

Actions of U.S. and China to Shape Deals to Come

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To many people, China is the Japan of the 1980s, a hurtling, unstoppable economic goliath.

Whether China will fulfill this destiny or, like Japan, will be tripped up by internal failings remains to be seen, but China will undeniably be a deal-making force for years. Two recently announced acquisitions show the shape of Chinese deal-making and how the United States may react.

The first is the \$2.4 billion purchase of a controlling interest in Makhteshim Agan Industries, an Israeli company and the world's seventh-largest agro-chemical manufacturer, by the China National Chemical Corporation, known as ChemChina. The state-owned ChemChina is one of China's largest chemical manufacturers.

MA Industries manufactures crop protection products, which are important for the Chinese food supply. This deal is about strengthening that supply link and may be followed by similar deals.

ChemChina will pay for the acquisition not in shekels, Israel's currency, but in United States dollars. The Chinese government is sitting on \$2.85 trillion of currency reserves. This is a huge number, though it is inflated because all Chinese are required to keep their dollars with the government. Historically, China has invested these dollars in low-yielding United States government securities. But China can use these dollars outside the United States to buy higher-yielding assets that are in line with its internal needs. This is exactly what it is doing with the Israeli purchase.

And when Chinese companies spend these dollars outside the United States, they do not run up against American national security laws, which have been a substantial barrier to Chinese investment. The MA Industries acquisition and similarly large deals outside the United States will give the Chinese a chance to show the world that they are good global citizens and can responsibly own non-Chinese companies.

It is in this light that the second deal must be viewed: the agreement by the Industrial and Commercial Bank of China to buy the American bank business of the Bank of East Asia.

This \$140 million purchase is small, but vitally important for all Chinese banks. Under bank regulations passed after the 1991 collapse of the Bank of Credit and Commerce International, the Federal Reserve cannot approve the acquisition of an American bank by a foreign bank unless it can confirm that the foreign bank is adequately supervised by its home country regulator.

If the Chinese bank is allowed to proceed, the Federal Reserve's conclusion that Chinese mainland regulators exercise adequate control over their banks will apply for all future Chinese acquisitions. So this small acquisition has large political implications.

The bank's acquisition is different than that of ChemChina's and most other Chinese acquisitions because it is not about building foreign supply and resource chains. Chinese banking is notoriously inefficient and opaque. With the Bank of East Asia unit, the Industrial and Commercial Bank of China would be acquiring management and gaining a toehold in the West. Indeed, it could be the first step toward building itself into a global champion.

Will China succeed in these acquisitions? Chinese outward investment is still small, accounting for only \$47.4 billion, or about 2 percent of total global acquisitions last year, according to Dealogic. But it will grow.

The experience of Japan is telling. In the 1980s, Japanese investment in the United States was met with significant hostility. The core national security laws governing acquisitions in the United States were enacted in the 1980s to stop an effort by the Japanese electronics company Fujitsu to acquire Fairchild Semiconductor.

We don't worry much about Japanese investment anymore, but the Chinese may run into the same problems. We do not yet know whether the Chinese are savvy bargainers or are overpaying in a hot global commodities market. There is also the question about how effectively the Chinese can run their new companies. Chinese management is premised on low-paid, replaceable wage earners. The Chinese do not have a special management technique that can be transported as the Japanese did.

And buying assets is one thing, but, as the experience of the Persian Gulf nations has shown, simply having cash or size isn't enough. Chinese companies need to be able to operate these assets effectively in different cultures with different laws. China's service and banking sectors are not particularly efficient, because they are protected from local

competition by the government. Many large Chinese companies lack the management skill set to become global.

It is with this knowledge that Washington should respond. **The United States has been strictly enforcing the national securities laws with respect to the Chinese**, even rejecting a recent proposed Chinese acquisition of a gold company because it owned a mine too close to a United States military base.

There is a role to be played here for national security, particularly when these are purchases to acquire sensitive technology or lock up favorable supply chains. Expect the United States to increasingly coordinate its national security review with other countries to address deals like the one involving MA Industries.

But there is also the wider issue of how to address Chinese companies expanding global operations through acquisitions that do not touch upon issues of national security. In these cases, the United States should be careful not to reflexively block these acquisitions on fears that Chinese dominance will impact United States national security.

The approach in this case should instead be a political one. The Chinese have been adamant about demanding technology transfers to allow American companies to invest in China and have put up barriers to United States entry in many sectors, including banking.

China's efforts to grow globally allow the United States to play the same game and impose a fair playing field. In other words, if the Chinese want to come into the American retail banking sector or another industry, then the Chinese should allow similar investment in their country on equal footing.

The United States, and the Western countries generally, should use China's efforts to expand abroad as a welcome basis for both sides to establish rules for investment that go both ways. Permitting investment on this basis is likely to push Chinese companies to be more open and liberal, further integrating China into the Western world. And it just may show that our fears are unfounded and that American companies are still the best global competitors. For they know something China is about to learn: it takes very hard work to make a cross-border acquisition succeed.
