HSBC Global Research

29 November 2023

A pivot to new frontiers

China's outbound direct investment

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Economics - China

- A channel to secure access to resources, markets and trade routes, China's outbound direct investment is set to accelerate
- Manufacturing is the new mainstay of overseas investment; global energy transition means big, new opportunities for China's ODI
- China's annual ODI flows are set to rise sharply from their pace in recent years, with at least USD1.4trn in spending until 2028

Frederic Neumann
Chief Asia Economist, Co-head Global Research Asia
The Hongkong and Shanghai Banking Corporation Limited

Ines Lam
Economist, Asia
The Hongkong and Shanghai Banking Corporation Limited

Pick-up and a shift

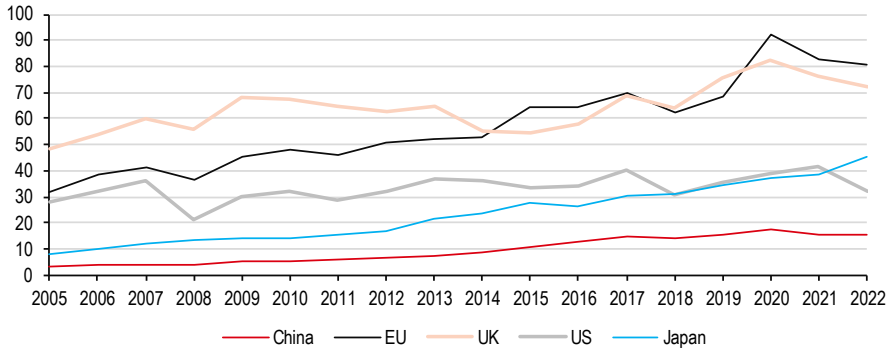
China's overseas investment, though increasing, is still small relative to the size of its economy. At 15.7% of GDP, China's outward direct investment (ODI) stock is well below that of the major developed economies, as well as the world average of 34% (Chart 1).

There is therefore plenty of room for China's overseas investment footprint to grow. While a change in the government's ODI policy in 2016-17 and the pandemic have made a dent in China's outbound investment in recent years, Chinese firms continue to have strong incentives to "go out" to explore the global market in search of growth.

In our baseline scenario, whereby ODI rises in line with its recent trend, annual flows could rise by over 50%, with at least USD1.4trn to be invested abroad between now and 2028. In a more 'dramatic' scenario, in which China's ODI rises in line with its per capita GDP, flows can potentially rise up to three times their recent annual pace to well over USD400bn per annum.

There is also a shift under way in the type of ODI China pursues: Belt and Road-related spending continues to slow, notably SOE-led infrastructure projects. At the same time, private-driven investments, such as in energy, transportation, and logistics, are picking up.

Chart 1: Outward direct investment stock, % of GDP



Source: OECD, HSBC. NB: The European Union (EU) aggregate excludes the UK.

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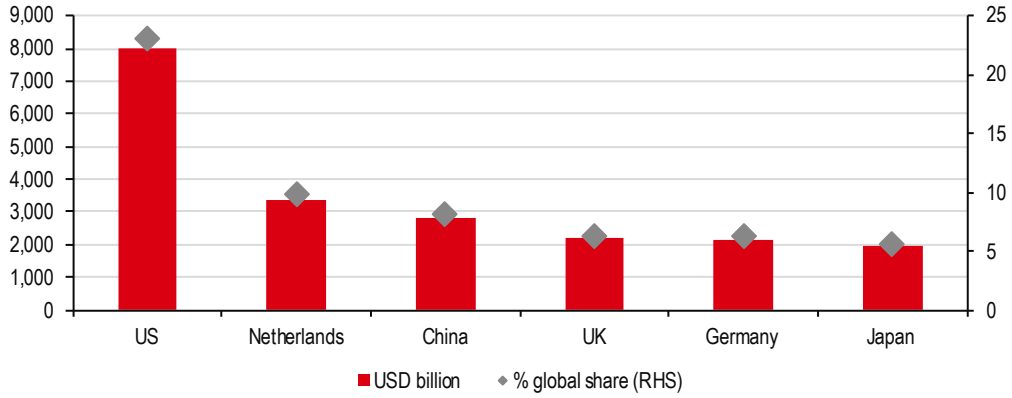
China holds the third-largest ODI stock in the world

Only starting to venture out into the international investment landscape in the mid-2000s, China is, in a sense, 'late to the game'. However, rapid increases in ODI in the first half of the 2010s have allowed China to join the ranks of other large economies, and China's stock of outward direct investment has now surpassed that of Japan, Germany and the UK. That said, China's overall stock of outward investment is only one-third that of the US (Chart 2).

Chart 2: Outward direct investment stock, USD billion and global share, 2022

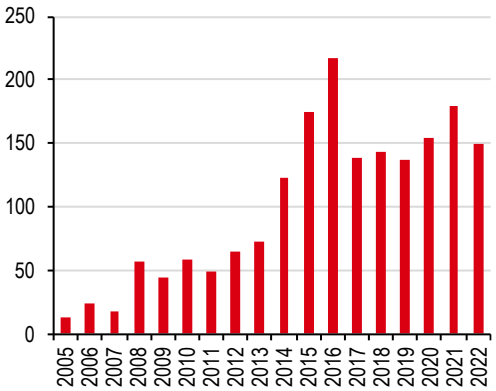


Source: OECD, HSBC. NB: China refers to mainland China.

ODI peaked in 2016; 2022 was less than 70% of 2016

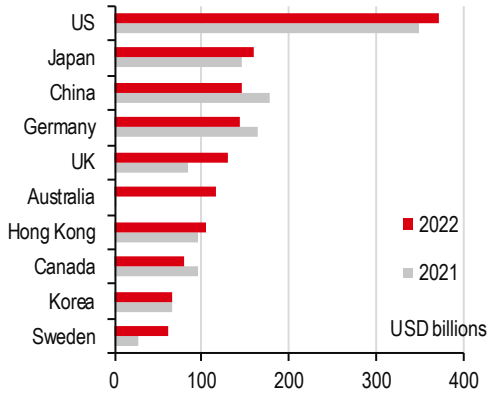
A long list of factors hindered China's outbound investment over the past few years. Using data from the OECD, Chart 3 shows that China's ODI flows peaked in 2016 and dropped by almost one-fifth in 2017. The decline was precipitated by a tightening in Chinese regulators' supervision of capital outflows and private companies' overseas investment transactions. In the following years, COVID-19 and the war in Ukraine severely interfered with global investment. The ongoing geopolitical tensions between China and developed economies also cast a shadow on China's overseas investment. In 2022, China's ODI flows fell 16% y-o-y and were more than 30% down from the 2016 level. Nevertheless, it was the third-largest cross-border direct investor in the world, following the US and Japan (Chart 4).

Chart 3: China's ODI flows, USD billion



Source: OECD, HSBC

Chart 4: ODI flows, top 10 investors

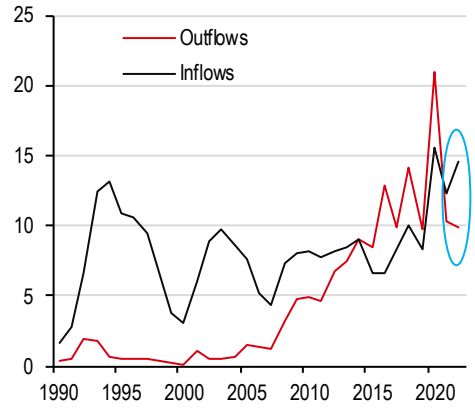


Source: UNCTAD, HSBC. NB: China refers to mainland China.

China became a net foreign direct investor in early 2023

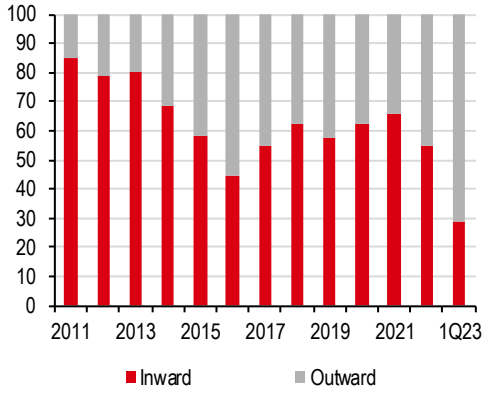
As a result, China's share of global ODI flows fell in the last couple of years to around 10% (while the global inflow share, at least through 2022, held up better; Chart 5). A different set of data, which extends to the first quarter of 2023, suggests a fundamental shift is now under way: outflows have rebounded faster than inflows, turning China into a *net* direct overseas investor (Chart 6).

Chart 5: China's FDI inflows and outflows, % world total



Source: UNCTAD, HSBC

Chart 6: China's inward and outward direct investment, % share of total cross-border direct investment



Source: OECD, HSBC

Whether China will remain a net investor depends on a variety of factors. FDI inflows to China will likely face continued headwinds from geopolitical tensions. A slowing economy and the perceived rise in policy uncertainty are adding to the drag.

The time when inflows always exceed outflows is over

Greater certainty surrounds the outlook for Chinese direct investment outflows. These are likely to accelerate in the coming years as they increasingly align with Chinese economic and political development priorities. That said, there are important changes afoot: official projects under the Belt and Road Initiative (BRI) banner may continue to be de-emphasised (Chart 7), though, as per MOFCOM data, non-financial BRI investments have continued to climb. Meanwhile, the share of ODI by private firms is likely to continue to rise, especially with a focus on energy projects, transportation, and logistics (Chart 8).

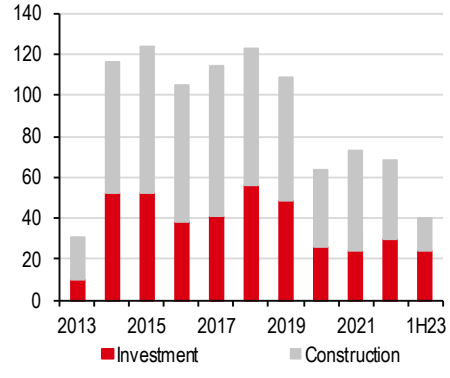
China found a new mission for ODI

A new mission for ODI

In 2016-17, the government initiated a 'clean-up' for foreign investment by Chinese companies, aiming to rein in "irrational" investments in areas, such as real estate, entertainment, hotels and sports clubs. As a result, ODI in recent years has been moving away from investments in these service sectors.

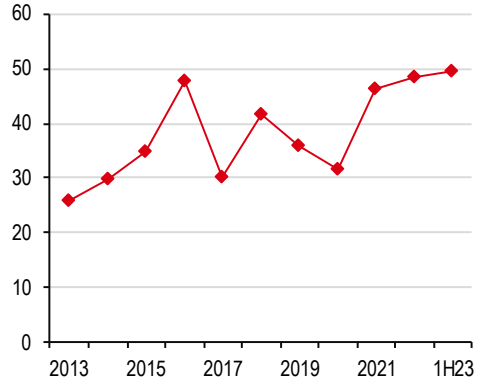
Chart 9 tracks the changes in China's ODI destination by industry over the past 15 years, according to MOFCOM data. In Chart 10, we compare the industry's average share in total ODI in the five-year period of 2022-18 with the period of 2012-16. We skipped 2017, the year that was the watershed in China's ODI strategy and when ODI dropped by 36% y-o-y using OECD data (Chart 3).

Chart 7: Chinese BRI engagement (USDbn)



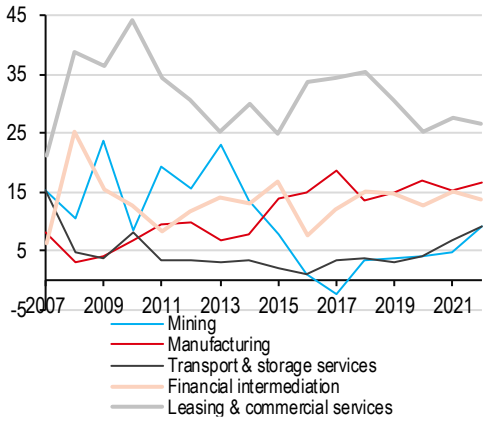
Source: Green Finance & Development Center FISF Fudan University, HSBC

Chart 8: Private share of BRI investment (%)



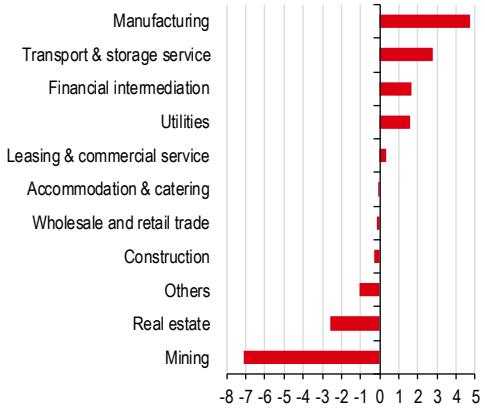
Source: AEI, HSBC

Chart 9: China's top 5 ODI sectors, % total



Source: CEIC, HSBC

Chart 10: Percentage point change in share of ODI by sector, 2018-22 minus 2012-16



Source: CEIC, HSBC

Investment in manufacturing has been rising steadily

These are the changes we observe:

- Overseas investment in manufacturing has been rising consistently. There was a near 5ppt increase in manufacturing's share in total ODI in 2018-22 versus 2012-16
- Transport, storage and postal services have been rising steadily in the past few years
- A steep decrease in ODI in mining since 2014; however, after reaching a trough in 2017, mining is picking up again
- Real estate showed a big decline after the central government's tightening of capital controls and screening rules of overseas investment. In 2018-22, real estate's share in total ODI more than halved from 2012-16

In its coverage of China's overseas investment trends, the OECD pointed out a definitional caveat of using official ODI data. It is that MOFCOM classifies investment through third parties as investment in leasing and business services in the first destination economy, and not according to the sector where the *ultimate* investment is made at the *ultimate* destination. This issue overstates investment that goes into leasing and commercial services and, therefore, understates investment that goes to other industries.

The private sector, with Beijing's backing, increasingly takes the lead

Private sector will lead, with Beijing's green light

Apart from a shift in sectoral focus, there has also been a change in the key players in overseas investment. In 2020, the portion of non-financial ODI stock owned by SOEs was 46.3%, down from 66.2% in 2010. Non-SOEs own more than half of the stock since 2017.

This likely reflects, at least in part, the official strategy: having learned the lesson from the first generation of the "Going Out" policy, which resulted in investments considered as unproductive by the government, this new round of ODI represents a more focused, though still-often private sector-led, strategy of using overseas investments to support wider industrial policy priorities.

We expect that Chinese companies in the technology, renewable energy and EV sectors, blessed with the government's green light, are increasingly in the driver's seat and will actively lead overseas investment. Yet, the split between private and state players also depends on the sector. For example, the Digital Silk Road (DSR) initiative is dominated by private companies, such as Huawei, ZTE and Alibaba, while state-owned firms will continue to have an important role in sectors, such as large-scale energy or construction projects.

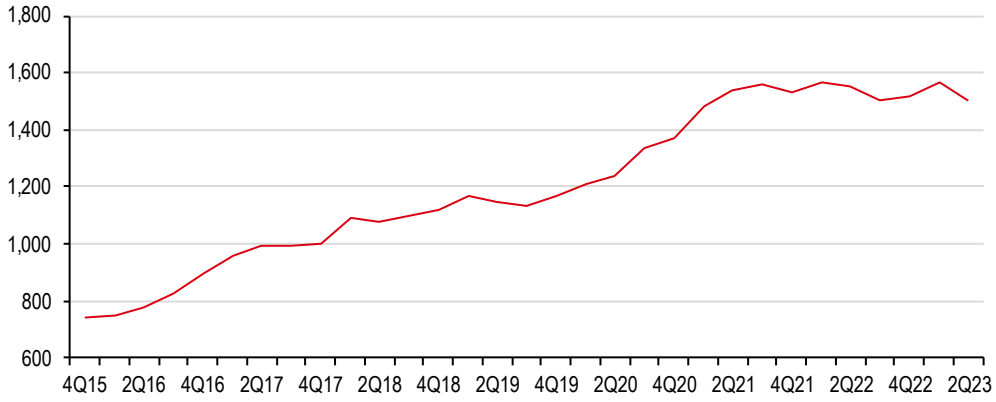
Belt and Road Initiative: Retrenching with a new focus

The BRI wobble

As discussed, the Belt and Road Initiative has undergone some changes, with reduced project volumes and shifting investment focus. International banking statistics from the Bank for International Settlements (BIS) show that Chinese banks' claims on the rest of the world, after having nearly doubled between late 2015 and early 2021, have flattened out since the second half of 2021 (Chart 11).

This likely reflects the deliberate step of cutting back on BRI lending mandated by Chinese policymakers. Following a series of bad loans, China's BRI is expected to scale back and prioritise "small but beautiful" projects, a strategy set out by Xi Jinping in November 2021. Apart from the scale of lending, China is also prioritising new development projects that mainly focus on digital and green infrastructure rather than the large-scale transportation projects that shaped the early stages of the BRI.

Chart 11: Chinese banks' claims on the rest of the world, USD billion



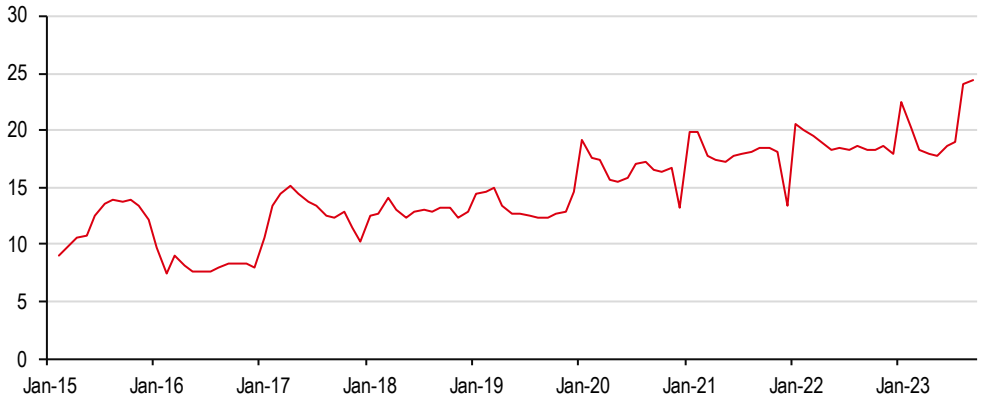
Source: BIS Locational banking statistics, HSBC. NB: Total claims of banks with headquarters in China vis-à-vis residents of all economies), all sectors, all instruments in all currencies.

The BIS dataset estimates China's total claims on the rest of the world at USD1.5trn by 2Q23. While this figure includes non-BRI lending, its trend is more consistent with the USD1trn figure that has been quoted widely (e.g., Wall Street Journal, 27 December 2022) to be the true scale of BRI lending. The MOFCOM data, in contrast, only include non-financial direct investment to BRI countries; the cumulative non-financial direct investment in BRI was estimated to be less than USD200bn.

China's ODI likely to shift more to BRI countries

Although official data may not fully capture the full extent of the BRI's scale, they still help to highlight a trend that is emerging from China's new investment direction. Chart 12 shows that the share of ODI going to BRI countries has more than doubled between 2015 and 2023. We expect that this trend will continue, or even pick up pace going forward, as the portion of China's outbound direct investment to Southeast Asia, Latin America and the Middle East – the majority of the countries are BRI participants – will increase, while ODI to non-BRI regions, such as the US, and Europe to a lesser extent, will decline in proportion in light of the arguments we make in the sections below.

Chart 12: Share of China's non-financial ODI to BRI countries, % total



Source: CEIC, HSBC

Estimating China's ODI growth potential

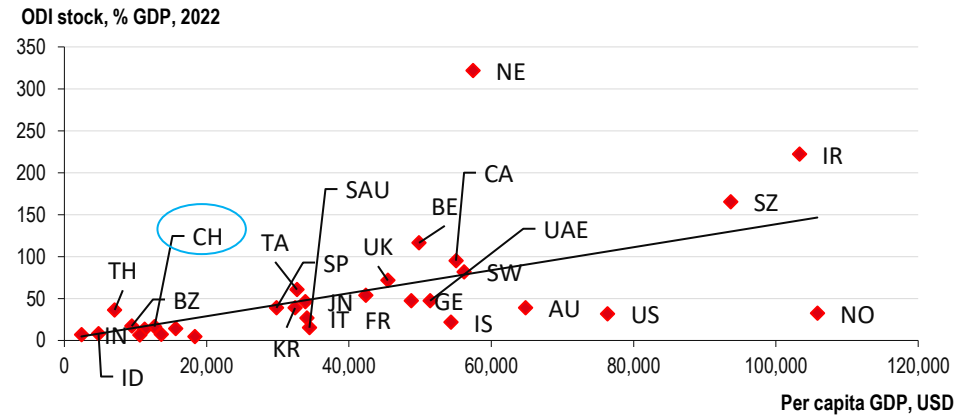
In the most dramatic, upside scenario, ODI flows from China could more than triple in coming years…

With strong economic incentives and political commitment to expand its overseas footprint, we believe that China's ODI will accelerate and catch up with the size of ODI stock that other major economies have. In Chart 1, we showed that China's ODI stock was 15.7% of its GDP in 2018-22, much lower than Japan's 37.4% and the US's 35.8%. Over time, an economy's ODI stock tends to rise with per capita GDP (Chart 13). Based on this trend and using IMF forecasts for China's per capita GDP in 2028, its ODI stock as a share of GDP could rise to 25%. Cumulatively, this would amount to an incremental USD2.97trn in ODI, or slightly below USD500bn per year – more than triple the annual flows seen over the last several years.

…with even a pessimistic scenario entailing a 50%-plus rise in annual outflows

While this estimate amounts to a 'best case' scenario, our baseline estimate is based on the recent trend in ODI flows. As mentioned, since bottoming in 2017, outflows have gradually picked up again (with the exception of 2022). Assuming recent trends hold, Chinese ODI could reach a cumulative USD1.4trn through 2028 – averaging around USD240bn per year, which would represent a 50%-plus increase in the annual flow of recent years.

Chart 13: ODI stock as a percentage of GDP and per capita GDP



Source: UNCTAD, IMF, HSBC. NB: CH refers to mainland China.

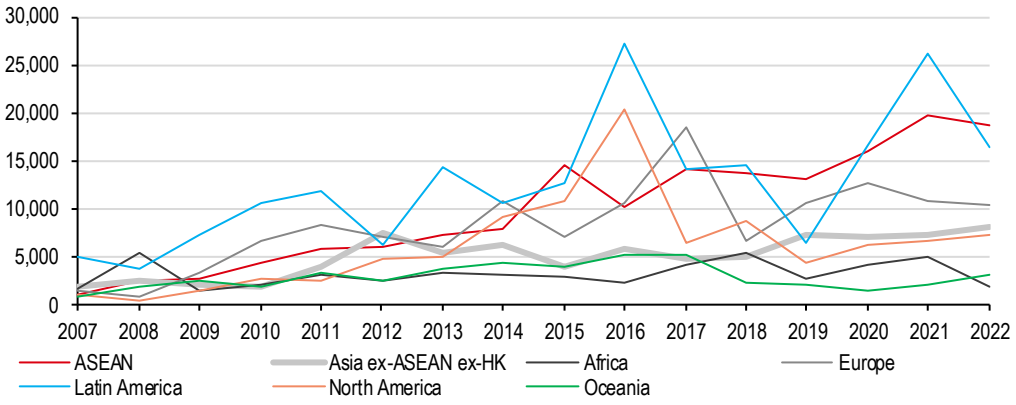
ASEAN: Chinese ODI as a driving force for regional integration

Among the main regions in the world, ASEAN was the number one recipient of China's outbound direct investment flows in 2022 (Chart 14), according to data from the MOFCOM. Chinese ODI flows to ASEAN have been rising steadily in the past 15 years. Their share in total Chinese ODI has tripled from 3.7% in 2007 to 11.4% in 2022 (Chart 15).

The data conundrum

For other regions, Latin America has recovered strongly from 2019. Europe, North America and Oceania have seen their portion of the pie shrinking over the past five years. However, this set of MOFCOM data considerably overstates the share of Latin America because of the outsized flows to the British Virgin Islands and Cayman Islands, which together account for about 90% of ODI flows to Latin America in any given year. This, at the same time, understates the share of other regions.

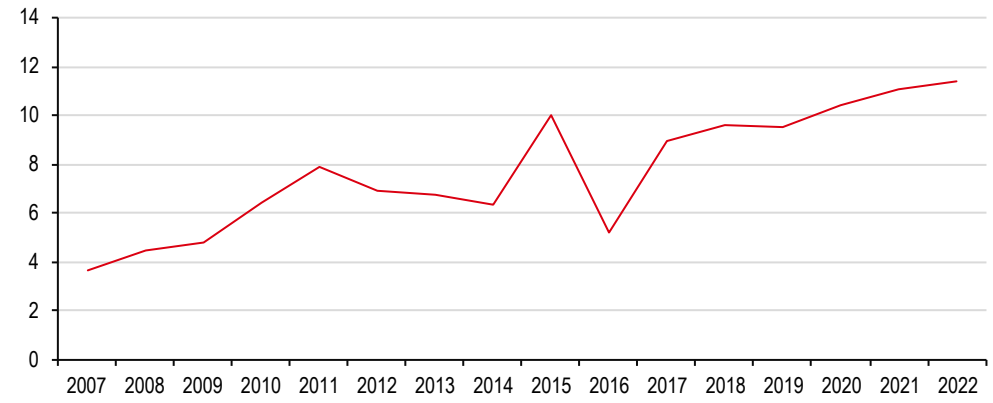
Chart 14: China's ODI flows by region, USD million



Source: CEIC, HSBC. NB: China refers to mainland China.

ODI flows to ASEAN rising steadily

Chart 15: China's ODI flows to ASEAN, % total flows

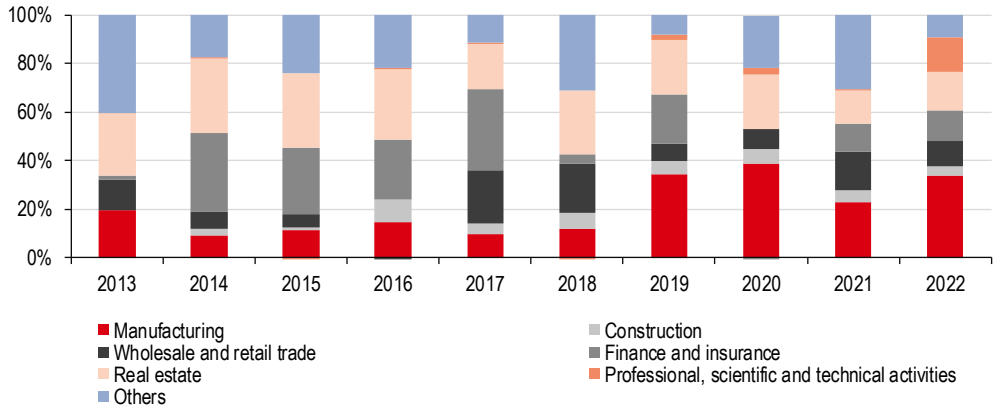


Source: CEIC, HSBC

Increasing FDI inflows to manufacturing in ASEAN from China

To mitigate the shortcoming of official data that we mentioned earlier, we look at alternative data, such as statistics published by recipient economies of China's ODI. And to revisit the discussion that Chinese investment has been increasingly flowing to manufacturing, we observed, using data from ASEANstats, a rise in FDI inflows to ASEAN's manufacturing since 2019, and a corresponding decrease in Chinese investment to real estate, finance and insurance (Chart 16).

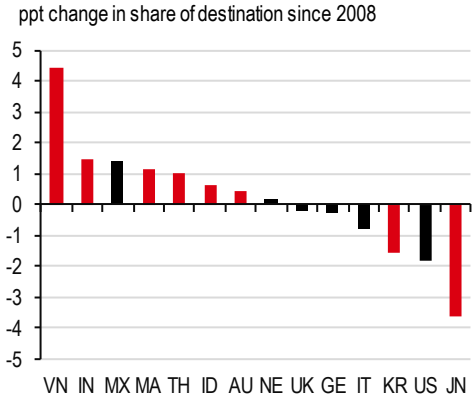
Chart 16: Flows of FDI from China to ASEAN by industry, % total



Source: ASEANstats, HSBC. NB: ASEAN includes Brunei Darussalam, Cambodia, Indonesia, Lao, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

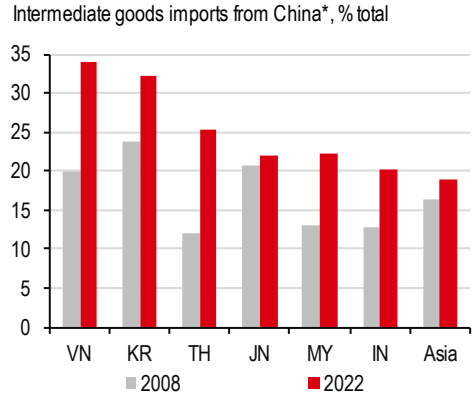
The first underlying force of the rise in Chinese FDI in ASEAN's manufacturing sector is that China is becoming more of an exporter of intermediate goods used by manufacturers in the region (Chart 17 and Chart 18) as it moves up the value chain, a subject we have discussed in previous reports, such as *Asian Economics: Retooling factory Asia*, 16 December 2022.

Chart 17: China's intermediate goods exports, change in export partners' share between 2008 and 2022



Source: UN, HSBC. NB: China refers to mainland China.

Chart 18: Imports of intermediate goods from China, change in import partners' share between 2008 and 2022



Source: UN, HSBC. NB: China refers to mainland China. *2022 data or latest available.

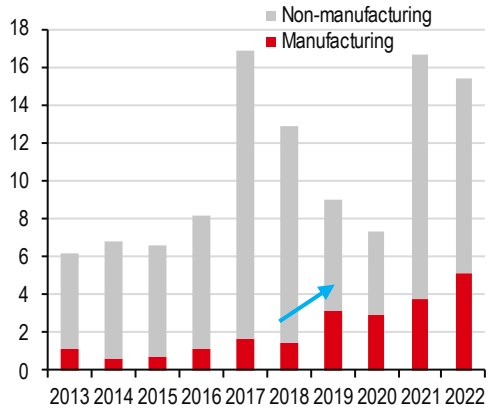
Manufacturing migration from China to ASEAN

Experience shows that trade and investment integration go hand-in-hand. Therefore, the increased trade linkages between China and ASEAN are mirrored in the rise in cross-border investment, increasingly from the former to the latter. For over a decade or so, Chinese manufacturers have been gradually moving production to ASEAN economies in search of lower production costs and new market opportunities, driving a shift in manufacturing supply chains within the region.

Manufacturing is one-third of China's total FDI into ASEAN

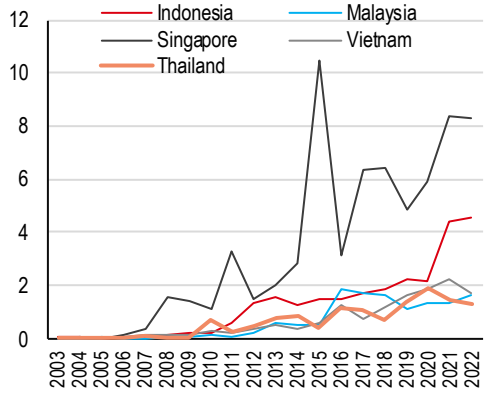
In addition, the jump in FDI inflows to manufacturing in 2019 (Chart 19) was likely triggered by the US's imposition of tariffs on Chinese imports. In response, Chinese (and other) companies have expanded factories, and diverted final assembly or entire production, to economies, such as Vietnam, to counter US import restrictions from China. In fact, China's investment in ASEAN's manufacturing sector in 2022 was triple the amount in 2018.

Chart 19: FDI flows from mainland China to ASEAN, USD billion



Source: ASEANstats, HSBC

Chart 20: FDI flows from mainland China to ASEAN, USD billion

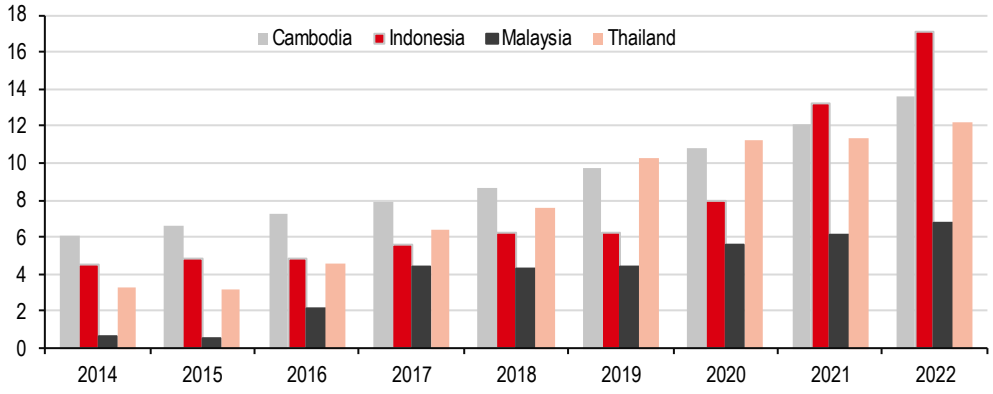


Source: CEIC, HSBC

Indonesia overtook Thailand as the second-largest recipient of Chinese ODI in 2021

Using official data that cover a longer timeframe, China's ODI flows to individual ASEAN economies, apart from Singapore, began to pick up materially around 2010. A particularly large jump occurred in investment into Indonesia in recent years (Chart 20). In 2021, Indonesia overtook Thailand as the economy with the second-largest stock of Chinese ODI (Chart 21).

Chart 21: Stock of FDI from China in individual ASEAN economies, USD billion



Source: ASEANstats, HSBC

Strong investment in Indonesia's mineral processing industry

The recent increase in Chinese FDI in Indonesia is a prime example of China's strategy of building a comprehensive supply chain and securing material supplies for its new energy vehicle sector. Indonesia's rich reserves of metals that are essential for making electric vehicle (EV) batteries have attracted Chinese firms to invest in nickel and cobalt processing projects before companies from other economies did.

The quest for critical metals will drive China's ODI

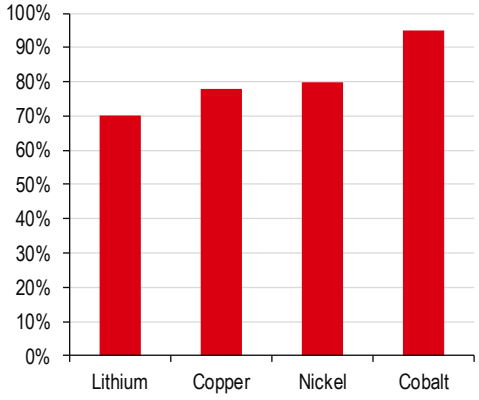
Nickel, copper, lithium and cobalt are some of the metals that are crucial to a low-carbon future. While China controls more than half of the refining capacity of these key elements of the EV and renewable energy value chains, it relies heavily on imports for the raw materials (Chart 22). Going forward, we believe that the demand for metals and minerals is a key determinant in the nature, geography and magnitude of China's outward direct investment.

In fact, high import dependence on critical minerals is one of China's key vulnerabilities amid complicated global geopolitics and rising risk of export restrictions. To secure supplies, China is cementing its ties with resource-rich economies. Compared with normal imports, ODI represents deeper, more hands-on engagement and a stronger presence in the foreign economy, and it

also offers a greater degree of control over management and operations. Meanwhile, the barrier for the host country to restrict Chinese access to such resources is, at least theoretically, also likely to be higher when Chinese companies own and operate mining and processing facilities.

At the same time, in some cases, it is out of necessity that China directly invests rather than simply imports from the country. For example, Indonesia has banned exports of unprocessed nickel to attract investment in downstream processing.

Chart 22: China's dependence on imports of key metals (share of total demand)



Source:ChinaIRN.com, China Geological Survey, HSBC. NB: There is a wide range of estimates and we have taken the upper bound of these estimates.

Table 1: Top 5 producing countries of critical metals

Lithium	Australia, Chile, China, Argentina, Brazil
Copper	Chile, Peru, China, Congo, US
Nickel	Indonesia, Philippines, Russia, New Caledonia, Australia
Cobalt	Congo, Indonesia, Australia, Philippines, Cuba
Rare earth metals	China, US, Australia, Myanmar, Thailand

Source: US Geological Survey, World Economic Forum, World Bank, HSBC

Midstream and downstream EV investment in Thailand

While lacking upstream materials, Thailand is the region's biggest auto manufacturing hub and there have been some high-profile investment projects by various Chinese carmakers in setting up production facilities in Thailand. The Thai government has been keen to show its ambition to become the EV production hub in ASEAN and has been active in bringing in foreign investment. A number of Chinese car companies, such as SAIC and BYD, plan to expand EV production in Thailand, drawing on its mature automotive manufacturing industry. Chinese firms' investments, if continued, may displace Japanese carmakers' decade-long dominance in the Thai auto market. At the same time, Thailand faces growing competition from Indonesia, with its abundant resources, as a potential site for major EV and component assembly.

In mid-October, it was announced that Rever Automotive, headed by the family that owns Thailand's Siam Motors Group, has become the exclusive dealer for BYD, giving BYD a head start to the second-largest auto market in Southeast Asia.

Table 2: Key recent Chinese investments in ASEAN

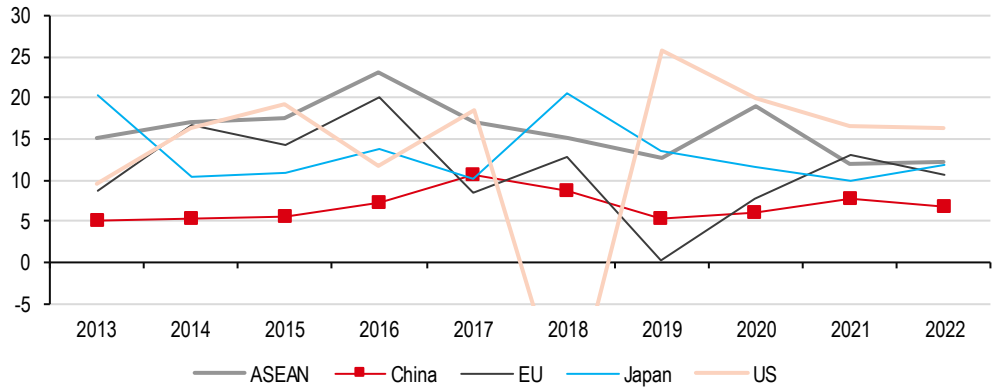
Sector	Host	Investment or Chinese company involved
Nickel mining	Indonesia	Tsingshan Holding, Zhejiang Huayou Cobalt
Nickel smelting	Indonesia	Jiangsu Delong Nickel Industry, Tsingshan Holding, Zhejiang Huayou Cobalt
Mining, EV battery	Indonesia	CATL to partner with local state-owned enterprises to develop a USD6bn mining-to-battery ecosystem
EV battery, parts and components production	Thailand	SAIC opened its first EV battery plant that cost USD14bn of investment
EV production	Thailand	BYD, Great Wall Motor to set up factories
Solar	Malaysia	Risen Energy to build its first facility, worth USD10bn, to manufacture photovoltaic modules
Petrochemical	Malaysia	Rongsheng Petrochemical to invest USD9bn in a petrochemical refinery
Pharmaceuticals	Singapore	Wuxi Bio and Wuxi AppTec to invest USD4bn in pharmaceutical manufacturing

Source: ASEAN Investment Report 2022, fDi Intelligence, Nikkei Asia, HSBC

China's rising FDI into ASEAN is driving regional integration

While still eclipsed by traditional investors, such as the US and Japan (Chart 21), China's share in ASEAN's FDI is primed to rise. The significance of this is twofold. First, China will grow its EV presence in the region. Second, China's increasing role as a source of inputs and components as well as investment in ASEAN economies has not only reshaped supply chain networks in Asia but also has acted as a common thread and has deepened regional economic integration.

Chart 23: Share of FDI flows in ASEAN, by region, % total



Source: ASEANstats, HSBC. NB: ASEAN includes Brunei Darussalam, Cambodia, Indonesia, Lao, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

Other large Asian economies, such as Japan and Korea, are included in the "Asia ex-Hong Kong ex-ASEAN" category in Chart 14. OECD data show that ODI flows to Japan and Korea are rather insignificant, at an annual average of USD500m. Once a popular investment destination for its mining and real estate sectors, mainland China's investment flows to Australia have been falling in the past decade, from USD6bn in 2013 to USD2bn in 2021.

Europe: Facing a dilemma

Europe has been one of China's favourite ODI destinations

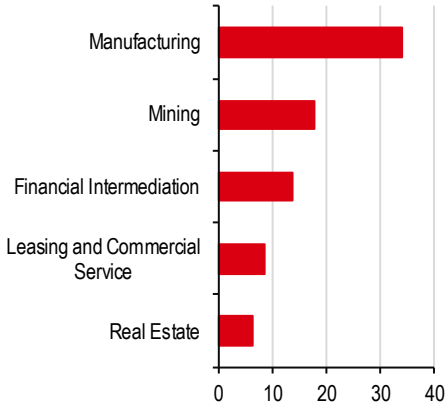
MOFCOM data show that the cumulative level of Chinese ODI in Europe amounted to USD101bn in 2022, or 4.8% of China's total stock of ODI. The USD level of Chinese ODI stock estimated by the OECD is in fact very close to the MOFCOM data, but the 4.8% share substantially underestimates Europe's standing as China's overseas investment destinations (due to the Latin America distortion). Europe is one of the regions where China took interest in investing early on, and Chinese companies have been keen to acquire European businesses in a wide range of sectors, including infrastructure, utilities, telecom, energy and advanced technologies.

Yet European governments began questioning ties with China

China's growing access, through ODI, to Europe's cutting-edge technologies and critical infrastructure has raised security concerns among European economies, many of which have launched or tightened screening regulations targeting inward investment, even before the pandemic, which, in turn, brought attention to countries' reliance on China-made goods.

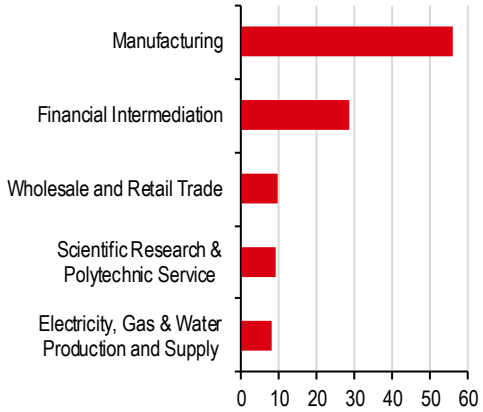
The debate around Chinese investment in European assets started with the acquisition of Kuka, a German robotics companies, by the Chinese electrical appliance manufacturer Midea in 2016. The German government was criticised for failing to safeguard a national champion and risk losing cutting-edge technologies to China. More recently, opposition from members in Germany's coalition government has resulted in a scaled-down version of COSCO's acquisition of one of four Hamburg's container terminals. The controversy on Huawei's participation in building Europe's 5G network has also been in the media spotlight. China's DSR initiative that enhances China's participation in other economies' digital infrastructure has sparked a debate as to whether Chinese investment poses a threat to European states' national security.

Chart 24: China's ODI stock in Europe, top 5 industries, % total, 2022



Source: CEIC, HSBC

Chart 25: China's ODI flows to Europe, top 5 industries, % total, 2022



Source: CEIC, HSBC

Europe is more than half of China's shipments of EVs versus less than 10% prior to 2020

Notwithstanding the heightened geopolitical tensions, the advance of made-in-China new energy vehicles to the European market has been remarkable. According to the China Passenger Car Association (CPCA), 740,000 units of new energy vehicles were exported to Europe in the first nine months of this year, compared with less than 10,000 units in 2019. The European Commission, at the launch of an investigation into Chinese EVs regarding state subsidies in September, pointed out that vehicles manufactured in China take up about 8% of EVs sold in Europe currently and could reach 15% in 2025, noting that prices of China-made cars are typically 20% below EU-made models.

To be fair, the majority of EVs that are shipped to Europe from China belong to foreign brands, such as Tesla, BMW, MG and Polestar (the latter two are Chinese-owned). In 2022, Chinese brands made up of only 3.7% of all electric cars sold in Europe (still a sizeable increase from 0.4% three years ago), according to the European Automobile Manufacturers' Association (ACEA). Foreign carmakers have been using China's production capability, while in the process contributing to consolidating China's status as the global auto manufacturing hub. However, there have been debates whether European, especially German, carmakers' heavy investment in China will lead to a loss in competitiveness and a weakening of Europe's industrial base.

Following the first wave of Chinese ODI in European car brands in the 2000s, most notably the acquisitions of MG and Volvo by SAIC and Geely, respectively, the second wave of Chinese investment in Europe's auto market is about to accelerate. Chinese carmakers are coming to Europe with deep expertise and capabilities in EVs, accumulated over the past two decades.

Chinese carmakers increase investment in EV manufacturing plants

Having tested the waters with robust sales to Europe in recent years, a number of Chinese car companies have set up, or are planning to set up, manufacturing bases to expand EV production on the continent. With the EU's goal to completely phase out fossil fuel cars by 2035, demand for EVs in Europe has considerable room to grow. It is reported that BYD, already operating an electric bus factory in Hungary, is considering building factories in Germany, France and Spain, aiming to begin production in around 2025. SAIC is also looking for a location to build its first European factory.

Europe lacks battery production capacity that is necessary for its 2030 goal

China is a clear leader in EV manufacturing, but an even more staggering gap between China and Europe exists in the more upstream stages: raw material processing and battery manufacturing. According to data from the International Energy Agency (IEA), China commands more than three-quarters of global battery-making capacity, while Europe only has 8.3% (Table 3). European carmakers heavily depend on batteries procured from China for domestic EV production.

Table 3: Lithium-ion battery manufacturing capacity, 2022-30

	2022		2025		2030	
	TWh	% world	TWh	% world	TWh	% world
China	1.2	76.4	2.93	73.8	4.65	68.5
Europe	0.13	8.3	0.33	8.3	0.77	11.3
US	0.11	7.0	0.44	11.1	1.03	15.2
Rest of the World	0.13	8.3	0.27	6.8	0.34	5.0

Source: IEA, HSBC. NB: 2022 is actual. 2025 and 2030 figures are the IEA's projections.

To address the dependence on foreign imports, the EU has been pushing for the localisation of battery production since 2017, at a time when it had only 3% of the world's battery cell manufacturing capacity. In March 2023, the EU proposed the Net Zero Industry Act, which aims for nearly 90% of the bloc's annual battery demand to be met by EU battery manufacturers, with a manufacturing capacity of at least 550 GWh in 2030.

Based on the IEA's projection, the EU will be able to meet the 550 GWh requirement by 2030. The IEA estimates suggest that battery-making capacity worldwide will be more evenly distributed by 2030, as economies implement policies and incentives to spur domestic infrastructure and technology to build an EV supply network.

China's ODI can help achieve Europe's decarbonisation objectives

However, to scale up battery capacity by almost six-fold in eight years, Europe does not have much time to lose. Here Chinese battery makers' rich technological know-how can potentially help. The IEA pointed out the difference in battery production lead time between Chinese and European manufacturers: China's Contemporary Amperex Technology Co. Ltd. (CATL) has been able to deliver a new cell manufacturing facility in less than one year due to its experience, while four years have passed between the announcement of Northvolt's first battery plant in Sweden and the beginning of production in 2021.

From Chinese companies' perspective, there is another rationale to build factory plants in Europe instead of simple exporting. Goods produced in Europe will be treated as EU products and therefore, can avoid the 10% import duty. This is akin to the path some Japanese automakers took in previous years.

Europe is walking a tight rope in its approach to Chinese investment. While wary of increasing Chinese influence, European economies or firms also do not want to miss out on the vast opportunities the China-dominated EV ecosystem presents. For instance, the French finance minister Bruno Le Maire visited BYD's headquarter in Shenzhen in July, lobbying for Chinese investment in France's EV market. In contrast, Germany has a much bigger presence in China's EV manufacturing network.

National industrial policy and FDI controls are the main obstacles for Chinese ODI

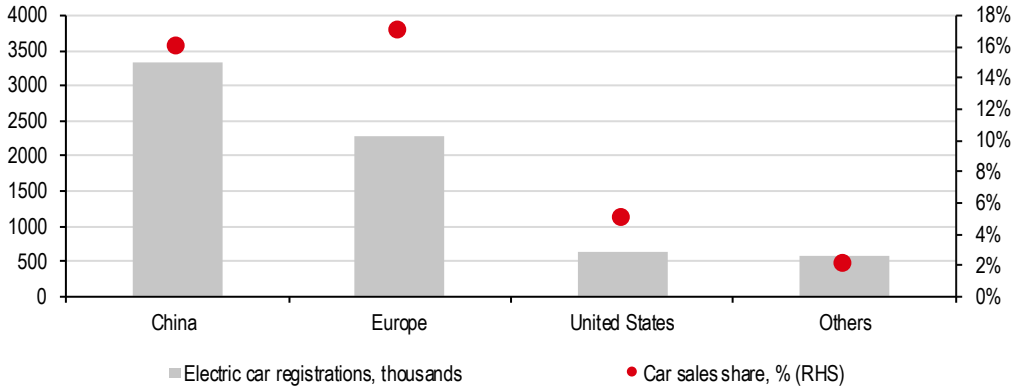
However, despite strong demand from Europe for EV manufacturing investment, Chinese ODI could face obstacles as the EU ponders its economic engagement strategy with China. This is a risk that presents itself in other parts of the world as well, especially in developed economies that increasingly compete head-to-head in key sectors with Chinese manufacturers.

US: Shrinking presence

The EU passed a law that states that all new passenger cars and light commercial vehicles sold in the EU will need to be emissions-free starting in 2035, making the EU the frontrunner of electrification in the transportation sector. The ACEA projects that by 2030, three out of five vehicles in Europe will be powered by electricity, compared with the world average of 26%.

Still, China will need new markets beyond Europe. As the world's second-largest auto market, the US presents significant business opportunities for Chinese carmakers, although its EV adoption rate currently pales in comparison to that of China and the EU (Chart 26).

Chart 26: EV car registrations and EV in total car sales, 2021

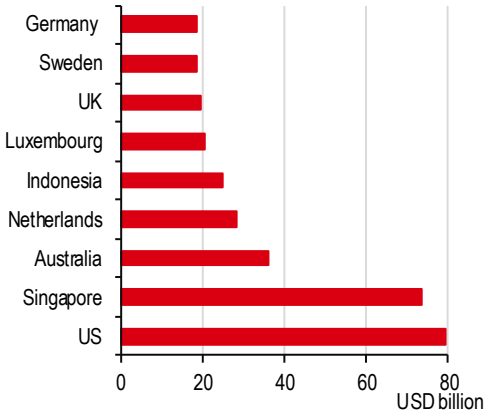


Source: IEA, HSBC. NB: Electric vehicles include battery EVs and plug-in hybrid EVs. China refers to mainland China.

Ever since mainland Chinese companies began to venture out, the US has been mainland China's favourite investment destination, after Hong Kong. According to MOFCOM data, mainland China's ODI stock in the US amounted to USD79bn in 2022 (Chart 27).

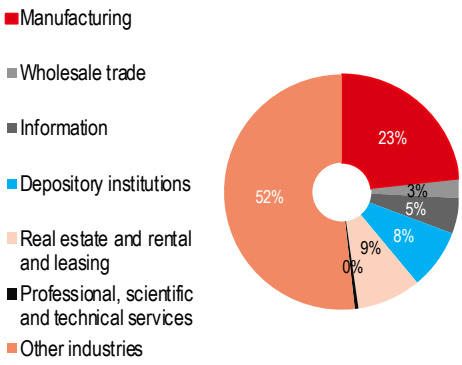
As in other regions, manufacturing is the industry that received the most mainland Chinese FDI in the US. Its share in total mainland Chinese ODI stock in the US increased from 15.5% in 2016 to 23% in 2022 (Chart 28), using data from the US Bureau of Economic Analysis (BEA).

Chart 27: Top 9 economies, after Hong Kong, with the largest stock of mainland China's ODI, 2022



Source: CEIC, HSBC

Chart 28: US FDI position from mainland China, 2022

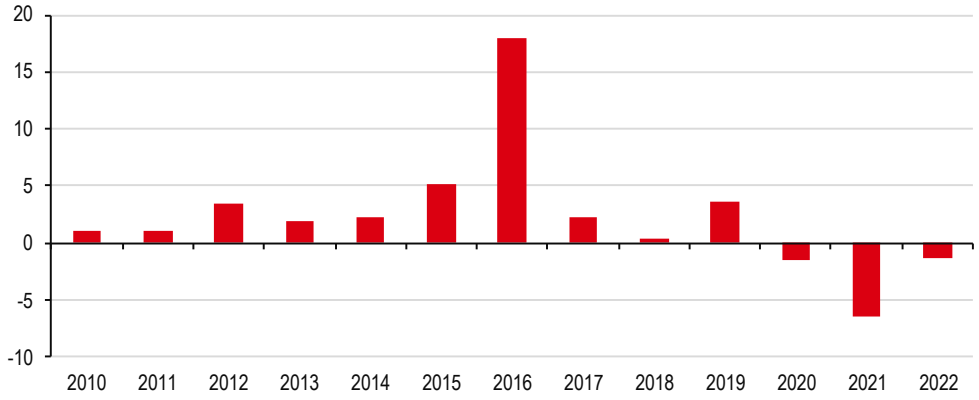


Source: BEA, HSBC. NB: FDI stock on a historical cost basis. Other industries include mining, construction, transportation, tourism, entertainment, consumer and agriculture.

Mainland Chinese FDI into the US have been falling since the trade tensions

However, tensions between China and the US in the past few years mean Chinese FDI flows into the US have dropped significantly since 2016, and the extent of the decline has been much greater during the pandemic than in other regions. In fact, over the past three years, Chinese firms have in aggregate disinvested from the US (Chart 29).

Chart 29: FDI flows to the US from mainland China, USD billion, 2010-22



Source: BEA, HSBC

As argued, the US is a relatively untapped, yet sizeable market for EVs, despite an acceleration in EV sales in recent months. Chinese auto companies have been expanding, or trying to expand, their footprint in the US EV space. BYD entered the US market in 2011 by acquiring its first electric bus manufacturing plant in Lancaster, California. Since the beginning of the operation in 2013, the production volume has grown almost four times and BYD Coach and Bus became the largest electric bus manufacturer in the US.

Widening split deters investment from both sides

Nevertheless, aside from BYD's electric bus business, Chinese automakers have not made much headway compared with their advance in Southeast Asia and Europe. Currently, there are two headwinds facing Chinese companies' investment in the US. First, geopolitical tensions. Notwithstanding periodic easing, strained US-China relations continue to weigh on economic cooperation between the two economies. In February, Ford announced its plan to build a USD3.5bn plant in Michigan that will manufacture lithium iron phosphate (LFP) batteries using technology from Chinese battery maker CATL. The project sparked security concerns. Virginia withdrew its bid for Ford's plant and Virginia's Governor Glenn Youngkin expressed concerns over China's involvement. The downtrend in Chinese FDI to the US shown in Chart 27 is unlikely to reverse without a material and sustained improvement in US-China bilateral relations.

Another example of the US backlash against Chinese investment is the opposition to a plan by Gotion High-Tech, China's fourth-largest EV battery producer, to build an EV battery materials plant in Michigan.

The US administration is fortifying walls against Chinese investment

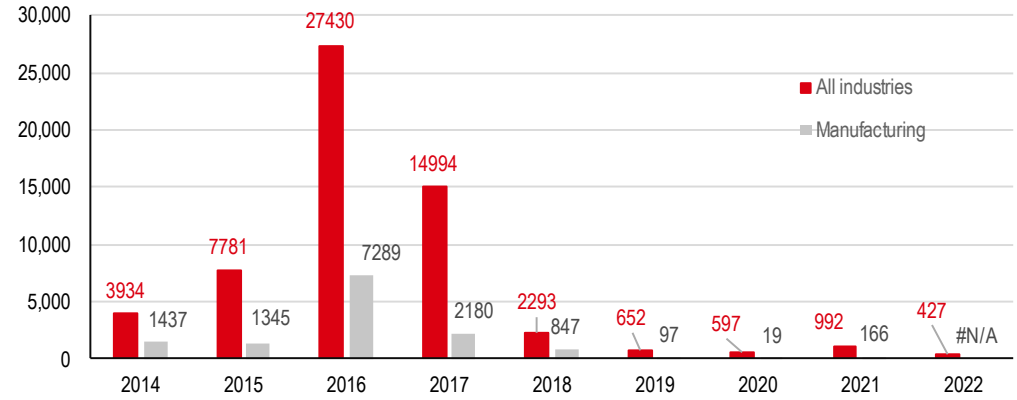
Without explicitly stating China as the intended target, President Biden signed in September an executive order directing the Committee on Foreign Investment in the United States (CFIUS) to consider scrutinising foreign investments through the lens of national security risks, with the purpose to guard against cybersecurity vulnerabilities and exploitation of Americans' data. The areas that investment reviews could cover include emerging and critical technologies, such as semiconductors, quantum technologies, biotechnology, and artificial intelligence.

The Inflation Reduction Act may further accelerate the retreat of Chinese firms from the US

The second impediment to Chinese investment is the US's new industrial policies, namely the CHIPS Act and the Inflation Reduction Act (IRA), that aim at bringing manufacturing capacity onshore and, implicitly, reducing the US's reliance on China. The policies provide strong incentives to build domestic clean energy supply chains in the US. According to the IRA, EVs using batteries produced by "foreign entities of concern" – China being one of them – will be excluded from receiving government subsidies.

The geopolitical context and industrial policies may, therefore, further curtail Chinese investment in the US. Amid regulatory and political headwinds, Chinese companies will be cautious in making investment in the US, represented by the sharp falls in new FDI expenditures in the US since 2018 (Chart 30).

Chart 30: New first-year FDI expenditures by China in the US, USD million, 2014-22



Source: BEA, HSBC

Latin America: Growing closer

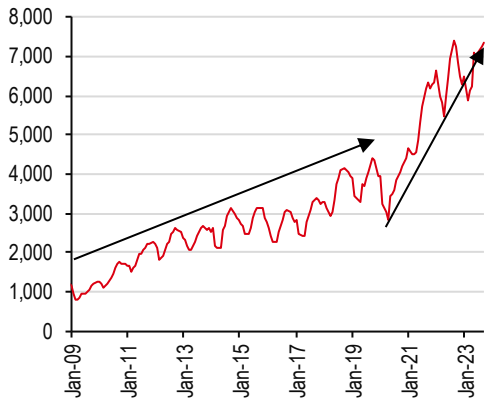
Mexico – Growing manufacturing base

Chinese exports to Mexico surged

As we mentioned earlier, trade flows often precede FDI flows. Following a sharp drop in 1Q20 due to the pandemic, China's exports to Mexico soared (Chart 31). In the first nine months of 2023, China's exports to Mexico increased 78% from the same period in 2019 to USD61bn. The share of Chinese exports to Mexico suffered a small drop at the beginning of COVID-19 but have subsequently risen (Chart 32).

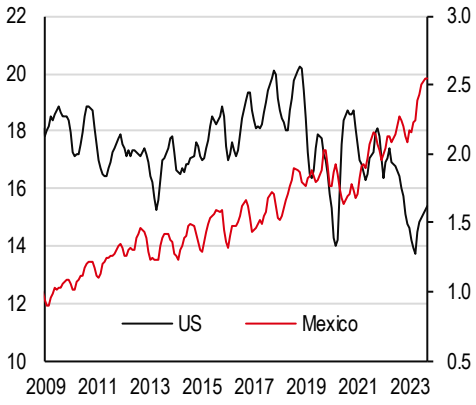
Mexico is a major beneficiary of nearshoring

Chart 31: China's exports to Mexico, 3-month moving average, USD million



Source: CEIC, HSBC

Chart 32: Exports to Mexico and US, % China's total exports, 3-month moving average



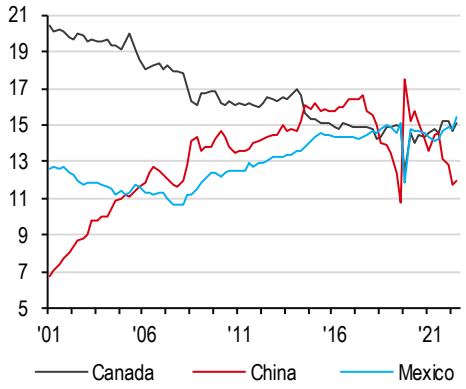
Source: CEIC, HSBC

During the same period, the US-China trade tensions catalysed a steep downtrend in Chinese shipments to the US, whose share in total US trade only recovered briefly in 2H20 when most of the world was in lockdown and Chinese exports surged. In September 2023, the US accounted for 15.4% of all Chinese exports, a 5ppt decrease from the end of 2018, when the market share of the US in Chinese exports peaked.

Mexico emerges as the US's top trading partner

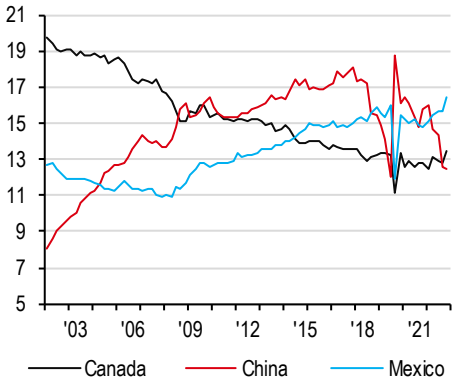
In parallel, with Chinese imports to the US sliding, Mexico picked up part of the slack and surpassed China to become the US's top trading partner (Chart 33). Chart 34 shows manufacturing trade alone: Mexico's standing as the US's leading trading partner is readily apparent; Mexico's shipments of manufactured goods to the US jumped by 29% in 2Q22-1Q23 from 2019.

Chart 33: Share of total US trade, %



Source: Census Bureau, HSBC

Chart 34: Share of total US manufacturing trade, %

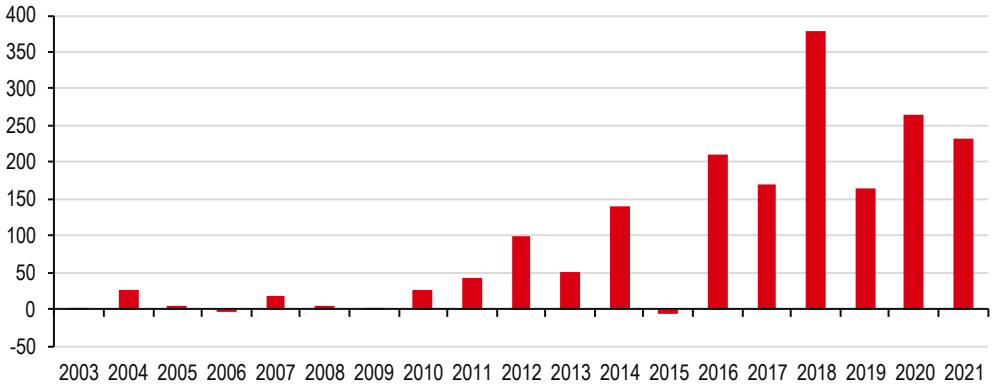


Source: Census Bureau, HSBC

Incentives for Chinese manufacturers to set up factories in Mexico

These figures suggest that Mexico may have become a new conduit of Chinese goods to the US. They could either represent goods produced in China being shipped to Mexico for final assembly before exporting to the US, or Chinese manufacturers building factories or operations in Mexico to avoid US tariffs (27.5% for cars). Under the IRA, EVs made with raw materials sourced and processed in economies that have a free-trade agreement with the US, such as Mexico, will be eligible for subsidies. Chinese companies in the EV sector would, therefore, have strong incentives to set up factories in Mexico for eventual shipments to the US. We expect Mexico to be a main Chinese ODI destination in the years ahead.

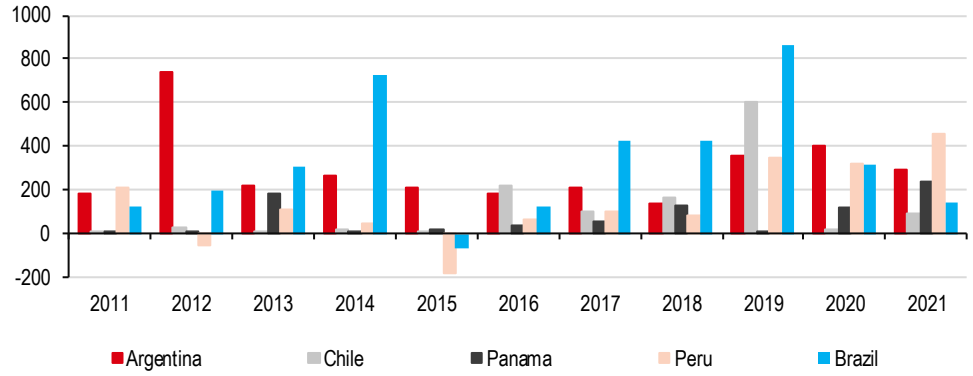
Chart 35: China's ODI to Mexico, USD million



Source: CEIC, HSBC

Compared with the US, Latin America offers a much friendlier investment environment. Mainland China's investment to Latin America represents 10% of mainland China's total ODI in 2022, trailing Hong Kong (60%) and ASEAN (11.4%) (Chart 14). Excluding Mexico, Cayman Islands and British Virgin Islands, Chart 34 shows the five Latin American economies that receive the most investment flows from mainland China.

Chart 36: China's ODI to Latin American countries, USD million



Source: CEIC, HSBC

Considerable reserves of critical minerals in Latin American economies

A number of Latin American economies have begun to closely engage with China through becoming a member of the Chinese-founded Asian Infrastructure Investment Bank, and also joining the BRI. Particularly, Brazil, Chile and Argentina participate in China's global EV and renewable energy push. Table 1 above, which shows that a number of Latin American economies are top producers of crucial minerals, provides a rough roadmap of where Chinese investment will flow.

China's priority to secure resources is compatible with Latin American economies' development plans. In many cases, Latin American economies lack the infrastructure to turn mineral reserves into economically viable projects. As a result, government officials and business leaders in Argentina, an economy facing periodic economic challenges yet with significant mineral potentials, have been active in attracting Chinese investment and finance into renewables and other types of energy to promote the country's efforts of embarking on a hybrid path to an energy transition. Other economies have also received Chinese investment and loans in wind farms and solar projects. We expect China's outbound investment will increasingly flow to Latin America, with resources and renewable energy the main sectors to receive Chinese capital.

Table 4: Recent Chinese investment in Latin America

Chinese company	Country	Project
BYD	Chile	Investment of USD290bn in a lithium mine
Great Wall Motor	Brazil	Acquisition of a Mercedes-Benz factory in São Paolo to begin production in 2024
China National Nuclear Corp	Argentina	Building of an USD8bn nuclear power plant using Chinese technology
Jiangsu Lixing General Steel Ball Company	Mexico	Building a precision steel ball (automotive parts) manufacturing plant
CATL, China Molybdenum Company Limited	Bolivia	Development of a lithium reserve and building of transport infrastructure and two plans to produce battery-grade lithium carbonate
China Southern Power Grid International	Peru	Acquisition of Peru's largest electric company Luz del Sur
Trina Solar	Colombia	Building of three solar photovoltaic power projects with nearly 350 MW capacity

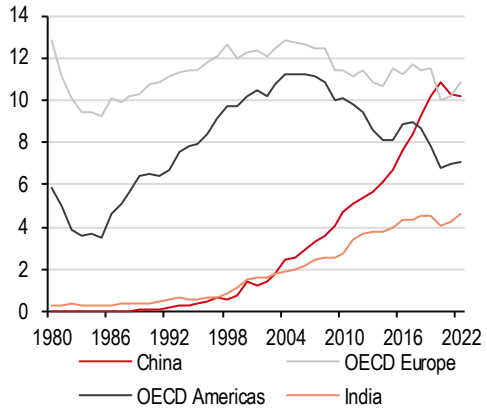
Source: Nikkei Asia, fDi Intelligence, Reuters, HSBC

Middle East: Flourishing partnerships

The China-Middle East friendship in the limelight

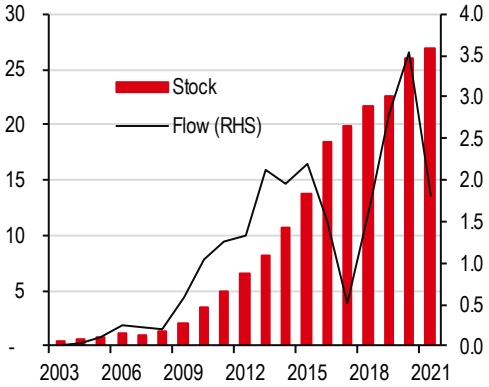
China's bourgeoning ties with the Middle East have been in the international spotlight lately. Starting with China's rapidly growing demand for oil (Chart 37), China has increasingly expanded its investment ventures in the Middle East over the years, mainly through the BRI. In March 2023, the Saudi Arabian-Iranian agreement brokered by China marked a milestone in China's rise as a significant player in the region.

Chart 37: Imports of crude oil, millions of barrels per day



Source: International Energy Agency, HSBC

Chart 38: China's ODI flows to the Middle East, USD billion



Source: CEIC, HSBC. NB: Aggregate value of 15 economies.

According to MOFCOM data, the stock of Chinese ODI in the Middle East in 2021 was USD27bn (2% of China's total ODI stock) and annual ODI flows to the region is around USD1.8bn, or 1% of total flows (Chart 38). Again, these figures seem to substantially understate the presence of Chinese investment in the Middle East.

The COFI project is a collaboration among a few US think tanks and universities

For example, a complementary source of BRI data is the China Overseas Finance Inventory (COFI) database, which includes power generation projects in 87 BRI countries financed by Chinese corporates and banks that reached financial closure from 2000 to 2023. Covering only investment in the power generation sector, the COFI database shows that in this period, China has invested a total of USD108bn in projects, four times that of the MOFCOM figure.

The main reason for the discrepancy is because ODI data omit debt and only include equity investment, while the COFI database includes both types of financing. Apart from Europe and North America, a lot of economies on other continents are exposed to Chinese investment and the BRI in the form of lending.

The Middle East is critical to China's access to vital energy supplies

The BRI has two components – the Maritime Silk Road and the Silk Road Economic Belt – and the Middle East is at the heart of the first. China's construction investment and contracts in the area have been mostly in energy and transport infrastructure, such as oil pipelines, oil power plants, rail networks and ports. Traditional investments in the Middle East serve the purposes of securing vital energy supplies and ensuring safe passage of energy resources and goods along trade routes.

Traditional BRI investment in energy and infrastructure will still be big in the Middle East

The BRI has received a fair amount of press in recent years. However, at the tenth anniversary of the BRI, Beijing has now begun to recalibrate its approach to overseas lending and investment. One of the changes proposed is to move away from the large-scale, costly infrastructure projects that characterised the first stage of the initiative and to focus on "high-quality" and "small but beautiful" deals.

Yet, we believe that energy and infrastructure projects will continue to be the backbone in China's investment in the Middle East. That is not least because many BRI-participating economies in other parts of the world are facing increasingly funding constraints, partly as the result of elevate spending earlier, partly as the result of the pandemic and high global interest rates. However, Chinese ODI in the Middle East is mostly flowing to the cash-rich oil-producing economies – the UAE, Saudi Arabia, Iran and Iraq – that have a lower risk of running into financial challenges.

The scope of China-Middle East economic collaboration is, however, not going to be confined to energy and infrastructure. This year, the two sides have stepped up diplomatic and commercial engagement. For instance, at the Arab-China Business Conference in June, more than 30 investment agreements worth more than USD10bn were signed. Some of the largest deals signed are in EVs, information and communications technology and renewable energy (Table 5).

The Middle East, with a population of over 400m, presents a large market for China

Two factors contribute to the emergence of new sectors in the China-Middle East investment landscape beyond the traditional energy and infrastructure sectors. The first is China's ambition to expand its growing industries into new markets, as in other parts of the world. As the adoption rate of EVs in the oil-abundant region is still comparatively low (the UAE Ministry of Energy and Infrastructure estimates it to be about 1%), it presents ample opportunities for Chinese EV makers. Almost all major Chinese auto companies have developed plans to tap into the Middle Eastern market.

Table 5: Recent Chinese investment deals in the Middle East

Country	Sector	Amount (USDm)	Project, Chinese counterpart, remarks
Iraq	Infrastructure	10,000	Rail networks, power, roads, water dams
Various countries	5G		Cloud data centres, Huawei
Saudi Arabia	Electric vehicles	5,600	Joint venture between the Saudi Ministry of Investment and Chinese EV maker Human Horizons
Saudi Arabia	Copper mining	500	China National Geological & Mining Corporation
Saudi Arabia	Information technology	266	Hong Kong Android developer Hibobi to develop mobile applications for tourism
Saudi Arabia	Chemical	150	China's Sunda to produce calcium chloride, chlorine and other chemicals
Saudi Arabia (NEOM)	Clean energy	N/A	Sungrow, 536 MW/600 MWh energy storage system
Saudi Arabia (NEOM)	Wind	N/A	Envision Energy, 1.67 GW of wind turbines
Saudi Arabia (NEOM)	Construction	N/A	PowerChina, construction of super-tall towers
Saudi Arabia (NEOM)	Construction	N/A	China Railway Construction Corporation, adits and portals package for the tunnels at The Line (the smart residential city of NEOM)
UAE	Solar	N/A	Various mega solar projects, China Energy Engineering Cooperation, China Machinery Engineering Corp, Trina Solar, Jinko Solar
UAE	Gas	N/A	2.4 GW gas-fired Hassyan Power Plant (BRI) in Dubai, China Machinery Engineering Corp

Source: Financial Times, Wall Street Journal, HSBC. Note: N/A – Not applicable/available

GCC nations seek to diversify their economies away from oil

The second reason for the push of new industries is the Gulf States' desire to diversify their economies away from oil and gas. Economies in the Gulf Cooperation Council (GCC), namely Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE, have long been conscious of the finite nature of oil and gas reserves and that the global green transition will lead to dwindling demand for fossil fuels.

Chinese tech firms are going in to build the region's digital infrastructure

From the Middle East' perspective, China is a source of consumer demand, capital and technology, which can help the region develop new industries, such as tourism, healthcare, digital technology, financial services, metals and renewable energy, facilitating the region's pivot away from the reliance on oil. In particular, China's involvement in the Middle East's digital transformation has accelerated since the introduction of the DSR, the technological arm of the BRI, in 2015. Leading Chinese tech and telecom firms, including Alibaba and Huawei, have

taken part in the Gulf's digital transformation. For example, Alibaba has partnered with Saudi Telecom Group to set up a cloud computing venture, with an initial capital investment of USD234m in 2022. Huawei has also made headway in expanding the Middle East's 5G network, at the same time when the firm is facing a diminished presence in Europe.

We expect China to play a large role in Saudi Arabia's USD500bn project NEOM city

Notably, China is also going to play a large role in Saudi Arabia's high-tech development NEOM city, the centrepiece of the country's Vision 2030 and the world's first carbon-free city. NEOM will host the world's largest utility-scale hydrogen plant powered by up to 4 GW of solar and wind capacity. As China leads the market in renewable energy development, Chinese companies have been bidding for contracts with Saudi Arabia to provide the technologies needed for this ambitious project. We listed a few deals that Chinese companies have recently signed for the NEOM development at the bottom half of the table in Table 5.

Apart from Saudi Arabia, the UAE has also been active in engaging with China. Despite having the world's seventh-largest oil reserves and the sixth-largest natural gas reserves, the UEA has a clear plan toward energy diversification with the UAE Energy 2050 plan that aims for an energy mix of 44% renewable energy, 6% nuclear energy, 38% natural gas, and 12% super-critical clean coal.

The UAE aims to develop solar and nuclear energy

To achieve a cleaner energy mix, the UAE is building mega solar plants in Abu Dhabi. The 2 GW Al Dhafra Solar Power Plant, once operational, will be the world's largest single-site solar power plant. A number of state-owned and private Chinese companies have already secured contracts in the construction of power plants (Table 5). Apart from solar, the UAE has also signed agreements with China's Nuclear Power Operations Research Institute, the China National Nuclear Corporation Overseas, and the China Nuclear Energy Industry Corporation to develop its nuclear energy sector.

We expect FTAs to come shortly

At the China-GCC economic and trade ministerial meeting in Guangzhou in October, China's Minister of Commerce Wang Wentao met with the GCC Secretary General Jasem Mohamed AlBudaiwi and ministers of individual GCC economies, with all parties agreeing to strengthen "high-quality" Belt and Road cooperation. As a first step, we expect to see China reach free trade agreements (FTAs) with the bloc shortly, further deepening trade ties.

China-Middle East ties to deepen further

In addition, capital flows in the opposite direction – from the Middle East to China – are set to accelerate. Middle Eastern sovereign wealth funds are looking to invest in China. A few recent examples are Saudi Arabia's Ministry of Investment's USD5.6bn deal to build a joint venture with Human Horizons, a Chinese EV company, and the more than USD1bn injection of capital into NIO, an EV company, from an Abu Dhabi government-backed fund. Looking ahead, China-Middle East economic cooperation is going to strengthen in both scope and depth.

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