves as good corporate citizens.