

Li, Zhongmin

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How Foreign Direct Investment Promotes Development: The Case of the People's Republic of China's Inward and Outward FDI

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Zhongmin Li

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Zhongmin Li is Senior Research Fellow in the Institute of World Economics and Politics, Chinese Academy of Social Sciences.

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CONTENTS

| | |
|--|----|
| ABSTRACT | v |
| I. INTRODUCTION | 1 |
| A. Twin Surplus | 1 |
| B. Balance of FDI Item in Balance of Payment | 2 |
| II. INWARD FOREIGN DIRECT INVESTMENT | 3 |
| A. Determinants and Motives | 3 |
| B. Main Characteristics and New Trends | 4 |
| C. Inward FDI from Developing Countries or Regions | 7 |
| III. OUTWARD FOREIGN DIRECT INVESTMENT | 10 |
| A. Determinants and Motives | 10 |
| B. Main Characteristics and New Trends | 11 |
| C. Outward FDI to Developing Countries or Regions | 14 |
| IV. FOREIGN DIRECT INVESTMENT AND DEVELOPMENT | 18 |
| A. Inward FDI and Development | 18 |
| B. Outward FDI and Development | 21 |
| C. Dynamic Mechanism | 22 |
| D. Global Production Network | 22 |
| V. CONCLUSION AND POLICY ISSUES | 24 |
| APPENDIX | 25 |
| REFERENCES | 26 |

ABSTRACT

In the last 33 years after the People's Republic of China's (PRC) openness and reform, huge amounts of foreign direct investment (FDI) flowed into the PRC. The capital inflow and technology spillover in turn enabled outward FDI from the PRC. This paper gives a brief introduction to the PRC's inward and outward FDI, including their determinants, motives, main characteristics, and impact on the PRC and host countries. Inward FDI contributes to the PRC's economic growth and industry development, increases tax revenue, and improves labor quality. The contribution of inward FDI to gross domestic product averages around 3%–6%. At the same time, outward FDI improves the PRC's dynamic efficiency, and helps the host countries with capital inflow and infrastructure improvement.

Based on the PRC's experience, four policy issues are proposed: dynamic mechanism inside FDI, investment liberalization, international coordination, and trade-related policy.

Keywords: FDI, PRC, South–South investment

JEL Classification: F21, O53, E22

I. INTRODUCTION

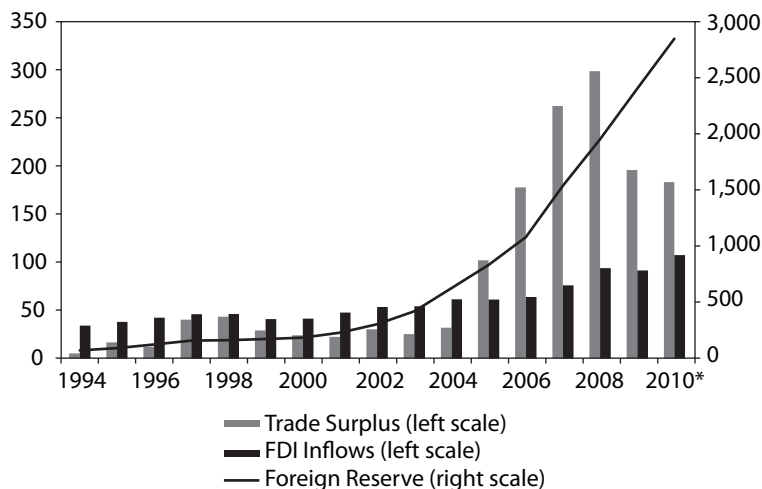
At the beginning of the People's Republic of China's (PRC) reform, the government promoted export and foreign direct investment (FDI) inflows because of a shortage of foreign reserve. However, many companies in Europe and the United States (US) hesitated to invest in the PRC that time, though a few of them tried. At the beginning of investment promotion, most of the FDI inflows came from Hong Kong, China. At the same time, export promotion policies seemed not to work either, as the PRC maintained a trade deficit for many years after 1978.

A. Twin Surplus

Things changed after the 1980s, as more and more multinationals invested in the PRC. This trend accelerated in the 1990s. Before 1985, the progress of FDI inflow promotion seemed ineffective. Only \$4.1 billion of FDI inflows to the PRC were recorded between 1979 and 1984, improving only after 1985. In 1992, FDI inflows reached a historical high of \$11.0 billion and further accelerated after that. FDI inflows enlarged the PRC's export and trade surplus, a "twin surplus," that began in 1994.

Until now, twin surplus is still the best description for the PRC's external economic relationship. The monetary authority accumulated huge amounts of foreign reserve from the trade surplus and financial account surplus. In 2010, the PRC's foreign reserve stood at \$2,847.3 billion. After that, outward FDIs almost doubled every year and had reached \$59.0 billion by 2010. According to the PRC's international investment position, FDI inflows amounted to \$997.4 billion in 2009, accounting for 41.6% of the PRC's foreign reserves (Figure 1).

Figure 1: "Twin Surplus" and Foreign Reserve of the People's Republic of China, 1994–2010 (\$ billion)



* Primary release data.

Sources: National Bureau of Statistics of China, the PRC's Ministry of Commerce, People's Bank of China.

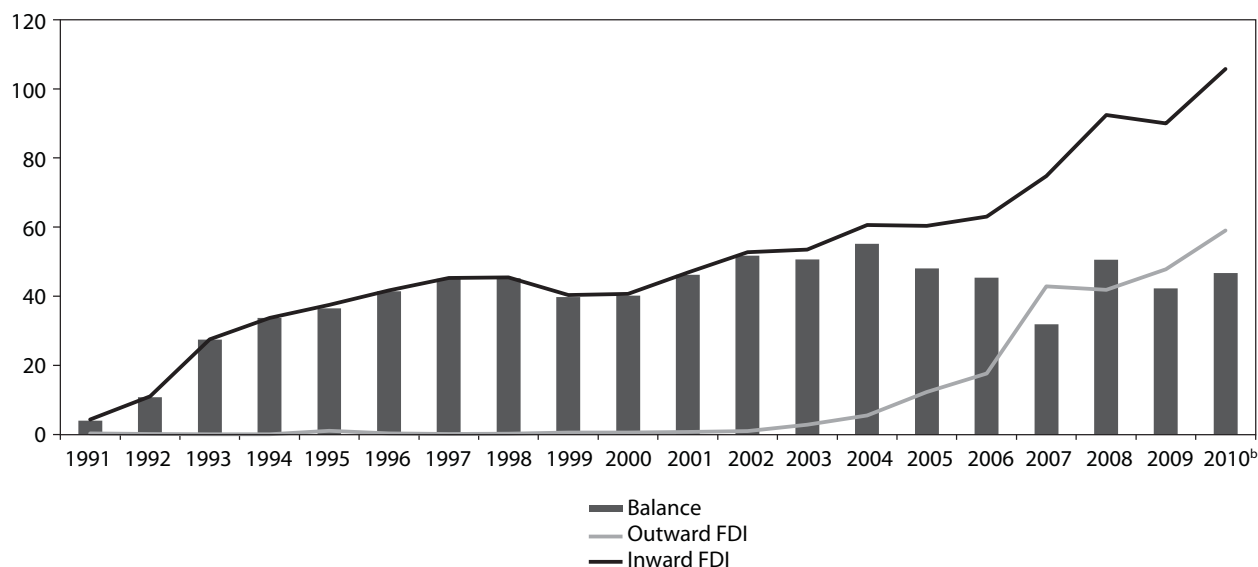
B. Balance of FDI Item in Balance of Payment

The PRC's outward FDI is quite interesting in that the history of outward FDI seems longer than that of inward FDI. The PRC's outward FDI began in 1976 but remained at a very low level for a long time. The most common channel for the PRC's outward FDI is through joint ventures. Chinese companies invested \$5.1 million in joint ventures between 1976 and 1981, which went to Hong Kong, China (81.4%); Macao, China (0.6%); Sudan (17.1%); and the US (0.8%). The PRC's investments focused on trade-related and resource industries.

However, the PRC's outward FDI did not develop smoothly because of two constraints. One is shortage of foreign reserve, as previously mentioned. The other is absence of strength and internationalization of Chinese companies until 2003.

As a result of the different performance of inward and outward FDIs, the PRC held an FDI surplus in its balance sheet for a long time. This is quite unlike other Asian countries like Japan, but consistent with the performance of a developing country. However, with the PRC's outward FDI growing dramatically, the FDI surplus is narrowing gradually. It is very possible that the PRC might hold a deficit in the FDI item in the near future (Figure 2).

Figure 2: Balance of FDI Item of PRC, 1991–2010^a
(\$ billion)



FDI = foreign direct investment, PRC = People's Republic of China.

^a Data between 1991 and 2002 is the approved outward foreign direct investment of the PRC according to the Ministry of Commerce.

^b Primary release data.

Sources: National Bureau of Statistics of China, Ministry of Commerce of the PRC.

II. INWARD FOREIGN DIRECT INVESTMENT

Under the PRC's open and reform strategy, the government published FDI promotion policies after 1978. In 1978, Panasonic and Coca Cola entered the PRC. Prior to that, foreign companies were retreating from the PRC, exemplified by Shell's withdrawal in 1966. Because of the open policies and market prospects, some enterprises from Hong Kong, China; Japan; and the US started investing. In 1990, FDI inflows to the PRC stood at \$3.5 billion, most of which came from Hong Kong, China; Japan; and the US, which accounted for 54.9%, 14.4%, and 13.1%, respectively.

In the last 20 years, the PRC's FDI inflow has grown from \$3.5 billion to \$100.0 billion. Also, the sources, destination, structure, and even the target of the foreign-invested companies have changed dramatically.

A. Determinants and Motives

The theory on determinants and motives of inward and outward FDI is quite mature. Dunning and Lundan (2008) classified enterprises engaged in international production into four types. First is the natural resource seekers, a very broad classification that includes physical resources, cheap and well-motivated unskilled or semi-skilled labor, technological capability, management or marketing expertise, and organizational skills. Second is the market seeker, which often occurs in the country with huge amount of imports, and where international production can reduce tariffs and other types of trade barriers. Third is the strategic asset seekers, enterprises that invest abroad for certain strategic assets to enhance their future competitiveness. Besides the above three types of FDI, Dunning and Lundan (2008) also mentioned investments to escape restrictive legislation or macro-organizational policies, and investments aimed at supporting related enterprises.

Beside the traditional explanation for FDI, there are also new findings. More and more researches take the gravity equation from trade-related areas into investment-related research. Blonigen and Piger (2011) find the traditional gravity variables—cultural distance factor, parent country per capita gross domestic product, relative labor endowments, and regional trade agreements—are most likely to be the determinants of FDI activities. According to empirical data from the PRC, this explanation actually makes.

As far as the PRC is concerned, Zhang (1994) pointed out that deregulations and reforms make some provinces or cities more attractive for multinationals. The establishment of special economic zones is the best example. Head and Ries (1996) found that policies supporting the development of infrastructure and industry have positive effects on FDI inflows at the provincial level. Both of the researches prove that FDI-promoting policies are determinants of FDI inflows. Another is the difference between different investors. Fung, Lizaka, and Parker (2002) found investments from Hong Kong, China and Taipei, China are efficiency-seeking, affected most by infrastructure conditions and labor cost. While Japanese investments are market- and resource-seeking, they pay more attention to the labor quality. In the interesting work by Fetscherin, Voss, and Gugler (2010), they gave a more dynamic summary for these researches.

Other important factors that affect FDI inflow is the financial constraint and competition at the provincial level. The provincial government wants huge amounts of investment in pursuit of high growth. But investment is hampered by fiscal expenditure and financial constraints.

Under this situation, FDI is one solution to local investment demand and is in fact encouraged by the central government.

Combining the works of Dunning and Lundan (2008) and Fetscherin, Voss, and Gugler (2010), the determinants of the PRC's FDI inflow can be summed up in three stages: First, between 1978 and 2000, most of the enterprises the invested in the PRC were resource seekers or escape investment. The purpose of investing in the PRC is to take advantage of preferential policies, low labor cost, and lesser environment regulation. At this stage, FDI is mainly from Hong Kong, China; Macao, China; and Taipei, China. Recently, because of more environment regulations and higher labor costs, some investments of this kind moved from eastern PRC to the western PRC. More recently, between 2001 and 2007, market seekers and efficiency seekers came in. Because of FDI in the first stage, the PRC can invest more in infrastructure, and labor quality improved much also. These two factors entice investors to the PRC to use the PRC as their base use the PRC as their base in Asia. Also, the PRC's accession to the World Trade Organization (WTO) ensures the multinationals of a more open market. Besides these, there is also supporting investment through agglomeration. The typical investors in this stage are from Europe, Japan, and the US. Third, after the global financial crisis, more and more multinationals became resource seekers and strategic asset seekers as they discovered the PRC's advantage in aspects like excessive liquidity, skilled labor, and new technology. More foreign investors invested in the PRC, even established joint ventures outside of the PRC, to take advantage of this.

Though the last 33 years of the PRC's history can be divided into three stages, it is quite difficult and impossible to tell where we are. Current investors belong to all the three stages. However, we can discern them from location and source. Investors of the first stage come mainly from Hong Kong, China; Macao, China; and Taipei, China, and located in the western or middle part of the PRC. Investors after the PRC's accession to the WTO mainly belong to the world's top 500 multinationals, and located in the eastern PRC, especially the Yangtze River Delta or Bohai Economic Circle. Most of the third stage investors are investors in the second stage, too. The typical behavior of the third stage investors the establishment of joint ventures with the PRC's central state-owned enterprises (SOEs) locally or abroad.

B. Main Characteristics and New Trends

We have pointed out several characteristics and new developments of inward FDI and discussed the determinants and motives of the PRC's inward FDI. In the following section, we will discuss the sources of inward FDI from developing countries to the PRC as we analyze the distribution of industries and host subregion, ownership structure, and some new trends in ownership structure of foreign-invested enterprises.

At the industrial level, before 2001, most of the inward FDI went to the manufacturing sector. In 2000, 63.5% of FDI flowed to manufacturing industries. After 2001, FDI in the services sector grew gradually. But after 2006, FDI in the services sector increased dramatically. Though the value of manufacturing FDI keeps growing, the percentage keeps decreasing because of increases in the share of services and other sectors. In 2000, the percentage of services and other sectors is only 33.4%, while in 2009 it increased to 45.9% (Table 1).

Table 1: Distribution of Inward FDI at Industrial Level in the PRC, 1997–2009
(\$ billion)

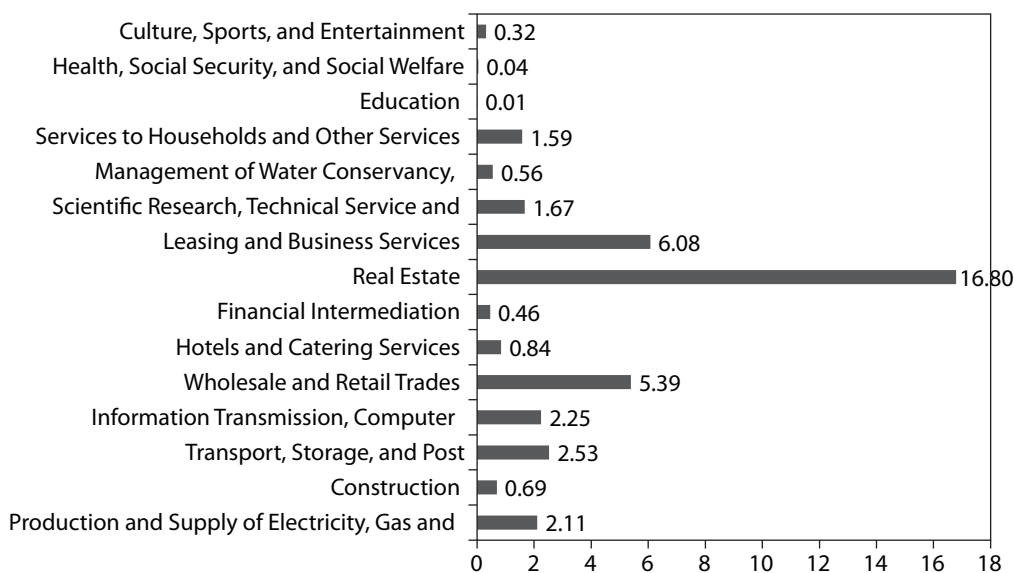
| | Total | Primary ^a | Mining | Manufacturing | Service and Other |
|------|-------|----------------------|--------|---------------|-------------------|
| 1997 | 45.3 | 0.6 | 0.9 | 28.1 | 11.7 |
| 1998 | 45.5 | 0.6 | 0.6 | 25.6 | 14.4 |
| 1999 | 40.3 | 0.7 | 0.6 | 22.6 | 16.4 |
| 2000 | 40.7 | 0.7 | 0.6 | 25.8 | 13.6 |
| 2001 | 46.9 | 0.9 | 0.8 | 30.9 | 14.3 |
| 2002 | 52.7 | 1.0 | 0.6 | 36.8 | 14.3 |
| 2003 | 53.5 | 1.0 | 0.3 | 36.9 | 15.2 |
| 2004 | 60.6 | 1.1 | 0.5 | 43.0 | 16.0 |
| 2005 | 60.3 | 0.7 | 0.4 | 42.5 | 16.8 |
| 2006 | 63.0 | 0.6 | 0.5 | 40.1 | 21.9 |
| 2007 | 74.8 | 0.9 | 0.5 | 40.9 | 32.5 |
| 2008 | 92.4 | 1.2 | 0.6 | 49.9 | 40.7 |
| 2009 | 90.0 | 1.4 | 0.5 | 46.8 | 41.3 |

^a Includes agriculture, forestry, animal husbandry, and fishery.

Sources: National Bureau of Statistics of China.

In the services sector, most of the FDI goes to real estate, leasing and business services, and wholesale and retail trades (Figure 3).

Figure 3: Distribution of Inward FDI in Service Sector, 2009
(%)



FDI = foreign direct investment.

Source: National Bureau of Statistics of China.

Most of the subregional distribution of FDI inflows, until now, go to Eastern PRC. In 2000 and 2009, the percentage of FDI inflows to Eastern PRC was 84.0% and 81.2%, respectively. But as mentioned earlier, some resource seekers also went to the middle PRC and Western PRC under the pressure of labor cost increases and stricter environment regulations. Because of this, the percentage FDI inflows to the western PRC grew from 4.1% to 5.0% between 2005 and 2009 (Table 2).

Table 2: Host Sub-region Distribution of Inward FDI Stock, 2000, 2005, and 2009

| | Inward FDI Stock (\$ billion) | | | Percentage | | |
|--------------|-------------------------------|--------------|--------------|--------------|--------------|--------------|
| | 2000 | 2005 | 2009 | 2000 | 2005 | 2009 |
| Total | 82.5 | 146.4 | 250.0 | 100.0 | 100.0 | 100.0 |
| Eastern PRC | 69.3 | 125.6 | 203.1 | 84.0 | 85.8 | 81.2 |
| Middle PRC | 7.5 | 14.8 | 24.7 | 9.1 | 10.1 | 9.9 |
| Western PRC | 3.7 | 6.0 | 12.5 | 4.5 | 4.1 | 5.0 |
| Other | 2.0 | 0.0 | 97.0 | 2.4 | 0.0 | 3.9 |

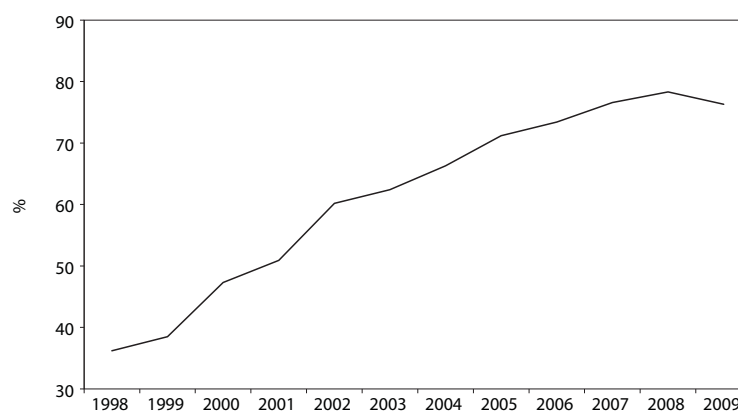
FDI = foreign direct investment, PRC = People's Republic of China

Sources: PRC's National Bureau of Statistics, calculated by author.

Another important factor that caused more FDI go to the Western PRC is the Western PRC Development Strategy. Under this strategy, some preferential policies abandoned in the Eastern PRC are kept in the Western PRC.

At the beginning of the PRC's opening and reform, most of the foreign enterprises choose establishing joint venture with Chinese partners. This ownership structure is the rational choice to reduce investment risk and abide by regulations. After more than 30 years of reform, the political risk of investing in the PRC has decreased gradually. Because of this change, more and more multinationals choose the wholly controlled ownership structure. Between 1998 and 2009, the wholly controlled enterprises increased from 36.2% to 76.3% (Figure 4).

Figure 4: Percentage of Wholly Foreign-owned Enterprise in Terms of FDI Inflow



FDI = foreign domestic investment.

Sources: PRC's National Bureau of Statistics, calculated by author.

There are two other factors that encourage multinationals to choose wholly owned enterprises. One is deregulation. For example, before, foreign car makers could not establish wholly owned enterprise in the PRC, they must invest through joint ventures with local car makers under the strategy of Market for Technology. In 2004, the newly published Catalogue for the Guidance of Foreign Investment Industries cancelled this restriction, paving the way for foreign car makers to establish wholly owned enterprises in the PRC.

C. Inward FDI from Developing Countries or Regions

In 1995, 95.5% of FDI inflows to the PRC came from developed countries or regions. Among the developed countries and regions, the most important source is Asian countries and regions, especially Hong Kong, China. FDI from Hong Kong, China accounts for 53.4% of all FDI inflow. After that, the percentage of Asian countries decreases gradually, and that of other regions increased. FDI from Latin America increased fastest among all regions, due mainly to the Cayman Islands and Virgin Islands, which, because of their local tax policies, attract more and more small- and medium-size enterprises, including some Chinese companies. In 2009, FDI inflow from the Cayman Islands and Virgin Islands accounted for 15.4% of the PRC's total FDI inflow (Table 3).

FDI inflow from developing countries is very small, accounting for only 2.9% in 1995. In 2009, the percentage nearly doubled but is still very low at 5.2%. For FDI from developing countries to the PRC, the most important region is Asia. This situation somehow verifies the possibility of using gravity equation in FDI research, as have tried by some scholars (Blonigen and Piger 2011). See Table 3.

However, according to the Asian Development Bank's (ADB's) classification, most of the PRC's FDI comes from Asian developing countries.¹ FDI inflows from Asian developing countries accounted for 71.72% in 1995. After that, the percentage of Asian developing countries decreased gradually between 1995 and 2005. In recent years, specifically between 2006 and 2009, FDI inflows from Asian developing countries increased markedly. In 2009, the percentage of Asian developing countries still accounted for 63.82% (Table 4).

FDI from developing countries to the PRC are mostly to small and medium-sized enterprises (SMEs). Most invested industries are labor-intensive. Because of this, inward FDI is very sensitive to labor cost changes. In recent years, many enterprises from developing countries moved to Southeast Asia, the middle PRC, or the western part of the PRC. Investors from the south are often called migrant enterprises as they are "easy to move."

¹ This happens because in ADB country classification, Brunei Darussalam; Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China, are all developing countries.

Table 3: Source of the PRC's Inward FDI, 1995–2009
(\$ billion)

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|----------------------------------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| Total | 37.8 | 42.1 | 45.3 | 45.5 | 40.3 | 40.7 | 46.9 | 52.7 | 53.5 | 60.6 | 60.3 | 63.0 | 74.8 | 92.4 | 90.0 |
| Developed Countries ^a | 36.1 | 40.0 | 43.7 | 43.6 | 38.8 | 39.0 | 44.6 | 49.4 | 49.5 | 55.3 | 55.5 | 57.6 | 68.7 | 85.2 | 83.6 |
| Asia ^b | 29.9 | 32.4 | 33.4 | 30.5 | 26.2 | 24.8 | 28.7 | 31.6 | 33.2 | 36.6 | 34.9 | 34.2 | 41.2 | 55.5 | 59.8 |
| Hong Kong, China | 20.2 | 20.9 | 20.6 | 18.5 | 16.4 | 15.5 | 16.7 | 17.9 | 17.7 | 19.0 | 17.9 | 20.2 | 27.7 | 41.0 | 46.1 |
| Europe | 2.2 | 3.0 | 4.4 | 4.3 | 4.8 | 4.7 | 4.4 | 4.0 | 4.2 | 4.6 | 5.5 | 5.6 | 4.2 | 5.3 | 5.4 |
| Latin America | 0.3 | 0.6 | 1.9 | 4.4 | 3.0 | 4.5 | 6.1 | 7.3 | 6.7 | 8.8 | 11.1 | 13.9 | 19.8 | 20.4 | 14.4 |
| Cayman Islands | 0.0 | 0.1 | 0.2 | 0.3 | 0.4 | 0.6 | 1.1 | 1.2 | 0.9 | 2.0 | 1.9 | 2.1 | 2.6 | 3.1 | 2.6 |
| Virgin Islands (US) | 0.3 | 0.5 | 1.7 | 4.0 | 2.7 | 3.8 | 5.0 | 6.1 | 5.8 | 6.7 | 9.0 | 11.2 | 16.6 | 16.0 | 11.3 |
| North America | 3.3 | 3.8 | 3.6 | 4.2 | 4.5 | 4.7 | 4.9 | 6.0 | 4.8 | 4.6 | 3.5 | 3.3 | 3.0 | 3.5 | 3.4 |
| Oceania | 0.3 | 0.2 | 0.4 | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 | 0.7 | 0.8 | 0.5 | 0.6 | 0.4 | 0.5 | 0.5 |
| Developing Countries | 1.1 | 1.2 | 1.4 | 1.5 | 1.3 | 1.6 | 2.2 | 3.2 | 3.2 | 3.8 | 3.9 | 4.5 | 5.4 | 6.3 | 4.7 |
| Asia | 0.9 | 1.0 | 1.0 | 1.0 | 0.9 | 1.0 | 1.4 | 1.9 | 1.9 | 2.2 | 2.3 | 2.5 | 3.2 | 3.5 | 2.9 |
| Africa | 0.0 | 0.0 | 0.1 | 0.2 | 0.2 | 0.3 | 0.3 | 0.6 | 0.6 | 0.8 | 1.1 | 1.2 | 1.5 | 1.7 | 1.3 |
| Europe | 0.0 | 0.0 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Latin America | 0.0 | 0.1 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 | 0.5 | 0.2 |
| North America | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.2 | 0.5 | 0.4 | 0.4 | 0.2 | 0.4 | 0.4 | 0.5 | 0.3 |
| Unspecified | 0.7 | 0.9 | 0.2 | 0.2 | 0.2 | 0.2 | 0.1 | 0.1 | 0.7 | 1.5 | 0.9 | 1.0 | 0.6 | 0.9 | 1.7 |

^a High income countries, according to the classification of World Bank.

^b According to the classification of National Bureau of Statistics of China.

Sources: PRC's National Bureau of Statistics, calculated by author.

Table 4: PRC's Inward FDI from Asian Countries, 1995–2009
\$ billion, percentage

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Total Value | 37.81 | 42.14 | 45.26 | 45.46 | 40.32 | 40.71 | 46.88 | 52.74 | 53.50 | 60.63 | 60.32 | 63.02 | 74.77 | 92.40 | 90.03 |
| Asian Developing Countries ^a | 27.12 | 29.10 | 29.69 | 27.59 | 23.73 | 22.46 | 25.44 | 28.74 | 29.57 | 32.64 | 29.84 | 31.27 | 39.87 | 54.32 | 57.46 |
| Central Asia | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.02 | 0.03 | 0.00 | 0.00 | 0.01 | 0.00 | 0.01 | 0.01 | 0.01 | 0.02 |
| South Asia | 0.00 | 0.00 | 0.00 | 0.01 | 0.00 | 0.01 | 0.02 | 0.04 | 0.02 | 0.06 | 0.05 | 0.07 | 0.04 | 0.11 | 0.07 |
| East Asia | 24.40 | 25.84 | 26.07 | 23.23 | 20.24 | 19.29 | 21.85 | 24.55 | 25.57 | 28.36 | 25.27 | 26.27 | 33.16 | 46.07 | 50.66 |
| Hong Kong, China | 20.20 | 20.90 | 20.60 | 18.50 | 16.40 | 15.50 | 16.70 | 17.90 | 17.70 | 19.00 | 17.90 | 20.20 | 27.70 | 41.00 | 46.10 |
| Southeast Asia | 2.65 | 3.19 | 3.43 | 4.22 | 3.29 | 2.84 | 2.98 | 3.26 | 2.93 | 3.04 | 3.11 | 3.35 | 4.39 | 5.46 | 4.68 |
| The Pacific | 0.06 | 0.07 | 0.19 | 0.13 | 0.21 | 0.29 | 0.56 | 0.90 | 1.06 | 1.16 | 1.41 | 1.58 | 2.28 | 2.67 | 2.03 |
| Percentage of Asia Developing Countries | 71.72 | 69.06 | 65.6 | 60.69 | 58.87 | 55.16 | 54.28 | 54.5 | 55.27 | 53.83 | 49.46 | 49.62 | 53.33 | 58.79 | 63.82 |

^aAccording to the classification of ADB.

Sources: PRC's National Bureau of Statistics, calculated by author.

III. OUTWARD FOREIGN DIRECT INVESTMENT

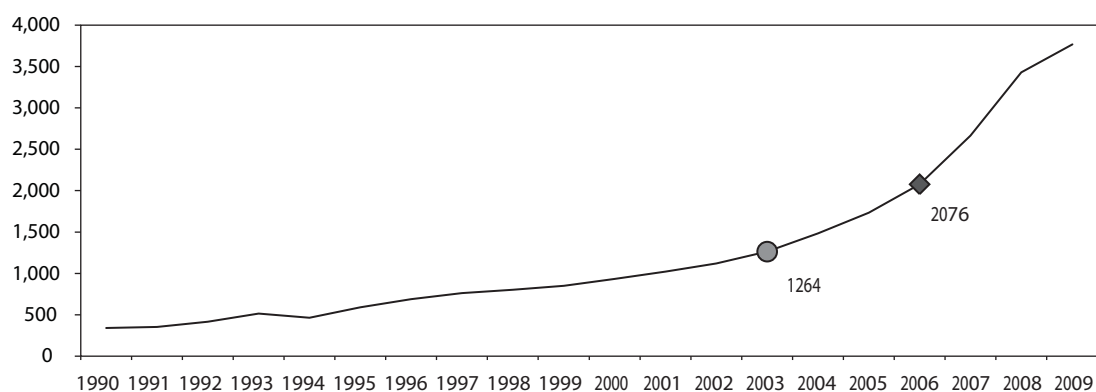
After 1976, the PRC government permitted domestic enterprises to establish joint ventures abroad. Most of the joint ventures serve the domestic economy, with main businesses in processing and marketing of export products, and mining and forestry. There are 113 joint ventures as of the end of 1984 totalling \$150 million, 20 of them located in Third World countries. In 1987, 109 of the 113 joint ventures were located in developing countries, accounting for 88.8% of the newly invested joint ventures. By the end of 2010, the stock and flow of the PRC's outward FDI had grown to \$59.0 billion and \$304.8 billion, respectively.

The first recorded joint venture serving processing and marketing of export products is Japan's Jinglian Industrial Co., Ltd. This corporation is jointly invested in by Beijing International Trust Co., Ltd.; Asahi Trading Co., Ltd.; and Sanwa Bank. The biggest Chinese company to go abroad is CITIC Canada, which was established in 1985.

A. Determinants and Motives

The theoretical framework for inward FDI is suitable for outward FDI also. As the PRC is a developing country, there is some concern about the PRC being a "third world multinational." Dunning (1981 and 1986) put forward his investment development cycle theory to explain the phenomenon of third world multinationals, and supported it with more empirical analysis in 1986. According to his theory, countries with per capita gross national income (GNI) under \$2,000 will have no outward FDI. One country will begin to have FDI outflow when per capita GNI enters the range of \$2,000–\$4,750. According to the investment development cycle, the PRC's outward FDI should begin from 2006 when its per capita GNI is \$2,076. The outward FDI data does not seem to support this hypothesis, as the breakthrough of the PRC's outward FDI happened in 2003 (Figure 5).

Figure 5: Per Capita GNI of the PRC, 1990–2009



GNI = gross national income, PRC = People's Republic of China.

Sources: National Bureau of Statistics of China, calculated by author.

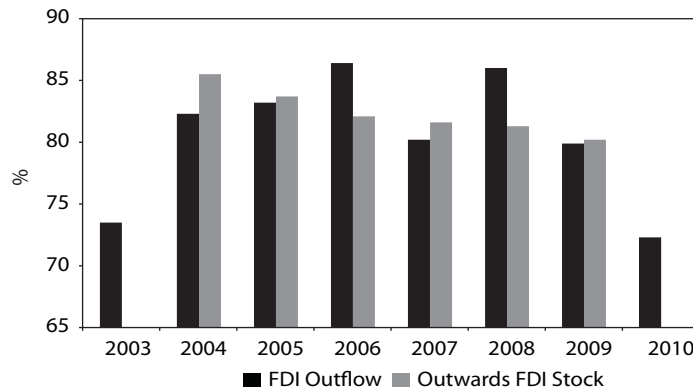
Other research find the PRC's outward FDI as two-way motivated (Kolstad and Wiig 2010). Outward FDI going to Organisation for Economic Co-operation and Development (OECD) countries is market-seeking, while those going to non-OECD countries seek a combination of large natural resources and poor institutions. This finding is very interesting, but there is no evidence from the operational level.

There are only a few literature on the determinants and motives of the PRC's outward FDI because it is only at the beginning stage. Hence, it is very difficult to draw any sound conclusions on this issue. What we can give are only observations. According to evidence at the operational level, the PRC's outward FDI can be divided into four types. First, with central state-owned enterprises (SOEs), which are resource seekers, high economic growth and low energy efficiency present a severe shortage of energy and resources. To guarantee the supply of raw materials, central SOEs seek physical natural resources from abroad. Second, with private companies, which are market seekers, Asia, Africa, and Latin America present target markets, specifically telecommunication, textile, shoe, and car industries. Some enterprises use domestic parts and assemble the final products in the local markets. Most of these enterprises are SMEs, but some big companies like Huawei and ZTE also belong to this category. Third, efficiency seekers such as air-conditioner manufacturer Green and machinery manufacturer Sany established production centers in Latin America to minimize transport costs, and use the local production center as regional base. Fourth, strategic asset seekers for example establish research or design centers in Europe, or acquire technology-intensive competitors through merger and acquisition, to enhance future competitiveness in domestic and global market. This type of investor includes Sany, Gily, Lenovo, Haier, etc.

B. Main Characteristics and New Trends

The most important characteristic of the PRC's outward FDI is the impact of central SOEs. Outward FDI of the PRC increased from \$0.98 billion to \$2.85 billion from 2002 to 2003. Of the \$2.85 billion outward FDI in 2003, 73.5% in value, or \$2.10 billion, is done by central SOEs. This also indicates that the main engine behind the dramatic growth of the PRC's outward FDI in recent years is central SOEs. Between 2003 and 2009, the central SOEs' outward investment accounted for more than 80% of the PRC's outward FDI flow and stock (Figure 6).

Figure 6: Central SOEs' Percentage in the PRC's FDI Outflow and Outwards FDI Stock (%)



FDI = foreign direct investment, SOE = state-owned enterprise.

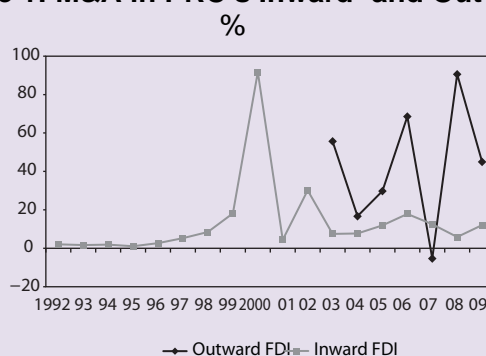
Sources: PRC's Ministry of Commerce, calculated by author.

Box 1: Greenfield Investment and Mergers and Acquisitions in the PRC's Inward and Outward FDI

Most of the PRC's inward FDI were greenfield investments rather than mergers and acquisitions (M&A). However, in 1999, 2000, and 2002, the percentage of M&A reached 18.2%, 91.7%, and 30.2%, respectively. One reason for this was the deregulation of M&A activity in the PRC, where most M&A deals were approved by the government. The other reason is the change in types of investors. Before, most of the investors were nonfinancial enterprises, now there are more and more financial enterprises and private equities that engage in M&A in the PRC.

However, the percentage of M&A in outward FDI is much higher than inward FDI. More than half of outward FDI is M&A in most of the years between 2003 and 2009. The basic reason for this is the tenure of chief executives of central SOEs. The chief executives only have 5-year terms. To see the result of outward investment quickly, the best choice is M&A (Box Figure 1).

Box Figure 1: M&A in PRC's Inward- and Outward FDI



Before 1998, SOEs were known for low efficiency and loss. The central government implemented reforms on SOEs in 1998. In the beginning, there was no clear strategy for SOE reform. Several years later, the government put forward the strategy of *hold the big, let the small go*, exemplified by the experience of Shandong province. The main idea of the strategy was to keep control of the big SOEs in strategic sectors like energy, natural resources, etc. but transfer ownership of other SOEs to local governments or private companies. This strategy achieved a huge success and the large SOEs under the central government's control, i.e., those managed by the state-owned Assets Supervision and Administration Commission of the State Council, laid the foundation of the central SOE system.

Central SOEs have monopoly market power without liability to hand in their profits.² Huge corporate savings are accumulated by taking advantage of monopoly market power and preferential dividend policy. By the end of 2009, there were 426,113 enterprises above the designated size,³ with total assets of \$6,314 billion. Of these enterprises, 129 were central SOEs with total assets of \$3,083 billion, accounting for 48.8% of the total assets and 27.5% of total profits (Table 5).

² There is a new policy in 2010, 0%–10% of their profit is collected as the revenue of the central government.

³ Also known as "above-designated size enterprise", includes all stated-owned enterprises and enterprises with annual sale above CNY5 million.

Table 5: Position of the PRC's Central SOEs

| | Profit of Above-designated Enterprises ^a (billion yuan) | Central SOEs ^b | |
|-----------|--|---------------------------|------|
| | | Profit (billion yuan) | % |
| Nov 2006 | 1,653.2 | 688.8 | 41.7 |
| June 2009 | 894.1 | 317.9 | 35.6 |
| Nov 2009 | 2,589.1 | 711.0 | 27.5 |
| June 2010 | 1,611.1 | 525.0 | 32.6 |

PRC = People's Republic of China, SOE = state-owned enterprises.

^aAlso known as "above-designated size enterprise", includes all stated-owned enterprises and enterprises with annual sale above 5 million yuan.

^bCentral SOEs are all above-designated enterprises.

Source: PRC's National Bureau of Statistics, PRC's state-owned Assets Supervision and Administration Commission of the State Council, calculated by author.

In terms of industry distribution, the basic structure of the PRC's outward FDI has been unchanged since 2005. The top three industries are leasing and business services, mining, and wholesale and retail trades. The investors of the first two industries are mostly central SOEs, while those in the third are mostly private companies (Table 6).

Table 6: Industry Distribution of China's FDI outflow, 2004–2009
(billion \$)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|--|-------------|--------------|--------------|--------------|--------------|--------------|
| Agriculture, Forestry, Animal Husbandry, and Fishery | 0.29 | 0.11 | 0.19 | 0.27 | 0.17 | 0.34 |
| Mining | 1.80 | 1.68 | 8.54 | 4.06 | 5.82 | 13.34 |
| Manufacturing | 0.76 | 2.28 | 0.91 | 2.13 | 1.77 | 2.24 |
| Production and Supply of Electricity, Gas, and Water | 0.08 | 0.01 | 0.12 | 0.15 | 1.31 | 0.47 |
| Construction | 0.05 | 0.08 | 0.03 | 0.33 | 0.73 | 0.36 |
| Transport, Storage and Post | 0.83 | 0.58 | 1.38 | 4.07 | 2.66 | 2.07 |
| Information Transmission, Computer Services, and Software | 0.03 | 0.01 | 0.05 | 0.30 | 0.30 | 0.28 |
| Wholesale and Retail Trades | 0.80 | 2.26 | 1.11 | 6.60 | 6.51 | 6.14 |
| Hotels and Catering Services | 0.00 | 0.01 | 0.00 | 0.01 | 0.03 | 0.07 |
| Financial Intermediation | 0.00 | 0.00 | 3.53 | 1.67 | 14.05 | 8.73 |
| Real Estate | 0.01 | 0.12 | 0.38 | 0.91 | 0.34 | 0.94 |
| Leasing and Business Services | 0.75 | 4.94 | 4.52 | 5.61 | 21.72 | 20.47 |
| Scientific Research, Technical Service, and Geologic Prospecting | 0.02 | 0.13 | 0.28 | 0.30 | 0.17 | 0.78 |
| Management of Water Conservancy, Environment and Public Facilities | 0.00 | 0.00 | 0.01 | 0.00 | 0.14 | 0.00 |
| Services to Households and Other Services | 0.09 | 0.06 | 0.11 | 0.08 | 0.17 | 0.27 |
| Education | 0.00 | 0.00 | 0.00 | 0.01 | 0.00 | 0.00 |
| Health, Social Security and Social Welfare | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Culture, Sports and Entertainment | 0.00 | 0.00 | 0.00 | 0.01 | 0.02 | 0.02 |
| Public Management and Social Organizations | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Total | 5.50 | 12.26 | 21.16 | 26.51 | 55.91 | 56.53 |

Source: PRC's Ministry of Commerce.

C. Outward FDI to Developing Countries or Regions

Similar to inward FDI, most of the PRC's outward FDI go to developed countries, especially in Asia and Latin America. FDI outflows from the PRC to developed countries in these regions account for 82.6% of total outward FDI stock. FDI from Asia and Latin America goes to Hong Kong, China; Cayman Islands; and the Virgin Islands (Table 7).

Table 7: Destination of the PRC's Outward FDI, 2003–2009 (\$ billion)

| | FDI Outflows | | | | | | | Outward FDI Stock at the End of 2009 |
|----------------------------------|--------------|------|-------|-------|-------|-------|-------|--------------------------------------|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | |
| Total | 2.85 | 5.50 | 12.26 | 17.63 | 26.51 | 55.91 | 56.53 | 245.76 |
| Developed Countries ^a | 2.57 | 4.81 | 11.24 | 16.12 | 21.68 | 47.48 | 51.96 | 220.41 |
| Asia ^b | 1.35 | 2.77 | 4.11 | 7.27 | 14.45 | 41.20 | 38.00 | 174.34 |
| Hong Kong, China | 1.15 | 2.63 | 3.42 | 6.93 | 13.73 | 38.64 | 35.60 | 164.50 |
| Europe | 0.11 | 0.07 | 0.19 | 0.13 | 1.06 | 0.45 | 3.01 | 6.29 |
| Latin America | 1.02 | 1.72 | 6.41 | 8.38 | 4.52 | 3.57 | 6.98 | 28.65 |
| Cayman Islands | 0.81 | 1.29 | 5.16 | 7.83 | 2.60 | 1.52 | 5.37 | 13.58 |
| Virgin Islands (US) | 0.21 | 0.39 | 1.23 | 0.54 | 1.88 | 2.10 | 1.61 | 15.06 |
| North America | 0.06 | 0.13 | 0.32 | 0.26 | 1.13 | 0.36 | 1.52 | 5.18 |
| Oceania | 0.03 | 0.12 | 0.20 | 0.09 | 0.53 | 1.90 | 2.45 | 5.96 |
| Developing Countries | 0.29 | 0.69 | 1.03 | 1.51 | 4.83 | 8.42 | 4.57 | 25.35 |
| Asia | 0.16 | 0.24 | 0.38 | 0.43 | 2.38 | 2.40 | 2.44 | 11.67 |
| Africa | 0.07 | 0.32 | 0.39 | 0.52 | 1.57 | 5.49 | 1.44 | 9.33 |
| Europe | 2.04 | 2.09 | 2.21 | 0.47 | 0.48 | 0.43 | 0.34 | 2.39 |
| Latin America | 0.02 | 0.05 | 0.05 | 0.09 | 0.39 | 0.10 | 0.35 | 1.95 |

FDI = foreign direct investment; PRC = People's Republic of China, US = United States.

^a High income countries, according to the classification of World Bank.

^b According to the classification of National Bureau of Statistics China.

Sources: PRC's Ministry of Commerce, calculated by author.

However, the percentage of outward FDI to developing countries is higher than that of inward FDI. As of the end of 2009, \$25.35 billion outward FDI in developing countries were made by Chinese investors, accounting for 10.3% of total outward FDI stock. Most of the investors choose Asian and African developing countries as destination (Table 7).

Again, according to ADB classification, most of the FDI outflow goes to Asian developing countries. As of end-2009, about 73.77% of total outward FDI went to Asian developing countries. Of this 73.77%, \$181.29 billion or 92.10% went to developing countries or regions in East Asia (Table 8).

Table 8: PRC's Outward FDI to Asian Developing Countries, 2003–2009

| | FDI Outflows | | | | | | | Outward FDI Stock at the End of 2009 |
|--|--------------|-------|-------|-------|-------|-------|-------|--------------------------------------|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | |
| Total Value | 2.85 | 5.50 | 12.26 | 17.63 | 26.51 | 55.91 | 56.53 | 245.76 |
| Asian Developing Countries ^a | 1.45 | 2.93 | 4.35 | 7.46 | 16.51 | 42.67 | 39.31 | 181.29 |
| Central Asia | 0.01 | 0.02 | 0.11 | 0.10 | 0.38 | 0.67 | 0.35 | 2.34 |
| South Asia | 0.01 | 0.00 | 0.02 | -0.05 | 0.94 | 0.49 | 0.08 | 1.95 |
| East Asia | 1.31 | 2.71 | 4.06 | 7.04 | 13.99 | 38.98 | 36.14 | 166.96 |
| Hong Kong, China | 1.15 | 2.63 | 3.42 | 6.93 | 13.73 | 38.64 | 35.60 | 164.50 |
| Southeast Asia | 0.12 | 0.20 | 0.16 | 0.34 | 0.97 | 2.48 | 2.70 | 9.57 |
| Pacific | 0.00 | 0.00 | 0.01 | 0.04 | 0.24 | 0.05 | 0.03 | 0.47 |
| Percentage of Asian Developing Countries | 50.63 | 53.25 | 35.49 | 42.29 | 62.30 | 76.33 | 69.54 | 73.77 |

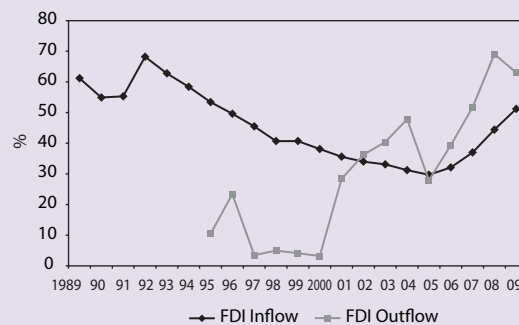
^a According to the classification of ADB.

Sources: PRC's National Bureau of Statistics, calculated by author.

Box 2: Transformation of Hong Kong, China's Role in the PRC's Outward and Inward FDI

Hong Kong, China acts as a very important conduit for the PRC's inward and outward FDI. According to official data, 51.2% of the PRC's inward FDI came from Hong Kong, China and 63.0% of outward FDI went to Hong Kong, China in 2009 (Box Figure 2).

Box Figure 2: Role of Hong Kong, China in the PRC's Inward- and Outward-FDI



Sources: PRC's Ministry of Commerce, calculated by author.

At the beginning of the PRC's openness and reform, most of the inward FDI came from overseas Chinese. This is why the percentage of Hong Kong, China in 1989 was as high as 61.2%. During that time, because the risk of investing in the PRC was still high, many multinationals chose Hong Kong, China as a base.^a Eventually, more and more American and European multinationals invested in the PRC. The risk of investing in the PRC decreased as well. As a result, the percentage of Hong Kong, China decreased.

However, after 2005, percentage of Hong Kong, China rose again, the main reason being round-tripping investment. The ratio of round-tripping investment between the PRC and Hong Kong, China was previously 25%, i.e., 25% of inward FDI was originally done by investors from the PRC with domestic capital. Recently, the ratio is much higher, around 40%. During 2001–2009, the correlation coefficient between inward FDI from Hong Kong, China and outward FDI to Hong Kong, China is 0.79 (Table 9.).

Table 9: Estimation of the Round-tripping Investment from in the PRC
Percentage

| Literatures | Estimation Result | Sample Period |
|-----------------------|--|---------------|
| Lardy, 1995 | 25 | 1993 |
| Harrod and Lall, 1993 | 25 | 1993 |
| Huang, 1998 | Low Scenario, 23 Middle Scenario, 36 High Scenario, 49 | 1993 |
| Bhaskaran, 2003 | 25 | 2003 |
| Subramanian, 2002 | 50* | 2002 |
| World Bank, 2002 | 50* | 2002 |
| Xiao, 2004 | 40, between 30 and 50 | 1982–2003 |

* Percentage of FDI from Hong Kong, China to the PRC.

Besides round-tripping investment, Hong Kong, China also acted as a conduit for investments from the PRC to other countries and regions. Because of the effective protection system for investors, low taxes, and good human resources, some Chinese companies listed or set up headquarters in Hong Kong, China before investing in other regions and countries.

^a This phenomenon happened in all industries before. However, most multinationals in the financial and nonfinancial sector moved their headquarters to Yangtze River Delta, Beijing, and Bohai Economic Circle.

The PRC's outward FDI is of a dual nature: central SOEs and private companies. The former is big in scale and strong in capital with more policy support, while the latter is small in scale and weak in capital without policy support. The PRC's outward FDI to developing countries are mainly of two types: for central SOEs, natural resources and energy; while for the private sector, mostly for future market share. Most of the private companies are invested in labor-intensive industries, with some exceptions. The PRC's private companies have done a good job in telecommunications, city bus making, and infrastructure construction in developing countries. Outward FDI to developing countries also seems to be affected by diplomatic policy. Most of outward FDI is carried out with the help of local embassies, so more companies invest in countries with good diplomatic relationships with the PRC and where the investment environment is more stable.

Box 3: Outbound Direct Investment of the Financial Sector in the PRC

Before 2000, commercial banks in the PRC, especially those state-owned, were hobbled by nonperforming loans. Soon after, non-performing loans were decoupled from the commercial banks and managed by four asset management corporations. This action saved the commercial banks from market competition. The PRC’s financial institutions invested overseas more and more after 2006. During 2006 and 2009, the stock of the PRC’s overseas investment in the financial sector grew from \$15.6 billion to \$46.0 billion (Table 10).

Table 10: Stock and Flow of the PRC’s Outward FDI in Financial Sector, 2006–2009

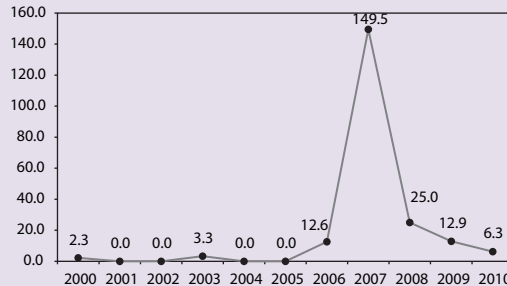
| | 2006 | 2007 | 2008 | 2009 |
|-------|-------|-------|-------|-------|
| Stock | 156.1 | 167.2 | 366.9 | 459.9 |
| Flow | 35.3 | 16.7 | 140.5 | 87.3 |

FDI = foreign direct investment, PRC = People’s Republic of China.

Source: Ministry of Commerce, [People’s Republic of] China.

Three factors drove up the PRC’s outward FDI in the financial sector. First, the demand from *Go Abroad* of the nonfinancial sector. More and more companies in the nonfinancial sector invested overseas and the commercial banks followed them. According data on M&A, this work began in 2007 (Box Figure 3). Second, the establishment of *China Investment Corporation* (CIC). Even before its establishment, CIC had invested \$3.0 billion in Blackstone (Box Figure 4). Third, the global financial crisis of 2008–2009 provided some opportunities for the PRC’s financial institutions.

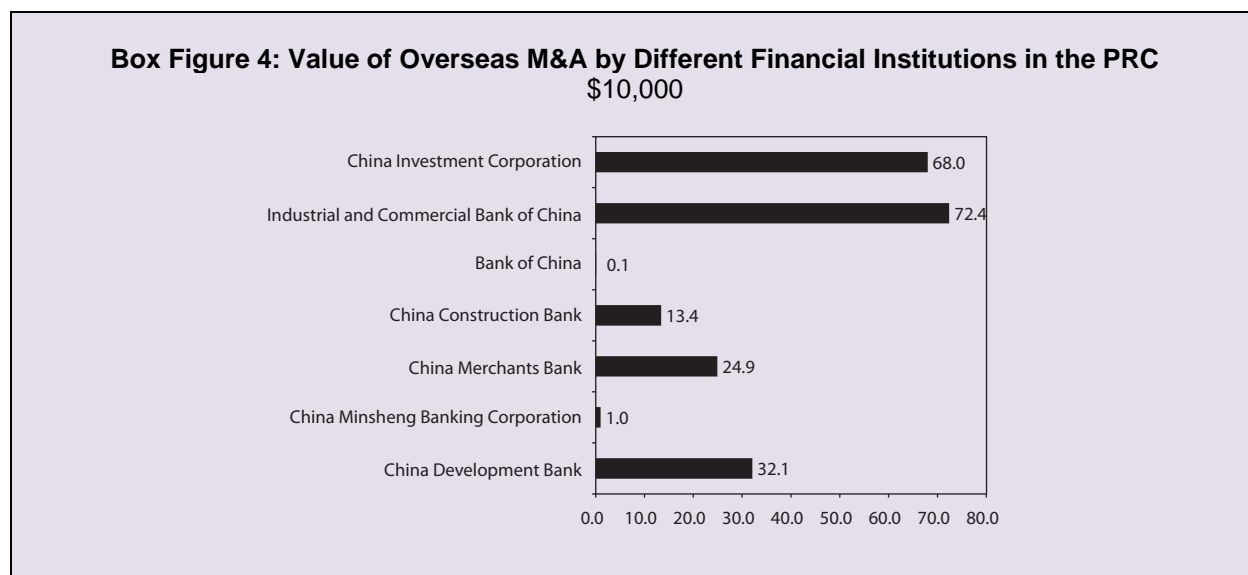
Box Figure 3: Oversea M&A by the PRC’s Financial Institutions, 2000–2010
in \$10,000



M&A = mergers and acquisitions, PRC = People’s Republic of China.

Note: Sata here is inconsistent with Table 9 because of different source. Because of limit to data accession, the data here maybe incomplete.

Source: News release of financial institutions in PRC, summed by author.



M&A = mergers and acquisitions, PRC = People's Republic of China.

Note: data here is inconsistent with Table 9 because of different source. Because of limit to data accession, the data here maybe incomplete.

Source: News release of financial institutions in PRC, summed by author.

IV. FOREIGN DIRECT INVESTMENT AND DEVELOPMENT

The PRC has opened its doors to foreign investors for more than 30 years, so the impact of inward FDI on the economy is significant, impacting the economy in many aspects and at different levels. However, the effect of outward FDI is currently not so clear.

A. Inward FDI and Development

If current Chinese economy is an engine of world economic growth, the FDI must be the first bulk of fuel enabling its beginning rotation. Generally speaking, the impact of inward FDI happened at macroeconomic level, industrial level, and microeconomic level.

On the macroeconomic aspect, inward FDI impacted local GDP growth in terms of gross investment and net export. We can calculate the contribution of inward FDI to the PRC's GDP according to the share of foreign-invested enterprises in domestic gross investment and net export. Our calculation shows that the average contribution of inward FDI to the PRC's GDP is between 3% and 6%. Inward FDI also increased domestic consumption indirectly through labor wages and other channels (Figure 7).

Figure 7: Direct Contribution of Foreign-invested Enterprises to PRC's GDP (%)



GDP = gross domestic products.

Source: National Bureau of Statistics of [the People's Republic of] China, PRC's Ministry of Commerce, calculated by author.

In addition to its contribution to GDP, inward FDI also contributed to the PRC's tax revenue and industrial growth. In 2009, the share of foreign-invested enterprises in tax revenues was 21.58%. Foreign-invested enterprises also contributed 27.95% of industrial value added in 2009 (Table 11).

Table 11: Contribution of Foreign-invested Enterprises to PRC's Gross Investment, Tax Revenue, and Industrial Value Added

| | Gross Investment | Tax Revenue* | Industrial Value added |
|------|------------------|--------------|------------------------|
| 1990 | n.a. | n.a. | 2.28 |
| 1991 | n.a. | n.a. | 5.29 |
| 1992 | 7.51 | 4.25 | 7.09 |
| 1993 | 12.13 | 5.71 | 9.15 |
| 1994 | 17.08 | 8.51 | 11.26 |
| 1995 | 15.65 | 10.96 | 14.31 |
| 1996 | 15.10 | 11.87 | 15.14 |
| 1997 | 14.79 | 13.16 | 18.57 |
| 1998 | 13.23 | 14.38 | 24.00 |
| 1999 | 11.17 | 15.99 | 27.75 |
| 2000 | 10.32 | 17.50 | 22.51 |
| 2001 | 10.51 | 19.01 | 28.05 |
| 2002 | 10.10 | 20.52 | 33.37 |
| 2003 | 8.03 | 20.86 | 35.87 |
| 2004 | 7.16 | 20.81 | 31.43 |
| 2005 | 6.69 | 20.71 | 31.41 |
| 2006 | 5.28 | 21.19 | 31.50 |
| 2007 | 4.63 | 20.17 | 30.91 |
| 2008 | 4.36 | 20.94 | 29.74 |
| 2009 | 2.86 | 21.58 | 27.95 |

* Exclusive of tariff and land rental fee.

Sources: PRC's Ministry of Commerce.

Foreign investors bring new products to the PRC market. This is the most useful information for Chinese enterprises at the beginning of reform and openness. Another contribution of inward FDI is technology spillover through imports, fairs, and inward FDI.

Because of the contribution of inward FDI, many industries developed in the PRC through spillover in industries including household appliances, food, and machinery manufacturing. The household appliance industry not only matured, but also acquired competitive edge at global market.

Foreign-invested enterprises enhanced the labor quality in the PRC and transformed labor from unskilled to skilled. This contribution can be regarded at the macroeconomic level as human capital investment, and labor skill improvement at the micro level.

However, though the contribution of inward FDI to export and export is apparent, the contribution of FDI to the PRC's employment is very limited, with only 5.46% of labor in urban areas working in foreign-invested enterprises.⁴ This percentage is consistent with GDP contribution. We can imagine the relatively small contribution of foreign-invested enterprises to the PRC's employment because of higher productivity in these enterprises (Table 12).

Table 12: Employment of Foreign-invested Enterprises

| | Total | Urban Area | Foreign-Invested Enterprises | | Rural Area |
|------|--------|------------|------------------------------|----------|------------|
| | | | Number | Percent* | |
| 1978 | 40,152 | 9,514 | – | – | 30,638 |
| 1980 | 42,361 | 10,525 | – | – | 31,836 |
| 1985 | 49,873 | 12,808 | 6 | 0.05 | 37,065 |
| 1990 | 64,749 | 17,041 | 66 | 0.39 | 47,708 |
| 1991 | 65,491 | 17,465 | 165 | 0.94 | 48,026 |
| 1992 | 66,152 | 17,861 | 221 | 1.24 | 48,291 |
| 1993 | 66,808 | 18,262 | 288 | 1.58 | 48,546 |
| 1994 | 67,455 | 18,653 | 406 | 2.18 | 48,802 |
| 1995 | 68,065 | 19,040 | 513 | 2.69 | 49,025 |
| 1996 | 68,950 | 19,922 | 540 | 2.71 | 49,028 |
| 1997 | 69,820 | 20,781 | 581 | 2.80 | 49,039 |
| 1998 | 70,637 | 21,616 | 587 | 2.72 | 49,021 |
| 1999 | 71,394 | 22,412 | 612 | 2.73 | 48,982 |
| 2000 | 72,085 | 23,151 | 642 | 2.77 | 48,934 |
| 2001 | 73,025 | 23,940 | 671 | 2.80 | 49,085 |
| 2002 | 73,740 | 24,780 | 758 | 3.06 | 48,960 |
| 2003 | 74,432 | 25,639 | 863 | 3.37 | 48,793 |
| 2004 | 75,200 | 26,476 | 1,033 | 3.90 | 48,724 |
| 2005 | 75,825 | 27,331 | 1,245 | 4.56 | 48,494 |
| 2006 | 76,400 | 28,310 | 1,407 | 4.97 | 48,090 |
| 2007 | 76,990 | 29,350 | 1,583 | 5.39 | 47,640 |
| 2008 | 77,480 | 30,210 | 1,622 | 5.37 | 47,270 |
| 2009 | 77,995 | 31,120 | 1,699 | 5.46 | 46,875 |

* As percentage of total employees in urban People's Republic of China.

Source: PRC's Statistical Yearbook, 2010, calculated by author.

⁴ What we should point out here is the statistical term maybe causes underestimation. Because the "urban workers" in the PRC's statistical term excluded the immigrant workers. So, the contribution of foreign-invested enterprises to the PRC's employment is quite possible to be much higher.

B. Outward FDI and Development

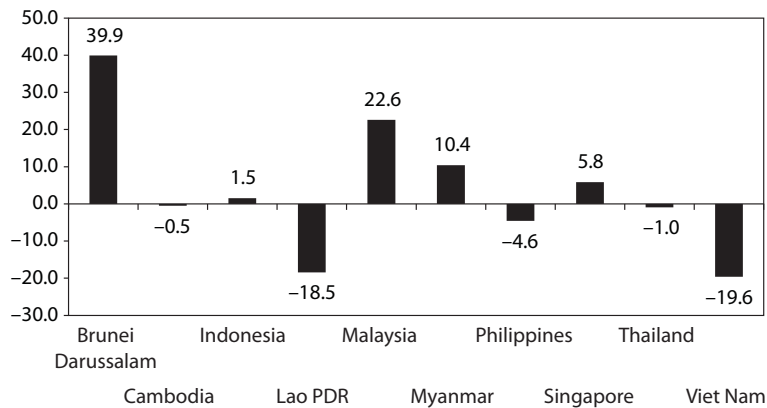
Though outward FDI grow fast in recent years, the flow and stock of the PRC’s outward FDI is still relatively small. Hence, the impact of outward FDI cannot be clearly discerned.

The impact of outward FDI on domestic economic development seems more important. The PRC’s economy has fallen into dynamic inefficiency for many years because of overinvestment and overcapacity. Outward FDI has alleviated this, and domestic macroeconomic efficiency has improved.

Also, outward FDI in the energy and natural resources sector guaranteed a stable supply of energy and resources. This contributed to domestic industrial development.

The benefit of the PRC’s outward FDI to host developing countries lies in capital supply and infrastructure. Some developing Asian countries are faced with a shortage of capital for development. For example, in the Lao People’s Democratic Republic (Lao PDR) and Viet Nam, the investment rate is much higher than the savings rate, which means a local capital shortage. Inward FDI from the PRC partly met the demand (Figure 8).

Figure 8: Investment–saving Gaps in Southeast Asian Countries, 2008^a (%)



ASEAN = Association of Southeast Asian Nations.

* The number indicates the result of investment rate minus savings rate in different Southeast Asian countries.

Sources: ASEAN Secretary.

Also, the PRC’s outward FDI help developing countries in building infrastructure. Chinese enterprises built roads and bridges in Southeast Asia. In India and other developing countries outside Asia, Huawei developed local telecommunication networks. According to the PRC’s experience, infrastructure is one of the most important factors to attract FDI.

The PRC’s outward FDI helps some Southeast countries in their anti-drug campaign through opium-poppy control alternative development. Power Group and Hongyu Group from Yunnan province invested in Cambodia and the Lao PDR, developing alternative crops for planting in the farms.

Box 4: The PRC's City Bus Makers in Africa and Latin America

Zhengzhou Yutong Group Corporation (also known as Yutong) and Xiamen King Long United Automotive Industry Corporation (also known as King Long) are two main city bus makers in the PRC that have invested overseas.

Yutong started as a small factory in the transport division of the Henan provincial government. After its establishment in 1963, the factory developed into a corporation.

In 2002, Yutong established the LIONS bus corporation with Maschinenfabrik Augsburg-Nürnberg AG (MAN). After that, Yutong developed a series of products with help in technology from MAN. After 2005, Yutong's city bus has exported to Cuba, Mozambique, the Russian Federation, and other countries. At present, 99% of imported city buses in Cuba are made by Yutong. In 2007, Yutong established a completely knocked down (CKD) assembly line in Cuba with a local government-sponsored company. Yutong helped Cuba's government in improving local public transportation condition, developing the automobile industry, and enhancing labor skill by providing training to local assembly workers.

King Long established in 1988 in Xiamen city, Fujian province. King Long imported the technology from Benz in the beginning and developed a series of products based on Benz's technology.

In 2009, the Export-Import Bank of China provided a \$18.0 million preferential loan with interest subsidy to Senegal's Ministry of Finance. Senegal gave the loan to Senbus Corporation, which later established a joint team with King Long for a completely knocked down assembly line. The contracted supply from the CKD line is 406 city buses. From Senegal, King Long hopes to expand to other African countries.

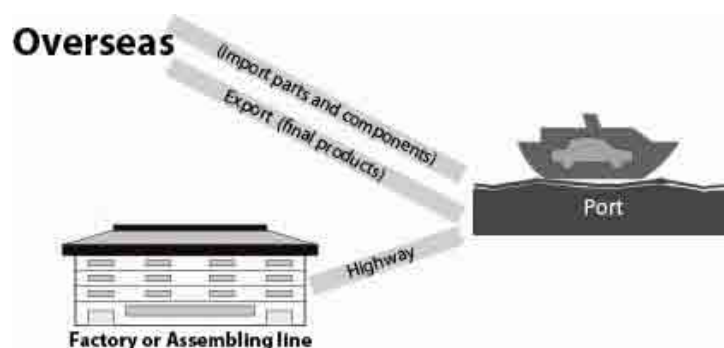
C. Dynamic Mechanism

For more than 30 years, the PRC has developed into an emerging economy from a typical developing country. During this process, the PRC benefited much from inward FDI. However, the most important experience from the PRC is how to become more attractive for FDI, and how to accelerate the process of FDI inflow. In this sense, FDI inflow to the PRC is a dynamic process. Among the determinants and motives of inward FDI, good institutions, good infrastructure, and high labor quality are key. First, the provincial governments, especially those of the Eastern PRC, improved the efficiency of approving FDI. According to the Doing Business Database of World Bank, the average procedures to establish an enterprise in the PRC is 14 days, costing 38 days (our survey shows 3–7 days). Second, improving infrastructure made the host country attractive for FDI. Local governments use tax revenue and land rental fees from foreign-invested enterprises to improve the infrastructure, including land development and road building. Third, the Chinese labor market proved to be very stable for foreign-invested enterprises. Immigrant workers improved their skill working for foreign-invested enterprises, becoming skilled labor.

Inward FDI is closely linked to outward FDI as mentioned earlier. Capital inflow and technology spillover from inward FDI make outward FDI possible, and enable Chinese enterprises gain competitiveness in the global market.

D. Global Production Network

FDI in the PRC followed that of a typical global production network. Companies imported parts and components from overseas and assembled it in the PRC, which then exported the final products overseas (Figure 9).

Figure 9: Typical Global Production Network in the PRC

Source: Author's diagram.

Two factors characterize the PRC's typical global production network. First, preferential policies established export-oriented processing zones at the start of openness and reform. In these zones, enterprises can import parts and components without duty. This policy expanded to all special economic zones in the Southeast PRC. Second, low labor costs enabled the usage of labor that cannot be replaced by machines; this situation happened especially in the electronics, textile, and clothing industries.

The result of the PRC's typical global production network is a huge amount of imports and exports by foreign-invested companies. Though the employment of foreign-invested enterprises accounts for only 5% of all employment in the PRC, and the contribution to the PRC's GDP is only 3%–6%, the share of imports and exports is almost 55% (Table 13).

Table 13: Import and Export of Foreign-Invested Enterprises

| | Import | | Export | |
|------|---------|------------|--------|------------|
| | Value | Percentage | Value | Percentage |
| 1986 | 42.9 | 5.60 | 0.6 | 1.88 |
| 1987 | 43.2 | 7.81 | 1.2 | 3.07 |
| 1988 | 55.3 | 10.64 | 2.5 | 5.18 |
| 1989 | 59.1 | 14.87 | 4.9 | 9.35 |
| 1990 | 53.3 | 23.06 | 7.8 | 12.58 |
| 1991 | 63.8 | 26.51 | 12.0 | 16.75 |
| 1992 | 80.6 | 32.74 | 17.4 | 20.44 |
| 1993 | 104.0 | 40.24 | 25.2 | 27.51 |
| 1994 | 115.6 | 45.78 | 34.7 | 28.69 |
| 1995 | 132.1 | 47.66 | 46.9 | 31.51 |
| 1996 | 138.8 | 54.45 | 61.5 | 40.71 |
| 1997 | 142.4 | 54.59 | 74.9 | 41.00 |
| 1998 | 140.2 | 54.73 | 81.0 | 44.06 |
| 1999 | 165.7 | 51.83 | 88.6 | 45.47 |
| 2000 | 225.1 | 52.10 | 119.4 | 47.93 |
| 2001 | 243.6 | 51.67 | 133.2 | 50.06 |
| 2002 | 295.2 | 54.29 | 169.9 | 52.20 |
| 2003 | 412.8 | 56.18 | 240.3 | 54.83 |
| 2004 | 561.4 | 57.81 | 338.6 | 57.06 |
| 2005 | 660.1 | 57.81 | 444.2 | 58.30 |
| 2006 | 791.6 | 59.70 | 563.8 | 58.18 |
| 2007 | 955.8 | 58.53 | 695.5 | 57.10 |
| 2008 | 1,133.1 | 54.71 | 790.6 | 55.34 |
| 2009 | 1,005.6 | 54.22 | 672.2 | 55.94 |

Source: Ministry of Commerce, [People's Republic of] China.

This typical production network can explain why foreign-invested enterprises do not want to move to the middle PRC or the Western PRC where labor costs are much lower, but no ports can be found.

V. CONCLUSION AND POLICY ISSUES

The PRC has opened its doors to foreign investors for more than 30 years. More and more multinationals come to the PRC because of its market prospects, labor quality, and preferential policies. During this process, the PRC benefited from foreign-invested enterprises in terms of technology spillover, capital inflow, and economic growth, among others. Partly because of inward FDI, the PRC's outward FDI developed as well. Outward FDI benefited both the PRC and host countries. For the PRC, inward FDI and outward FDI comprise two types of dynamic mechanism, inward FDI, and one between inward and outward FDI.

The PRC experience reveals four policy implications. First, how can a dynamic process be started, especially one involving inward FDI? The answer is efficient institutions, good infrastructure, and stable supply of high-quality labor. Second, developing countries should open their doors to FDI. The benefits of inward FDI are obvious. Currently, the WTO's role in trade liberalization is stagnant, but the promotion of investment liberalization is quite necessary. Promotion of investment liberalization can be done at the bilateral level through bilateral investment treaties, or through a multilateral system consisting of regional development banks, the WTO, and the United Nations Conference on Trade and Development. Third, international coordination must be strengthened. We need the platform to solve investment disputes and coordinate environment regulations to achieve low carbon emissions. The current mechanism through diplomatic channels will not be efficient and sustainable in the future.

Finally, trade-related policies are necessary at the beginning of openness. The PRC established special economic zones, allowing foreign-invested enterprises to import parts and components without duty. This enabled the PRC to participate in global production networks.

Appendix

Summary of the PRC's Preferential Policies for Foreign-invested Enterprises^{a, b}

| Valid Date | Contents | | Situation |
|--|--|---|--|
| 10 Sept. 1980 Last revision in 1 July 1991 | General | | |
| | For enterprises ³ taxed by central government | No corporate income tax rate from the first to the second year of operation. Reduction of corporate income tax rate by half (15%) from the third to fifth year of operation | Preferential industries or region No corporate income tax rate from the first to the second year of operations. Reduction of corporate income tax rate by half (15%) from the third to tenth year of operation |
| | For enterprises taxed by local government | No corporate income tax rate from the first to the second year of operations. Reduction of corporate income tax rate by half (16.5%) from the third to fifth year of operation | No corporate income tax rate from the first to the second year of operations. Reduction of corporate income tax rate by half (16.5%) from the third to tenth year of operation |
| 1984–1985 | For foreign-invested enterprises, free of Urban Maintenance and Construction Tax and Education Surtax. | | Repealed in 18 Oct. 2010. |
| 1 July 1991 | For foreign-invested enterprises with promise of operation for more than 5 years, the reinvested income will get 40% of tax rebate of corporate income tax. For enterprises in preferential industries and regions, the rebate rate will be 100%. | | In effect |
| 1 Jan. 1994 | Land use fees policy making is up to local government, reduction varied in different region, usually with reduction from 10% to 50%. | | In effect |
| 1 Jan. 1994 | For foreign-invested enterprises in export processing zone, or those in export processing business, free of import duty and value-added tax for imported components and parts. | | In effect |
| 22 March 2010 | For R&D center of foreign-invested enterprises, the imported good for research use is free of import duty. For research-used purchase in the PRC, full rebate of Value-Added Tax. | | In effect |

^a Disclaimer: this is an incomplete and unofficial summary of the PRC's preferential policies. It does not in any way necessarily imply consistency with currently valid regulation and legal system. Also, it does not in any way necessarily represent the opinion of the PRC government, Chinese Academy of Social Sciences, the Institute of World Economics and Politics, and the authors.

^b The policies summarized here is for foreign-owned enterprises only, no matter specified or not.

^cTo receive the tax reduction, the foreign-invested enterprises must prove to operate in the PRC for the future 10 years.

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**How Foreign Direct Investment Promotes Development:
The Case of the People's Republic of China's Inward and Outward FDI**

This paper gives a brief introduction to the PRC's inward and outward FDI, including their determinants, motives, main characteristics, and impact on the PRC and host countries.

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