

Chinese Investments on the African Continent and Political Risk: the Ongoing Debate in China

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Abstract:

The recent turmoil in North African and Middle Eastern countries has, at various degrees, affected Chinese investments in these regions, as well as the security of Chinese citizens abroad. During its fieldwork in Beijing and Hangzhou from February till June 2011, the author had the opportunity to get a hint of the ongoing debate on risk assessment practices of Chinese firms investing in Africa. This article aims to illustrate some major aspects of this ongoing debate, hoping to stimulate further debate.

Key Words: Political Risk, China, Africa, Libya

1. INTRODUCTION

The recent turmoil in North African and Middle Eastern countries has, at various degrees, affected Chinese investments in these regions, as well as the security of Chinese citizens abroad. During our fieldwork in Beijing and Hangzhou from February till June 2011, we had the opportunity to get a hint of the debate on risk assessment practices of Chinese firms investing in Africa. This article aims to illustrate some major aspects of this ongoing debate, hoping to stimulate further discussion. Before addressing the core topic of this article, we will introduce some preliminary concepts related to political risk.

2. POLITICAL RISK

For multinational companies, political risk refers to the risk that a host country will make political decisions which prove to have adverse effects on the multinational's profits and/or goals, provoking strategic, financial or personnel losses. Political risk is related to changes in macroeconomic and social policies (such as fiscal, monetary, trade, investment, industrial, income, labor and developmental policies) or to political instability (terrorist attacks, riots, coups, civil wars and insurrections).¹ While in developed countries political risk due to regulatory excesses usually prevails, in developing countries political risk is often linked to structural risks. These might include regime instability, out-of-sync economic policies and ethno-religious-cultural imbalances in development, due to the monopoly of political power and economic wealth by a single dominant ethnic or religious group.

Political risk related to political instability in developing countries is indeed the focus of this article. Its relevance has recently been increased by the financial crisis, which has brought rising levels of unemployment, declining remittances and, due to shrinking government revenues, it has limited resources available for social programs. The risk of social unrest has therefore increased, as both movements of protest in developed countries (i.e. Indignados, Occupy Wall Street) and often more violent revolts in low-income countries have shown. Although uprisings in North Africa and Middle East have caught the attention of the media, other protests, such as famine riots, have indeed been endemic in several Sub-Saharan African countries since 2008.

Political risk indexes are often based on indicators of one country's stability, defined as "the ability of the government to implement policies and enforce laws despite a shock to the system."² Indeed, some of the most politically stable states are also the most authoritarian. The correlation between political stability and political freedom is therefore not straightforward. A

¹ C. Kennedy, "Political Risk Management: A Portfolio Planning Model", *Business Horizons*, 31: p. 21 (1988).

² I. Bremmer, "Political Risk: Countering the Impact on Your Business", *QFinance* (2001), available at <http://www.qfinance.com/business-strategy-best-practice/political-risk-countering-the-impact-on-your-business?page=1>, last accessed on 03/10/2011

low level of political risk related to political instability in a given country does not necessarily correspond to a high degree of political freedom. However, political change in authoritarian regimes is likely to be particularly disruptive for investors in the country, as the case of the unexpected regime overturn in Libya clearly shows. Being shocks by definition unpredictable, political risk remains particularly difficult to monitor, assess and forecast. Firms trying to lessen their exposure to political risk can therefore rely on different strategies, including in-deep analysis and planning before undertaking the investment, enhanced understanding of local business practices and regulations, investment diversification and purchase of political risk insurances. The establishment of joint ventures (JV) with local companies can also provide the foreign firm with a better knowledge of the local cultural, legal and business environment. Another common practice among foreign investors is the establishment of good relations with host governments, local communities and NGOs. Nevertheless, close ties with local political elites in charge might obviously aggravate the position of a foreign firm in case of an unforeseen political overturn. Besides these prevention strategies, firms can also adopt country-exit and/or damage reduction strategies, in an attempt to alleviate the consequences of a crisis.

Having defined the main features of political risk, we will now focus on specific practices of Chinese firms investing abroad.

3. CHINESE FIRMS AND POLITICAL RISK

According to the “World Investment and Political Risk Report 2009”, Chinese investors are aware of political risk and, compared to other North-based and South-based investors, they are concerned in particular with risks related to political violence, namely war, civil disturbance and terrorism.³ There is indeed empirical evidence that Chinese firms are less adverse to political risk compared to Western counterparts, which can be explained by several factors. Chinese companies, as latecomers to Africa, may attempt to take advantage of the opportunities presented by high-risk countries, such as first-mover advantages, lower competition and lower level of consumer sophistication. As a Chinese official from the Ministry of Foreign Affairs (MFA) said, “we would like to go to democratic countries with good human rights records and good business environment but the problem is that we are latecomers on the African continent and that many of the opportunities in those countries have been taken by Western first-comers.”⁴ The choice of the investment location for Chinese firms in the extractive sector is moreover bound by the geography of mineral deposits, letting them with even less room for maneuver. In several cases, moreover, potential economic benefits for Chinese firms investing in unstable countries are high enough to be regarded as offsetting political risks. Research results also show that Chinese State Owned Enterprises (SOEs) tend to be less risk-adverse

³ MIGA, “World Investment and Political Risk 2009”, *World Bank*, p. 38 (2010).

⁴ Interview with a Chinese official from the MFA, Beijing, 26/04/2011.

than Chinese private firms.⁵ SOEs in fact, conditioned by the institutional influence of the Chinese government, may not behave solely as profit maximizers. Thanks to the financial support of Chinese state banks, they might indeed be able to undertake higher risks.⁶ Moreover, compared to the majority of Chinese private companies, SOEs can take better advantage of the friendly relations between the Chinese government and several African host governments, which allows them to operate in a more secure business environment.

A striking 18% of the Chinese companies which participated to the MIGA's survey admits not to take any measure against political risk. This is the highest percentage among South-based investors and it is three times higher than the world average. The main reasons seem to be lack or unawareness of appropriate tools to offset political risk.⁷ Most of the firms that participated in the survey were SOEs. We can therefore assume that, among Small Medium Enterprises (SMEs), the percentage of firms undertaking extremely limited political risk-avoidance measures (or no measure at all) is much higher, since SMEs have even more limited human and financial means at their disposal to invest in these activities.

Among those firms trying to diminish their exposure to political risk, the main risk mitigation tool employed is political risk analysis, followed by the creation of joint ventures with local companies and the establishment of good relations with host governments. Engagement with local communities and NGOs is instead rarely taken into consideration, which obviously reflects Chinese firms' general inexperience and uneasiness in dealing with civil society representatives, in China as well as abroad. Informal and internal means to lower political risk exposure prevails, thanks to their lower costs, while only a very limited amount of Chinese firms purchase political risk insurances.⁸

Despite the fact that political risk analysis ranks first among risk mitigation tools employed by Chinese firms, Chinese MNEs feel particularly ill equipped to evaluate risk mitigation strategies.⁹ As a Chinese scholar from the CASS acknowledged, "there is a gap of research and understanding of Africa in China. We haven't fully understood Africa, African way of thinking, their culture, social interactions, political and religious context."¹⁰ In fact, among 18 African studies centers in China reviewed in Bassan's article¹¹, nine have been created after 1994 (and six of them after 2004) and only eight are not based in Beijing, proving that African studies in

⁵ B. Ramasamy et al., "China's outward foreign direct investments: location choice and firm ownership", *Journal of World Business*, 3/11/2010 (2010).

⁶ D. Quer, E. Claver and L. Rienda, "Political risk, cultural distance and outward foreign direct investment: empirical evidence from large Chinese firms", *Asia Pacific Journal of Management*, pp. 1-16 (2011).

⁷ MIGA, *op.cit.*, p. 87-89.

⁸ *Idem*, p. 86-88.

⁹ *Idem*, p. 41.

¹⁰ Interview with CASS scholar, Beijing, 08/03/2011.

¹¹ Bassan M., "Principaux centres et instituts chinois de recherche sur l'Afrique", *Revue Outre Terre*, n. 30, pp. 379-392 (2011)

China are still rather undeveloped and centralized but clearly expanding. Certain Chinese lawyer firms have launched specific projects to advise Chinese firms investing abroad but these programs have not always been successful. According to a lawyer firm from the Zhejiang province, “most of Zhejiang enterprises going to Africa are SMEs and, in order to assess the risk of investing abroad, they rely on personal networks and diasporas, rather than lawyers, mainly for cost reasons”. However, “more Chinese companies investing abroad will have problems in the future so they will be more likely to ask legal advices.”¹² These comments highlight a clear need to incentive African studies in China, to develop Chinese understanding of African issues and to connect this expertise with the industrial world.

4. THE LIBYAN TURMOIL AND ITS IMPACT ON POLITICAL RISK DEBATE IN CHINA

Among political risks, risks related to political violence are the first concern for Chinese investors in Africa. As a consequence, recent uprisings in North Africa and Middle East surely had an important impact on Chinese firms' and political elites' visions of political risk. This paragraph illustrates in particular which has been the impact of the Libyan turmoil on Chinese firms' activities and investments in that country.

According to statistics released by China's Ministry of Commerce, 75 Chinese companies, including 13 SOEs, have invested in 50 projects in Libya since 2007.¹³ Chinese FDI commitments have totaled on the order of US\$ 9-13 billion, of which the vast majority was in the civil construction sector (i.e. housing development, railway construction, oil services and communications).¹⁴ As the unrest spread, Chinese companies suspended their operations one after the other and many construction sites were looted and abandoned. Although China's role as a contractor has limited its exposure to direct losses in the unrest, some Chinese assets like Sinopec refineries were raided and destroyed while supplies have been disrupted.¹⁵ During the riots, bilateral trade, which amounted to US\$ 6.6 billion in 2010, was also disrupted. On March 4th, the MFA organized an evacuation operation for 35,860 Chinese citizens.¹⁶ The cost of this operation is set to surpass US\$ 3 billion.¹⁷ Losses therefore include, but are not limited to, disrupted employment of the workers, abandonment and looting of the construction sites, disruption of operations, disruption of trade between China and Libya and evacuation costs of

¹² Interview with a member of a lawyer firm from Zhejiang province, Hangzhou, 17/06/2011.

¹³J. Junbo "China's second coming in Libya", *Asian times* (2011), available at <http://www.atimes.com/atimes/China/MH31Ad01.html>, last accessed 06/10/2011

¹⁴Y. Wang, "China's reaction to political risk in Africa", 17/03/2011, available at <http://pt.scribd.com/doc/51385610/China%E2%80%99s-Reaction-to-Political-Risk-in-Africa>, last accessed 03/10/2011

¹⁵ China imports 3% of its crude oil from Libya.

¹⁶ Wang, *op.cit.*

¹⁷ Lao, *op.cit.*

the Chinese expatriates. Beijing had then to deal with a messy aftermath of compensation claims, third party debts and re-employment of all returned workers. According to an EXIM Bank official, losses in Libya, which have been far more than in any other country, accounted for US\$ 18.8 billion as in April 2011, while “nobody knows how much we have lost in total because of the North African turmoil”.¹⁸ At a conference in Shanghai in May, Sinosure¹⁹ revealed that in the first three months of 2011, its reported loss claims from North Africa and the Middle East have risen by 167 percent over the same period of last year. China Investment Corporation has therefore won approval from the cabinet to inject US\$ 3.1 billion into Sinosure at the end of May 2011.²⁰

What has then been the impact of these major events on dominant visions among Chinese officials? The following paragraph offers an overview of the ongoing debate on political risk due to political insecurity and instability.

5. THE ONGOING DEBATE

Political and social stability are major concerns for Chinese officials from both the MFA and the Ministry of Commerce (MOFCOM). According to a MFA official, the long term solution is to address the root of the problem, that is poverty, as well as to increase Chinese involvement in conflict resolution and management in Africa. However, “political instability in Africa won’t change our Going Out policy because it is endemic, it is always here and there. In this period in North Africa it is only lasting longer and with a more intense degree.”²¹ Within the MOFCOM, there is an ongoing debate on which measures should be adopted in order to reduce Chinese firms exposure to these risks. Some officials suggest to “work closely with local and Western companies and to establish better relations with tribal leaders because the central government does not always control the whole territory and the population does not have a strong feeling of national belonging.”²² Another official however admits that “situations of social unrest are beyond our expectations. So far we have no idea of how to solve this problem. The MOFCOM and the MFA ask Chinese enterprises to pay attention to risk, to do more accurate researches on the local context before investing in a certain country and to prefer some more stable

¹⁸ Interview with Chinese official from the EXIM Bank, Beijing, 05/2011

¹⁹ Sinosure, China’s official export credit insurance agency, has been established in 2001. Its portfolio exposure grew 10-fold from 2005 to 2008. The agency total PRI portfolio exposure was US\$ 6.6 billion in 2009, of which US\$ 4.7 billion allocated to Asia and US\$ 1 billion to Africa. [MIGA (2010), p. 57] Other insurances are offered by regional organizations (e.g. ADB). Nevertheless, cultural differences and evolving sectorial requirements underscore the need for investment insurance products more tailored on the needs of South-based investors.

²⁰ Reuters, “China CIC to inject US\$ 3.1 billion into Sinosure” (2011), available at <http://www.reuters.com/article/2011/05/26/us-china-cic-sinosure-idUSTRE74P1CH20110526>, last accessed on 03/10/2011.

²¹ Interview with a Chinese official from the MFA, Beijing, 26/04/2011.

²² Interview with Chinese officials from the CAITEC-MOFCOM, Beijing, 05/05/2011.

countries.”²³ This is confirmed by an MFA official stating that “political risk is difficult to foresee. The Chinese government monitors the situation but specific firms might lack the capacity to assess this risk. We encourage firms to be more aware of this kind of risk. We surely should monitor the situation more closely.”²⁴ These statements are in line with the already cited data on the lack of political risk expertise and anti-risk exposure programs among Chinese firms investing abroad, while they also reflect a certain inexperience of Chinese institutions in dealing with these issues at the early stage of Chinese MNEs' internationalization process.

Besides MFA and MOFCOM shared concerns, we can observe that the Libyan events had a different impact on different branches of the Chinese administration, while the position of the Chinese government towards the Libyan Transitional National Council has notably evolved in an attempt to secure Chinese firms' access to Libyan resources and investment opportunities. As the rebels were gaining ground in Libya, the Chinese government feared that Chinese companies could be sidelined in the reconstruction phase, since China, as well as Russia, Brazil, India and South Africa, did not support NATO air strikes aimed at defeating Gaddafi, nor provided military aid to the rebels. As Wen Zhongliang, deputy head of the Chinese MOFCOM's trade department, affirmed in an interview in March 2011, “China hopes that after a return to stability, Libya will continue to protect the interests and rights of Chinese investors and to continue investment and economic cooperation with Libya”.²⁵ However, despite the colder stance of the Chinese government towards the Libyan Transitional National Council, EXIM Bank officials have always been convinced that Chinese enterprises were unlikely to lose ground in the reconstruction phase, and this for at least two reasons. On one side, the new Libyan government relies in oil revenues to foster reconstruction and growth and it needs to diversify its export markets. On the other side, before the turmoil Chinese firms in Libya were mainly involved in the civil construction sector, where their expertise and lower costs are even more appreciated in the reconstruction phase. Although aware of the disruptive economic effects of the Libyan war for Chinese firms, a well placed EXIM Bank official has affirmed that losses would be fully recovered in the reconstruction phase and that “troubles will however end and there will be even more business to do with the reconstruction”.²⁶

The Libyan case might, indeed, have had a more serious impact on the MFA's perceptions of political risk. Although it is not the first time that Chinese nationals found themselves in danger on the African continent, it was in Libya that the MFA organized its first large scale rescue operation of Chinese nationals. If these operations become more frequent, the MFA, who is in

²³ Interview with Chinese official from the CAITEC-MOFCOM, Beijing, 14/04/2011. Alleged lists of more stable “recommended countries” was not delivered to the author.

²⁴ Interview with Chinese officials from the MFA, Beijing, 11/05/2011.

²⁵ J. Jumbo, “China's second coming in Libya”, *Asia Times online*, 31/08/2011, available at <http://www.atimes.com/atimes/China/MH31Ad01.html>, last accessed on 6/10/2011.

²⁶ Interview with Chinese official from the EXIM Bank, 05/03/2011.

charge of them, might become particularly worried with their massive organizational and financial costs. Finally, it is interesting to notice that these events could even lead to some new form of cooperation between China and Europe. In fact, although it is common opinion among European officials in China that Chinese companies often disregard political risk when it comes to their investment choices, they also consider that, since Chinese nationals and companies have recently been victims of African insecurity, Chinese rising concerns on political risk might offer an entry point for specific Euro-Chinese cooperation initiatives in the security field.²⁷ Conflict prevention and arms control policies have been cited by European officials as promising area for cooperation with the EU.²⁸ Some Chinese officials from the MFA seemed to share the same view when they affirmed that “peace, security and stability are among the major common interests of China and the EU in Africa, because they both have to protect their investments. Cooperation in this area should better take place under the UN framework. However, risk analysis, the creation of an early warning system or expertise exchange and cooperation in rescue operations could be promising areas for bilateral cooperation between the EU and China, although this has never been officially discussed”.²⁹ Even if concrete Euro-Chinese cooperation initiatives in the security field haven't been launched yet, future developments in this area are nevertheless to be monitored.

6. CONCLUSIONS

In this brief article we define what political risk is and how Chinese firms investing abroad are dealing with it so far, pointing out possible shortcomings in their approach, which are mainly due to the lack of financial means and expertise at the firm and institutional level. We tried to illustrate how the recent turmoil in North Africa and in Libya in particular, has affected, at various degrees, visions and perceptions of officials from different branches of the Chinese central government (MFA, MOFCOM, EXIM Bank), but we also introduced the point of view of European officials based in Beijing. The narrow approach of this article can however only offer a hint of this debate, leaving many topics, and first of all African visions of these issues, open to discussion.

²⁷ Interview with European member state official, Beijing, 22/04/2011: “So far the Chinese practically did not take the political factor into account. They invested heavily in weak states and this might turn against them. After the events in North Africa, China will be forced to adjust its country risk assessment procedures.”

²⁸ Interview with EU official, Beijing, 07/04/2011.

²⁹ Interview with Chinese officials from the MFA, Beijing, 11/05/2011.