Political Risk, Foreign Direct Investment and the China Mining Sector

Written by: Julian Campisi, Phd

Risk identification and management are powerful tools and a business that generates billions of dollars annually. Traditionally, ‘spheres’ of risk have centered on the fields of security, safety and crisis/disaster-relief, and property and finance. In short, the fields in which insurance underwriters can do their work. Yet in a complex and changing world, otherwise characterized by Beck and Giddens as a ‘risk society’, micro/macro socio-political, economic, and budgetary decisions are increasingly being made through a lens of ‘risk’. Even more importantly perhaps, this awareness is demanded by the private sector and established through the public sector, In other words, important decisions are analyzed for their loss/gain potential prior to the implementation of policy or contract, and adjusted by the various risks to the desired outcome.

The term ‘Political Risk’ is a multi-faceted concept that can be broadly understood as occurrences in the international business context where public actions, non-state actors or politically-charged events in a host country interfere with the performance of the international business or investment operation. Hence the purpose of political risk analysis is to provide companies and investors with specific information on the protection and profitability of their potential investments and business opportunities abroad, and on the likelihood that the investment will encounter problems specific to a country or region (forecasting). The diffusion and free flow of investment capital and foreign direct investment (“FDI”) across borders epitomizes modern global capitalism in its current form. These transactions are predicated on some form of *stability,* including the assumption of reasonably predictable governments and policies—a kind of certainty that investors and multi-national enterprises (“MNEs”) crave in foreign locales. Political risks can be further differentiated between micro and macro, that is, those affecting only certain industries versus all foreign firms in a country; internal and external, that is, risks that initiate from local political action versus those more trans-national in nature.

Case in point: China’s mining sector

The mining sector in China is often cited as a market with huge potential, but mired in a political-economic system that is a hotbed for risks. China is endowed with abundant mineral resources (about 12% of the world’s total reserves of mineral resources, ranking behind the United States and Russia). Not surprisingly, on par with the Chinese government’s economic expansion strategies, the exploitation of mineral resources has grown rapidly over the past two decades. In the early 1990s, the Chinese central government opened up its mineral market to foreign investment by granting exploration and mining rights. The presence of FDI was considered a conduit to modernize existing mines and improve technology, and it was meant to augment supply of mineral commodities in response to rising demand. Over the years, foreign mining firms and investors have sought to actively participate in the development of the highly competitive Chinese mining sector as the potential for profit is immense. Yet more recently, many foreign firms have run into significant difficulties with their mining investments that fall under the umbrella of ‘political risk’, including:

- *Economic and fiscal situation*: lower GDP growth, protectionism and tariff barriers, trade wars, types of taxation, uncoordinated fiscal regime, uneven incentives;
- *Operational efficiency*: infrastructure, transfer of ownership, controlling investors/holdings, partnerships/licensing;
- *Legal-regulatory inconsistencies*: national/regional mineral policies, approval processes, standards and regulations, governmental cooperation, corruption and instability;
- *Environmental concerns*: quality of mineral titles system, data and geological assessments/maps, environmental and safety concerns, reputational costs;
- *Socio-cultural factors*: support/partnership with local stakeholders, *guangxi* (relationships), cross-cultural communication, ethnic minorities.

It must be said that China has made impressive and rapid improvements to the entire mining sector with respect to infrastructure, capital influx and site development, technology, mineral titles, centralization of policy, and an increase in outward-FDI for Chinese mining firms. The growth in resource extraction has benefitted Chinese state-owned enterprises ("SOEs") and MNEs tremendously, helping spur the economic miracle of the past few decades. Yet complaints are often made that foreign firms have had their participation limited at the behest of domestic MNEs. Compounding this problem for Canadian and other foreign mining companies is the reality that:

- Open tariff barriers and trade wars between China and the US seem unlikely to be resolved in the near future;
- China will support its domestic SOE champions as they globalize, as part of its greater multilateral and geo-political economic strategy (belt and road initiative);
- The US/Canada – China political and diplomatic situation around Huawei, technology, and national security is creating obstacles for further cooperation and investment;
- China's use of rare earths to distort trade by withholding supply, and its undertaking to buy gold or other minerals from the US helps the China-U.S. trade balance but displaces producers in other countries, as noted by Bloomberg.

It will be a difficult, but not impossible, task for foreign investors to regain a foothold in the Chinese mining market. Notwithstanding the above-mentioned risks, the market has serious potential, but to start with, governments and businesses must be in constant and positive dialogue with the Chinese government and private sector, and aim to have a respectful relationship with one another. Additionally, both government and industry in Canada must 1) be cognizant of the fact that mining in China operates not just on commercial, but also political considerations; and 2) as such, the Canadian government could reflect on any potential political/policy risks that might result in a change of PRC attitudes or policies aimed at foreign mining companies in general, and Canadian firms in particular. From another angle, government and business should 3) have strategies in place to respond to unfair treatment or threats if necessary – restrictions on Canadian exploration rights for Chinese SOEs/MNEs, restrictions on M&A on 'national security' or similar grounds in concert with allies; yet also 4) endeavour to be a stable, predictable partner for the Chinese mining sector globally, but quietly insist on reciprocity and fair treatment in the Chinese market. The next few months will be a pivotal time for the important relationship between Canada and China not only in the mining sector, but across all trade industries.