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Partners or rivals? Chinese investments in Central and Eastern Europe

Shared experience, common development

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Dr Jan Kulczyk
Founder of the CEED Institute,
entrepreneur
and owner of Kulczyk Investments.

Towards a CEE-Chinese partnership

Ladies and Gentlemen,

With great pleasure, I would like to announce that throughout the past year, CEED has played a significant role in the debate on the role of CEE countries in finding innovative solutions to Europe's economic dilemmas. The first CEED report became a part of a lively discussion at the region's most important economic forums including the EEC in Katowice, the Wroclaw Global Forum and the Economic Forum in Krynica.

The experience we have gained, coupled with noticeable interest that the CEED idea has attracted, convinced us to move to the next stage by creating a permanent CEED Institute. This forum will provide institutional support to the initiative, further strengthening its position. I firmly believe that the CEED Institute will become one of the most important platforms for discussion on key European challenges and predicaments in the future. Moreover, the initiative will promote better understanding and shape a more positive image of the CEE countries in the world.

The last CEED report focused on economic growth in CEE. This time we have dared to go further, concentrating on Chinese direct investments in Central Eastern Europe. The uniqueness of the report lies in its structure, combining a macroeconomic outlook with perspectives on economic diplomacy and business practices in the region.

I am convinced that stronger cooperation with China will be an integral part of the future development of the region. However, it is crucial to highlight that partnership with China brings not only opportunities, but also challenges. As such, we will have to do our best to prepare for the next phase of doing business in China.

I wish you an interesting reading.

Yours sincerely,

Dr Jan Kulczyk
Founder of the CEED Institute

Lech Walesa

Historical leader
of Solidarity movement (1980-1989),
Nobel Peace Prize Laureate (1983)
and the President of Poland (1990-1995).
CEED Institute Ambassador.

Without China there is no globalization

Today we are living in times of knowledge and globalization, not borders and divisions. The age of the nation state and autarchic countries has came to an end, and we have entered a new era of globalization and the more and more necessary European integration. Globalization is neither a good nor bad phenomenon. The fundamentals on which it is being built are of crucial importance for our future. I am convinced that these fundamentals should be based on certain values.

We cannot imagine globalization today without China. However, some of the aspects of Chinese political and economic order should not be transferred to the rest of the world. Keeping this in mind, we should support peaceful changes in China itself as well as in the rest of the world, which will enable the continuation of the next phase of successful globalization. While China is a powerful state, deserving of enormous respect and admiration, the Chinese should also respect and observe the norms and values we have come to accept as universal.

China needs time to become a responsible international player, aware not only of its power, but also of its duties that come with the privileges. Chinese leadership is not yet fully immersed in what we recognize today as globalization, with different measures of freedom and human rights, complicating deeper international cooperation.

Chinese direct investments in Central and Eastern Europe will be a litmus test not only for business, but also for economic diplomacy. CEE has much to offer to the Chinese. To succeed, however, we need more solidarity in this part of Europe. The CEED Institute will be a crucial think-tank promoting regional cooperation in CEE as well as a promising platform to support economic development combined with the spirit of solidarity.

Lech Wałęsa
CEED Institute Ambassador

Janusz Reiter
Former Poland’s Ambassador
to Germany and the US,
President and founder of the Center
for International Relations,
CEED Institute Partner.

Chinese investments in Central and Eastern Europe have recently been in the spotlight. Certainly, the phenomenon is worth paying attention to as since 2010, Chinese investments in Europe have increased by over 100%. Between 2004-2010 China's FDI (foreign direct investment) was almost inexistent in this part of the world. Without doubt, Chinese FDI in CEE represents a new horizon of opportunities, not only for the CEE region, but also for the Chinese themselves. A stable yet dynamic CEE is an alluring market for the Chinese, as well as a solid safe haven for Chinese surplus capital and profit-making investment.

Clever economic diplomacy and clear communication are the key factors which will determine the success rate of future business relations between culturally and structurally different partners. The case of Covec in Poland demonstrates for example how not to deal with the Chinese.

CEED Institute's report is an extremely valuable contribution to the ongoing debate about Chinese investments in the CEE region and in Europe more widely. Encompassing multiple aspects of their mutual economic relations, the report gives the reader a deeper glimpse into CEE/ Chinese cooperation while providing background for a better understanding of China itself.

Partners or rivals?
Chinese investments in Central and Eastern Europe

Executive summary

The report is made up of four independent sections. In part one, we discuss the shift in international relations currently under way. We analyse China's Going Out Strategy in Europe and Chinese motives for outward investment. The argument is that China uses crises as opportunities, taking advantage of the current turmoil in global markets to make its debut in sectors and places previously neglected. China has a strategic interest in acquiring European Assets. Europe is witnessing impressive rates of growth in inward investment from China.

In the second section, we discuss Chinese/ Central East European economic relations, with emphasis on investment. The paper argues that new horizons for investment opportunities and developing of Sino/ CEE business ventures have opened up along with the current European debt crisis. In this section, we cover the main trends in China's outward investment in CEE. This includes types of investors in the region, investment flows by industry and distribution of FDI according to countries.

In section three, we cover Sino/ CEE economic diplomacy and business in practice. This chapter focuses on the role of culture and perception in economic relations. By examining the case of Covec in Poland, we show how miscommunication and misunderstanding of cultural differences can lead to economic and business failures. We also demonstrate the importance of interpersonal relations for strengthening Chinese/ CEE partnerships, evident in the case of both large Chinese ventures into CEE, as well as smaller scale business activities characteristic of the way the local Chinese communities work. We discuss some interesting developments around the case of Covec, followed by the growing visibility of the activities of the Chinese Diaspora.

In section four, we re-assess our finding and conclude with policy prescriptions for the way forward. We believe the main obstacle to increasing investment links between CEE and China lies in misunderstanding of the other's cultural and business ethics. The argument is made for strengthening the effectiveness of CEE economic diplomacy. Simultaneously, we make a case for setting up CEE/ Chinese joint ventures to allow both sides to complement each other's strengths in the global supply chain and market. As partners, these emerging growth economies can use the synergy of their specific experiences in change and reform to strengthen their position together vis a vis the world.

In general, the paper presents arguments around several themes. First of all, we are witnessing a change in the risk perception of investors world-wide. Emerging markets have become new hotbeds for foreign direct investment; along with this CEE and China are both becoming more attractive destinations for both capital and new business ventures.

In addition, we argue that there is abundant evidence of a recent change in Sino/ CEE relations. While the transformation of the global economy is partially responsible for the newfound Chinese interest in CEE, it is not the only one. CEE for China presents new challenges and new opportunities, as the CEE countries become hybrid economies - somewhere between emerging markets and developed economies. The growth potential, institutional stability and market size make CEE a very attractive place for Chinese investments. The European sovereign debt crisis has been an additional impetus for both the Chinese and for CEE to strengthen their economic relations.

Moreover, the question of China's intentions in its outward investment strategies is important. Contentious as these are, the way we perceive Chinese motives determines whether we view them as allies, competitors, enemies or partners. To understand China's intentions, we argue, we should look at China's perception of the world and of Central Eastern Europe in particular.

China's policies tend to be driven by both political and economic motives. In fact, rarely do the Chinese separate business from politics, a crucial cultural difference when it comes to investment strategies. In addition, China is usually very pragmatic in its approach to its strategic interests. Chinese value concrete profits over ideological values. However, the Chinese base their business transactions on inter-personal relationships.

China's perspective in its policies is long term, focusing on achieving subsequent five year plans and with a time scale of looking into the horizon. In the short term, Chinese behaviour shows signs of irrationality, often reactive towards current events. This is probably the result of both the changes in international affairs and instability in China itself. Chinese domestic politics and economic reforms are in a state of flux.
The leadership in Beijing and Chinese interests are fractionalised. Divisions in Beijing coupled with the current transitions of power make it difficult to predict Chinese future policies.

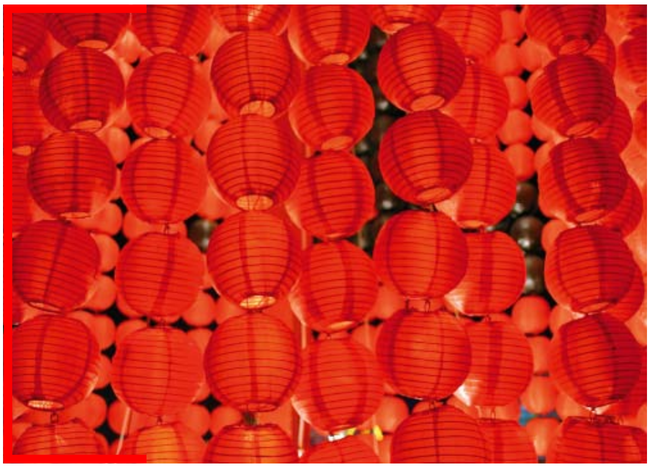
China has been the source of a very negative campaign in western press and media. As a result of this negative image, the Chinese have started to focus on a public diplomacy campaign and Chinese soft power. This is important as far as the Chinese use a charm offensive when dealing with their potential investment partners. China has faced its own security and economic dilemmas in its investments abroad. Consequently, the Chinese have started to re-assess their strategies and change their policies. We are witnessing this in CEE.

In addition to large Chinese conglomerates, the role of the Chinese community or Diaspora is significant in CEE. The Diaspora forms Chinese networks throughout CEE, on which small and medium size Chinese firms rely to conduct their business activities.

As China tends to chose its strategic partners carefully and without official documents to reveal its true intentions, CEE should be ready for some surprises. We demonstrate this by examining the case of the Covec investment in Poland, followed up by the signing of the Polish-Chinese Strategic Partnership. As a result of this Covec case study, the paper highlights the importance of culture and local preferences in building partnerships with the Chinese.

The weaknesses in CEE economic diplomacy makes it difficult to react to Chinese behaviour. The understanding of China and knowledge about the Chinese, their culture, business ethics and policies are not adequate in CEE. In addition, the Achilles heel of CEE investment into China is the lack of coordination between firms interested in the Chinese market and CEE foreign and commercial services.

We conclude that there is vast room for manoeuvre in expanding and strengthening Sino/ CEE joint business ventures, cooperation and partnerships for future investment opportunities. While CEE has not yet defined its comparative advantage clearly vis a vis the Chinese, steps have already been taken to begin this kind of market analysis and feasibility studies.



Today China holds 1/3rd of the world's currency reserves. By 2030, the Chinese economy will surpass the United States, becoming the world's largest market. Shifts in economic power usually signal changes in economic relations.

It is no longer possible to ignore the increasing presence of the Chinese in global economic affairs. Chinese money is coming to CEE, as are Chinese firms and Chinese competition. The next phase of CEE development will depend on how CEE countries and firms take advantage of this.

Despite ample negative forecasts and gloomy predictions for 2012 as to the state of Europe's economy and CEE growth levels, business confidence is up, and firms are still open for business. Markets are becoming ever more integrated and entrepreneurship is driving the way forward. **Opportunities present risk, highlighting the need for coordination between the activities of the private sector and those of the public sector, governments and administration. This is even more so the case of building partnerships and relations with the Chinese.**

In fact, this paper will show that sophisticated investors will analyse risk and take opportunities, preparing for the next phase of intensive global economic rivalry. **China has been accused of the abuse of level playing fields, price dumping and undercutting and unfair competition. Is CEE ready for this?**

We believe that the main obstacles to increasing investment and trade ties between CEE and China will be cultural, social and political. Economics present opportunities; often political and cultural relations complicate the fulfilment of these opportunities. As usual, the interplay between markets and states, between economics and politics will determine how rewards are reaped for taking risks.

The paper will argue that strategies adopted by CEE towards China are at the moment inadequate to meet the needs of building partnerships with the Chinese. **CEE tends to think in the short term. Economic diplomacy as well as corporate partnership building are in their infancy. China, on the other hand, is much more adept at using long-term strategizing when dealing with CEE.** Chinese policies display signs of both rational thinking and reactive responses. At times, the Chinese seem to use political motives to promote their activities in CEE. At other times, economic opportunities are the clear priority. Sometimes Chinese act, at other times, they react to external and domestic events.

With current turmoil in international relations and domestic politics, it is difficult to predict the state of affairs in Chinese-CEE relations in the coming decades. However, **given recent trends in investment activities, no doubt economic links between CEE and China will increase. Drawing upon the lessons of transition and EU integration, CEE can benefit from these changing opportunities. CEE has proven their capacity to adapt and change to a rapidly shifting environment. Nowhere is this more evident than for the resiliency of the CEE private sector and enterprise adjustment.** This paper analyses current economic relations between China and CEE, followed by policy recommendations.

CEE needs to develop a coherent strategy towards China, based not only on feasibility studies of potential sectors for investment, but more importantly on political, cultural and regulatory barriers. Public diplomacy is at the key of this analysis. **How we perceive China and the Chinese, will depend on how we react to them.** China has a long term vision of its relations with CEE. This will be demonstrated in the paper. CEE lack this kind of long term thinking, often reacting to crisis situation or putting out fires.

For Chinese, interpersonal relationships and cultural ties come before building professional alliances. The exact opposite is true in European corporate culture, where transactions in business precede personal relationships. To work with the Chinese, we have to at least partially understand this.

We have to learn how to talk to them to win their trust and to build partnerships based on personal relations.

For business leaders in CEE, the challenge will be how to work with government on this strategy. However, business in CEE is sceptical of government and administration; and this will indeed pose a problem. Without public-private partnership, there will be little hope of developing a more coherent economic policy towards the Chinese, an indispensible tool for building better and closer relations.

Analysis needs to precede strategy, and both firms and governments in CEE should be investing more into education and research on the kind of multi-cultural global market we are currently learning to take advantage of. **If we imagine the world's market as one big global supply chain, we can attempt to see our place within it. Will we be partners in business for the Chinese, despite our asymmetric power, or tokens in their own plans?**

What needs to follow research is action involving both government and business.

Changing dynamics in international relations

Between 2007 and 2012, the Chinese economy grew by close to 60 percent, emerging Asia as a whole by almost 50%. Over the same period, economies of high income countries have grown by a mere 3%. Clearly the world is undergoing profound changes.

Central and Eastern Europe's rise on the global economic scene is at the forefront of this transformation. The weaker performance of the older incumbents in the global market is driving extraordinary divergence in growth levels. The speed of convergence in income per head between high and low economies continues, despite shocks as those of 2008. In fact, even with questions remaining about the future of the Eurozone, growth rates of emerging economies will probably continue to outpace rich countries.

The current unpredictability in international markets coupled with gloomy forecasts for the developed economies have led to a debate about shifting power to the East. **However, it is not yet evident where this Great Economic Shift of Power to the East is heading.**[1] China as a reluctant international player and rising superpower star has its own dilemmas to address before it can declare triumphalism in international relations. It is the aim of this paper to demonstrate **how China is refocusing its economic policies to correct various imbalances which have arisen as a result of the "Peaceful Rise and Going Out Strategies."**[2]

The Chinese are entering new markets at rapid rates. CEE is one of the new destinations for Chinese capital. For CEE, governments and businesses alike, now is the ripe time to take advantage of these new horizons and beginnings.

This year, the Great Transformation and Economic Shift was the theme of the Davos World Economic Forum. Ironically Davos clashed with the Chinese New Year. While the Chinese celebrated the year of the Dragon, leaders of the western world racked their heads on how to save the Eurozone and stabilize growth in the United States.

In the West, capitalism has been declared to be in crisis. **Issues of competitiveness, debt, stagnation and governance have come to dominate the discussions of global leaders with doomsday predicted.** While the west stagnates, emerging economies continue to impress. The Great Economic Shift implies that the current transformation of the global economy is a complicated process. **Transformations in power bring new chances and new dilemmas, but also earthquakes as economic plate tectonics shift.**

A theme has emerged of the decoupling of emerging markets from the West.[3] In 2008, in first wave of the economic crisis, emerging markets took part, albeit timidly in this debate. In 2012, it appears that this in fact has happened already to some extent. Growth economies such as BRICS, Mexico or Africa are now much more confident about their own domestic future. Developed economies need to sell to these growth economies, invest in their markets and create new relationships with them to export their way out of their own domestic problems and economic malaise.

China has taken a back step in international economic relations. No longer does China need to prove it is a responsible international player. **Instead China now views the problems of the West as something these nations need to address themselves, such as the Euro crisis. However, as the Chinese signal to the developed economies to fix their own problems, simultaneously, the PRC admits to having enough troubles of its own.**[4]

As such politics and economics mix yet again. Shifts in economic power having political consequences and in turn, politics feeding back to economic results. China needs the rest of the world as much as the rest of the world needs China. It is the argument of this paper, that CEE should embrace this shift in economic power world-wide and finds its place among the world's growth economies.

Ample opportunities exist for CEE to develop closer relations in trade and investment with the Chinese. We are witnessing only the beginning of the process. Constraints of doing business between China and CEE exists as well. Local markets matter, as do local cultures, social attitudes, and legal institutions. The global supply chain and logistic networks are currently under refurbishment. Change is taking place as globalization speeds up. CEE is set to take advantage of this process if it plays its cards right. Increasing internationalization of production will open up new opportunities for CEE, well placed geographically, culturally, and economically to take advantage of these new developments.

Dynamism, energy and innovation appear to be shifting to the East and reaping benefits from this energy will be dependent on both political relations and developments in economics. In another words, Sino-CEE relations will be built on both the state and the market. Chinese and CEE businesses will depend on government policies to deal with the changes in the global economy. These will include taxation, investment and other risk management policies as well as various rules defining trade and investment relations. Governments will need the input from business to make wise policy decisions.

1 Davos World Economic Forum 2012
2 ECFR, http://ecfr.eu/content/entry/china_analysis_facing_the_risks_of_the_going_out_strategy (2012)
3 Financial Times, Davos Coverage; http://www.ft.com/intl/indepth/davos
4 FT, http://www.ft.com/intl/cms/ddde54de-d323-11e0-9ba8-00144feab49a.html

China's contentious intentions

It could well be argued that **the outside world does not really know what China's goals are. Chinese going out strategy is contentious.** Some analysts persuade that China is a passive aggressive empire on the rise, patient, calm and ideologically determined to achieve its goals and retake its proper position among the world's empires. Others see China as pragmatic, with economic motives outweighing geopolitical calculations. Whatever Chinese intentions are, the PRC[5] strategy is itself fascinating to examine. It helps to come from an ancient civilization.

In his latest book The Future of US-Chinese Relations, Henry Kissinger claims that, when American negotiators tend to compartmentalize issues and seek solutions, their Chinese counterparts prefer to integrate issues and seek understandings. Whereas Americans believe that agreements can be reached in one sector while disagreements are expressed in another, Chinese prefer to characterize the whole atmosphere as warm or cold, friendly or tense, creating an incentive for the other side to put disagreements on the back burner. Whereas Americans are troubled by deadlocks, Chinese know how to leverage them to keep pressure on the other side. **American diplomacy is transactional, Chinese diplomacy is psychological.**[6]

Kissinger's analysis is all the more interesting as he **compares modern Chinese policy makers to the ancient military strategist Sun-tzu, who argued that one can win a battle before it begins by staking out a dominant political and psychological position**. As far back as the third century, the military commander Zhuge Liang turned back an enemy army by opening the city gates and sunning himself on the ramparts; this looked like a trap and frightened away the opposing general. In 1793-94, the Qianlong emperor fended off the British delegate Lord George McCartney with smothering hospitality; when McCartney failed to get the point, the court dismissed him with a note left on a silk chair. In 1958, Mao Zedong received the Soviet leader Nikita Khrushchev not just at his private swimming pool but in it, forcing the Soviet leader to negotiate in water wings.

In the book Kissinger argues that such tactics make hospitality "an aspect of strategy," leaving a foreign guest awed, discomfited, or wooed by the host's wealth, generosity, and composure. Chinese diplomats are adept at the use of friendship, which leaves "the other side . . . flattered by being admitted to the Chinese 'club' as an 'old friend,' a posture that makes disagreement more complicated and confrontations painful," Kissinger writes. As the Manchu diplomat Qiying said about dealing with the British "barbarians," it was necessary to "curb them by sincerity."

If a **key technique of Sun-tzu-style diplomacy is to convince the other side that certain issues are too culturally and politically sensitive to be discussed**, China seems to have secured that part of the wei qi board when it comes to Kissinger's views on human rights. This is a lesson as we will see below that the CEE countries have learned all too well.

[5] PRC will be used throughout this paper as the People's Republic of China
[6] Foreign Affair http://www.foreignaffairs.com/articles/137245/henry-a-kissinger/the-future-of-us-chinese-relations?cid=soc-facebook-in-essays-the_future_of_us_chinese_relations-022212

China's "Going Out" global strategy in Europe

The continuation of the Eurozone crisis remains the biggest threat to the world's economy. China appears to be heading for a soft landing with its own economic slow-down, to figures less than double--digit. At the same time, US GDP figures have surprisingly shown steady improvement, despite the possible threat of inflation as a result of quantitative easing. Through all this, China has been testing the international climate to turn its going out strategy to new horizons.[7]

In fact, the global economic crisis has changed China's strategy towards Europe. As one of Chinese argues, Europe needs our money.[8] According to a paper published by the European Council on Foreign Relations, "a kind of scramble for Europe is taking place," whereby China is replicating a strategy it has already used in the developing world; purchasing European government bonds and debt, investing in European companies and exploiting Europe's open market for procurement. On the other hand, crisis hit Europe needs China in order to boost market confidence, to save companies and thus jobs, and to save money on infrastructure projects. Consequentially China is striking cut-price deals, but also playing member-states against each other and against their own collective interests.

On the economic front, as Europe's top priority has become debt, growth and employment, China needs markets for its export, know-how and access to high technologies as well as bonds for its currency reserves. A historic opportunity exists to develop European-Chinese relations with mutual interest in building closer ties based on reciprocity and trade-offs. This should be a win-win scenario.

What is **worrying none the less is the tendency for Europeans to compete with each other for business with China and hence to lose their bargaining strength.** Europeans should not blame China for taking the opportunity to expand. However, work needs to be done for the EU to unify its position vis a vis the Chinese, and as such increase the success of its economic diplomacy.

[7] IMF World Economic Output, - http://www.imf.org/external/pubs/ft/weo/2012/update/01/pdf/0112.pdf (2012)
[8] ECFR, European Council on Foreign Relations, Godemart, F., Parello-Plesner, J. The Scramble for Europe. Policy Brief ECFR (2011)

Chinese build up of chains of influence

China is attempting to build up chains of influence in Europe extending **from transport (ports, airports, roads) to local assembly (designated Chinese industrial parks) and logistics (China's sea, air, and container companies, telecom networks) eventually to distribution, from small scale traders** who form a sizeable portion of Chinese immigrants to large distribution firms working up the value chain.[9] All of these phenomena are also now taking place in CEE. We will discuss below the difference between business for the Chinese Diaspora and for big Chinese firms.

China's going out logic seems to be both strategic and political, as well as pragmatic and based on economic opportunities. China is focusing on the Mediterranean and south-east EU member states with 30% of investments going to Portugal, Greece, Italy and Spain, and another 10% to CEE countries. Given the size of these economies, it is clear there are strategic reasons for Chinese investments. China needs the political support of these smaller member states vis a vis the larger ones. It is easier to invest in countries in need of cash, than to play the human rights game with richer nations. In addition, in the EU, an alliance of smaller states in favour of China could influence EU decision making considerably in China's interests. There is a sphere of influence to be acquired.[10]

China's expansion is directly visible in purchasing (and creating the appearance it is purchasing) European government bonds, by directly investing in European companies, particularly in Europe's periphery, and by participating in European public procurement. As China intends to diversify away from the US dollar, bond purchases from countries such as Greece or Hungary are on the increase. Similarly, greenfield projects, mergers and acquisitions and trade and cooperation agreements relying on Chinese financing have suddenly risen in the overall level of Chinese investment in Europe.

Europe is beginning to overtake Asia and the rest of the developing world as one of China's top targets in its going out strategy.[11]

According to **China's new 5 year plan, China will invest in sectors in which it has a comparative advantage or is seeking one.** This includes key sectors that the Chinese government has openly encouraged foreign investment in, of strategic importance for the Chinese economy.
As a result, large, well-capitalized foreign companies can more easily gain entry into the Chinese market and companies in these sectors in Europe can expect increase in investment from China.

9 Nicolas and Thomsen, The Rise of Chinese Firms in Europe: Motives, Strategies and Implications, (2008). http://www.apeaweb.org/confer/bei08/papers/nicolas.pdf
10 ECFR, Scrabble...
11 FT, http://www.ft.com/cms/s/0/f9d84446-4363-11e1-8489-00144feab49a.html#ixzz1kHWmgea1

IBIS China Development

Auto parts manufacturing
The development of auto parts manufacturing has been driven by the strong growth of the auto manufacturing industry, which produced an estimated 20 million automobiles in 2011. Parts manufacturers have grown rapidly over the past five years, with industry revenue growth averaging 28.0 percent per year through 2011. Foreign enterprises are estimated to account for 44.6 percent of industry revenue, which is expected to increase over the next five years, alongside export markets and domestic demand. The auto parts manufacturing industry's revenue is forecast to grow at an average annual rate of 10.9 percent over the five years to 2016, with 10.1 percent growth in 2012.

IT services
Accounting for roughly 20 percent of China's total IT investment, the IT services industry has developed rapidly over the past five years, with annualized revenue growth of 9.0 percent. Within the industry, demand for systems integration services has grown rapidly, accounting for 25 percent of industry revenue. As major downstream industries open and industries invest significantly in IT equipment and services, more foreign IT service providers will enter to satisfy local demand. With 5.9 percent average annual growth projected, revenue is set to reach $108.97 billion in 2016. Revenue is forecast to grow 8.8 percent in 2012.

Advertising agencies

Government support and the changing strategies of Chinese businesses will likely provide opportunities for ambitious foreign companies. With rising wages and relatively cheaper production facilities developing in other nations, Chinese manufacturing firms aim to upgrade their status from high-quantity producers to high-quality producers. These businesses will look to change their image, requiring more advertising, marketing and brand building and thus benefiting the advertising agencies industry. IBISWorld forecasts revenue will grow by 15.1 percent to reach $51.75 billion in 2012.

Software development

The industry provides applications software and support and software design, testing and programming. Considered an industry of national strategic importance, the industry has experienced robust revenue and valued-added growth over the past five years, with average annual increases 29.6 percent and 28 percent, respectively. With domestic demand set to increase by 27 percent over the next five years, revenue will likely grow at more than twice the rate of China's GDP. These factors and assistance from the Chinese government have shaped positive industry projections, with revenue anticipated to grow an average of 25 percent per year through 2016.

Water pollution control

China has increasingly emphasized the cleanliness of its water, since the country accounts for 19.3 percent of the population and holds 7 percent of the world's water resources. As the world leader in industrial output, China has great demand for water pollution control services, with the quality of the nation's inland waters depending on the industry. While foreign-owned firms hold a 3.5 percent share of enterprises, these companies earn about 25 percent of industry revenue. Favorable government policies are expected to entice more foreign investment in the industry. Consequently, revenue is forecast to grow at an average annual rate of 9.8 percent over the next five years, with 13.2 percent growth in 2012.

[12] Source: http://www.ibisworld.com/industry/china/

China's time horizon in planning is long term. Facing all sorts of its own dilemmas, the stagnation of growth in the West is not a source of satisfaction for the PRC. While indeed providing bail out money for indebted developed economies and firms, Chinese policymakers are cautious declaring the victory of its own capitalist model.

The post-Mao China began its reforms in 1978 when Deng Xiaoping returned to power. Alarmed by the prospect of economic stagnation and regime collapse, Deng forced the Chinese party to liberalise the economy. Economic reform has been taking place for the last 20 years, however, China faces deep internal problems of its own; and the sense of triumph can be skin deep only.

While publically berating the US government for economic mismanagement, in addition to the European sovereign debt crisis, China is none the less careful not to antagonize its main trade partners too far. To declare the Anglo-Saxon model of capitalism dead, would mean to have found a better alternative for it. So far, as China's internal problems demonstrate, this alternative has not yet been found.

The tussle between the state and markets, or rather control of the state and market place, is as much in turmoil and impasse in Chinese policy debates as in the developed world. Leverage, lending, regulation, financial management and risk occupy the minds of Chinese economic thinkers. With rapid rates of growth and industrialization, the Chinese variety of capitalism is causing its own variety of destruction.

Ecology has become a buzz word in debating sustainable development models in China. Inclusive growth, one combining equality and solidarity with wealth creation and bringing people out of poverty is another. While momentum in global economics has indeed shifted to the East, **China's interventionist policies combined with weak renminbi and export led growth have created domestic imbalances of their own. Asset bubbles combined with low levels of domestic demand, too weak to make up for falling external demand**, are to name but a couple. The post-Lehman stimulus package that supported the Chinese economy during the first wave of the global crisis has been unable to sustain previous levels of growth throughout 2012. With three consecutive quarters of falling GDP in 2011, China's economy is evidently decelerating.[13]

The slowdown in China's economic growth last year has fostered mixed reactions. Some argue that the recently-released 9.2% annual rate exceeds expectations and is consistent with a soft landing. The Chinese Government has announced a target in March of 7.5% for 2012. Others see the fall from 10.4% in 2010 as an indication that a sharper drop is still to come. In addition, big state-owned enterprises still dominate nearly all critical sectors such as banking, finance, transport, energy, natural resources and heavy industry. The private sector is often victimized by official discrimination and could be in retreat. According the Financial Times Jim O'Neil, prices are officially controlled and severely distorted. Foreign businesses are getting attacked with various protectionist measures. Some foreign business leaders are even publically voicing their bitter disappointment with the government.

[13] World Bank, China 2030: Building a modern, harmonious and creative high-income society.

Huge structural imbalances, chronic inefficiency, environmental degradation and rising social unrest accompanying increasing inequality are all signs of an unsustainable model.[14]

Like other emerging markets, China is experiencing a deterioration in economic outlook as a result of falling demand in the developed world. China is linked to global events through transmission belts of capital, credit and trade ties. Security concerns about the safety of Chinese firms and workers abroad have also led to changes in China's going out strategy. Rising labour costs in China plus weakening external demand means the Chinese businesses have begun looking for new opportunities in their shifting corporate strategy.

The current climate has signaled to Chinese leadership and business that its economic model is in crisis. **However, as the old Chinese adage goes, crisis and opportunity go hand in hand in China.**

In its structural reform efforts, Chinese leadership is thus taking advantage of the global recession and the European sovereign debt crisis. The Chinese are now at a stage where they are starting to look at penetration of overseas markets as part of their own growth strategies. Chinese companies, often large conglomerates are expanding into European markets for the first time. As well as strategic deals to acquire resources, energy assets, advanced industrial processes, know-how and consumer brands to bring back into China. The Chinese are emerging as serious bidders in snapping up well know European brands for a fraction of their pre-crisis prices and getting bargains in acquiring cutting edge technological skills. This is especially visible in sectors such as energy and finance. In 2011, Europe emerged as China's top destination for investment according to PWC.[15] Merger and acquisition activity was prioritized in banking, industrial and consumer sectors. China's 410$bn sovereign wealth fund has also shown interest in investing in infrastructure projects; preferring low-risk physical assets that carry steady returns such as the recent investment by the sovereign wealth fund in UK Thames Water.[16]

14 FT, http://blogs.ft.com/the-a-list/#ixzz1kNnGgPrX
15 PWC, The world in 2050 Beyond the BRICs: A broader look at emerging market growth prospects; (2008). http://www.pwc.com/gx/en/world-2050/growth-in-emerging-economies-oportunity-or-threat.jhtml
16 FT, http://blogs.ft.com/beyond-brics/2012/01/17/china-sees-upside-of-eurozone-crisis/#ixzz1kIEpNtnO

Europe needs China's money. This is even more the case of Central East European countries.

In CEE, China's aims are as contentious as discussed above. On the one side, they are economic – to enter the European market through the "eastern door" and become present in the region by increasing direct investments and manufacturing. This policy is consistent with the going out strategy, encouraging Chinese companies to invest abroad. On the other side, political and cultural issues play a large and supporting role in obtaining economic goals. Sometimes as we will discuss below, political motives take precedence.

The PRC's policy toward CEE remains based on China's EU Policy Paper published in October 2003. Relevant recommendations that can be perceived as advice for Chinese authorities are presented in the Report on China's Policy toward Central and Eastern European Countries, prepared by the China Institute of Contemporary International Relations (CICIR) and published in the Contemporary International Relations journal at the end of 2003. The only official document remains the new Chinese 12th five year plan for 2011-2015. **Official policy towards CEE is not readily or publically accessible.**[17]

Since 2003, there was number of high level visits between China and CEE countries, however, it is hard to find any documents on the current strategy toward CEE. This could perhaps be reconstructed from the visits between China and CEE, as well as. The Czech Republic has been the most active in this field, with the first Head of State to visit Beijing in 2004. In 2005, Czech Prime Minister was revisited by Wen Jiabao in Prague. In 2004, Hu Jinato came to Warsaw, while in 2008, Polish PM Tusk was received in Beijing. In 2009, Xi Jinping, future Chinese President designate, went to Romania and Bulgaria, while Hu Jintao visited Slovakia. In 2010, Hungary's Victor Orban was also present at the Chinese Expo. Polish President Komorowski's and Prime Minister Donald Tusk's visits will be documented in more detail below.

17 PISM Bulletin (2011)

New horizons for CEE growth and development[18]

Emerging Europe, New Europe or otherwise CEE countries should now take the lead in developing its growth potential by turning to new dynamic markets in the East. In fact, as Chinese investment shift from natural resources towards higher tech goods and developed economy assets, CEE countries and firms have much to gain from entering into partnerships with the Chinese. CEE is well-placed to deliver both growth and investment return opportunities, as well as the stable regulatory framework of the EU.

So far in CEE, China has been building offshore production bases for Chinese companies. Other investments include R&D and innovation developments in the automobile sector such as strategic partnerships with the Great Wall Motor Company in Bulgaria. Chinese business strategies show that China is investing in the battle over access to technology and intellectual property rights. China Development Bank is now active with offices carrying out various projects in countries including Bulgaria, Croatia, Greece, Portugal, Serbia, Slovenia and Poland. The example of Hungarian bonds shows other ways that China is taking advantage of the European debt crisis. Hit hard by conditions of the IMF bailout and cash strapped, Budapest originally relied on the Chinese to provide capital for its debt financing. In addition it has sold industrial plants to China, including chemical plants. These developments will be elaborated on below.

The Eurozone crisis has meant that CEE economies appear more dynamic as places to put Chinese money in than the periphery of old Europe. High growth rates in CEE, high intellectual potential, relative safety of doing deals due to EU institutional framework and entrepreneurial spirit combined together mean that CEE is becoming even more attractive as a region for venture capital and private equity.

As CEE continues to outpace growth levels in the Eurozone, China will increasingly invest in it. If growth stagnates in the region, on the other hand, the Chinese will take advantage of this opportunity to buy out assets put on sale by cash-strapped governments.

For example, as west European banks are looking to sell assets in the CEE region, Chinese money is looking to buy into this financial sector.[19]

Whichever the EU sovereign debt crisis plays out, China seems destined to increase its trade ties, capital and credit links with CEE. In CEE, this response should be welcome. Shifts in the global economy are beginning to accompany shifts in investment and shifts in the perception of risk. Investors are no longer just looking into the safe havens of developed economies for their returns. Instead, their appetite is increasing for emerging markets as these become less risky while continuing to impress with dynamism and youth.

Being ready means everything, and long term strategy is important for CEE governments and firms alike. It is worth emphasizing that neglecting this opportunity to prepare for partnership with the dynamic economy of China, CEE is setting itself up for probable scenarios of recession.
The alternative, to remain dependent on EU markets, leaves much to be desired.

EU/ CEE - vulnerabilities of the region

If we look at emerging economies' growth in detail, we see that Asia is still the most dynamic region, and the one least affected by the global crisis in 2008 and 2009. Sub-Saharan Africa came second to Asia, on both points. Latin America and CEE were less dynamic and hence more vulnerable to adverse external shocks. With the exception of Poland, whose growth rates continue to impress, the rest of the region remains extremely vulnerable to external events and cash shortages.[20]

CEE is linked to the Eurozone through trade, capital flows and bank flows. Unless some form of decoupling begins to takes place, CEE could be hit harder this time than the first round of recession in 2008. According to the World Bank, the world might not endure a new economic crisis, because rich countries had little monetary or fiscal ammunition available to stem any vicious circle and poorer countries now have "much less abundant capital, less vibrant trade opportunities and weaker financial support for both private and public activity [than in 2009.]"[21]

In October of 2011, according the Financial Times Investing in CEE Special Report 2011,[22] no one was predicting another recession in CEE. **CEE had recovered relatively well from the 2008 crisis. The countries' economies were judged to be more robust and better prepared than in 2008. Poland, Czech Republic, Slovakia and Hungary had all bounced back after the turmoil, stronger, and more capable of dealing with another financial meltdown.** Manufacturing strength and exports allowed CEE to wither the storm in 2008. Despite relying on export led recovery and growth to western markets, the countries of the region were mostly able to repair many of their fiscal and trade imbalances that had been the cause of previous weaknesses.

18 Please refer to the primary CEED Initiative report; http://www.ceedinstitute.org/web/guest/strona-glowna%3bjsessionid=002C6A5E387DD0C34A1CA52AEF96537E
19 ECFR, ThinkTank, PISM
20 PWC, The world in 2050 Beyond the BRICs: A broader look at emerging market growth prospects; http://www.pwc.com/gx/en/world-2050/growth-in-emerging-economies-oportunity-or-threat.jhtml
21 World Bank, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/0,,menuPK:258604~pagePK:158889~piPK:146815~theSitePK:258599,00.html
22 FT, http://www.ft.com/intl/reports/central-eastern-europe

Recovery remained multi-speed with growth highest in the Baltics as well as in Poland. The Baltics owe this to strong export performance, while Poland relied in internal demand. The Czech Republic, Hungary, Slovakia and Slovenia all took advantage of a strong rebound in global trade following the first wave of the crisis. Perhaps this was owed to spectacular growth and resilience of the German economy. Trade contributed to growth through strong exports and weak imports. Export volumes in 2011 were set to expand more than 10% in Estonia, Romania, Czech Republic, Slovakia and Latvia, exceeding their pre-crisis levels by 16%. Estonia and Latvia diversified their trade from EU countries to other regions including Asia and benefited from this. However, with economic outlook worsening for western trade partners, CEE could again be waiting for more difficulties.[23]

In fact, investment in the second quarter of 2011 remained below pre-crisis levels in all countries but Poland, and consumption exceeded pre-crisis levels only in Poland, Slovakia, Slovenia and the Czech Republic.

It is not a generalization to say that small, open economies, with high exposure to foreign exchange reserves as well as dependent on foreign banks and capital tend to fare less well in times of recession than bigger, more closed markets. On the whole, Central Eastern Europe tends to be at risk as a region in times of market turbulence.[24] In 2012, analysts are particularly concerned about the dangers of a new credit crunch, triggered by the heavy borrowing needs of debt-laden developed world countries, not the weaker member of the Eurozone. Financial Times reports,

While contained for the moment, the risk of a much broader freezing up of capital markets and a global crisis similar in magnitude to the Lehman crisis remains. In particular, the willingness of markets to finance the deficits and maturing debt of high-income countries cannot be assured. Should more countries find themselves denied such financing, a much wider financial crisis that could engulf private banks and other financial institutions on both sides of the Atlantic cannot be ruled out. The world could be thrown into a recession as large or even larger than that of 2008/09.[25]

While the CEE are fast becoming hybrid economies - somewhere between emerging and developed countries, the Eurozone crisis could shake up market confidence in the region. CEE countries are reliant on European banks and this need for external financing and western capital could spell fiscally unsustainable balance sheets. **If tightening credit conditions in the west are somehow overcome by capital flows from other emerging economies, this danger could be overcome.** While Poland, with a bigger domestic market and less exposed to Western banks, is of a lesser risk, Bulgaria, Romania, Latvia, and Lithuania remain extremely vulnerable. Hungary with its own unique situation triggered by both public finance crisis and political populism remains at a particular crossroads.

Already, the region's equities and currencies have slipped; perhaps for the better, buttressing further export led growth. The Polish zloty and Hungarian forint both fell around 15% in value against the dollar. In January 2012, with the crisis in the Eurozone nowhere near resolution, predictions for growth in CEE were again being lowered. Despite the fact that the region's public debt dynamics are healthier than those of most western European countries, largely tacked by austerity programmes following the 2008 crisis, the IMF and EBRD are also signaling danger ahead for these economies.[26]

The EBRD has shown first net capital outflows from Eastern Europe since the 2009 crisis. Western banks appear to be deleveraging under regulatory pressure to rebuild balance sheets at home. In January of 2012, growth prospects projected for Poland, Slovakia and the Baltic states were cut to 1.4% from 1.7%. Hungary and Slovenia are forecast to go into recession. Hungary is projected to contract by 1.5% in 2012. South East Europe including Romania and Bulgaria is forecast to grow at 1.6%.[27] However here exposure to Greek banks is a luring unknown.

Other date is however more optimistic, paining a mixed picture of CEE. According to the World Bank, in 2012, Poland will grow by 2.9%, Romania and Bulgaria by about 2%, Estonia and Lithuania by 3.5% each, Latvia by 2.8%, the Czech Republic by 1.0%, Slovakia another 1.5%, Slovenia 1.4%. Finally, Hungary's growth is expected to reach 0.5%. This would be an estimated growth of 2.1% for the EU 10, or CEE as a whole.[28]

Whichever way we interpret the growth projections for 2012,[29] estimates confirm that capital flows and especially FDI were halved to CEE from the West after the Lehman Brothers collapse. Alternative sources of lending could prove hard to find. Any further cut back in lending from western investors and banks could spell troubles for the dependent CEE banking sector, where three quarters of banks are controlled by western headquarters. Foreign banks with subsidiaries are under more pressure than post-Lehman in 2009 to cut off credit and sell subsidiaries. Big lenders include Italy's UniCredit and Austria's Raiffeisen Bank International and Erste Group, as well as Italy's Intesa Sanpaolo, Belgium's KBC and France's Société Générale. Deleveraging is already taking place and Hungary has been hit hardest. Banks do distinguish between strong Poland and less exposed to risk lending, and weak Hungary, as witnessed recently by the Orban government.[30] Basel III and current capital requirements for banks in western Europe will only add to the illiquidity scenario.

While Poland is not as exposed to western banks, most of the rest of CEE is. In fact, in order to prevent capital flight of western banks from CEE as they attempt to rebuild their capital balance sheets in home markets, in January of 2012, Vienna 2 was signed in Vienna by regulatory, government and finance officials. This shows the gravity of the problem.[31]

In addition to capital dependence, trade ties are the oldest and most resilient form of CEE integration with the rest of the EU. If demand falls further in CEE's biggest trade partners, especially Germany, CEE export led growth could at least visibly slow down. The Czech Republic, Hungary, Poland are as vulnerable here as the smaller Baltics.

23 Eurostat, Central Statistical Offices, World Bank calculations; http://siteresources.worldbank.org/ECAEXT/Resources/258598-1256755672295/6517642-1321421981603/EU10RER_Nov15_final.pdf
24 http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/0,,menuPK:258604~pagePK:158889~piPK:146815~theSitePK:258599,00.html
25 http://www.ft.com/cms/s/0/dc86e646-405b-11e1-9bce-00144feab49a.html#ixzz1kIIjvYF5
26 EBRD,- http://www.ebrd.com/downloads/research/REP/REP_January_2012_230112_FINAL_1.pdf; IMF,- http://www.imf.org/external/pubs/ft/weo/2012/update/01/pdf/0112.pdf
27 EBRD
28 Source: Eurostat, Central Statistical Offices, World Bank staff calculations
29 Also see Narodowy Bank Polski, Instytut Ekonomiczny, Biuro Gospodarki Światowej: Analiza sytuacji gospodarczej w krajach Europy Środkowej i Wschodniej, 2012
30 FT, - http://www.ft.com/intl/cms/s/0/1d3bc546-4807-11e1-b1b4-00144feabdc0.html#axzz1oc6s4ByN
31 Bloomberg, http://www.bloomberg.com/news/2012-02-07/popa-says-vienna-ii-initiative-to-focus-on-banking-groups-1html

Poland, a regional winner, seems to be coming out of the recent turmoil with top marks. Polish GDP rose by 4.2% in 2011, well ahead of pessimistic forecasts, and is forecast for growth of 3% in 2012. Polish business and enterprises have remained resilient and confidence in the economy is on the rise despite gloomy predictions from international institutions.

Poland appears to be avoiding the recession and will remain as Europe's best performing economy since the crisis hit in 2008, according to Belka's forecasts.[32] The optimism in Warsaw somehow is at odds with predictions of the World Bank or EBRD. It remains to be seen how far Poland will be vulnerable to any further derailment of the Eurozone crisis.

We argue that proper policy responses could alleviate further risks to growth in the region. The spectacular CEE catch up phase of impressive growth levels out-pacing those of developed economies is not yet over. Neither are the growth potentials of Asia. China's growth levels continue to impress. With 8.9% GDP in 2011, hard landing might not take place despite some opinions to the contrary. Growth economies could be facing new horizons and new beginnings as they attempt to refocus their economic policies and business strategies and expand their trade and investment portfolios to other emerging markets experiencing similar catch up stories. Nowhere is this more true than with new opportunities coming from developing closer Chinese-CEE economic relations.[33]

Trade

To begin with, it is not the purpose of this paper to go into detail about CEE-Chinese trade relations. Instead we have chosen to focus on investment opportunities. The scope of the paper does not allow us to cover both subjects in detail. **Even though Europe is becoming a more attractive market for China, trade intensity between the two regions is among the lowest in the world. Proportionally, China economic relations with the rest of Asia, North America, Africa and Latin America are much more important than with Europe.** The trade intensity between China and the US is almost 100% higher than the intensity between China and the Europe. In fact, exportations from the EU to China are extremely low. In Poland in 2008, for 1 dollar exported to China, 7.2 were imported from the Middle Kingdom. The proportion was of 7.3 in Hungary, 8.6 in Czech Republic and almost 15 in Romania, but only of 2.85 in the US.

In brief, **two-way trade between China and CEE has grown rapidly. While it only amounted to 3 billion US dollars in 2000, in 2010 the volume of trade surpassed 41.1 billion, representing an annual average growth of 32%. China's imports from CEE have grown even faster, registering an annual average rate of 38.7%.**[34]

The overall composition of trade has also developed with electric, mechanic and high-tech products exceeding 60% of CEE exports. Rose oil, amber, crystal, beer and cars from CEE have arrived in Chinese households, and other so-called luxury products are on the rise. Clearly, inexpensive consumer goods from China have been warmly welcomed by CEE publics.

Poland is China's biggest CEE partner in general turnover and imports. Hungary is the biggest export market for the Chinese. In 2007, the Polish Embassy noted that total trade reached some 16 billion euros; this figure was holding generally steady through to 2009, although the financial crisis has led to a drop on both sides.[35] Recent growth of total trade has been significant, but considering the amounts in question it is still far too modest, and due to a decrease in import value and of course the financial crisis, it even slowed down in 2009. Polish imports from China account for 9.3% of total imports to Poland while exports from Poland to China make only 1.1% of total Polish exports. The imbalance in trade between the two countries is therefore significant, with exports from Poland to China roughly ten times smaller than Chinese imports.

Significantly, in Poland exports to China have increased five times while imports only four times during the last 5 years. However, the proportion of low-value-added products among Polish exports to China is relatively high, with raw materials, minerals and simple components being the major commodities offered so far for the Chinese market. The biggest exporter from Poland is KGHM (Kombinat Górnictwa i Hutnictwa Miedziowego) Polska Miedź SA (copper mining industry), a major global player in the copper mining and silver extraction industries. Others include chemicals, fertiliser and coal mining industries and the trend in commodity pattern seems to be improving and moving up the value chain. Conversely, the most important commodities imported from China are computers, cell telephones, electronic gadgets and electronic components, as Poland looks for comparatively cheap products necessitated by the increased importance placed in the knowledge economy on ICT in trade competition. Chinese goods imported into Poland are therefore much more sophisticated than those exported. Many small and medium size companies in Poland are looking for technologically advanced but cheaper products and components on the Chinese market.[36]

According to statistics by the Chinese Customs office and China's Ministry of Commerce, Chinese-Latvian bilateral trade reached a volume of 1.256 billion US dollars in 2011, up by 50.69% year on year. China's import from Latvia amounted to 63 million US dollars, while export to Latvia was 1.193 billion US dollars. This amounted to 1.129 billion US dollars trade surplus for China.[37]

32 Bloomberg, Central Bank governor interview, Bloomberg Jan 27, 2012
33 World Bank, http://siteresources.worldbank.org/ECAEXT/Resources/258598-1256755672295/6517642-1321421981603/EU10RER_Nov15_summary.pdf
34 Xinhuanet news, http://news.xinhuanet.com/english2010/china/2011-06/26/c_13950035.htm
35 People's Daily Online 2009
36 Azja-Pl think tank, http://www.polska-azja.pl/2011/01/21/economic-and-trade-relations-between-poland-and-china-since-2004/).
37 China's Ministry of Commerce, http://english.mofcom.gov.cn/

	2007				2008			
	Import*/**	Export/	Total	Balance	Import/	Export/	Total	Balance
Bulgaria	609/6.7	75/1.4	684	-534	756/7.0	110/1.8	866	-646
Czech Republic	4336/25.3	507/3.9	4843	-3829	4721/21.2	548/3.6	5269	-4172
Estonia	299/12.2	65/2.7	364	-235	294/13.3	54/2.1	348	-240
Hungary	5394/25.3	752/5.1	6146	-4642	5586/23.7	762/4.7	6348	-4824
Lithuania	498/8.8	15/0.3	513	-483	542/6.0	19/0.3	561	-523
Latvia	257/10.2	17/1.0	274	-240	250/9.3	19/0.9	269	-231
Poland	5050/15.6	724/3.4	5774	-4326	6276/15.7	867/3.4	7143	-5410
Romania	1667/11.3	157/1.9	1824	-1511	2397/13.8	160/1.6	2557	-2237
Slovakia	1587/14.2	321/5.7	1908	-1266	2078/15.4	419/5.9	2497	-1659
Slovenia	447/7.4	69/1.0	516	-378	616/8.5	121/1.6	737	-495

	2009				2010			
	Import/	Export/	Total	Balance	Import/	Export/	Total	Balance
Bulgaria	456/6.9	115/2.7	571	-341	493/6.2	189/3.1	682	-304
Czech Republic	4303/26.0	602/4.9	4905	-3701	6929/28.9	918/5.7	7947	-6010
Estonia	182/12.8	55/2.8	237	-182	336/18.0	112/4.1	448	-224
Hungary	4837/27.7	886/7.0	5723	-3951	6564/30.6	1180/7.2	7744	-5384
Lithuania	325/6.1	22/0.5	347	-303	430/5.6	28/0.4	458	-402
Latvia	143/8.3	17/0.9	160	-126	220/10.4	28/1.2	248	-192
Poland	5557/18.9	1050/5.3	6607	-4508	7041/18.0	1235/4.9	8276	-5806
Romania	1902/18.3	213/2.8	2115	-1689	2551/19.8	308/3.0	2859	-2243
Slovakia	1416/14.1	551/9.7	1967	-805	2014/14.6	971/12.8	2985	-1043
Slovenia	553/10.0	85/1.5	638	-468	934/12.8	106/1.7	1040	-828

Source: Eurostat, External and Intra EU Trade Statistical Book 1958-2009 & Eurostat, External and Intra EU Trade Monthly statistics, issue number 8/2011

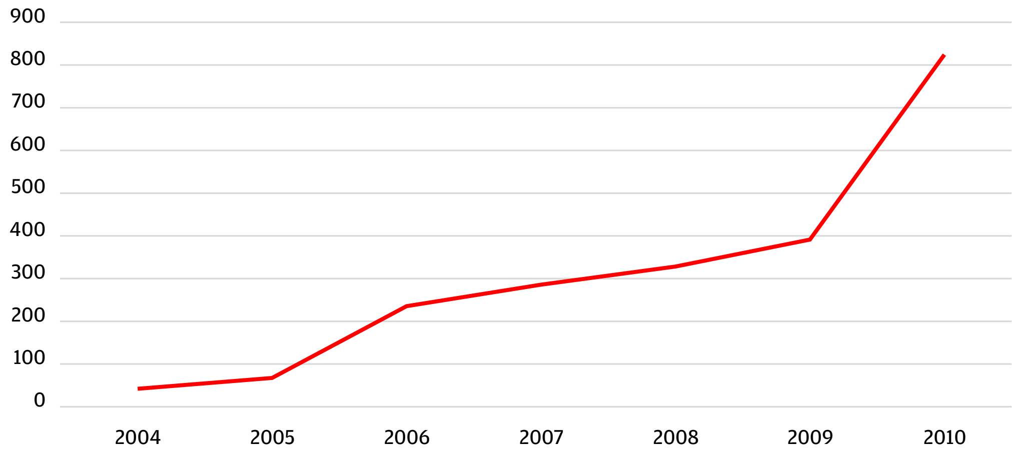
- *Bln EUR
- **EXTRA EU 27 share in %

It seems that the recent increase of China's outward FDI in the CEE region is only the start of a much broader process. Both regions have strong interest in continuing and intensifying economic relations. However, even though positive signals are seen both in China and in the CEE area, important obstacles still need to be overcome in order to achieve rapidly common objectives.

The strong increase of Chinese investments in the CEE region follows from both push and pulls factors. On the one hand, the huge foreign exchange reserves acquired by China since the early 90s urge Beijing authorities to invest in order to re-balance its finances. Furthermore, China's objective to restructure its economy in focusing on emerging strategic industries including biotechnology, new energy, high-end equipment manufacturing, energy conservation, clean-energy vehicles, new materials and IT technology cannot be fully implemented without acquisitions of new technologies and strong cooperation, in particular with the EU. On the other hand, the CEE region needs investments in order to modernize its infrastructures. In whole Central and Eastern Europe, important efforts were made during last decade in order to attract foreign investments.

Less than seven years ago, Chinese investments in the region were almost inexistent. In 2004, the total flow of China's FDI (foreign direct investments) in the Czech Republic was only of US$ 0.46 million and in Poland, of 0.1 million. However, in recent years, China has significantly increased its foreign investments in the whole CEE region.[38] As shown in figure 1, China's outward FDI stock in the area, which was only of US$ 43.67 million in 2004, augmented to 821.28 million in 2010.

Figure 1 China's outward FDI stock in the CEE region, 2004-2010, millions of US$



Source: Authors' own calculation based on the 2010 Statistical Bulletin of China's outward FDI

38 In this paper, we define the "CEE region" as the area including the 10 post-Communist countries member of the EU, referring again to the CEED initiative classification

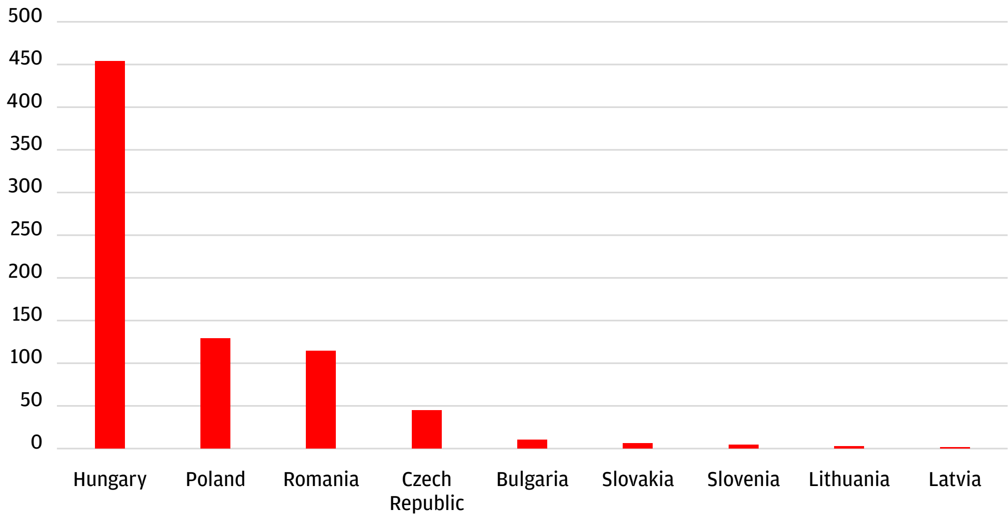
It should be noted that this trend is not restricted to Central and Eastern Europe. Chinese investments have significantly increased in all continents and almost all countries within the last 7 years. Nonetheless, its intensity in CEE countries is unique. **During the period 2004-2010, China's investments stock was multiplied by 6.8 in Asia, 5.3 in Latin America, 8.6 in North America and 7 at the international level, but by more than 18 in the CEE region.** Even in Africa, where China started recently to invest massively, the increase is smaller (14.5).

Despite this, not enough is officially known about the Chinese in CEE. Being a recent phenomenon, and remaining proportionally very small (they accounted for less than 1.5% of all inward FDI flows in the CEE region in 2010), until now this development has been neglected.
To understand the long term trends, we should ask ourselves what is the logic behind the increase into these investments? What are China's intentions, what is the Chinese long and short term strategy?

The period investigated in this paper stretches from the first post-Mao economic reforms (1978) until today. Furthermore, the national tendencies are briefly discussed, obstacles to increasing trade ties analyzed and policy prescriptions proposed. Emphasis is placed on 5 major China's foreign investments recipients in the CEE region, namely, Poland, the Czech Republic, Romania, Hungary and Bulgaria. The Baltic countries, Slovenia and Slovakia's share of investments in the region is still marginal. As shown in figure 2, in 2010, they all together represented only 3.5% of the overall China's FDI stock in the region.

Lack of official and transparent data concerning China's investments makes the analysis of Chinese FDI in the CEE region particularly challenging. Statistics from the Ministry of Commerce of China are most readily available. However, it should be noticed that these are not as precise or reliable as one could expect. The amount of Chinese investments is often underestimated, with small scale firms not always taken into account in the official statistics.

Figure 2 China's outward FDI stock in the CEE region, 2010, millions of US$



Source: 2010 Statistical Bulletin of China's outward Foreign Direct Investment

China's FDI policy major phases

The rise of Chinese FDI in the CEE countries should be considered as a part of a larger strategy that has its roots in the late 70s. In fact, Chinese economic reforms process can be divided into three main phases. Since the first Chinese economic reforms which took place in 1978, outward FDI have been gradually authorized, discretely encouraged and then publicly promoted.

Phase 1. 1979-1991

From 1979 to the early 90s, China slowly moved from a harsh planned economy to what can be called a semi-planned economy. Special Economic Zones (SZEs) were progressively established and free market developed in the coastal area. In order to acquire foreign currencies and new technologies outward foreign direct investments were authorized. However, until 1984, only trading companies were allowed to qualify for outward FDI ventures. The communist ideology was still dominant within the government and therefore outward foreign direct investments were limited.

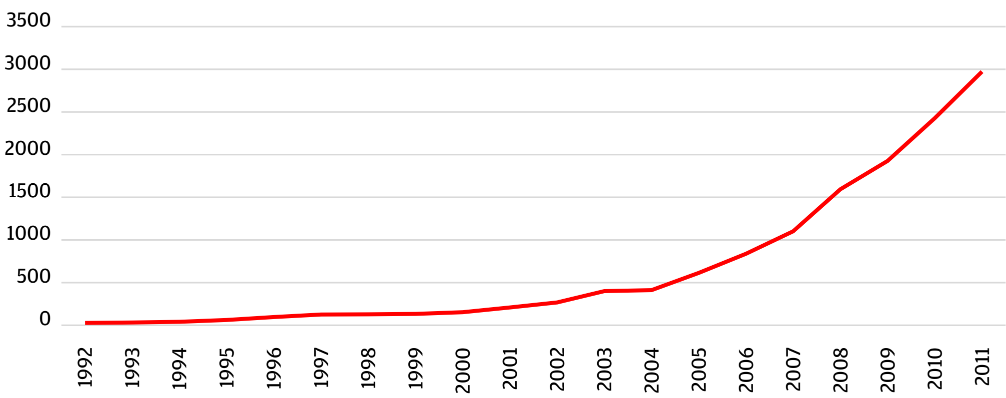
Phase 2. 1992-2000

The 1989 Tiananmen Square protest and the implosion of the Eastern Bloc urged Chinese authorities to accelerate economic reforms and modernize the state. As a result, the Chinese government publicly acknowledged its support for outwards foreign investments. However, major investments were essentially made in Asia. From the first economic reforms until the early 2000s, more than half of all Chinese foreign investments were directed towards Asian countries (Hong Kong being by far the largest outward China's FDI recipient with almost 28% of all investments).

Phase 3. 2001-present

The accession of China into the WTO in 2001 and the strong increase of foreign exchange reserves (they were multiplied by more than 10 between 1992 and 2001) both mark the start of a new stage in China's economic development and foreign investments which coincides with the development of China's FDI in the CEE region. The increase of foreign exchange reserves which was already important during the 90s suddenly rose and attained unprecedented levels in the 2000s. During the last 11 years, the annual rate of increase never went below 20%. Thus, in 2006 already, China became the largest foreign exchange reserves holder in the world. Exceeding by far its natural demand, China started to invest massively in order to re-balance its reserves. Between January 2004 and June 2005, exchange reserves raised from US$ 415.7 billion to 711. During the same period of time, outward FDI flows almost quadruple passing from US$ 5.5 billion to 21.16.

Figure 3 China's foreign exchange reserves, 1992-2011, billions of US$



Source: Authors' own calculation based on the 2010 Statistical Bulletin of China's outward FDI

Few years earlier, in 2001, Chinese authorities anticipating the foreign exchange reserves boom had launched the “Going Out” strategy which main purposes were the diversification of the Chinese economy and the increase of outward FDI. In 2007, China reinforced its pro-outward FDI policy by creating the China Investment Corporation doted of US$ 200 billion. Few months after its establishment, this fund, totally owned by the Chinese government had already acquired 9% of Blackstone, an American investment group, 9.9% of Morgan Stanley and 80% of JC Flowers an American financial company. In 2009, the Ministry of Finance put another US$ 150 million into the CIC, making the fund one of the largest in the world. That same year, new rules were implemented providing Chinese companies willing to invest abroad, assistance and new sources of funding.

Types of Chinese investors in the region

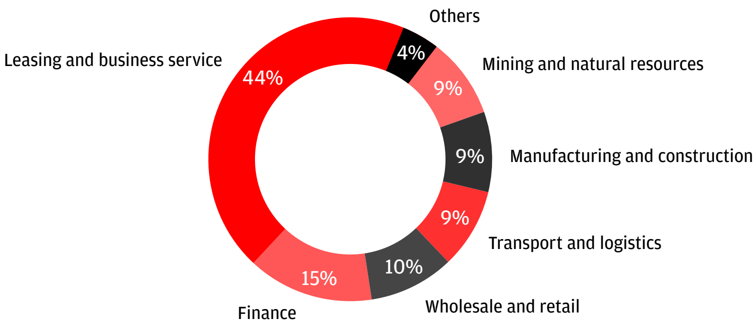
Large Chinese investors can be classified into three main categories: the state-owned companies, the private investors and as mentioned previously, since 2007 - the China Investment Corporation (CIC) – the Chinese sovereign wealth fund. What is to be distinguished from large Chinese firms, are the small family owned businesses characterized by strong informal networks and generally run by the Chinese Diaspora. This will be discussed in more detail below.

Even though the share of private investors is increasing, state-owned enterprises are still, and by far, the most important Chinese investors abroad. According to the study of Y. Korniyenko and T. Sakatume from the European Bank for Reconstruction and Development, in 2010, 84% of China's FDI stock came from state companies. However, if the sources of Chinese investments are relatively stable over time, the sectorial distribution of China's FDI stock undergoes significant development. Investments are always more concentrated in the services and especially in the leasing and business services sector.

In 2004, the leasing and business services sector accounted for 13.6% of all investments, in 2007, it was of 21% and in 2010, it represented 44% of all Chinese investments. On the other hand, the mining sector underwent a significant decrease. In 2004, almost one third of all investments abroad were directed towards mining. In 2011, it accounted for less than 9%. There are different ways of explaining this shift but it is obvious that the recent reorientation of the Chinese economy towards services and high technology development is not extraneous to the increase of investments in the tertiary sector. In fact, unlike Japan and Korea, which started to invest abroad only after becoming developed countries, China uses outward FDI as a tool in order to acquire new knowledge and technologies. Furthermore, by concentrating investments in services, Chinese investors pave the road for further exportations. Distribution, logistics and communication networks are of primary importance in the export process. Thus outward FDI enable China not only to acquire the necessary knowledge in order to rebalance its economy towards services but also to develop its access to export markets.

Investments in Central and Eastern Europe are essentially made in the secondary sector. In fact, the three largest investments in the CEE region were concentrated in car manufacturing in 2009, US$ 120 million were invested by Great Wall Motor in the Bulgarian firm Litex Motors and chemical industry. In 2010, Wanhua Industrial invested US$ 190 million in the Hungarian enterprise BorsodChem and acquired it in February 2011 for US$ 1,660 million.[39] In Romania and Poland, important investments are projected in the energy and infrastructure sectors. According to Romanian media, China plans to invest more than US$ 2 billons in the energy sector and more specifically in wind and nuclear energy (project in Cernavoda by Guangdong Nuclear Power Group). In Czech Republic, projects are concentrated in aerospace and precision engineering and in Bulgaria, in manufacturing and nuclear energy (Belene project).

Figure 4 Distribution of China's outward FDI flows by industry, 2010



Source: 2010 Statistical Bulletin of China's outward Foreign Direct Investment

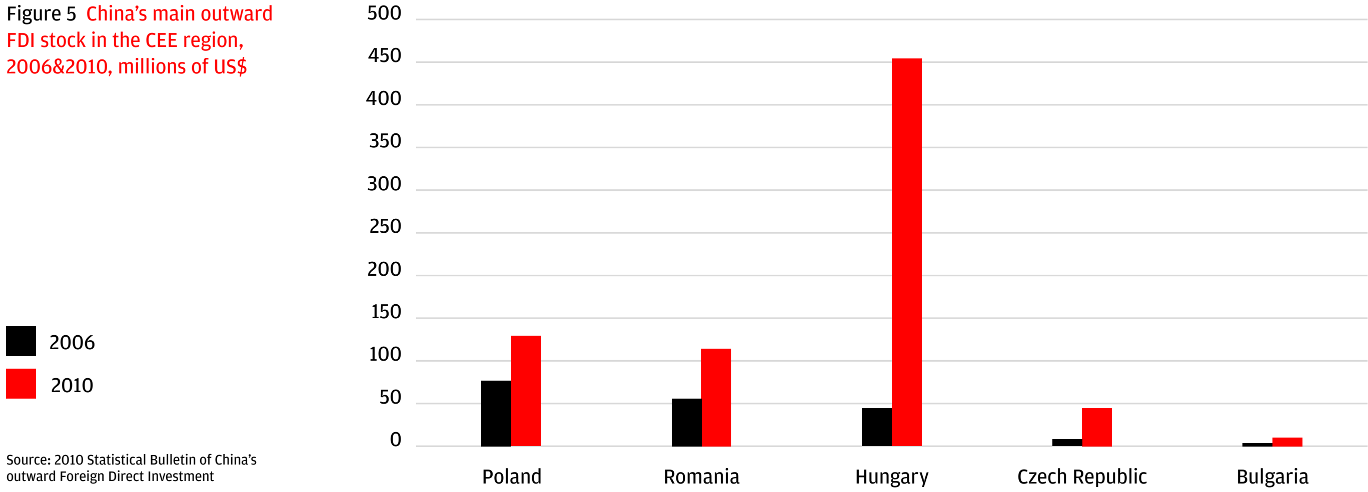
[39] Heritage Foundation, Scissors, D. (2011). China's Investment Overseas in 2010. The Heritage Foundation: WebMemo, No 3133

The economic characteristics of the CEE area and more specifically the low cost of the workforce associated with high productivity and the easy access to the single European market makes this region an extremely attractive place for secondary sector investments. Furthermore, as Peter Hyl, executive chairman of the China Investment Forum in Prague explains,

There is a synergy between China and many Eastern European countries since their economies operate with similar business models. China can be characterized as being a manufacturing base supplying Western economies and that is the same with large part of Eastern Europe.[40]

Nevertheless, behind this common picture, important variations exist between CEE countries in term of investments flow. China's outward FDI are concentrated in unexpected places. **Hungary which is, in term of GDP, the fourth country in the region, received in 2010 more investments from the Middle Kingdom than all other CEE countries together. At the European level, Hungary was only surpassed by Germany and Luxemburg.** The case of Romania is also interesting. In 2010, its total inward foreign investments were almost 75% less important than the Polish ones, but when it comes to the Chinese investments, the gap is only of 35%. On the other hand, Poland and the Czech Republic, the two largest economies and foreign investments destination countries in the CEE region (source: UNCTAD), are respectively the second and fourth China's FDI stock's recipients.

Figure 5 China's main outward FDI stock in the CEE region, 2006&2010, millions of US$



Source: 2010 Statistical Bulletin of China's outward Foreign Direct Investment

As shown in figure 5, the disproportional importance of Hungary and to a lesser extent Romania tended to increase with time; and while this trend was certainly confirmed in 2011, 2012 marked a year of change as we will see below. We turn to this in the next section.

[40] China Daily, http://europe.chinadaily.com.cn/epaper/2011-07/15/content_12910160.htm

Sino-CEE relations and perceptions; multi-cultural management in investment opportunities

China is seen as both a threat and an opportunity for CEE. As such, **perception of Chinese intentions clearly matters for understanding the PRC's motives in its economic and political relations. These are often unclear and inseparable, as the Chinese tend to mix business with politics.** So how does China view CEE? We argue that cultural misunderstandings are the main obstacle to strengthening economic relations. As such, in this chapter, we will examine the role of perception in multi-cultural management and investment opportunities between China and CEE.

There is clearly a growing need for both public and economic diplomacy in forgoing closer relations between the Chinese and CEE governments and publics. Business, likewise, should play a supportive role, along with academic and research institutions. Strengthening investment ties and cooperation requires understanding the cultural preferences and business ethics of the partner. Additionally, it is important to know what Chinese businessmen think of investment in CEE and vice versa.

In CEE, Chinese investment activities are divided into two areas: big firms and conglomerates on the one side; as well as the small-scale businesses run by the Chinese community, on the other. We will briefly consider both phenomena below to show how much misperception there is in the conduct of Chinese-CEE economic relations and business ventures. It is worth highlighting that both types of investment activities by the Chinese are not entirely transparent, making finding reliable data extremely difficult. Most of the facts available are sourced from informal knowledge, interviews and word of mouth, anecdotal evidence.

Chinese perception of CEE

Contemporary China and its global expansion we are witnessing today as the Going Out Strategy is a new phenomenon. In its history, China was rarely interested in the outside world, often calling itself Shenzhou, or The Sacred Continent. The Chinese considered themselves the Middle Kingdom and believed their civilization was superior to those of other nations. Not understanding Chinese culture to the Chinese meant being uncivilized. Chinese officers distinguished between "mature/ familiar barbarians" (foreigners influenced by Chinese culture) and "raw barbarians." China's trade and other interactions with the outside world, thus presupposed its superiority. Even today, China's version of history, and especially its own, differs significantly from Western accounts.[41]

Today, China is experiencing a dynamic time, probably the best in its history since the XIX century. China's potential is growing and with the opportunities come international responsibilities calling for Chinese engagement abroad. For a nation used to being isolationist, this is indeed a challenge and an extraordinary situation.

As a result of the isolationism, China tended to have few contacts with Europe. This lack of experience or contact of Imperial China with the world means that today's New China is facing difficult dilemmas in its Going Out Strategy. The Chinese do not yet understand the culture or business ethics of investing in developed economies, and in European economies more specifically.

China's Imperial perception of Europe has left behind a legacy of misapprehension how the world has changed. Because Europe tended to be viewed as inferior, backwards and poor, Europe could offer little to the Chinese. In the case of CEE, this perceptions was even more pronounced.

Despite the fact that the CEE nations have been successfully reintegrated with the West, for the Chinese they are still perceived as a part of Eastern Europe (or Soviet Europe). Jin Yan in foreword of her famous book From Eastern Europe to New Europe claims that the Chinese underestimated reforms or even missed the profound changes that took part in the Eastern Europe.[42]

As CEE countries joined the EU, China simultaneously started its Going Out Strategy and increased its interest in the regions of the world that so far has been neglected. In CEE, this started to change very slowly. In fact, CEE is the last part of the world that is experiencing the consequences of the rise of China and receiving Chinese investments.

Partly, this is because of the lack of natural resources in CEE, which brought China to Africa, Latin America, and Australia. Partly because of different histories, physical distance and different socio-political systems in the last 20 years. CEE was not a region well known to the Chinese. Moreover, **CEE countries were perceived as the "unfriendly," and as research shows, Chinese business leaders' decisions about where to invest were positively correlated with this variable.**[43]

In CEE, the Chinese appear to have come to countries where others withdrew or did not see opportunities. A good example is the offer made in 2009 to Moldavia to provide it with a loan worth $1 billion, mainly for infrastructure projects. China also offered a $1 billion loan to Belarus during Chinese vice-Chairman Xi Jinping's visit to Minsk in 2010. China takes advantage of its "friendship" with particular CEE countries, such as Hungary, Bulgaria, Romania, Ukraine and Belarus. These states maintain good relations with China and rarely put on the agenda sensitive issues like human rights, Tibet or Taiwan. In 2009 and 2010, the probable next leader of China, Xi Jinping, paid two visits to Europe, including to CEE countries. In 2009, he visited Bulgaria, Hungary and Romania, and in 2010, Belarus. This could be perceived as a signal that these countries, and generally speaking Eastern Europe, will be one of the directions for China's foreign policy under Xi's leadership.[44]

CEE perception of China

It is often said that China is a soft power champion. As the evidence of this is the example of 21 Confucius Institutes established in CEE to promote a positive image of China. While these institutions that focus on educational and cultural exchanges could have spectacular results in bringing Chinese culture and society closer to CEE, this will indeed take place in the long-term perspective. In the short term, on the other hand, CEE perception of China is still marked by profound lack of knowledge or understanding of the giant economic superpower.

41 FT, http://www.ft.com/intl/cms/s/0/41cb0e34-6c34-11e1-8c9d-00144feab49a.html
42 Jin Yan, From Eastern Europe to New Europe – looking back into 20 years of transformation, Bejjing University Publishing House, 2011
43 Report, World Class Aspirations – The perception and reality of China outbound investments, 2010
44 PISM Bulletin (2011).

CEE tend to know little if anything about Chinese history for example. Following the collapse of the Berlin Wall, China was for Poland and the Czech Republic not of primary importance. Central Europe was in its post--1989 phase, trying to consolidate democracy, and the idea of befriending a Communist country on the other side of the world was not the preoccupation of the time.[45]

In subsequent years, China has not been able to successfully communicate to CEE societies its own vision of political and economic changes. The popularity of Tibetan leader Dalai Lama is an interesting case especially in the Czech Republic, where he was received many times by Vaclav Havel, both as acting president and after stepping down. In Poland, according to a survey conducted in 2009, Dalai Lama turned out to be one of the most influential public figures for the younger Polish generations ranking number five, as the most influential foreigner, just after famous local TV stars.

Chinese infrastructure inherited after Communist era has not been very efficient. For example China Radio International has been broadcasting its programs in seven CEE national languages. There are 46 sections, including 7 CEE sections: Czech, Polish, Hungarian, Romanian, Bulgarian and newly established Estonian, and Lithuanian, but the media is seldom quoted by the local CEE broadcasters, and it is difficult to find anybody who follows it.

The consequences of this has been to, at best, create an atmosphere of misunderstanding, at worst of suspicion between CEE and their Chinese counterparts. While, this is changing the process is slow and surely will require more time and effort on both sides. To demonstrate this change in attitude, in 2008 upon a visit to China, **Polish Prime Minister Donald Tusk stressed that he went to China <u>to confirm that Poland unconditionally respects the development of the Chinese model. The Polish model and Chinese model brought prosperity to both nations</u>.**

Moreover, after the successful Beijing Olympics, coinciding with the global economic crisis, Victor Orban PM of Hungary on the occasion of welcoming Wen Jiabao in June 2011 said that <u>the West is in decline, and the rise of China and the way it is changing global economy is not an episode. It will last longer that I am going to be in power, although it is not going to be short time either</u>.[46]

CEE policies towards China

We could argue, that there are three main dimensions differing CEE countries policies toward China. First, is the one stressed in the Scramble for Europe[47]: the attitude towards Human Rights. Since 1989, CEE countries have been very supportive of HR issues, but after 2008, they all turned to more a pragmatic approach. The reason for this was probably the success of the Chinese model which turned out to be very stable and survived smoothly through the economic crisis.

But there are two other dimensions that are very useful tools in classifying CEE's attitudes. To begin with, we have either an active or a passive policy toward China.

Secondly, is China's own strategic and thought out interest in developing closer relations with particular states. This is crucial, as we have seen with Kissinger's metaphor of the charm offensive and Sun-tzu-style diplomacy.

Some countries like Slovakia, the Baltic States, or the Czech Republic have been very active in coming up with constructive proposals to develop closer relations with China. Interesting enough, this has met with little Chinese enthusiasm. On the other hand, there is Poland, to which we will turn to below.

Definitely, the most active policy has been led by Hungary, and Victor Orban, who has been seeking an alternative in the Chinese to worsening relations with the EU. Hungary's economic crisis at home has led Orban to develop an advanced strategy towards China. In 2010, a special Commissioner was established in the Hungarian government responsible only for Chinese affairs. After the collapse of Covec in Poland, Victor Orban sped up the visit of Wen Jiabao (originally scheduled at the end of his European tour) and received him with honours. **Orban has shown an aggressive approach to seeking China's special relationship. Despite this, Poland was chosen.**

Another example is the **Czech Republic** which, after the idealist policy of Vaclav Havel (who refused to visit China because of HR violations and received the Taiwanese president Li Deng Hui/ Lee Teng Hui), started a more pragmatic policy. In 2004, as the first Czech (or even Czechoslovak) president Havel paid an official visit to China. The Czech Republic formulated a strategy towards China in 2010, and built a solid infrastructure for developing relations, business, and tourism with the Chinese. The Czech trade department opened its office in Chengdu (West China). However, policy still remains uncoordinated.[48]

China interest in **Estonia** is due primarily to its favourable geographic position, good transport and logistics infrastructure, and scientific and technical potential. Estonia has been welcoming China to invest in construction of the Tallinn port and include it into group of ports cooperating with China's Ningbo port. In this case, Tallinn has been competing with Gdansk, also bidding to become a part of the group. Estonia, none the less, has something unique to offer to China.[49]

Slovakia, Lithuania and Latvia so far are probably just too small to be off consequential interest. Slovakia came up with constructive proposals, and its president visited the national pavilion at Shanghai EXPO, Following the 2009 Hu Jintao's visit to Bratislava, some promises were made. Neither the Polish president, nor the PM paid a visit to EXPO, but again little did this mean to the Chinese. The dynamics of the Sino-Slovak relations remain not impressive.[50]

[45] Bondiguel, Th. (2008), Central Europe and China: towards a new relation? EUROPEUM Institute for European Policy. http://www.europeum.org/doc/pdf/876.pdf
[46] http://esbalogh.typepad.com/hungarianspectrum/2011/06/viktor-orb%C3%A1n-in-the-limelight-wen-jiabao-in-budapest.html?cid=6a00e009865ae5883301543352872f970c
[47] ECFR, (2011)
[48] Jana Sehnalkova, Institute of Teritorial Study, Faculty of Social Sciences, Charles University, Shanghai, September 2010, The relations between the Czech Republic, and the PRC: some key issues.
[49] Laura Barauskaite, Turku school of Economics, Chinese Foreign Investments and Economic Relations with Baltic Sea Region States, Electronic Publications of Paneuropean Institute 6/2009.
[50] http://ekonomika.etrend.sk/ekonomika-slovensko/slovensko-a-cina-viac-politiky-ako-biznisu.html

Romania and Bulgaria are exceptions to these observations, traditional allies of China and familiar with Chinese relations from the 1980's onwards. For example, during a 2009 trip to Europe, vice-president Xi Jinping's Romanian and Bulgarian hosts gave assurances that their EU accession would be "beneficial" for China-EU relations. The complex chain of committees and informal discussions in the EU's decision-making process could perhaps permit these countries to slow down protectionist measures and further restrain European demarches on human rights. On issues such as climate change they could even be closer to Beijing than to Brussels.[51]

The Polish case will be discussed in more detail below.

Chinese business and economic diplomacy in practice

Economic potential and political attitude are inextricably linked in Chinese investments in CEE. This explains at least partially why Poland and the Czech Republic used to receive disproportionately low investments from the Middle Kingdom. Hungary, Romania and Bulgaria, on the other hand, tended to adopt extremely supportive attitudes towards China. Thus, **sensitive subjects were systematically avoided, and investments from China were higher**. This has all none the less changed following events in the last year.

China for the last few years has been trying to take advantage of the lack of a coherent EU policy, using a "charm offensive" in the CEE to try to circumvent EU rules. Somehow the strategy was based on "tying" these states to China and its interests. China was investing in car manufacturing in Bulgaria and Slovakia, and in building logistic and transit points for Chinese exports destined for Europe in the port of Tallinn. Hungary was conceived as European hub for the Chinese. In 2010, Bulgaria made an agreement with Zhejiang Province to establish a joint Bulgarian-Chinese industrial zone near Sofia. Furthermore, the PRC has been investing in wind and solar plants in Romania and Bulgaria, electronic device manufacturing in Poland, Hungary and the Czech Republic and in the agriculture and mining sectors in Romania.

Sometimes decisions might be made according to political interests of China. At other times, pure business dictates the logic. The large Chinese consortiums are all state owned, and they are headed by Chinese elites of power. For example, the Chinese company Chery interested in buying the Polish Automobile Factory (FSO) belongs to the municipal government of Wuhu in Anhui Province. The president of Liugong company, who has already signed a memorandum to take over Huta Stalowa Wola, is a high rank CPCh official and deputy to Chinese People's Representative Gathering (the Chinese Parliament). In addition, although the government is under the supervision of the State Council, there are many fractions within, often competing with each other.

Many contracts for Chinese consortiums are negotiated on a political level, and some countries are punished by the Chinese government if they don't "respect the rules" and "break taboo." For example after receiving Dalai Lama in 2008 in Poland, all the Chinese business delegations the following year was cancelled.[52] On the other hand, in 2010, the Hungarian Prime Minister refused to meet the Dalai Lama. As a form of reward, Chinese authorities pushed Chinese enterprises to invest in those three countries. Recently, President Hu Jintao directly encouraged Chinese enterprises to invest in Romania. Even though, China is only the 16th investor in Romania today, major projects in the field of energy and communication are currently planned.

This issue alone cannot explain the disproportional share of investments in Hungary. In fact, **unlike in other CEE countries, Chinese investors can count on a strong Chinese community in Hungary**. Most of them came to Hungary soon after visa procedures were abolished between the two countries in 1988. Today, there are a dozen of Chinese organizations all over the country which essentially serve as a communication link to the authorities in Beijing. This characteristic makes Hungary particularly attractive to Chinese investors. In fact, it permits Chinese companies to enter the EU market successfully and without much effort, cultural barriers being one of the major obstacles in overseas investments. The role of this Chinese Diaspora will be discussed in more detail below.

Currently, there is a clear shift among the five major China's FDI recipients in the CEE region. While the 10th Chinese five year plan referred to the goal of "actively and steadily going out," and the 11th to "going out further outwards," the current 12th plan calls for accelerating the implementation of "the strategy for going out." **Europe as a whole has witnessed a 102% increase in investment from China since the going out strategy began in 2010. 15% of Chinese companies that have gone out have chosen Europe as their destination. In CEE, the same phenomenon has been taken place.** One surprising turn of events was the spectacular failure of the COVEC project and its implications for Chinese foreign investments. The Chinese have been forced to rethink their own risks and adapt to a very different ball game.[53] To this we will turn below.

51 Financial Times, Jonathan Holslag, China builds a bridge across Danube
52 PISM bulletin (2011).
53 ECFR (2012)

The Covec case study – a short story of miscommunication

China's policy towards CEE has started to change in the last year or two. This could be best illustrated by the case of the investment in Poland by the Chinese company COVEC (Chinese Overseas Engineering Company 中海外). In the autumn of 2009, COVEC won the tender for construction of two short parts of the A2 highway. The subsequent fiasco of Covec demonstrated to the Chinese which traps to avoid in the future to prevent possible failures, either in any CEE country, or even in the EU as a whole. The failure of COVEC eventually resulted in many surprising and unexpected results. This included the most surprising one – Covec's running away from the construction site in June 2011, followed by the signing of the strategic partnership with Poland in December.

Covec was the first Chinese company that won a tender for constructing a highway in the EU. If we look at the official website, there are 22 offices all over the world including one in Europe in Warsaw. This office can still be found on the official Covec website, although Covec suspended its activities in Poland. To add to the confusion, looking at the list of Covec offices, one is sure of the lack of transparency in the firm's activities. The 22 offices worldwide include laboratories and textiles companies, technical teams in West Africa, and managers with hotmail email addresses on the official website.[54]

China acting in the long time perspective selected Poland as its future strategic partner. We might assume that this was caused by the hope of Chinese government to receive access to the Polish market and public procurement market. Chinese business probably believed that after Africa, and the Middle East they would enter the EU infrastructure market. The Polish Minister of Internal Affairs Grzegorz Schetyna and the Minister of Sports and Tourism Miroslaw Drzewiecki who visited China on the occasion of closing ceremony of Beijng Olympics to encourage Chinese companies to participate in public procurements, believed that Chinese companies, which did so well at home, might do the same in Poland, possibly by importing Chinese labor force.

Few weeks later, in October 2008, during the Asia Europe Summit in Beijing, the Polish PM was one of the five European PM's received by the highest Chinese authorities.[55] However, prior to this Covec lost the tender for the 2nd line of the Warsaw metro. Unaware of the PR issues, and the role of public opinion, the Chinese company decided to contest the decision and as a result, started to delay the construction.[56]

Then Covec took part in the next procurement for two sections of A2 highway offering the lowest price. According to anecdotal evidence, the Chinese wanted to enter the infrastructure market at any price. That is why they offered 50 % price provoking many allegations of unfair competition. **Offering a low price to win the customer and renegotiating the price afterwards is, however, very common business practice in China.**

Another controversy was probably the import of Chinese workers to Poland.

The drive for getting a large part of Polish and eventually EU procurement market is illustrated by the fact, that after the crash of the presidential plain in Smolensk, China appointed its Minister of Transportation to attend the funeral of presidential couple at the Royal Castle in Krakow, believing this to be a solid gesture of support.

Contrary to other Asian countries (like Mongolia, Japan, and Korea, who announced sending their PM, Chairman of Parliament, and Ministry of Foreign Affairs) the Chinese side showed that it is not very familiar with Polish culture, where dealing with business issues during the funeral is very unwelcome. Another example of miscommunication was the arrival of the biggest Chinese business delegation ever to Poland on Good Friday just before Easter, when usually it is not the best time for such an event.

Local competition

It turned out very quickly that Chinese were not prepared. They did not have their materials, suppliers, and labor force. They were also unable to establish their own network, as the local subcontractors decided to take an advantage of a new company coming to town, and started to offer higher prices than before. The prices of materials rose, and the original calculations proved unrealistic. In the last four months of the construction, local workers were replaced by some 400 workers from China. However, this did not make much difference to the budget.

Another issue, very unfavorable for the Chinese side, were the local big players of the public procurement market in Poland. The local companies decided to appeal in Brussels, claiming that Covec, which was a state owned company, was heavily subsidised by the Chinese state-owned banks. Local Polish companies accused Covec of predatory price under--cutting to eliminate competition and take over massive market share for the future. To confirm this, Germany's Committee on Eastern European Economic Relations, an industry body, alleged that state-owned Chinese companies were securing contracts in the region "via price-dumping, aggressive financing and generous risk guarantees."

Local competitors were very active in the media, drawing the image of completely unprofessional Chinese, and playing into anti-Chinese resentment.

Covec was unable to defend itself, partly – as some insiders maintain – because of the respect to authority which is deeply rooted in Chinese culture, and definitely because of unawareness of the role of public opinion, and local customs. They refused to talk to the media. Among some internet polls conducted in June 2011, 81% of responders found that breaking the contract with Covec by the Polish Governmental Agency was the right decision.

54 http://en.covec.com/newEbiz1/EbizPortalFG/portal/html/worldwide.html?GeneralContentShow_DocID=c373e91b02eb298a8feae22afd4edca4
55 http://www.fmprc.gov.cn/eng/xwfw/s2510/t518418.htm
56 http://www.money.pl/archiwum/wiadomosci_agencyjne/pap/artykul/chinskie;konsorcjum;zaskarzylo;decyzje;w;sprawie;ii;linii;metra,15,0,497423.html

Covec was supposed to be a part of a political deal. That is why there was the expectation on the Chinese side that the Polish government would at least assist in the construction, after encouraging the Chinese company to come to Poland. As one of the Chinese managers said: "I have had the dinner with deputy Minister of Infrastructure, our relations are very good, so we shall have no problems with subcontractors."

Renegotiating the contract or budget by the local government often happens in Africa. This did not happen in CEE. The deputy director of the General Directorate for National Roads and Motorways, Andrzej Majewski, said: "one has to finish the contract which was agreed, for the price that was agreed, with the conditions that have been described."

In February 2011, Liu Zhi Jun 刘志军 of the Chinese Ministry of Railway was dismissed due to the high speed train scandal in China and corruption allegations. Covec, as a part of China Railway Group, during its first ever EU infrastructure project, was affected very much by this earthquake at the top of Chinese leadership power struggles in Beijing. Much of the managerial staff was replaced by younger staff. Some of the newcomers were sent for the first time abroad, and had never before worked on construction. At the time of the project's closing in May, Covec faced a potential US$ 394 million in losses from surging costs.

Finally, there is growing dissent about the going out policy in China itself. Public opinion alleges Chinese companies are "overseas adventures" at the cost of taxpayers. Covec faced harsh criticism in the Chinese media. Caixing Business Magazine, published a cover story with a Chinese engineer with the yellow helmet, and black velvet on his eyes with an inscription: "How not to Invest Abroad – Ugly Highway Crash for Chinese Firm in Poland."

Soon after suspending the project, and this publication, president of Covec Fang Yuanming was dismissed officially due to "the ignorance of the European market, conflicts within the consortium and other examples of mismanagement that led to the company having to cancel the contract." In May, China's State-owned Assets Supervision and Administration Commission started to probe the Polish highway deal.

Dealing with Chinese companies like Covec, where the politics and business are combined, leads to phenomenon of so called "double sword." Depending on situation, the Chinese side might claim "it is political issue" or "it is just business issue."

Although the Chinese government maintained that the collapse of Covec was a "business issue," the reaction was immediate. Soon after, we could observe quick moves on the chessboard. In June 2011, a strategic partnership with Ukraine was signed, and the visit to Hungary was sped up (at the beginning of Wen Jiabao European tour, although originally it was planned in the end). In Hungary another 12 business agreements were signed including establishing the main headquarter for CEE of the Chinese tycoon Huawei and another business deal for Covec, rebuilding the Budapest Airport.

Than the investment in steel mill Huta Stalowa Wola was postponed, officially due to the unrealistic expectations of the local trade unions. Eventually this was signed during the visit of Polish President Bronislaw Komorowski to Beijing in December.

All these moves seemed to be well-coordinated and put pressure on Poland, being a good example of emperors "divide and rule" principle of playing CEE countries off against each other.
To everyone surprise in July, the ambassadors of two countries announced that both sides made mistakes, and it was "episode" and both countries are focused on developing the cooperation. Since that time, the issue was not discussed.

But there is still the sensitive issue of compensation (741 mln PLN) for breaching the contract that was not paid by Covec. Also Bank of China which is about to set up its Polish branch soon and guaranteed for the contract did not pay the guaranteed 130 mln PLN (only Deutsche Bank paid what it guaranteed – 13 mln PLN). What's more, COVEC sued along with Bank of China and the Export Import Bank of China, the Polish authorities in court in China. Also Polish side hired Chinese lawyers, and got involved in judicial proceeding held in China.

Loosely written contracts could be to blame. Evidence in other countries where China had invested, such as Saudi Arabia, demonstrates that **if strong and high quality institutions exist, the Chinese side will respect them. China abides by a well written rule of law. If the institutions are weak, however, the Chinese will take an advantage of the loopholes.** This is also a good example of situational ethics.

Saudi Arabia, an oil exporter is a country too important for China to ignore. Poland or even CEE probably are less so as they have little natural resources or high technology. **This means that CEE cannot play the same game as Saudi Arabia, deporting Chinese workers or adding new functions to the contract on the cost of Chinese side. However, CEE can secure its own interests and terms through well-written contracts and the EU institutional and regulatory framework.**

Challenges to the Chinese “Going Out” strategy

According to China Analysis[57] and the Chinese weekly Xin Shiji, the **failure of the COVEC project has openly revealed to the Chinese their own vulnerabilities in investing in developed economies. In this case, when the Chinese took part in the tender, China did not treat Poland as an emerging market, but rather as an integral part of the EU**. Poland's adoption of the EU legal and institutional framework has meant that in view of the Chinese, the failed experiment of COVEC can be tantamount to other potential Chinese disasters in investment in Europe more broadly.[58]

Chinese strategy of relying on policies that have worked in emerging markets is failing in Europe. The inability of the Chinese managers to understand the rules of operation in local markets caused Covec to lose control over its budget and cash flow. According to the Xin Shiji investigation, Covec failed to analyse the market properly which led to an inadequate costs assessment and insufficient understanding of the legal, economic and political situation in Poland. Its 1.3Bnzl price offer won in the public tender was less than half the amount allocated in the Polish government budget.

Noticeably, the fundamental mistake of the Chinese made might have been the confusion between business and politics characteristic in the way Chinese enterprises behave abroad. The themes of this paper seems to confirm this analysis. The tension between different cultural perspectives on building business partnerships seems to lead to business failures. The Chinese side thought it would receive political support from the Polish government it had come to an agreement with. Covec underestimated the difficulty it would have with EU regulation. This includes social policy and the costs of hiring foreign workers in Poland. In addition to labour law, there were environmental law concerns. For two weeks in late autumn, work had to be halted on building the highway while seven rare species of frogs, toads, and newts were moved out of the path; an obligation to create tunnels for the passage of wildlife was included in the terms of the contract! Legal issues were thus underestimated by the Chinese, while it expected political support from the Polish government to come to its side when costs began to sky-rocket.

No such thing happened. Poland being under EU law is under EU competition policy regulation, and the government could not favour the Chinese company even if there was a privileged political relationship involved. The sensitivity of the case shows how the Chinese misunderstood how business functions in the EU.

The anecdotal evidence found by Xin Shiji shows that Covec only partially translated the original Polish contract, leaving itself open to any legal risk. On the other side, the Polish had to abide by EU anti-competitive practices or face charges of corruption themselves. In the end, the Chinese did not blame the Polish, rather insisting that neither side won. In this case both sides lost.

The firm eventually withdrew from the contract disheartened by the fact that the Polish government did not come to its rescue. In addition Covec is paying a 390$mn compensation fee.[59] Risk management was clearly miscalculated from the Chinese side, and this has led to a reassessment of all of China's outward investment.

Role of the Chinese Diaspora

On the other side of big investments which focus public opinion, are small and medium enterprises, often a part of the shadow economy of a country. In CEE, in addition to high level of political visits and Chinese big business, there is another important factor that plays crucial role in CEE-Chinese relations. This is the Chinese Diaspora, in another words, the overseas Chinese community.

In Poland, this is represented by small firms located in Jaworzno and Wolka Kosowska. These firms offer mainly retail products for sale to other Chinese shops. Functioning on the economies of scale motto and whole-sale, the amounts sold are, according to anecdotal evidence, too large for Polish buyers to acquire. Containers of clothes imported from China, for example, could run up to 200,000 Euro. In Wolka Kosowska and Jaworzno,[60] the Chinese Foreign Investment Corporation invests for the Chinese state. **The interest is in Chinese developers opening up offices for other Chinese in Poland. Local administration and management are then recruited from the Chinese Diaspora.**

This Chinese community in Poland moved from two provinces in China about 15 years ago, and is mainly made up of emigrants with low skills. Often, these families have only come to Poland once opportunities in other places ran out, such as Chinese immigrants from Italy or Hungary. They are pragmatic and run by entire families. Goods bought from China include textiles, toys, shoes, and other low tech stuff. This is a closed community where business interest and pragmatism prevail over any geopolitical interest of the Chinese state. Local business owner claim that this Chinese Diaspora live, eat and breathe the Chinese way of life, unhindered by issues of cultural assimilation or understanding. Often, these small firms are not even legally registered in Poland, but act through joint ventures with others that are.

57 Xin Shiji, China Analysis, Ni Weifang, Gu Yongqiang and Yao Weiter, “How to wreck an industrial project abroad,” New Century, 25 July 2011
58 According to the ECFR (2012)
59 Judicial proceedings and the payment are still a matter of controversy
60 The author conducted interviews with local Chinese business in Jaworzno and Wolka Kosowska

It is clear that these small scale Chinese businesses prefer to work with other Chinese only. Questions of trust towards the local population and culture remain an important obstacle to pursuing partnerships with Polish firms. While they lack formal experience in working in European culture, they continue to rely on vast Chinese networks, from China to the rest of Europe and globally. Quite a few of these businesses end up successful, spreading the word to other Chinese and growing Chinese business from the bottom up.

The firms remain driven by business and profit incentives. Their motives for investment are mostly pragmatic. Currency stability might be important for example for the traders of Chinese goods.

While the Polish market might not be as important for the Chinese as the German one, new market opportunities lure the Chinese deeper and deeper into CEE.

For the Diaspora, understanding European regulation is the main obstacle to expanding their activities. For example, the act of opening sole proprietorships and the bureaucracy involved in functioning as legal and registered enterprises in Europe is an overwhelming barrier. These Chinese are afraid of local courts, administrations and the police. Other issues include visa rejection and other immigration local residency dilemmas. Questions of the "greyness" of these economic activities remain.

On the bigger side, there are political issues, lack of communication and cultural understanding between the Diaspora and the local communities. The largest Chinese community lives in Hungary. It is hard to estimate the exact number, however according to official sources, the number of Hungarian Chinese is similar to official numbers of Polish Vietnamese – that is approximately 30,000. Both Asian nations started to come to CEE during the socialist era and eventually settled down. The Chinese have made Hungary the hub for Chinese goods, spreading all over CEE.

In countries like Lithuania and Latvia, these small family businesses are the only existent Chinese activities, as it is hard to find the evidences of any medium, or big size companies involved. In 2009, according to the Lithuanian Department of Statistics, there were only 34 Chinese investors in Lithuania, in most of the cases Chinese family businesses.

Moreover, the role of Chinese from Austria in CEE is important and significant issues for which we have little official data. Most probably, so-called Austrian-Chinese in CEE have more capital and resources to invest in other countries, which is why they have subsequently moved to other places in the region.

Upon arriving in countries like Poland or Hungary, Austrian-Chinese often avoid registration and work through their networks, based on personal relations.

We know very little about the Diaspora phenomenon as a whole, as it is non-transparent. There is little research on the subject. The Chinese (as well as Vietnamese) who work in CEE are very closed communities, keeping to themselves and rarely publically discussing their work.[61]

What we know from informal discussion is that many Chinese have in fact moved from Austria, the Czech Republic, Hungary and Slovakia to Poland after 2008, but it is hard to estimate as they tend to move within Schengen countries. As everywhere in the world, the Chinese community integrates very slowly with the locals. There is also no reward for integration with local population. It is very unlikely that Chinese speaking Polish would be hired by local company. Certainly there is local staff working for the Chinese, but there is little cooperation with local small business as Chinese tend to trust each other not the foreigners. Moreover, they do not really care about the local country or their residency as long as they can make a profit.[62]

To conclude, we would argue that **there is a reward from integrating the Chinese community with CEE cultures.** This is very much the same as with the Vietnamese in Poland, who speak the language, and having grown up here, can achieve more in running the businesses of their parents and of others. Integrating the local Chinese population would help to build a bridge between China and CEE. However, this is not easy. In Hungary in 2004, for example, many Sino-Hungarian schools were established. Never the less, Chinese parents prefer to send their Children to English speaking schools.[63]

61 http://www.presseurop.eu/en/content/article/243221-chinese-keep-themselves-budapest
62 This might sound harsh, however, it is the wording of local Chinese themselves
63 Interviews with Chinese, Jaworzno, Wolka Kosowska

China is not entering Europe in one big jump. Instead its long term strategy is to do so carefully and gradually.

Simultaneously, however, its short term vision tends to be reactive, as we have examined above in the context of the Polish Covec case. This new Going Out Strategy will be fully implemented by the next generation of Chinese leaders, under the auspices of the China 2030 plan: Building a modern, harmonious and creative high income society.[64]

So far, the Chinese state and leadership seem to choose to go to countries in CEE where there is either strategic long term interest, or where economic assistance is needed in the face of the global and European economic crisis. On the other side is the Chinese Diaspora in CEE, running small and medium Chinese firms and motivated by pragmatic business interests. We have examined these two phenomena above.

How can CEE benefit from this recent surge in investment coming from China? Sectors and regions most likely be at the forefront of investment opportunities display wide diversity. CEE must work at increasing its competitiveness and developing a comparative advantage vis a vis the Chinese. The key to future expansion of trade and investment flows lies in changing the approach to economic diplomacy, re-focusing on the role of multi-cultural management and strengthening private partnerships.

What will be the future challenges that China and CEE face in their on-going relationship building? Current events such as the Eurozone crisis have deeply impacted CEE/ Chinese relations. We can extrapolate probable future scenarios based on some assumptions. The role of the EU as a whole will remain important; however, forum shopping and building relationships and cooperation through regional, bilateral and multilateral levels will be a priority. The same can be said for building inter-personal networks and business joint ventures. CEE as a region will need to strengthen its alliances to work together on the international stage.
No doubt, with the state of world affairs in crisis, CEE can benefit from its lessons of transition to adapt to a rapidly changing world and new opportunities coming with the rise of China.

[64] World Bank Report (2012)

Summary in FDI trends between China and CEE

FDI and trade flows are the two main indicators of the state of economic relations between partners. Foreign direct investment is made up of inward and outward investment. In the case of CEE-Chinese relations, one could argue that the geographical distance coupled with cultural obstacles initially led to low trade and FDI intensity. In fact, CEE and China were seen as competing against each other for inward FDI against third party investments. Both regions, vibrant and growing economies, yet still emerging markets, were seen rivals in the global race for FDI.

According to various studies[65] however, China and CEE are not competing for FDI. Instead, trends show that **inward FDI stock into China and CEE is complimentary. This is in fact interesting as in the global production chain, these two emerging regions, CEE and China should in fact work with each other to both gain in a win-win scenario.**

However, when looking at relations between China and CEE, the story is different. China invests into CEE, with insignificant amounts going the other direction. This obvious asymmetry results from the fact that China has the capital, while CEE is still in its catch up phase and as such has scarce capital. Alternatively, CEE firms that do possess the capital to invest in China are either unaware of the opportunities or afraid of the unknown. The fact is that for the last 20 years CEE have only begun investing in markets abroad. Most of this investment has gone to the EU. Where firms have learned to be competitive on European markets, they have not yet had the chance to learn this on Asian markets. Investors have been unable to communicate with each other directly.

What motives do CEE firms have in investing in China? Are they meeting too many obstacles? Are the cultural, political and economic barriers too high? Perhaps, no one has yet answered the question of comparative advantage. What can CEE offer China in return for its opportunities? We will return to this below, after initially discussing Chinese investment in Europe.

Chinese outward investment into CEE

Despite their strong increase, Chinese investments in Central and Eastern Europe are still limited by number of obstacles. These limitations mainly originate from the lack of experience of Chinese investors, the complex institutional framework prevailing within the EU and the low intensity of trade between the two regions. As a result, Chinese investments success rate in Europe is extremely low. With only 53%, it is lower than in Latin America, Africa, and North America! According to H. Ebbers and J. Zhang,[66] the success of foreign investments is influenced by 4 main factors including the institutional framework of the host country, the intensity of trade, the experience and use of advisors and, in the case of China, the ownership of the investor (private vs. state-owned companies).

[65] Nicolas and Thomsen (2008), World Bank
[66] Dr. H. Ebbers and J. Zhang (2000), "The development of the Chinese- EU trade relation," CEA-UK Annual Conference, 17-4-2000

The special **EU institutional framework including supranational institutions as well as national ones makes the European market more difficult to enter for Chinese investors. In fact, inward investments policies are still not harmonized within the EU. The Chinese investors which put a great importance on personal relations and networks (Guanxi) have immense difficulties to find out to whom they should speak to. This gives the traditional Chinese partners in the CEE region and especially Hungary (hosting the main Chinese community of the CEE area) an important advantage and tends to disadvantage the others.**

Chinese firms are less experienced in Europe than in other regions. This lack is partially compensated by an important use of advisors and consultants (0.167/1 in Europe vs. 0.1269/1 in North America). However, this does not seem to be sufficient to counterbalance the complicated institutional EU framework combined with the low familiarity with the European market.

Chinese state-owned enterprises are less successful in CEE than private ones. This is probably due to the slow and rigid structure of the state--owned enterprises. However, private SME's run by the Chinese Diaspora are a separate case in point. Their pragmatic approach to business and small scale activities makes them relatively successful in CEE.

The principal obstacles limiting Chinese investments in the EU and CEE in turn are all intimately interrelated. Thus, one may reasonably expect the slow erosion of these obstacles by the simple combination of increasing investment intensity, while developing experience. This could be highly accelerated and strengthen by the creation of clear long-term strategies towards Chinese investments within the EU and the CEE region.

Inward investment into China

If we turn towards opportunities for investment into China, the story is somewhat mixed. EU and CEE firms still face important obstacles to investing on the Chinese market. The corporate strategy of large Chinese companies presents a problem for European investors. State--owned Enterprises receive massive state aid and subsidies, often at odds with WTO rules. Direct and hidden subsidies include true costs of land use and massive under-pricing of natural resources. Many so called private companies are still owned by the state. Frequent questions arise about the lack of transparency and opaque corporate structure of these firms, such as who is behind the financing for small companies that bid for European firms.[67]

One has to consider **Europe's limited market access in China. China's capital market remains largely closed in sectors that the government deems important for its economic development.** This exclusion of strategic sectors is permissible under the terms of China's 2001 accession to the WTO.

Barriers to foreign capital have increased with the passing of legislation favouring domestic innovation. These sectors range from air transport to banking to alternative energy, with a 20% limit on foreign stakes. The Chinese state rejects bids from foreign companies even when it allows them to apply. In direct investments as well as in public procurement, European companies are excluded from equivalent markets in China.

China has not yet joined the WTO's Agreement on General Procurement, agitating its European investors further. On the other hand, Europe's public procurement market is open.

Cash-strapped countries in Europe's periphery are especially eager to use Chinese financing to upgrade roads, railroads, and public buildings. This is visible in high level Chinese delegations asking for shopping lists of infrastructure projects on which their companies can bid.

Contentious intentions and perceptions

Examining both the Chinese strategy towards inward investment characterised by market obstacles and the outward investment going out strategy could lead one to think China is an aggressive buyer of European assets while protecting its own market. Hence, China could be seen as a global threat. Is this just a misguided perception? Strategic acquisitions of well-known European companies have led to an image of China as an expansionist global player, highly selective in allowing firms to compete on its own territory on level playing fields.

The threat seems to be highly exaggerated. In reality, besides the limited magnitude of Chinese ODI, the other reason for downplaying the alleged threat pertains to the low success rate of Chinese M&As so far. Moreover, China is not seeking to buy up European firms, acquisitions may be an important form of investment, but again they are marginal, and more often they target European firms under financial stress.

Chinese ODI is still very much at the trial and error stage. Targeted firms are not necessarily well-selected or Chinese firms are not in a position to handle the difficulties associated with cultural differences as well as with the challenge of turning them around as we will see below. Moreover, EU firms should probably prepare for competitive pressure from Chinese investors, but they should also take the opportunity to discharge underperforming assets.[68]

From a theoretical perspective, Chinese ODI does not reflect a new ODI paradigm. Although motives are varied, it has much in common with other Asian investors which have preceded it: Japanese and Korean FDI were also strategic asset seeking, R&D listening posts and tariff jumping. The difference probably lies in the weighting of the different motives but not in their range.

[67] ECFR (2011)
[68] The McKinsey Quarterly, Reassessing China's SOE's, Jonathan Woetzel (2008)

An important difference between Chinese ODI and Japanese or Korean ODI is that the home country (China) still has a strong comparative advantage in basic manufacturing. It remains to be seen whether it will accelerate the structural transformation of the world economy already under way through trade.

From China's perspective, a number of questions remain unanswered. While Chinese ODI is expected to help upgrade some of China's industries, for the time being, the persistence of China's comparative advantage in basic manufacturing and the reinforcement of the traditional division of labour with R&D centres in the EU and manufacturing facilities in China do not point in this direction. In addition, there may be a risk of compromising continued economic growth by deflecting capital away from more efficient private sector ventures. However, all of this is in flux and changing rapidly.

Chinese ODI is as much a sign of weakness as of strength. In this respect it differs in one important way from earlier waves by US or Japanese MNEs.

Chinese firms have still not developed adequate technological strengths to compete by themselves on western markets. One half of Chinese manufacturing exports are by foreign-owned firms in China, or over 80 percent of exports of technologically sophisticated goods.

In a sense, ODI is a manifestation of the limitations of export-led development when, as other countries such as Malaysia have discovered, export-oriented FDI does not always result in the transfer of significant amounts of technology to local firms. The acquisition of existing brands may provide a short cut to competitiveness in some cases but it may also turn out to be a dead end.[69]

Of course, the past is not necessarily a good guide to the future. Underperforming Chinese ventures in Europe could be expected to turn around given appropriate responses from Chinese firms and the state. In addition, joint ventures could be established with European and CEE firms to increase the likelihood of success or limit the probability and risk of failure.

[69] World Bank, Asia and Central Europe, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/0,,menuPK:258604~pagePK:158889~piPK:146815~theSitePK:258599,00.html

Assessing the lessons of Covec and meeting the challenges of the future

China claims that its primary interest is pragmatic. Secondly, it wants to improve its image, as the stabilizer of global economy and not a fee rider in the international system. Third of all, China needs to diversify its capital surplus. However, the unavoidable consequence of Chinese companies' business activities and China's state-owned conglomerates is none the less shifting and transforming the global economic scene. As China maintains, it is going through a “peaceful development” path, slowly and in an unspectacular fashion. Chinese leadership tries to calm down global public opinion by declaring that this process is not political, not expansionist, but simply pragmatic and driven by economic interests. China proclaims that it's going out strategy is a win-win scenario.

As mentioned above, China's perceived intentions are a matter of contentious debate. However, the Covec case is again illustrative of the link between business and politics in Chinese strategy. To begin with, CEE seems to be one of the last regions of interest to the Chinese. It is far beyond Asia, Africa, and Latin America, North America or even Western Europe. However, the Chinese have now arrived in CEE. Is this a coincidence?

Additionally, there is the issue of competition between the CEE countries. This could be observed in the efforts of the Czech Republic under V. Klaus since 2004 and in Hungary under Victor Orban. In CEE, Hungary accumulates half of investments from China, but December last year China signed a Strategic Partnership with Poland during the visit of president Komorowski in Beijing. Is this act of declaration of strategic partnership meaningless for the Chinese? Or does it serve to demonstrate how China has its own vision of who can be considered a partner, or whom the Chinese envision as playing the most important role in its future architecture?

Poland, in contrast to the Czech Republic and Hungary, was not very active in attracting Chinese investment. However, if we analyze the Chinese proposals and projects that were announced after signing of the Strategic Partnership with Poland, we might assume that China had prepared for this. It now remains to be seen if Poland will indeed experience the Chinese boom in investment, probably replacing Hungary as the regional leader.

Poland abandoned its pro-HR politics in the rhetoric presented to the Chinese in 2011. The Polish leadership demonstrated a very pro-business and pragmatic approach to China. KGHM signed a long term agreement for selling copper cathodes between 2012-2016, at an estimated value of the contract 1.8-3.6 bln USD. President Komorowski also signed the memorandum for selling Steel Mill HSW, which would become the largest Chinese investment in Poland. This followed a long and protracted 2 year period of negotiations. The role of President Komorowski was crucial in sealing the deal. Finally, HSW became Liugong Machinery Poland on February 1st, 2012.

Secondly, upon the visit to China, the Polish President encouraged Chinese companies to invest in Poland, the Polish stock market and Polish bonds. That is why during the visit the opening up of the Polish branch of Industrial Commercial Bank of China which specializes in financial investments was officially announced.

It became very clear that China is building the infrastructure for developing a true strategic partnership with Poland. Examples range from establishing a new direct flight from Warsaw to Beijing (operated by LOT) to the Chinese CCTV 4 (broadcasting in Chinese) opening its branch in Poland. Another case is the opening up of a branch of the Bank of China. Previously, the Bank of China did not pay its guaranteed insurance for the withdrawal of Covec from the construction site. From unofficial sources we know that although everything is already prepared, this issue is still a matter of controversy, and might delay the operation of Bank of China is scheduled to start in April 2012.

Another interesting message was sent to the Polish partner, when the documentary about the visit of Zhou En Lai saving Poland from the Russian intervention in 1956 was removed from Polish pavilion at the Chinese EXPO. The signal sent could be read that if you want to do business with China, remember that while political goals are indeed a part of business, they are by no means the trump cards to be used against the Chinese partner. The asymmetry in this case of strategizing is obvious.

Finally, in the Special Strategic Partnership declaration, Poland agreed that it would support China on EU level, on lifting the arms embargo and supporting the status of free market economy for the Chinese.

Clearly, for the Chinese, political interest and long-term economic strategizing overcame any short-term interest associated with the fiasco of Covec or the lack of Polish business links with China.

China's five principles

Time perspective matters especially in Chinese situational ethics. It refers to priorities changing due to the situation, a very common trait in Asian cultures. China still tends to promote Zhou Enlai's theory of 5 principles.[70]

When meeting an Indian government delegation at the end of 1953, Premier Zhou Enlai for the first time put forward the five principles of mutual respect for sovereignty and territorial integrity, mutual non--aggression, mutual non-interference in each other's internal affairs, equality and mutual benefit and peaceful coexistence. He visited India and Burma the following year, and in the respective joint statements issued, Premier Zhou and his Indian and Burmese counterparts called for adopting the Five Principles of Peaceful Coexistence as the norms governing international relations. That is why China always supports the ruling party, elites and even dictators. China would never meet any representative of the opposition party, like British PM James Cameron who received Jaroslaw Kaczynski in 2010.

As China gets more and more powerful, it is almost obvious that in the long term it will abandon this policy of five principles, turning to new strategies. In the Chinese tradition there are no equal partners, as they are no equal people in vertical Confucianist society. Partnerships with China could be argued to be good in the short-term, but dangerous in the long-term, unless one understands this. Mental maps and perceptions of reality are different for the Chinese than for the Europeans. Analysing China's recount of its own history demonstrates this quite clearly.

That is why one should be very careful in using western terms and words, or at least in their western meaning, when referring to China. If in XXI century we could live in Pax Sinica World, all these terms will be redefined. As Deng Xiaoping once advised in his 24 Character Strategy, <u>Observe calmly; secure our position; cope with affairs calmly; hide our capacities and bide our time; be good at maintaining a low profile; and never claim leadership</u>. China is slowly building a new architecture in the globe. As this is a dynamic process, the question of time perspective is crucial to describe it.

[70] http://www.fmprc.gov.cn/eng/ziliao/3602/3604/t18016.htm

Soft power, public diplomacy and Going Out

The perception of China by its partners, Chinese intentions, its motives are all contentious issues, and global public opinion does not seem swayed by the arguments of peaceful development and innocence. Nowhere is this more obvious than in the rise of economic nationalism in Europe and the US against Chinese firms. China has to take a look at its soft power and public diplomacy campaigns. Both economic and political motivations of Chinese companies should be taken into account on a balanced assessment. The typical Chinese "absentee landlord" syndrome discussed in above interviews and analysed in several papers, has to given way to a more active approach. Chinese firms investing in CEE need to better understand the legal and social environment of the local market place.

Perhaps, the wisest decision would be to form more joint ventures with trusted CEE firms.

Chinese cannot rely on networks of Chinese alone.

Mergers and acquisitions (the current majority of foreign investment) can only be successful for the Chinese if local conditions are understood. In the non-financial sector which still accounts for more than 75% of China's foreign investment, mergers and acquisitions are favoured. In the financial sector, financial participation and the opening up of branch offices tend to be two other often used strategies. However, Chinese companies do not have the necessary management skills to manage overseas subsidiaries effectively.

Challenges facing Chinese firms abroad are plentiful. We can witness this today in places even like Sudan. **Strategies used in the previous phase of going out mainly to emerging economies in Southeast Asia, Africa and Latin America are proving unreliable in investing in developed economies. Chinese companies are used to working with countries that have legal systems, social networks and economic organizational models similar to their own.** However, this does not work in Europe, as we have seen with Covec.

Even Chinese writers claim that China must be aware of the link between cultural influence and soft power or reputation. A country's international image is as important when it comes to forging closer cooperation in trade and investment as its economic and military potential. This will be the crucial component in dealing with CEE, particularly as the knowledge and understand of China in CEE is lacking![71]

[71] Minxin Pei in interview, "Remembering Deng in our era of crony capitalism," for FT, Jan 23, 2012

Ultimately CEE and China are still considered as emerging markets and as such are witnessing what could be considered the prosperity paradox. In catch up phases, emerging markets grow at high levels. However, when this phenomenon slows down, and this has to happen, ultimately it is the role of institutions that guide countries from low income to middle and finally high-income levels. Poland has already reached this phase, moving from middle income emerging country status and towards high income developed economy. China is only beginning this journey.

It is not the role of this paper to provide policy prescriptions for the Chinese in their next phase of economic and political transition. Suffice it to say, China has many internal imbalances to address before it can be considered a normal developed economy. Investment fatigue is already being witnessed in China, as is the ever present question of soft versus hard landing of the economy. Ultimately it could be political crisis that will influence future economic developments. We leave this topic for future papers.

Another issue left for future research will be the role of the EU as a whole in supporting CEE with its inward and outward investment ventures with the Chinese. On the outward side, market access to the Chinese economy will remain a priority. On the side of inward investment, there is a clear need in Europe for vetting foreign investments such as is the case in the USA with the Committee on Foreign Investments. According to the ECFR,[72] Europe has neither the data nor regulation on this. Another regulatory black hole in Europe exists in the case of public debt purchases, where the lack of transparency of Chinese bailouts and financing presents a serious challenge.

The role of the state and economic diplomacy – importance for China

In prescribing policy scenarios for the development of better and closer relations between CEE and the Chinese, we will begin with the importance of economic diplomacy. The scope of the paper does not allow us to expand on various economic diplomacy tools. However we want to highlight that **building relations with the Chinese will be dependent on the use of state-led economic diplomacy tools such as trade and investment promotion in combination with building alliances through business relations and private partnerships.**

As we have seen above, the importance of high level relations for larger Chinese investments cannot be over-estimated. Chinese partners and the Chinese state seek out relations at the level of high political contact. Simultaneously though, the role of networks and personal relationships is just as important for smaller investments, through the Chinese community.

To reiterate, in CEE, two types of investments take place. One, through state-led investments such as Covec. The other through the Chinese Diaspora such as Wolka Kossowska. Both are important, and both require different approaches. None the less, both require building personal relationships based on trust and communication. Both are based on understanding the Chinese partner, their culture and their business ethics.

On the level of state-led economic diplomacy, CEE can use various forums for building closer relations with China. This includes bilateral relations, such as strategic partnerships negotiated and signed, or regional and multilateral levels, through international institutions, such as the WTO. The role of the European Union as an umbrella for CEE here is not to be underplayed.

CEE should have a clear and well-defined list of priorities in its position vis a vis China, which can be pursued at EU level.

The asymmetry in CEE-Chinese relations is evident. China has a large market and China has capital. CEE firms are usually not treated as equal partners. It is difficult to find CEE firms that possess the kind of knowledge and capital required to break into the Chinese market. As opposed to other EU or American firms, there are a few big players in CEE. Small entrepreneurs might be CEE biggest assets on this market, and small and medium enterprises posses evident possibilities. However, those firms that could potentially establish a presence in China market need the support of the state and foreign commercial services, which is most often lacking.

CEE potential comparative advantage in brief

What can CEE sell to the Chinese? What is our comparative advantage? **There is the old story passed around by Polish entrepreneurs of the so called "empty container." Polish firms buy goods from China and ship them home in containers to be sold on our markets. Apparently, as anecdotes go, if someone can invent what to send back in the containers arriving in CEE from China, they will make a fortune.** Containers usually return empty to China. We still have not found the products to sell to the Chinese, despite some increasing potential such as the case of Orka Airplanes recently sold by Marganski and Myslowski SA.[73]

To sell to China, **CEE must establish a presence there, setting up headquarters and local representatives, to actively promote their products.** The support of government and administration is crucial here, with a variety of economic diplomacy tools available for supporting CEE firms. China acts with a long-term perspective. CEE acts with short-term visions. Thus, it does not help that CEE governments and administration are often in flux. CEE foreign commercial services likewise function with too much of short-term opportunism, and not enough of a coherent long--term vision.

72 ECFR (2011)
73 Interview with Brokerage House; P. Malicki – private equity manager in Maganski and Myslowski

If we cover briefly, the kinds of products Chinese might be interested in, the list would include high-tech and value-added manufacturing. Know--how and technologically advanced goods as well as innovative products remain underdeveloped in CEE; as such opportunities would exist to develop this segment further.

Much has been written to suggest we should increase educational exchanges and university co-ventures with the Chinese. As in the case of technology, CEE has the capacity to educate Chinese students. Attempts are already being made to recruit Chinese to CEE universities. So far, unfortunately, this has taken place without much success. Evidence exists to confirm this.[74]

As the Chinese middle class grows, many segments will open as attractive for them in CEE. One of them could be healthcare and private provision of medical and dental services. Another could be the tourism industry, with cities like Prague, Budapest or Krakow certain to be of spectacular interest to the Chinese. This is already beginning to take place. Finally, luxury goods and products are another segment.

Alternative energy and cleaning pollution systems could provide another base for developing Chinese-CEE joint ventures based on manufacturing. Examples include water purification systems or solar power panels, two potentially interesting places to use Chinese capital and CEE local manufacturing as well as EU presence. For example, one could imagine selling solar panels made in the EU with preferential tariffs to the African Caribbean Pacific Countries. China could provide the capital for this.

Finally, the financial industry and capital markets remain a lucrative investment option. China is buying into capital markets worldwide. Exploring how Chinese capital could be used in the CEE banking and finance industry could provide further impetus to developing CEE capital markets and stock exchanges.

Local presence will be key for both Chinese firms in CEE and even more so for CEE firms heading to China. Understanding specific context-related cultural, social, political, institutional and economic needs should be a priority. Management must take account of this multi-cultural setting and develop techniques that build on this.

Marketing as well should focus on the local population, its specific preferences and tastes.

On the level of practical economic diplomacy, it is not uncommon to hear complaints from CEE entrepreneurs trading with the Chinese about their national foreign commercial services. According to anecdotal evidence, the Polish Foreign Commercial Service in China is not very helpful in either resolving legal issues of importance to Polish business, nor in promoting Polish business in China. Apparently, Polish firms operating in China feel that they have little if any support from the various Polish governmental agencies set up to help them. Perhaps this issue needs to be researched more thoroughly, and changes made accordingly.[75]

How CEE and China can work together – understanding different cultures

Can we as CEE form joint ventures with the Chinese to build solid partnerships in the global supply chain? This paper argues we not only can, but should. This kind of relationship will not be easy to cultivate, as partners tend to have vast cultural differences, but on the other hand, could make it easier for both Chinese and CEE to adjust to each other's different needs. Joint ventures if established could be the link to more successful Chinese investments in CEE as well as CEE attempts to export to China.

In addition, CEE and China should look beyond bilateral relations and into global economics. Logistics and production networks are becoming ever more integrated in global supply chains. China and CEE can together work to take advantage of the international market, complementing each other, rather than competing.

The Covec example shows the kind of hostility and obstruction that Chinese companies can face in CEE in their target markets. For these kind of lose-lose situations, the best policy prescription seems to work on understanding the potential partner.

China employs young and inexperienced agents to manage their investments in CEE countries. Currently, Chinese communicate through agents and consulting firms in CEE. Often these agents do not understand the local market or regulatory needs. As such, with the mistakes made by Covec, China has discovered the benefits of hiring local consulting companies to support them in the investments and to open doors.

Chinese favour face to face human connections and personal relationships. Their cultural preferences suggest they would rather do business with other Chinese, with certain levels of distrust towards their European partners. However, if this mental block can be overcome, the Chinese could do well with establishing personal relations with local firms and partners. There opportunity exists as such for CEE firms to market their offer to the Chinese, as potential and reliable partners.

[74] For more on this, author can cite cases at Vistula University or AGH both in Poland
[75] Interviews with entrepreneurs with established presence on Chinese market

Chinese business is pro-partnership while European is pro-transaction. Chinese establish relations before business; Europeans, business before personal relations. As such, understanding this difference could be crucial for strengthening cooperation. It is worth highlighting however, that with short-term CEE vision, people as well as policies change every few years, making it extremely difficult to establish long-term relations and partnerships based on trust with the Chinese.

In CEE and vice versa in China, knowledge of the other is still very poor. The Chinese are attempting to change this, setting up multiple think tanks and institutes to understand and their potential economic partners and rivals. In CEE this is still in its infancy.[76]

Perhaps the role of civil society groups and NGO's could be strengthened to promote these kinds of relations. Currently, NGO's are controlled by the government in China, and as such not very influential. This perhaps could be changing. Maybe, NGO's and civil society could build bridges between Chinese and CEE business and state apparatus, integrating from the bottom up.

Another issue is the media and its coverage.

In December 2011, the visit of Polish President to Beijing coupled with signing of the Strategic Partnership was number one news report story on Chinese TV. In Poland, the story did not even attract the attention of public opinion and media. The powerful presence of the media and its portrayal of the partners' images likewise cannot be over-stated. China is already aware of this, setting up English language news agencies in countries such as the USA. Worldwide, China is trying to use soft power and public diplomacy to change its image as the aggressive economic rival. On the other hand, questions still remain about CEE use of soft power and public diplomacy in practice. The dramatic shortage of knowledge in CEE about China presents itself at every level, from the media, to the state administration and finally to business.
This phenomenon, as a priority, should be addressed as soon as possible.

Decoupling of growth economies; new horizons and opportunities for Chinese and CEE joint partnerships

Decoupling of the world's new growth economies from recession in the West could result in a more dynamic landscape for the near and long-term future of the entire global economy. However, this scenario is not without risk. Asia is an important engine which will continue to driven global economic growth in the near- and medium-term future. CEE can benefit from this, providing it draws from the lessons of its own economic transformation. CEE has already had its crises, and has come out with top marks. **Now is the time to reap the benefits of flexibility and adaptability of CEE firms and governments.** Protectionism is not an option, neither is free for all acceptance of Chinese capital and low-cost providers of investment and public goods. Risks carry rewards. Rewards translate into responsibility.

In addition, CEE's growth potential could be hindered if the crisis in the Eurozone continues unabated. Lithuania, Latvia, Bulgaria and Hungary are particularly vulnerable, and lower risk Poland is also not immune. Risk has to be balanced with long-term strategic thinking on how best to diversify CEE market potential.

China as we have seen has its own internal problems, beginning with social unrest and leading to environmental degradation and political conflict. China cannot afford to lose global demand for its products and capital. China is also left with no choice but to diversify its own economic portfolio. China has reached a turning point in its development path, and its current growth model is unsustainable.

A recent World Bank report has warned that:
After three decades of averaging 10 percent annual growth, China is the world's second-largest economy and the largest exporter of goods but there is growing evidence that its export-dependent, investment-led growth model is running out of steam. Additionally, even if Beijing implements steady reforms and avoids any major shocks to the economy, annual growth will decline to 5.9 percent by 2021 and to just 5 percent by 2026.[77]

China is facing a leadership in transition and an economy undergoing massive transformation. This is not unlike CEE at the beginning of the 1990's.

The question as such remains is how these growth economies can benefit from further economic integration with each other? A good example of this can be the privatisation process of state enterprises. CEE has been undergoing this difficult course of action for two decades now.
Can China learn from these hard-won lessons?

What about the integration of capital markets and financial systems with the world economy? Is the European model adequate for Chinese reforms, or will China redefine the role of capital markets in its own unique way? Despite obvious difference in both models of development, this paper concludes that a unique synergy could be built between CEE and Chinese partners. Shared experiences undergoing reform from socialism to capitalism could translate into shared future aspirations.

76 PISM Bulletin, China's Policy towards Central and Eastern Europe, Justyna Szczudlik, (May, 2011); Polish Institute of International Affairs, Raport, Perspektywy rozwoju współpracy gospodarczej Polski z Chińską Republiką Ludową, http://www.pism.pl/files/?id_plik=9753 (2012); ThinkTank Dossier, Polska-Chiny, http://mttp.pl/pobieranie/chiny.pdf (2012)
77 World Bank, China 2030: Building a modern, harmonious and creative high-income society (2012)

Democracy as such will remain a contentious issues, however, greater political participation by China's citizens is already on the rise.

Increasing power of middle classes is common to both CEE and to China. Can these middle classes become the engines of growth and cooperation between the Chinese and the CEE?

Much work needs to be done to achieve closer cooperation between CEE and the Chinese. However, the basis for this has already been laid down. It is time to perhaps develop these seeds of cooperation into something more concrete and long-term. Strategic partnerships will be built through both business and government. Culture will play a significant role in this, especially multi-cultural management within the business setting itself.

Finally, Europe needs to play a more active and unified role as a whole in developing partnerships with China and policy towards the Chinese. New fault lines have emerged within Europe. The fragmentation between frustrated market openers on the one hand, and cash-strapped deal seekers on the other is growing according to the ECFR,[78] market openers aspire to push the Chinese to liberalise its own domestic market. Deal seekers, to bring Chinese money home where their own debt burdens have become unsustainable and others are no longer willing to lend them the capital necessary. The unity in EU negotiations with China is not there. Neither is there a coherent strategy of seeking reciprocity in EU-Chinese relations.

Accordingly, the **demonstration of political unity at the EU level could be a useful bargaining tool with the Chinese**. Enlarging the regulatory and bargaining capacity of the single market is another. Europe should seek a balanced model for cooperation and economic exchange with China, and attempt to address its own issues of competitiveness in this global rivalry. Business will take the lead, however business needs clarity in the policy arena. CEE should push for an EU wide system for government debt purchases, which is transparent and open. CEE should lobby for a system of vetting investments in Europe, much like the one already in existence in the United States.

Markets tend to balance over time, and financial crises are an inevitable part of this re-balancing. The stability of the global economic system itself is in question. What remains to be seen is how risks are calculated and how opportunities are expanded in this time of transformation.

[78] ECFR (2011)

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