

# FOREIGN DIRECT INVESTMENT IN CHINA

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## **ABSTRACT**

China's absorbing foreign direct investment (FDI) has contributed importantly to its economy growth. Based on the findings of some previous studies in the literature, this report presents a general review of FDI in China, which includes characteristic, history and regional distribution. In the report, I discuss various economic determinants of FDI (such as market size, labor cost, infrastructure, and government policies) and investigate the impact of FDI on China's economic growth. Furthermore, I discuss challenges, new trends and the future opportunities facing China.

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## **CHAPTER 1 - Introduction**

China opened up the door to the world economy since 1979. China has experienced a dramatic change in its economy. Meanwhile, FDI inflows in China have been growing quite rapidly. By the end of 2006, total accumulated projects, contractual value and realized value of FDI in China had reached 594,445; 1497.9 billion USD and 703.9 billion USD, respectively (see Table 2.1). Now, China is the largest FDI host country among the developing world.

Obviously, FDI is one of the main factors to explain the growth of China's economy in the past thirty years. But, who were the main investors? And how could China become so successful in attracting FDI? What roles did FDI play in the Chinese economy? Many studies have been focused on these topics. In this report, I seek to review and summarize major findings of several different studies in the literature.

The report is organized as follows: Section 2 provides a general review in terms of characteristic, history and distribution of FDI in China. The review includes (i) FDI trends, (ii) China's goals in attracting and utilizing FDI, (iii) five major types of FDI, (iv) five development stages of FDI from 1979 to present, and (v) the regional distribution of FDI in China. Section 3 lays out various economic determinants of FDI in China: domestic market size, labor cost, quality of infrastructure, government policies and other factors, which could help to explain China's success in attracting FDI from other countries. Section 4 discusses the role of FDI in affecting China's trade and economic growth.

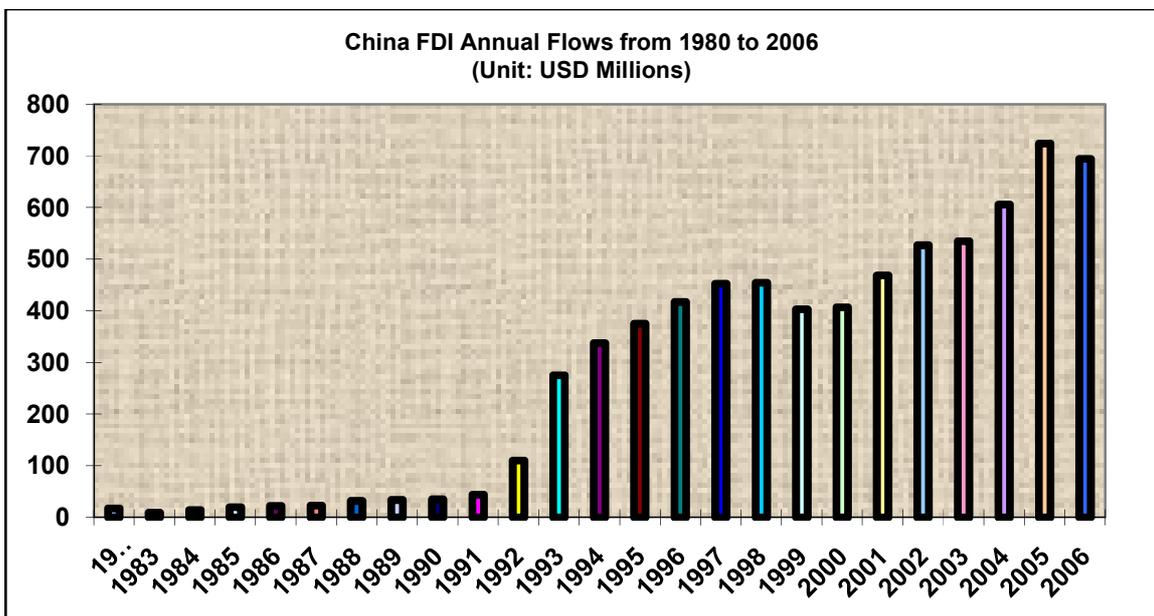
Section 5 analyzes the current challenge, new trends and the future opportunities of FDI in China. Section 6 contains concluding remarks.

## **CHAPTER 2 - General background of FDI inflows in China**

### ***2.1 Overall FDI trends in China***

The trend of FDI flows to China could be separated into three distinct phases: From 1980 to 1992, the inflows increased relatively slowly. Then, FDI inflows started to grow quite rapidly. There must have been certain economic changes favorable for investments which we will cover later in this report. This upward trend has been interrupted since 1998. But, after 2000, it began to rise again until 2005. It reached its highest level in that year (see Chart 2.1).

**Chart 2.1: China's total FDI inflows trends from 1980 to 2006**



Source: Foreign Investment Department of the Ministry of Commerce of China, 2007

In 2005, the number of FDI projects reached 44,019; the contractual value of FDI achieved \$189 billion and the realized value of FDI increased to \$72.4 billion. Details of these figures are shown in Table 2.1.

**Table 2.1: China FDI Inward from 1980 to 2006**

Unit: US \$100 millions

year	No. of projects	Contractual value	Realized Value
total	594,445	14,979.28	7,039.74
1979-1982	920	49.58	17.69
1983	638	19.17	9.16
1984	2,166	28.75	14.19
1985	3,073	63.33	19.56
1986	1,498	33.3	22.44
1987	2,233	37.09	23.14
1988	5,945	52.97	31.94
1989	5,779	56	33.93
1990	7,273	65.96	34.87

<b>Table 2.1 Cont.</b>			
1991	12,978	119.77	43.66
1992	48,764	581.24	110.08
1993	83,437	1,114.36	275.15
1994	47,549	826.8	337.67
1995	37,011	912.82	375.21
1996	24,556	732.76	417.26
1997	21,001	510.03	452.57
1998	19,799	521.02	454.63
1999	16,918	412.23	403.19
2000	22,347	623.8	407.15
2001	26,140	691.95	468.78
2002	34,171	827.68	527.43
2003	41,081	1,150.70	535.05
2004	43,664	1,534.79	606.3
2005	44,019	1,890.65	724.06
2006	41,485	2,001.74	694.68

Source: Foreign Investment Department of the Ministry of Commerce of China, 2007

FDI has contributed to Chinese economy growth directly through the establishment of Foreign Invested Enterprises (FIEs). The industrial outputs by FIEs became major part of national industrial outputs. (Table. 2.2)

**Table 2.2: Industrial Outputs by Foreign Invested Enterprises (FIEs) as a Percentage of National Industrial Outputs**

Unit: RMB 100 million

Year	National Industrial Outputs	Industrial Outputs by FIEs	Share (%)
1990	19,701.04	448.95	2.28
1991	23,135.56	1,223.32	5.29
1992	29,149.25	2,065.59	7.09

<b>Table 2.2</b>	<b>Cont.</b>		
1993	40,513.68	3,704.35	9.15
1994	76,867.25	8,649.39	11.26
1995	91,963.28	13,154.16	14.31
1996	99,595.55	15,077.53	15.14
1997	56,149.70	10,427.00	18.57
1998	58,195.23	14,162.00	24
1999	63,775.24	17,696.00	27.75
2000	73,964.94	23,145.59	22.51
2001	94,751.78	26,515.66	28.05
2002	1,011,198.73	33,771.09	33.37
2003	128,306.14	46,019.55	35.87
2004	187,220.66	58,847.08	31.43
2005	249,625.00	78,399.40	31.41
2006	315,630.14	99,420.83	31.5

Source: Foreign Investment Department of the Ministry of Commerce of China, 2007

An interesting question is: who were the main investors? Apparently, the ten countries/regions in Asia, namely, Hong Kong, Macau, Taiwan, Japan, Philippines, Thailand, Malaysia, Singapore, Indonesia and South Korea, remained the main source of FDI inflows. (See Table 2.3)

By the end of 2006, the ten Asian countries/regions invested in a total of 460,205 projects, accounting for 83% total FDI projects, and reached a total realized value of US\$46.45 billion in China, accounting for 58.58% of total FDI realized value in China.

**Table 2.3: FDI Inflows from the Ten Asian Countries as of 2006**

Unit: US\$ 100 million

Country/Region	No. of Projects	Share %	Realized FDI Value	Share %
<b>Total</b>	<b>594445</b>	<b>100</b>	<b>7039.74</b>	<b>100</b>
10 Asian Countries/Regions	460205	83	464.52	58.58
Hong Kong	269555	48.62	2797.74	39.74
Japan	37714	6.8	579.73	8.24
Taiwan	71847	12.96	438.93	6.23
South Korea	43130	7.78	349.99	4.97
Singapore	15556	2.81	300.04	4.26
Macau	10697	0.733	69.4	0.99
Indonesia	1444	0.26	15.61	0.22
Malaysia	3947	0.71	42.26	0.6
Philippines	2523	0.46	22.01	0.31
Thailand	3792	0.68	29.68	0.42

Source: Foreign Investment Department of the Ministry of Commerce of China, 2007

The top eight countries/ investing in China by the end of 2006, in order of realized investment, are: Hong Kong (US\$279.77 billion), Japan (US\$57.97 billion), the Virgin Islands (US\$57.16 billion), USA (US\$53.95 billion), Taiwan (US\$43.89 billion). (See Table 2.4)

**Table 2.4: Top Eight Investors in China as of 2006**

Unit: US\$ 100 million

Country/Region	No. of Projects	Share %	Realized FDI Value	Share %
<b>Total</b>	<b>554445</b>	<b>100</b>	<b>7039.74</b>	<b>100</b>
Hong Kong	269555	48.62	2797.74	39.74
Japan	37714	6.80	579.73	8.24
Virgin Island	16616	3.00	571.64	8.12
USA	52211	9.42	539.55	7.66
Taiwan	71847	12.09	438.93	6.23
South Korea	43130	7.256	349.99	4.97
Singapore	15556	2.617	300.04	4.26
U.K.	5359	0.902	139.22	1.98

Source: Foreign Investment Department of the Ministry of Commerce of China, 2007

## ***2.2 China's goals in attracting and utilizing FDI***

Although China's orientation and targets of using FDI might have adjusted to its development needs in different stages, its main purposes can be described as below (Yuan, 2005):

1. Having based its economy heavily on agriculture, China intended to use FDI to boost its development of industries, including building up transportation infrastructure, exploring energy and processing raw materials.
2. With the aspiration of establishing local research and development centers, China would move into the technology-intensive fields, such as electronic information, bioengineer, new materials, aviation and aerospace.

3. China would also like to transform its traditional industries, such as machinery, textile and consumption goods manufacturing, with the new technologies and modern management systems brought in by foreign investors.
4. The deteriorating pollution draws China's attention to environmental protection projects and forces it to raise efficiency of utilizing raw and renewable materials and energy.
5. China also likes to enlarge its exports and strengthen its connection to the rest of the world via export-oriented FDI. As the gap between China's coastal and inner cities grows, it is also China's intention to direct FDI to the country's western region to build up industries there.

### ***2.3 Major FDI types in China***

Yuan (2005) illustrated that there are five major types of FDI in China, namely, (i) Equity Joint Venture (EJV), (ii) Contractual Joint Venture (or Cooperative Joint Venture, CJV) Cooperative Enterprises, (iii) wholly foreign-owned enterprises (WFOE), (iv) Share Company with Foreign Investment (SCFI) and (v) Joint exploration. The definition of each type is as below:

#### ***2.3.1 Equity Joint Venture (EJV)***

An EJV refers to company with limited liability, whose equity and management are shared between foreign investors and Chinese sides in accordance to their equity shares. EJV used to dominate the forms of FDI in China, as shown in Table 2.5. China's Joint

Venture Law and its Amendment Provisions set the percentage of a joint venture's capital contributed by a foreign investor between 25 percent and 99 percent.

### ***2.3.2 Contractual Joint Venture (or Cooperative Joint Venture, CJV)***

As indicated by its name, a CJV is established with a preset arrangement between foreign investors and their Chinese counterparts. The arrangement lays down the terms and conditions as stipulated in the venture contracts. It also clarifies the liabilities, rights and obligations of each cooperative side. Grub and Lin (1991) discussed in their research that different from those in EJV, the investors in CJVs do not assume the risk or receive profits in accordance to their respective capital shares but rather the risks and profits are preset in the venture agreement

### ***2.3.3 Wholly foreign-owned enterprises (WFOE)***

Obviously, a WFOE is an enterprises founded entirely by a foreign company with its own capital. Hence the risks, gains and losses of a WFOE are absorbed by the firm itself. This type of enterprise is under the coverage of the *Law on Enterprises Operated Exclusively with Foreign Capital* (1986) and its *Enforcement Regulations* (1988). The number of WFOEs gradually caught up with EJV and CJV from late 1990s when China further relaxed its restraints on FDI.

### ***2.3.4 Share Company with Foreign Investment (SCFI)***

SCFI is a stock limited company established by foreign companies, enterprises, or other economic organizations with their Chinese counterparts. The company is set up

according to the principle of stock. The specific responsibilities assumed by each stockholder depends on the amount of stocks he/she purchases.

### **2.3.5 Joint exploration**

Joint exploration often pertains to natural resources such as oil. It is characterized with features of both CJVs and compensation trade. Its risk and output are distributed according to agreed shares, which resemble CJVs. This type of FDI offers China access to advanced equipment and technical assistance from foreign companies. The foreign investors, in return, receive a portion of the output.

From Table 2.5, we can see that EJVs and WFOEs are the most important types of FDI, which accounted for 90% of the total FDI projects and 82.38% of total FDI realized value in China by the end of 2006.

**Table 2.5: Cumulative FDI by different types as of 2006**

Unit: US \$ Billions

<b>Form</b>	<b>No. of Projects</b>	<b>Share %</b>	<b>Realized FDI Value</b>	<b>Share %</b>
<b>Total</b>	<b>594,445</b>	<b>100</b>	<b>703.9</b>	<b>100</b>
Equity Joint Ventures	270,640	45.53	251.40	35.72
Contractual Joint Ventures	58,570	9.85	93.50	13.28
Wholly Foreign-owned Enterprises	265,288	44.62	328.46	46.66
FDI Shareholding Inc.	207	0.034	3.67	0.52
Joint Exploration	191	0.032	7.51	1.06
Others	62	0.01	19.43	2.76

Source: Foreign Investment Department of the Ministry of Commerce of China, 2007

As pointed out by Wei (2002), there are two reasons for EJV to become popular in China. First, the Chinese government believes that EJV best serve the Chinese objective of absorbing foreign capital, technology, and management expertise. Second, foreign investors hope that by engaging in joint ventures, the local partners may assist in penetrating the domestic markets and accessing utilities and critical inputs. Also, Deng (2001) notes that many foreign investors in China have chosen WFOEs over EJV in order to avoid the problems associated with EJV, mostly caused by uncooperative or incompetent partners, differences in strategic objectives between partners, and the fear of loss of control over proprietary technology and know-how and a loss of long-term competitive advantages.

## ***2.4 History of FDI in China***

FDI in China can be traced back to the 1950s, during which time the major source was Soviet Union. However, it was not until 1978 that China began to open up itself to the rest of the world and embrace FDI inflows in a gradual manner. The year of 1978 witnessed China's departure from its self-reliance strategies since Mao's era with the country announcing a dramatic program to reform its economic system and open up to the outside world. Starting from 1978, FDI in China became desirable and began to contribute its due share to the development of the Chinese economy. In general, the development of FDI in China can be divided into five stages.

#### **2.4.1 Experiment Stage (1979 – 1983)**

The Chinese government started from an experimental approach, which they called “crossing the river by feeling the stones under the water.” FDI was permitted into China in a step-by-step manner. One key action of the first step was the establishment of four Special Economic Zones (SEZs), namely Shen Zhen, Shan Tou, Zhu Hai and Xia Men, in July 1981. These SEZs were designated for the absorption and utilization of foreign investment. They provided foreign investors with preferential treatment for their businesses. As China’s “window to the world”, these zones not only succeeded in attracting FDI but also served as a buffer for those who were afraid that foreign investment might cause bourgeois spiritual pollution. Meanwhile, China was catching up with the effort to complete its legislative system. The first of its kind, *the Equity Joint Venture Law (the Law of People’s Republic of China on Joint Ventures Using Chinese and Foreign Investment)* was enacted in July 1979. The legislation both validated the existence of FDI in China and guaranteed the right and benefits of foreign investors. Another important policy initiative taken at this stage included *Regulation for the Implementation of the Law of the People’s Republic of china on Chinese –foreign Equity Joint Ventures* (1983).

#### **2.4.2 Growth Stage (1984 – 1991)**

There were surely flaws in China’s handling FDI in the previous stage. Up to 1982, China’s restraints on FDI outside the SEZs remained rigid. Laws and regulations limited foreign ownership and their domestic sales. FDI projects often encountered a long and

drawn out approval process even though they provided sufficient materials and explanation. The lengthy process to approve FDI projects was simplified gradually but steadily between 1983 and 1985. Below is the list of new laws and regulations at this stage.

- Wholly Owned Subsidiaries (WOS) Law (1986)
- Provision for the FDI Encouragement (1986)
- Constitutional Status of Foreign invested Enterprises in Chinese Civil Law (1986)
- Adoption of Interim provision on guiding FDI (1987)
- Delegation on approval of selected FDI projects to more local governments (1988)
- Laws of cooperative joint ventures (1988)
- Revision of equity joint venture law (1990)
- Rules for implementation of WOS law (1990)
- Income tax law and its rules for implementation (1991)

The year of 1984 witnessed two historic activities. In the spring of that year, Deng Xiaoping remarked that China needed to open wider instead of checking upon the opening process (Zheng, 1984). In the fall, the Chinese government announced the “decision on reform of the economic structure”, and called for the building of a “socialist commodity economy” by assigning a larger role to the market in the domestic economic system (*People’s Daily*, October 21, 1984). Also impressed by the success of FDI in SEZs, the Chinese government took a further step to give FDI access to other parts of the country besides SEZs. In 1984, fourteen coastal cities were announced to be opened to the outside world. They are Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang,

Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai. Compared to SEZs, these cities enjoyed more autonomy in making economic decisions. The local governments could approve FDI projects with capital investment up to certain level. For example, Shanghai could approve all FDI projects under 30 million USD (Yuan, 2005). They were also given the right to reserve and spend foreign exchange yielded by local FDI for their own growth. The approval procedures and processes for FDI projects were also greatly simplified.

The Law of People's Republic of China on Wholly Foreign-owned Enterprises (WFOEs), published on April 12, 1986, provides for the protection for the profits and interest of foreign investors when they founded WFOEs in China. A series of other laws and regulations further relaxed China's restriction in promoting FDI with measures for enterprise autonomy, profit remittances, labor recruitment and land use.

In 1987, China made Hainan, its second largest island, the biggest SEZ and a separate province (Before that, Hainan belonged to Guangdong province). Meanwhile, more parts of China, including the Yangtze River Delta surrounding Shanghai, the Pearl River Delta surrounding Guangzhou, the Southern Fujian Triangle, and the Liaoning and Shandong peninsulas, were designated to FDI. These areas received much of the preferential treatment as in SEZs and fourteen open coastal cities.

Also in this stage, the possibility of bringing in foreign management in foreign invested enterprises (FIEs) was considered and discussed. The practice was regarded not to weaken state sovereignty but to help "shake off the fetters of the old system and

promote strict management” (“Premier Zhao Zi Yang on the coastal areas” Development Strategy, Beijing Review, 8-14 February 1988).

In December 1990, the central government promulgated “Detailed Rules and Regulations for the Implementation of the People’s Republic of China Concerning Joint Ventures with Chinese and Foreign Investment.” The regulation aimed to encourage joint ventures that adopted advanced technology or equipments, saved energy and raw materials and upgraded products.

#### **2.4.3 Peak Stage (1992 – 1993)**

This stage witnessed the rise of Shanghai as China’s economic center with the opening up of Pudong New Area. The Chinese government sought to develop Shanghai into an international hub for finance, economy and trade. It was also the intention to carry out the experiment of new policies and apply successful practices within the rest of Shanghai and across the country (*Financial Times*, 1991; *Financial Times Survey: China*, April 24, 1991). With Shanghai’s location in Southeast China, the move signaled the Chinese government’s shifting emphasis to the area to avoid overly concentration of FDI in South China. Hi-tech enterprises, established manufacturers and financial companies were encouraged to set up their China operation at Pudong with various preferential treatments from central and local government.

Deng Xiaoping’s historic tour of the South in early 1992 and his remarks on the necessity to roll out more radical economic reforms had brought China’s open-up and FDI development to a new and higher stage. With the implementation of a new framework

for further opening up the economy, the Chinese government showed great effort to encourage export-oriented and Foreign Invested Enterprises (FIEs) with advanced technologies. A number of new sectors were also opened up to foreign investors, including wholesaling and retailing, accounting and information consultancy, banking and insurance. At the same time, governmental procedures were simplified in terms of FDI administration. China was also seeking to direct FDI into the country's inner regions where there were less developed and industrialized.

The year of 1992 witnessed the remarkable growth of FDI in China. In September of that year, the Chinese government announced its intention to adopt the strategy of "socialist market economy" and improve the economic framework for standard market operations. A series of laws and regulations related to market operations were passed during 1992 and 1993, which included:

- Adoption of Trade Union Law (1992)
- Company Law (1993)
- Provision regulations of value-added tax, consumption tax, business tax and enterprise income tax (1993)

As we can see in Chart 2.1 and Table 2.1, these initiatives proved effective as the pledged FDI in 1992 increased sharply by 385%. The value amounted \$58.1 billion in total. The realized FDI manifested an exceptional growth of 152%, adding up to \$11 billion, which equaled to the total amount of year 1989, 1990 and 1991. In 1993, the pledged FDI was valued at \$110.9 billion, more than the cumulative amount over the past fourteen years. The amount reached \$25.8 billion.

#### **2.4.4 Adjustment Stage (1994 – 2000)**

From 1994, the growth rate of FDI in China went down to a stable level from the relatively high rate in past two years, which indicated that a new stage had arrived. We see from Table 2.1 and Chart 2.1 that the contract value of FDI inflows increased from 82.68 billions USD in 1994 to 91.28 billions USD in 1995, and fell to 73.27 billions in 1996.

The Chinese government began to guide FDI to meet its goals set for economic development. According to the 1995 Provisional Guidelines for Foreign Investment Projects, enterprises in various industries were provided with different preferential treatment. The guiding directory of the Guidelines categorized all the FDI projects into four types: encouraged, restricted, prohibited and permitted (Yuan, 2005). The projects in infrastructure or underdeveloped agriculture and with advanced technology or manufacturing under-supplied new equipment to satisfy market demand fell into the first category. Those whose production exceeded domestic demand and those who engaged in the exploration of rare and valuable resources were treated as restricted. The third category included projects that would jeopardize national security or public interest, or those using sizeable amounts of arable land, or those endangering military facilities and so on. The rest projects are classified as permitted. Annual utilization of FDI reached to its peak in 1997 and 1998 but then trended downward in the following two years.

#### **2.4.5 Post-WTO Stage (2001 – present)**

On November 11, 2001, China became an official member of the World Trade Organization (WTO), after a 15-year negotiation marathon. Upon its accession to WTO,

China started to fulfill its obligation such as basic principles of non-discrimination, pro-trade, pro-competition and so on. In return, China also began to enjoy the privileges as a member of the WTO family. This historic event also exerted significant impact on FDI inflows to China.

Accession to WTO gives incentives to more export-oriented FDI. China's export market becomes larger and more predictable. China's export gains protection from opposing measures. In the opposite, China's domestic market attracts FDI in industries where there is large market potential. Typically, these industries used to be dominated by relatively inefficient state-owned enterprises, such as telecommunication, banking and insurance. Foreign investors, especially large multinational companies, have increasing interest in these industries.

Becoming a WTO member bestows upon China the opportunity to further its economic reforms and restructure its legal framework. This, in consequence, improves China's business environment and helps attract more foreign investment.

According to Yuan (2006), throughout the years, China has gradually reduced its industrial tariffs in a wide range of sectors and areas. More encouragingly to FDI, foreign firms are granted direct trading rights for the first time in the history, which means they can import and export themselves without going through a Chinese state-owned trading firm as the middleman. Reducing tariffs may decrease the incentives for some foreign investors to choose China to avoid possible high tariffs in other countries or areas, but China's acquiring WTO membership boosts investors' confidence in the Chinese economy and its market and thus attracts more FDI inflows.

## ***2.5 Distribution of FDI in China***

Almost every study on FDI in China would point out the unbalanced distribution of foreign investment across the country. China's thirty-one provinces were divided into three regions: east area, central area, and west area. Wei (2004) explains that the reason for the division into regions is primarily to compare the regional difference and dynamic changes in attracting FDI inflows.

Table 2.6 shows basic information on the number of projects and realized value of FDI among the three regions as of 2006. The FDI inflows are concentrated highly along the coast line of East China, especially in the southeast regions. Among these coastal provinces and cities, Fujian, Shanghai, Jiangsu and Guangdong are the hosts to a major share of FDI. Guangdong, in particular, has been a leading destination of foreign investment consistently throughout the years. However, these recent years have witnessed the gap of FDI inflows between Guangdong and other coastal provinces narrowing. As for regional distribution, the East, with an FDI percentage of 84.56%, absorbed most part of foreign investment; while the Central and the West made up 8.55% and 4.25% respectively in the national total of accumulated foreign investment.

The analysis of determinants of region differences in attracting FDI is presented in Section 3.

**Table 2.6: FDI Utilized by East, Central and West Parts of China as of 2006**

Unit: US\$ 100 million

Country/Region	No. of Project	Share %	Realized FDI Value	Share %
Total	594445	100	7039.74	100
East	493482	83.02	5952.93	84.56
Central	64031	10.77	602.18	8.55
West	36902	6.21	299.35	4.25
Others	30	0.01	185.28	2.63

*Eastern region: Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, Hainan*

*Central region: Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei, Hunan*

*Western region: Inner Mongolia, Guangxi, Sichuan, Chongqing, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia, Xinjiang, Tibet*

Source: Foreign Investment Department of the Ministry of Commerce of China 2007.

## **CHAPTER 3 - Summary of the economic determinants of FDI in China**

### ***3.1 China's market size and economy growth***

With the largest population in the world and the fastest growing economy, China manifests increasingly large demand and expanding market for domestic consumption. So, the FDIs from Europe and USA which are mostly market-oriented investment are

attracted by China's huge potential markets. They set up factories and firms to produce and serve for China's domestic markets.

In the past empirical studies, market size was found to be a significant and positive determinant of FDI. There are some theories and hypotheses underlying this finding. Shapiro (1998) pointed out that looking for the new market is one of the motivations of FDI. The larger the market size of a particular province, other things being constant, the more FDI the province should attract. Cheng and Kwan (2002), Liu et al. (1997), Tseng and Zebregs (2002) and Zhang (1999) indicate in their research that both at the national and the provincial level, empirical studies have found a strong positive correlation between GDP and FDI inflows in China. Meanwhile, they indicate that market size has been more important as a determinant of FDI from Europe and USA than for FDI from Hong Kong and Taiwan, as the latter tend to be more export-oriented. Besides these, Sun, et al. (2002) contend that the market demand and market size have exerted positive impact on attracting FDI because they directly affect the expected revenue of the investment.

### ***3.2 Abundant labor supply and lower labor cost***

During the past 30 years, even now, China is widely referred to as a "World Factory" or "labor-intensive manufacturing country". China took advantage of the world largest population with cheap labor to attract foreign investment since 1979. Hence, foreign investors found investment to China in order to lower their manufacturing cost. As

Moore (1993) confirmed that the lower the labor cost in the host country, the more attractive the host country, the lower wage is a significant determinant of FDI in China.

In previous empirical studies, Chen (1996), Cheng and Kwan (2000), Head and Rise (1996), and Liu et al. (1997) pointed out there is a positive relationship between lower wage and FDI. It means the lower wage in China; the higher will be inward FDI in China.

In the recent years of fast economic development, however, China attracts foreign investment not exclusively through cheap labor. As reflected in the model of Branstetter and Feenstra (1999), multinational firms in China tend to pay a wage premium to their workers. This may be because multinational firms desire to hire quality workers. The higher wage may well reflect higher labor productivity. Hence, it is conceivable that wages in those provinces that can attract relatively more FDIs can be higher, too. A negative relationship between lower wages and higher FDI inflows also has been indicated by many previous studies. Sun, et al (2002) provided evidence to show that the wage is positively related to FDI before 1991 but negatively related with FDI since then. In addition, Lipsey (1999) indicated that there is no evidence to support that low wages, associated with low per capital real income, were the main attraction for FDI.

### ***3.3 Infrastructure***

Infrastructure is also one of the important determinants of FDI. The construction of Chinese infrastructure has been improved greatly in the past 30 years. The infrastructure in transportation, communication, and the supply of water, electricity and natural gas has been almost completed in the coastal area. The ability of supply and

quality of energies, raw materials and components has been improved obviously, which provides foreign investors with excellent external conditions in production and operation. Cheng and Kwan (2000) and Head and Ries (1996) provide evidence that provinces in China with more developed infrastructure have tended to receive more FDI.

Going back to Section 2, I think the main cause of uneven distribution of FDI in China is the developed infrastructure in the coastal area. To prove the positive impact of infrastructure for FDI, Wei (2002) discussed a dummy variable of coastal regions and the non-coastal regions to analyze relationship with FDI. A consistent finding of these studies is that foreign firms have a significant preference for investing in the coastal provinces. This is not surprising, as the coastal regions are characterized by the low information cost areas and firms were able to enjoy preferential treatment during China's early experimentation with FDI.

### ***3.4 Favorable policies and stable political environment***

Favorite government policy has been found to be effective in attracting foreign investors (Janeba, 1995; Shapior and Globerman, 2003).

Tax incentives were most important factors, included income tax exemption, reduction, tariff-free during 1980 to 1993. From 1994, government used the same tax system for domestic and FDI firms. But in order to encourage more FDI and international trade, a five-year tax refund program was allowed, and tariff-free treatment was extended. For high-technology or export-oriented enterprises, the foreign investor may receive a full refund. Beside these, as I mentioned in Section 2, Chinese

government has improved the legal system for absorbing foreign investment and maintained on the steadiness, consistency, predictability and feasibility of the policies and laws of foreign investment.

### **3.5 Other determinants**

#### **3.5.1. Scale effects**

Observations made by Tseng and Zebregs (2002) indicated the importance of “scale effects” for the increase in FDI. They pointed out the greater the amount of investment, the greater the confidence of others to invest. For example, in Guangdong, Fujian, Zhejiang and other parts of the east area, economies of scale make investors share information and facilities, like schools, bank services, and hospital. Also, in these areas, the economy chain and transportation is quite extensive and convenient.

#### **3.5.2 Shared culture environment**

Tseng and Zebregs (2002) argue that China’s success in attracting FDI is unique because of the large Chinese Diaspora. The fact that Hong Kong, Tai Wan and Singapore, have accounted for more than half of the FDI flows to China (See Table 2.4) is usually used to support this argument. Zhang (2002) also indicates that investors from these areas prefer to invest in mainland China, because they could share the cultural background rather than comparative wage rates within China. For non-Chinese investors, they have to overcome culture barriers, like language, which may imply a cost.

## **CHAPTER 4 - The role that FDI plays in affecting China's trade and economic growth**

### ***4.1 The impact of FDI inflows on Domestic Economy***

China has succeeded in attracting tremendous FDIs, and foreign firms are the most important part of this for the Chinese economy. Zebregs (2001) indicates that FDI flows to China have contributed to GDP growth in several ways: one is that FDI has raised GDP growth by adding to capital formation; another is FDI has contributed to higher GDP growth through its positive effect on total factor productivity. In addition, Tseng and Zebregs (2002) found that FDI has contributed to GDP growth directly through the establishment of FIEs and indirectly by creating positive spillover effects from FIEs to domestic enterprises.

Lemoine (1998) shows that FDIs are now major players in China's international trade. This situation is the result of China's policy towards FDI which has strongly encouraged export-oriented activities. Lardy (2000) observed that the growth of China's trade has been four and a half times that of world trade, and China's share of world trade quadrupled from 0.9 percent in 1978 to 3.7 percent in 2000.

Chen (1999) and Zhang and Song (2000) concluded that FDI has a positive and significant impact on provincial export performance. Tseng and Zebregs (2002) further point out that FIEs played a key role in this achievement. Between 1985 and 1999, the share of exported accounted for by FIEs grew from 1 percent to 45 percent. FIEs

accounted for half of overall export growth and one-third of import growth during this period.

#### ***4.2 The impact of FDI on employment opportunities***

Without question, FDI created employment opportunities through the FIEs. Banerjee (2006) noted that the FDI firms' urban employment was particularly concentrated in the eastern region provinces (85.76% of the total) and more particularly in Guangdong, Fujian, Jiangsu, Shandong, Liaoning and Zhejiang, and some capital city, like Shanghai, Beijing and Tianjin. In contrast, FDI firm's urban employment in the central and the western regions made up for only 11.15% and 3.09% of FDI firms' total urban employment in China, respectively. This suggests that FDI may have contributed to widening the income gap between the eastern and western regions of China.

#### ***4.3 The impact of FDI on Technology Transformation***

Some surveys have been conducted over the last several years. The results from these surveys indicate that technology transfer from FDI was relative low, even though the Chinese government regarded FDI as a way of technology transformation. Chen et al. (1995) shared that the technology transfer from FDI was relative low, and argued that FDI's less than satisfactory contribution to high technology transfer to China is partially explained by the fact that China relied on Hong Kong and Taiwan as its principal source of FDI. Yong and Lan (1997), based on a case study in the coastal city of Dalian, found some reasons why the technology transformation from FDI is low. First, many investors were not genuine sources of technology. Second, local partners had distorted motives

and restricted absorptive capabilities. Third, moderate technology gap, an incomplete technology package and the dominant inflow of hardware hamper advanced technology transfer. Fourth, most direct technology transfer was conducted in EJV's but there was only a small difference between the technology gap and technology transferability in many EJV's. Besides these, Li and Yeung (1999) also obtained the same result by conducting case study of Shanghai Volkswagen Automotive Company and Shanghai Bell Telephone Equipment Manufacturing Company. They reported that there were inter-firm technology transfer and knowledge spillovers in both cases. Wei (2002) found that there was only evidence of low and intermediate technology transfers, mainly from Hong Kong and Taiwan.

## **CHAPTER 5 - The Road ahead: New trends and changing situation of FDI in China**

### ***5.1 Some current issues for export-oriented investment***

#### **5.1.1 The change of Exchange Rate**

The real exchange rate is assumed to function mainly through the effect of altering relative production (Yuan 2006). When the real exchange rate goes up, foreign firms usually experience higher production costs and they would like to relocate their domestic production facilities to a country where there are lower production costs, i.e., China.

However, by the end of June, 2008, the exchange rate was 1 USD to 6.82 RMB, and RMB cumulatively appreciate over 18.5% to US dollars since July 2005 (Chart 5.1).

Hence, the appreciation of Chinese Yuan to US dollars directly hurts export-oriented firms' profit.

**Chart 5.1 U.S. Dollar to Chinese Yuan Exchange Rate from Jan. 2005 to Aug. 2008**



Source: yahoo finance: <http://finance.yahoo.com/currency/convert?from=USD&to=CNY&amt=1&t=5y>

### 5.1.2 Increasing price of raw materials

Increasing the price of raw materials pushes up the cost of production in China. The crude oil price in the international markets reached new record high in May of this year. These situations lead to the increase of production cost. Some of the manufacturers have to seek for renew their production technologies to save material, while go after new supplies of raw materials in the international market. However, many small manufacturers who mostly rely on Original Equipment Manufacturing (OEM) are forced out of business under the pressure of escalating production cost. Taking the small copper-processing enterprises as an example, in the recent two years, quite a few of them went out of business. In addition, the Chinese government keeps adjusting the

tax refund of export of certain industries. As of June, 2008, some of the adjustment was 10% less, such as from 15% to 5%. It even cancelled the tax refund concerning some export goods. All these changes resulted in decreased profits for manufacturers.

### ***5.2 Further promote foreign invest in the central and western regions by Chinese government.***

Back to the Table 2.6, because of uneven regional distribution of FDI across the country, the central and western areas of China just accounted for less than 15% of FDI inflows. However, these areas are rich in resources for farming, stock rising, mineral resources and tourist resources. With a large population and potentially lower labor force, other key elements for production are relatively inexpensive. Also, infrastructures have been improved by central and local governments to attract investment. With the suitable investment environment and emerging markets, foreign firms who invest in these regions are facing new opportunities and great development space.

### ***5.3 Solving environmental issues will create new opportunities for FDI***

Environmental problems are one of the biggest challenges faced by China and the rest of World in terms of economic development. At the fourth round of Sino-US strategic talks held this year, China and America have reached multiple agreements on selected environmental issues. The USA will transfer its leading technologies in the energy and environmental protection areas by the means of foreign direct investment, joint technical research and talent exchange. In the following years, China will offer

more preferential treatment with more beneficial terms to FDI oriented toward environmental protection. Thus, it is predicted that the environmental protection industries would attract increasing FDI inflows.

#### ***5.4 Chinese Government will further perfect the environment for investment in the future***

After China joined in the WTO, the reform and opening up had entered a new developmental stage. The Chinese opening up is omni-directional, multi-leveled and wide-ranging. In November of 2006, the Communist Party of China held the 17th national congress which maintains the stability of the national political situation. The continuity of governmental principles and policies will guarantee that the Chinese reforms and opening up go on continuously and smoothly. The Chinese government announced that it will further perfect the environment for investment (the Ministry of Commerce of China, 2006):

1. Continuously strengthening the soft environmental elements of investment.

The soft environmental element refers to the market-based degree and policies of foreign investments including construction of law systems, perfect of market economy, establishment and implementation of policies and encouraging measures for foreign investment.

The Chinese government not only has already totally cleared and revised relevant laws, regulations and policy documents according to the requirements of market

economy and the promises to join in WTO, but also will make the establishment of laws, regulations and policies open, fair, standardized and transparent in the future. Meanwhile, the government will combine the transformation of governmental functions, improve the management and approval of investment, increase the efficiency of services and reduce the steps in examination and approval process.

2. The opening degree of the market should be expanded further. In order to implement the promise of WTO accession, China still needs to open more markets to foreign investors, particularly in the services sector, such as insurance markets, banking, and telecommunications. These markets are mostly monopolized by state-owned enterprises.

## **CHAPTER 6 - Concluding Remarks**

This report has attempted to present a general idea of FDI in China. China did a successful job in attracting FDI from other countries since 1979. The thirty year history of Chinese FDI has formed with a more and more open economic and political system which is key point for foreign investors. The average growth rate of FDI in China is about 10% in recent years. This is an important development for the Chinese economy, the Chinese people, and also for economic growth. This observation don't believe that this trend will continue unless the world economies get better, or China's legal system and governance become more effective in enforcing contracts, especially in western China.

As for the source of FDI in China, we have to mention two major investors, Hong Kong and Taiwan. They have always been the most important ones. Together with Singapore, Hong Kong and Taiwan have accounted for more than half of the FDI flows to China.

Based on the analyses in this report, several determinants have motivated the FDI in China. First, some FDI investors are interested in the Chinese domestic market. Second, investors would like to find ways to lower production costs, typically cheap labor from China. Third, the quality of infrastructures contributes much to FDI inflows. The good infrastructure helps firms to enhance their levels of technology and reap economies of scale and scope. Fourth, the political environment is an important factor in attracting FDI. In China, the political leadership imposed a vision for the path of growth and development of the country.

From China's experience, FDI contributes importantly to economic development. According to some researches, FDI inflows in China have raised the GDP growth by adding to capital formation, increasing in total factor productivity, and establishing Foreign-funded enterprises (FIEs). Second, FDI inflows in China play a major role in increasing China's export, which directly results in the huge trade surplus of China and US, EU, and other countries. Third, FDI inflows in China created a large number of job opportunities through FIEs, but it also widens the income gap between eastern and western China.

The FDI in China faces some new challenges and opportunities. The challenges are the appreciation of the Chinese Yuan in the world currency market and the increasing production cost of raw material and labor. However, the Chinese government encourages more investment in western China and takes measures to protect environment. This can be expected to provide new opportunities for FDI in China.

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