ИКОНОМИЧЕСКИ ИНСТИТУТ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ
ECONOMIC STUDIES
ГОДИНА XVIII, 2009, 1

András Székely-Doby[1]

ON SOME CHARACTERISTICS OF FOREIGN DIRECT INVESTMENT IN CHINA

In this paper we analyze foreign direct investment (FDI) in China from several points of view. After putting the subject into an historical context, we use time series to illustrate the main trends of capital inflows. Our main finding is that the significant growth of FDI inflows since the beginning of the 1990s can be attributed to two factors: first, the strengthening trust in the irreversibility of the reform process, second, the gradually opening domestic market. The paper also deals with two specific, and very important issues: the so called round-tripping capital, and role of off-shore areas in FDI inflows. We show that these phenomena are strongly linked to each other, and based upon the different handling of domestic and foreign enterprises by the government. Another special feature we try to understand is the large volume of FDI compared to portfolio investments. According to our explanation this is a consequence of the relative backwardness of the Chinese financial system compared to that of in advanced economies, which makes FDI a much safer way of financing than the use of the underdeveloped Chinese capital markets.
JEL: F21

Introduction

One of the key elements of the Chinese reform process initiated in the beginning of the 70s was the constantly growing inflow of foreign direct investment (FDI). By the millennium these inflows got so significant, that China became one of the most important destination for FDI in the world. As it became evident that both Japan and the so called Asian Tigers had been extremely successful in applying an export-oriented development strategy, giving up its import-substituting strategy based exclusively upon domestic production, China made a 180 degree turn in economic strategy and policy, and bound itself to a more open approach with market elements. By the millennium China became an extremely open economy, where multinational companies (MNCs) and foreign capital play an extraordinary role. We cannot imagine China without them, and nobody could say that China is the "Factory of the World" if they did not produce so many so different goods.

In this paper we analyze foreign direct investment (FDI) in China from several points of view. The first part is about the evolution of FDI inflows, putting the subject into an historical context. We are also talking about the so called Special

[1] *András Székely-Doby is Senior research fellow in the Institute for World Economics of the Hungarian Academy of Sciences.*

Economic Zones (SEZs), which were the only windows to the outside world in the initial phase of the reform process. The next section deals with the numbers concerning the capital inflows. We use statistics and time series to illustrate the main trends of capital inflows. In the third part we address two important issues of capital movements, the so called round-tripping capital, and the role of offshore areas in FDI inflows. The paper concludes with a brief summary.

Appearance of foreign capital in China

After the death of Mao the power-struggle in China ended with the success of reformist leaders, who initiated a new policy: reform and opening up. Learning from the experience of the Hungarian reforms in 1968 they believed that the bureaucratic planning mechanism had to be complemented by some market elements to achieve faster economic growth, and to narrow the gap between China and the developed world. Contrary to the Hungarian example, however, they did not mix up the different coordination mechanisms, but separated them completely. The planning system remained intact in the huge state enterprises, while market forces were allowed to play a bigger role in the burgeoning private sector, and, first of all, in the so called Special Economic Zones (SEZs).[2]

China in the end of the 70s has already had experience not only from the reforms in Central and Eastern Europe, but from the successes of export-oriented East-Asian economies. Deng Xiao Ping (the successor of Mao in the party central committee) thought that they could successfully combine the gradual development of market economy with export-oriented economic development strategy, but without changes in the political system of the country. As the first successes had occurred they became more and more brave in allowing foreign investors to invest in SEZs: the number these zones rose from 4 to 14. In these restricted areas there were mostly foreign enterprises producing goods exclusively for exports, using very cheap Chinese labor.

The pace of capital imports accelerated strikingly after 1992, reaching 20 billion USD in the next year. First, investors from Hong-Kong and Taiwan increased their investment, but Europeans and Americans soon followed them. The significance of FDI grew so rapidly that they began to transform the structure of the Chinese economy. What were the main factors that caused these radical changes? Deng in the spring of 1992 visited South China, and, in fact, rehabilitated the reform process that suffered a major setback because of the 1989 Tiananmen-square events. Of course this visit alone could not have changed the trends of FDI, there were other important factors, too.

Although China had already a decade of history of economic policy and institutional reforms in 1989, the bloody events in June disillusioned foreign investors. They became cautious and decided to wait. However, Deng's talks and visits in Southern China (as a sign of the irreversibility of the process) made them understood that the

[2] This approach is commonly referred to as "dual track system".

reform process had to be continued. Beside the return of the credibility the other most important factor was the opening up (at least in part) of Chinese markets for foreign investors. While before SEZs produced only for exports (and the volume of capital inflows was determined by this fact), from 1992 these factories began to produce also for domestic consumers. These changes had a huge impact on FDI inflows, because they opened up fantastic possibilities for international investors.[3]

Along with the capital inflows there were other effects, too. Chinese got access to modern management and marketing techniques, and up-to-date technologies. Perhaps this was the most important contribution of foreign enterprises in the process of economic development in China. Modernization without this technology transfer would have been impossible, and we can say that FDI became one of the most significant factor in China's growth and competitiveness.

As an evidence of the opening up process Special Economic Zones were set up in China. The first four such areas were in Shenzhen, Zhuhai, Xiamen, and Shantou, but, initially, they were not too successful. Foreign capital came in quite slowly, while the cost of building up adequate infrastructure were very high. After 1984 fourteen cities were designated as "open cities", where Economic and Technological Development Zones (ETDZs) where created. They were very similar to the initial zones. The island of Hainan declared as a SEZ, while the areas of the original SEZs were enlarged significantly.

SEZs in China are not unique in East and Southeast Asia. The first so called Export Processing Zone (EPZ) were opened in 1965 in Kaohsiung, Taiwan. By the 1980s their number had risen to 35, and they could be found almost in every country. One of the most successful was in Penang, Malaysia, and it became the heart of the electronics industry in the region. The structure of the EPZs were the same in every country. First, raw materials and semi processed goods could be imported without duties, second, they got offshore status with tax exemptions for 3 to 10 years, third, administrative barriers were reduced to a minimum level, and fourth, infrastructure building and raw material provision were the task of the Chinese government.[4]

One of the most important benefit of setting up EPZs was that the host country did not need to restructure either its domestic industrial sector, or its institutional setup to achieve favorable macroeconomic effects. At the same time there were setbacks, too. Tax income was very low, while organic linkages to the domestic economy were very rare. However, in some regions there were also very successive examples. Shenzhen, for example, became not only a regional industrial center, but the most dynamic growth center in China.

Chinese SEZs were in some respects very different from their Asian counterparts. The most striking difference was that China, in contrast to other countries in the region, remained a socialist country. On one hand this meant that it had to be applied a completely different institutional environment from that of used in the domestic

---

[3] Naughton, 2007, pp. 403-404.
[4] Naughton, 2007, pp. 407-408.

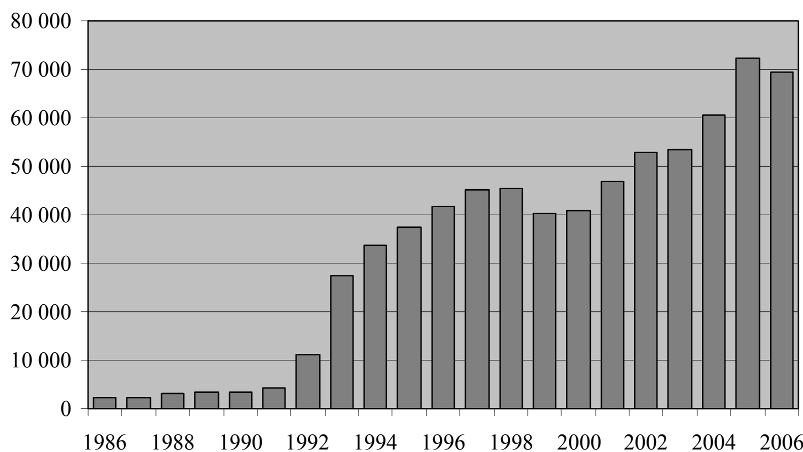
economy, on the other hand however, it gave a special opportunity to use these zones as experimental labs testing such institutional solutions that would have been very dangerous if they had been used elsewhere. The management of these zones were given quite big autonomy, which included the free use of taxes and profits (also in foreign exchanges). The zones were functioning as windows to the outside world, but they were the most important sources of technology transfer, too. As a new policy approach, from the beginning of the 2000s, the Chinese government tried to strengthen the development of the Western territories. The Western Development Program has been created, and by 2007 every province had opened up at least one ETDZ.

What do the numbers say?

China is one of the most important destination of worldwide FDI: Capital inflows in 2006 amounted to almost 70 billion USD. Inflows began to rise from 1992, and by the middle of the decade stabilized around 40 billion USD per year. The next bigger jump occurred after the millennium, and in 2005 inflows reached 70 billion USD. This is 5% of the total FDI worldwide, and 18% of FDI flowing to developing countries. Stock data are equally impressive: FDI stock reached 50 billion USD in 1993, 100 billion two years later, and 500 billion in 2003. Total stock of FDI was more than 700 billion USD in 2006. Figure 1 shows us the FDI inflows to China. The huge change in the beginning of the 1990s is very striking.

Figure 1

Foreign Direct Investment inflows to China (million USD)



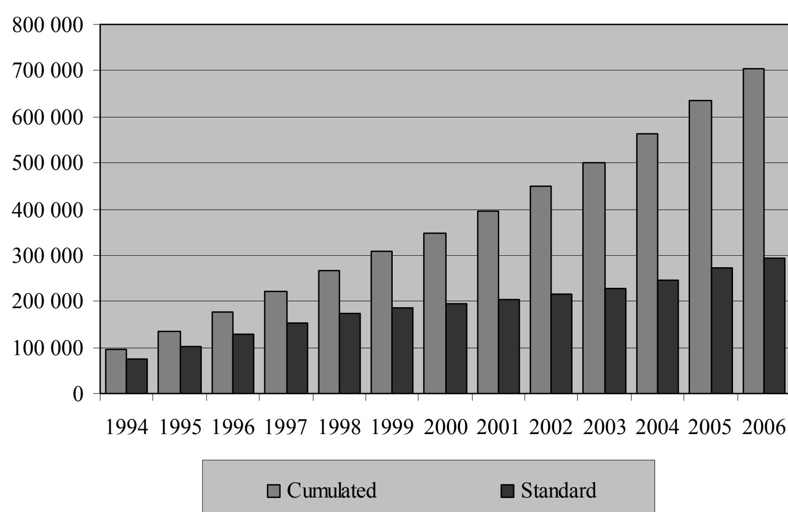
Source: UNCTAD [Web], http://www.unctad.org/sections/dite_dir/docs/wir2007_inflows_en.xls.

Until 2005 yearly capital inflows to China were simply aggregated by the Chinese Ministry of Commerce to get the stock data. This approach, however, is not

compatible with the statistical standards applied in the developed regions, because it omits both the changes in the market value of the assets, and depreciation. To solve these discrepancies the Ministry introduced a new accounting method in 2005, that was in accordance with the international standards. Unfortunately, these new data are available only on an aggregate basis, so we cannot use them to analyze either the regional or the industrial trends. In these cases we continue to use the cumulated data (we can do it because relative numbers are more important than absolute ones). Data according to both the new and the old method are shown in Figure 2. There are significant differences between the two series, and the difference is rapidly growing from one year to another. In 2006, for example, cumulated FDI reached 700 billion USD, while according to the standard accounting method it was less than 300 billion. In addition, FDI in China tends to be greenfield investment with large share of real fixed investment, which depreciates rapidly. This, however, is not deducted according to the cumulated accounting method.

Figure 2

FDI stock in China, according to the old and the new accounting method (million USD)



Source: UNCTAD [Web],
http://www.unctad.org/sections/dite_dir/docs/wir2007_instock_en.xls.

It is very interesting to analyze the inward FDI stock by source countries. We may think that China, like other developing countries, imports capital from the most developed countries: the United States, Europe, and Japan. Of course these countries are among the biggest investors, the most important sources of capital are, however, East-Asian countries: Hong-Kong, Taiwan, Singapore, and Korea. From the 70 billion USD arrived in 2006, 20 billion came from Hong-Kong, and only 14 billion from the US and the EU altogether, and only 5 billion from Japan. Taiwan and Korea exported a total sum of 6 billion, while Singapore 2 billion. Stock data are

equally interesting: the most investment came from Hong-Kong (40% of all FDI), while both the United States and Japan had only an 8% share. The next in the row is an offshore territory, the British Virgin Islands with a bit less than 8% share. However, if we count all the offshore territories we get a striking number of almost 12%. Other important investors are: Taiwan, South Korea, Singapore, the United Kingdom, and Germany. In China there are such special characteristics of foreign direct investment that are very different not only from other developing countries but also from developed ones. These phenomena stem mainly from the domestic environment, and they can be linked to domestic companies, not foreign ones. We will address some of these characteristics in the next section.

Industrial composition of FDI in China is quite one sided. In sharp contrast to other developing countries, the share of extracting industries are very low, while that of manufacturing is high. In 2006 nearly 60% of all FDI flowed to manufacturing industries, and only 1 into the primer sector. The most important manufacturing industries are: electronics (8 billion USD), automotive industry (2,8), and chemical industries (2,6). In the services sector the most important industries are the real estate (15,6), and the financial sector (6,7 billion USD).

Figure 3

Per capita GDP in Chinese provinces, in 2006 (RMB)

Source: NBSC [Web].

If sectoral composition is one sided, regional composition is even more so. As we can see in Figure 4, the biggest share of FDI concentrates in only a few provinces, like Guangdong, Jiangsu, and Shandong. The bulk of the incoming FDI in 2006 arrived here (with a share of 17, 15, and 14% of all FDI inflows, respectively). All three provinces are situated in the Eastern coast of the country. This part of China attracted 82% of all FDI inflows in 2006, and the stock data are similar, too. Beside

these provinces other important destinations are Beijing, Shanghai, Zhejiang, and Fujian. It is not surprising that FDI inflows and per capita GDP are strongly correlated (as we can see it in Figure 3 and Figure 4).

Figure 4

Cumulated FDI stock in provinces at the end of 2004 (million USD)

Source: Invest in China[Web].

There are other important aspects of FDI in China, like the different types of investment forms. In countries with a functioning market economy this question is not relevant at all, because almost all investment are linked to companies with limited liability (first of all corporations), and majority owned foreign affiliates are preferred. In China, however, the situation is completely different, because China is still a country in transition (in contrast to the official standpoint of a socialist country), with a wide variety of ownership forms, and a strong aversion of private property. In the beginning majority ownership was prohibited, and still years after it was allowed only in a few sectors. Although these restrictions were in large part abolished, in 2006 less than half of all FDI stock was in majority owned affiliates. More important were different joint ventures, where the two sides have equal rights, and it was also more suitable to carry out state policies (with preferences of control and employment).

Some special characteristics of foreign investment in China

The share of direct investment in all capital inflows is unusually high in China. Portfolio investment were only one fourth of direct investment in 2005[5], while this

[5] SAFE [Web].

ratio was six to one in Taiwan between 2001 and 2007.[6] Generally, in more advanced countries portfolio investment tend to be much higher than direct investment. Why is this pattern reversed in China? The answer to this question lies in the characteristics of the Chinese financial system, which is far less developed than that of in traditional market economies, and in the huge return on direct investment, which is much higher here.

By sourcing out production facilities to China MNCs get access to valuable sources, first of all cheap labor, while retaining property rights defends them from the instability of the country's financial system. The incentive is very strong to manage financial transactions within the company, and to avoid unreliable Chinese services. It is not surprising therefore that most of them use institutions in Hong-Kong for that purpose, because trust in its system is still very high.[7] So the huge amount of foreign direct investment is partly due to the underdevelopment of the mainland institutions compared to the Hong-Kong ones, and until the risk is so much higher in the mainland, portfolio investment remain moderated.

The other main characteristic of direct investment in China is the so called round-tripping capital. Round tripping capital means that the capital basically created in China first leaves the country, then returns as foreign direct investment. So, the origin of these foreign investment are in fact not foreign but Chinese. But why has to leave this capital China if, in the end, returns there?

Motivations lying behind this phenomenon are very complex, indeed. Some of them are much more important, however, so, in the following section, we concentrate on them. The first cause that forces the capital to leave China is the difference in the handling of foreign and domestic investment. For more than one and a half of a decade the most important base of the Chinese development have been foreign investment. The government tries to attract foreign investors by creating such favorable conditions that are not available for domestic enterprises. Tax allowances or area use rights are among the most common ones, but government guarantees and simple ways of profit repatriation are very widespread, too.[8] These incentives are designed to create a very favorable environment for capital inflows, domestic enterprises, however, are not eligible for them. To make use of these opportunities they are searching for other strategies, like sending their profits abroad, and bring it back as foreign capital.

The significance of round-tripping capital is stressed not only by the aforementioned fiscal incentives, but also by institutional deficiencies. Lack of adequate defense of property rights, for example, is another factor to be count with. If a Chinese company make profits, it is not clear at all, how big part of it can it be reinvest, retain or distribute. It is much more safe to accumulate its wealth abroad (like Chinese official reserves in the United States). Of course there is a difference:

---

[6] CBC [Web].
[7] This probably remains true until China insists to the "One country two systems" principle.
[8] World Bank [2002], p. 41.

private money usually leaves the country illegally[9], while official reserves follow a legal way. In addition, capital accumulated abroad is more protected from speculations, and get access to much more sophisticated financial services than in mainland China.[10]

Round-tripping capital explains the significance of Hong-Kong in FDI inflows to China. After all, it is quite unusual that a mini state like Hong-Kong is the most important investor, exporting FDI of more than 20 billion USD per year. The solution is that a big part of capital inflows from Hong-Kong is round-tripping capital originated in mainland China. Unfortunately we have only rough estimates how big this part may be, but the most probable ones are between 30 and 50% of the total capital inflows. Of course there are other places where this type of capital can escape (though the most straightforward, the less expensive, and the simplest way is via Hong-Kong), the total share of round-tripping capital in total FDI lies somewhere between 25 and 50%.[11]

We can link the big weight of offshore tax-heavens in capital inflows to the phenomenon of round-tripping capital. We can find numerous explanations of it in the literature.[12] First, it is evident that round-tripping capital can find other ways than via Hong-Kong, like offshore islands, or the United States. Escaping capital in these cases, too, first goes to an export destination country, from where it returns to China through a tax heaven. On the other hand this opportunity is also very attractive for real foreign investors, not only for Chinese enterprises. This is one of the main obstacles that prevents us from having realistic estimations of round-tripping capital. Anyway, the share and significance of offshore islands prove that there are serious deficiencies in the regulation of the financial system in China.

Conclusions

Since the beginning of the 1990s FDI inflows to China have grown significantly. This can be attributed to two factors: first, trust in the irreversibility of the reform process in China has strengthened, second, domestic market slowly opened up for foreign investors. Though FDI inflows are substantial (even on a worldwide scale), compared to the Chinese economy they are not so large. FDI concentrate only in a few provinces (mainly in the East coast), where per capita income is high. To address this problem the Chinese government took steps to channel FDI to poorer provinces, too.

There is a unique feature of capital inflows: the large share of Hong-Kong and offshore areas. This can be attributed to the so called round-tripping capital. Chinese

[9] E.g. underinvoicing exports or overinvoicing imports.

[10] Such services are available in Hong-Kong's advanced financial system, and the Stock Exchange.

[11] According to the analysis of the World Bank (World Bank, 2002, p. 41.) it is 25%, according to Xiao's estimations in his article (Xiao, 2004) its minimum is 29.2%, the most probable level is 40%, the maximum is 50.8%.

[12] See for example the articles from Gunter, 2004 or Xiao, 2004.

enterprises try to make use of the favorable conditions for foreign investors by "smuggling" their capital abroad, and return it as foreign investors. The share of round-tripping capital amounts to one fourth or one third of all FDI. Another special feature is the large volume of FDI compared to portfolio investment, which is a consequence of the relative backwardness of the Chinese financial system. In the form of FDI there is much less risk than in the stock markets, and, in addition, foreign investors in this case have much more control over their assets.

Anyway, one of the most important feature of the reform process in China was the large amount of foreign direct investment that entered the country. Foreign capital not only changed the Chinese export industries, it had a huge impact on the whole Chinese economy and society. Technology transfer along with other consequences have created a very competitive country from an underdeveloped, poor one, and made it possible to reenter the world economy. How far can China get with its current socio-economic system? It is very difficult to answer to this question. There are lots of threats and problems (like environmental pollution, and inequalities), and the outcome is still unclear, but the pragmatic and rational approach applied in the last decades may be a good way to handle them.

References

CBC, Central Bank of the Republic of China, Taiwan [Web]:
http://www.cbc.gov.tw/EngHome/eeconomic/statistics/BOP/new/eSY.pdf

Fung, Hung-Gay, Julius H. Johnson, Jr., Yanda Xu. Winners and Losers. Foreign Firms in China's Emerging Market. – In: *The Chinese Economy*, Vol. 37, No. 3, May-June 2004, pp. 5-16.

Gunter, Frank R. Capital flight from China: 1984-2001. – In: *China Economic Review*, Vol. 15, 2004, pp. 63-85.

Invest in China, Ministry of Commerce [Web]:
http://www.fdi.gov.cn/pub/FDI_EN/Statistics/AnnualStatisticsData/default.jsp

Naughton, B. The Chinese Economy. Transitions and Growth. The MIT Press, Cambridge, England, 2007.

NBSC, National Bureau of Statistics of China [Web]:
http://www.stats.gov.cn/tjsj/ndsj/2007/indexeh.htm

Prasad, E., Shang-Jin Wei. Understanding the Structure of Cross-border Capital Flows: the Case of China. Paper prepared for the Columbia University Conference "China at Crossroads: FX and Capital Markets Policies for the Coming Decade", Columbia University, February 2-3, 2006. http://www.brookings.edu/views/papers/wei/20051215.pdf

SAFE, State Administration of Foreign Exchange [Web]:
http://www.safe.gov.cn/model_safe_en/tjsj_en/pic/20061019114739654.pdf

UNCTAD [Web]: World Investment Report, 2007: http://www.unctad.org/.

World Bank. Global development finance, 2001: building coalitions for effective development finance. World Bank, Vol. 1, 2002.

Xiao, G. People's Republic of China's Round-tripping FDI: Scale, Causes and Implications. *HIEBS Working Papers Series*, No. 1137, July 2004.