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Foreign Direct Investment Flows To and From China

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FOREIGN DIRECT INVESTMENTS FLOWS TO AND FROM CHINA *

DR. ROSALINA TAN **

ABSTRACT

The study traces the growth of direct foreign investment (DFI) inflows in China, and its distribution by sector, receiving regions and source countries. It also looks into the trends and patterns of Chinese outward direct investments. Direct investment flows into China are shown to be significantly affected by China's GDP growth rate, wage rate and exchange rate as well as the world's GDP growth rate. Policy factors play a catalytic role. China's overseas direct investment, likewise, appear to be influenced by home country (e.g.: Chinese government policies, Chinese competitive advantage) and host country (e.g., market considerations, cost and price factors, and receiving countries' policies) variables. The study has also shown that the massive flows of inward DFIs have significantly contributed to China's capital formation and export performance. Furthermore, the improved shares of China as well as the ASEAN-4 countries in the global supply of DFIs do not indicate a crowding-out effect. Two-way DFI flows between China and ASEAN countries, particularly Thailand and Malaysia, have become increasingly important since the early 1990s.

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EXECUTIVE SUMMARY

The objectives of Chinese authorities in opening the country's door to foreign investors were many-fold. Taking off from a very low income base in 1979, domestic savings were not sufficient to fuel growth. Nor were its reserves of foreign exchange adequate to finance imports of capital goods and production inputs necessary to increase productivity and expand output. Foreign investors were also expected to introduce new management and production technologies that would make China internationally competitive. Further, the promotion of foreign investments, particularly in export-oriented sectors, was aimed at ensuring, not just one-time, but a continuing flow of foreign exchange into the country.

Since the enactment of the Equity Joint Venture Law in 1979, big waves of foreign investments has arrived in China. From 1979 to the end of 1996, a total of US\$ 175 trillion capital had actually been invested in China by foreign entities. The rate of growth of DFI was extremely impressive - an annual average of 57 percent in terms of contract amount and 45 percent in terms of utilized amount. By 1996, inflows of direct foreign investments were 275 times of 1983's level.

A number of internal and external factors contributed to this remarkable record. Opportunities offered by China's potentially expansive market was an important drawing force for direct foreign investments. The market size factor represented by the rate of growth of the Chinese economy was shown to have a statistically significant positive effect on inward DFI in China. China's abundant supply of low cost labor was a pull factor for the early small- to medium-scale export-oriented overseas Chinese investors. the regression analysis further revealed that the devaluation of the renminbi had a significant positive effect on DFI. The favorable influence of economic-related variables in China was greatly enhanced by policy variables. Policy played a catalytic role in attracting foreign investors to China. the package of incentives offered to foreign investors in special zones matched and even surpassed those offered by competing economies such as the ASEAN-4. Chinese authorities manifested such sensitivity to the needs of foreign investors Liberalization of trade and foreign exchange policies in China had evolved largely in response to and in accordance with the concerns of the DFI.

External factors were likewise at play in the investment boom in China. Economic conditions in the source countries dictated the available supply of funds for outward investments. As a general indicator of this factor, world GDP growth rate was included as one explanatory variable in the DFI equation. the relationship turned out to be strongly positive. A sizeable proportion of investments in China came from Hongkong, Taiwan and South Korea. The accumulation of trade surpluses in these countries in the late 1980s up to the early 1990s made available the foreign exchange that was recycled into DFI outflows to China. These capital movements were facilitated by improved political relations of the primary source countries with China.

A host of other non-economic and non-policy factors explained foreign investments in China as well. Historical, cultural and geographic affinity made the transaction costs of business in the Mainland lower for overseas Chinese. This was a relevant motivational factor for investments from Hongkong and Taiwan which

accounted for 60 to 70 percent of DFIs in China as well as for the ethnic Chinese investors which comprised a significant portion of investments from the ASEAN.

The impressive export performance of China, an annual growth rate of 17 percent, was contributed largely by foreign investors, whose export receipts grew by 74 percent per year. In 1996, foreign-funded enterprises produced nearly half of total Chinese exports, a big leap from their share of less than 1 percent in 1985. A spectacular build-up of capital has also taken place in China since the foreign investors arrived. Gross capital formation expanded at a rate of 23 percent per year. About 13 percent of these capital expenditures were undertaken by foreign-funded enterprises in the 1990s, a sharp improvement in from the negligible share of 0.3 percent during the early years of the "Open-Door" policy. It was also shown statistically that capital formation particularly by DFIs has a significant positive effect on GDP growth of China which posted double-digit rates in most of the "open-door" years. These growth records were translated into 5.4 million higher paid jobs in FFEs which made up for contracting employment in state-owned enterprises and urban collectives.

There are no indicators that DFIs in China have crowded-out DFIs in the ASEAN-4. The much improved share of China in the global supply of DFI has not been accompanied by the reduction in the shares of the ASEAN-4, nor of all developing countries as a group but as of the industrial countries. The greater magnitude of the increase in China's share relative to the magnitude of the drop in the industrial countries' share and the positive change in the global supply of DFI are indicative of new stocks of DFI generated by China's "Open-Door" policy. Moreover, China's opening has presented new opportunities for the ASEAN-4. Two-way DFI flows between China and the two ASEAN countries, Thailand and Malaysia, became important in the early 90s during which all three economies were in the expansionary trend. Remarkably, complementation in several respects, namely, material endowment labor skills, technology and market needs have been found.

Table of Contents

Abstract	
Executive Summary	
Introduction	1
I. Trends and Patterns of Direct Foreign Investment Flows to and From China	2
Inward Direct Foreign Investments	2
Outward Direct Foreign Investments	17
II. Factors Affecting Direct Foreign Investment Flows	21
Determinants of and Motivations for DFI	21
China's Inward Investments	24
China's Outward Investments	33
DFI Flows Between China and the Philippines	35
III. Effects of Direct Foreign Investments in China	37
Exports Expansion	37
Capital Formation	38
Employment	39
Income Growth	42
IV. Summary and Conclusions	45
Bibliography	48

Introduction

The Equity Joint Venture Law was enacted in 1979 to address two constraints to China's pursuit of economic growth. China's very low income base could not generate the amount of domestic savings that would be adequate to fuel a growth trend that would improve the living standards of the people. Second, having limited its economic contact with the outside world for more than thirty years, China barely had the foreign exchange necessary for the importation of capital goods and other production inputs. Direct foreign investments offer a single solution to this twin problem. Through direct foreign investments, foreign savings are channeled into China to bridge the domestic investment-savings gap. The inflow of direct foreign capital likewise generates the supply of foreign exchange to finance acquisition of imported capital goods and materials. Direct foreign investments were pursued over other forms of capital inflows such as foreign borrowing for two reasons. First, the entry of foreign firms into China was expected to result in the importation of new technology in both management and production as well as the introduction of new products. Second, by encouraging specifically foreign investments in export-oriented undertakings, continuous inflows of foreign exchange could be assured.

The study looks at the structure, determinants and impact of direct foreign investment flows to and from China since the start of its "Open-Door" policy. The first chapter traces the growth of direct foreign investment inflows in China, and its distribution by sector, receiving regions and source countries, and the type of arrangement. The chapter also discusses the trends and patterns of Chinese outward direct investments. The next chapter looks at the determinants and motivations for direct foreign investments. Indicators for the share of China in the global supply of investments are presented and factors contributing to this share are identified. Motivations for Chinese outward investments are likewise discussed. Chapter III analyzes the effects of inward investments in China on its exports, capital accumulation, employment and income growth. The last chapter summarizes the findings of the study and discusses the implications of these investment flows on the ASEAN-4 countries—the Philippines, Thailand, Malaysia and Indonesia.

Trends and Patterns of Direct Foreign Investment Flows To and From China

1. Inward Direct Foreign Investments

1.1 General Trends

The Equity Joint Venture Law was enacted in 1979 to address two constraints to China's pursuit of economic growth. China's very low income base could not generate the amount of domestic savings that would be adequate to fuel a growth trend that would improve the living standards of the people. Second, having limited its economic contact with the outside world for more than thirty years, China barely had the foreign exchange necessary for the importation of capital goods and other production inputs. Direct foreign investments offer a single solution to this twin problem. Through direct foreign investments, foreign savings are channeled into China to bridge the domestic investment-savings gap. The inflow of direct foreign capital likewise generates the supply of foreign exchange to finance acquisition of imported capital goods and materials. Direct foreign investments were pursued over other forms of capital inflows such as foreign borrowing for two reasons. First, the entry of foreign firms into China was expected to result in the importation of new technology in both management and production as well as the introduction of new products. Second, by encouraging specifically foreign investments in export-oriented undertakings, continuous inflows of foreign exchange could be assured.

With the 1979 Joint Venture Law, the doors of China were opened to foreign investors after more than three decades of isolation. To create an environment conducive to foreign business operations, five Special Economic Zones (SEZs) were developed. The first four, located in Shenzhen, Zhuhai, Shantou and Xiamen, were proclaimed in 1980. The fifth and the largest was established in Hainan in 1987. To facilitate export and import activities, fourteen coastal port cities were opened. Moreover, coastal Economic Development Zones (EDZs) as well as inland development areas were established. From 1979 to 1996, a total of 283,254 contracts were approved. During this period, substantial amounts of foreign capital had flowed into China despite the rather volatile rate at which they entered the country. On the basis of contracts, the approved amount of direct foreign investments reached a total of U.S. \$ 469 billion.

Pledged investment amounts were rather moderate during the first five years of implementation of the Joint Venture Law. Most of these involved Hong Kong investors and were concentrated in the SEZs. Investors from other countries were initially reluctant to penetrate the Chinese economy due to the uncertainties with regard to the business climate. There were no rules to clearly delineate the parameters within which foreign and private businesses could operate. And even if the rules already existed, there was insufficient information about them. This lack of transparency in the private business legal framework necessitated prolonged and protracted negotiations between the Chinese and foreign partners on every small detail of the agreements which discouraged many potential foreign investors.

Recognizing the problem, Chinese authorities formulated a series of Joint Venture Regulations in 1983 and 1984. Guidelines on land use fees and other business charges, for instance, were established for the first time. As the new rules reduced business uncertainties, large transnational corporations such as Peugeot and Volkswagen headed to China which triggered a bandwagon effect among American and Western firms as well as investors from capital-rich Asian countries. Hence, from only 470 in 1983, the number of joint venture contracts quadrupled to 1,856 in 1984. Entry of foreign capital in terms of the contract amount accelerated in 1984 and 1985 during which pledged amounts grew remarkably by 53 percent and 124 percent, respectively.

The upward trend in pledged direct investments in terms of both number and value of contracts was abruptly reversed in 1986. In 1984-1985, foreign businesses were in a rush to become part of the investment boom in China and as a consequence, failed to give adequate attention to details of the joint venture negotiations. Inevitably, problems soon emerged and frustration and disappointment grew as expectations were not met. As news of difficulties and conflicts in the joint venture negotiations spread quickly, the enthusiasm of other prospective foreign investors dwindled. Growing corruption in government and loss of macroeconomic control aggravated the pessimism. Thus, pledged investments in 1986 were reduced to even less than half of the 1985 level.

The Chinese hosts, however, were not slow to act on the problem. Determined to accommodate more foreign-owned enterprises, the Chinese authorities approved in October 1986 twenty-two provisions to encourage foreign investments. These included tax privileges, preferential land use fees and other incentives. Decision-making with respect to smaller joint ventures were decentralized thereby reducing red tape. More importantly, a solution to China's inconvertible currency¹ was presented by allowing joint ventures to exchange foreign currency at negotiated rates. Further, the Law on Wholly Foreign-Owned Ventures which signaled official approval of 100 percent foreign entities was passed. The offshoot of all these reforms was a renewed and more firmly anchored foreign investment expansion in China. In 1987 and 1988, approved direct investments grew by 31 and 43 percent, respectively. The growth slowed in 1989 and 1990 due to the political upheaval caused by the outbreak of the students' pro-democracy movement in Beijing in the summer of 1989 which culminated in the Tiananmen Square incident of June 1989. Because of the Chinese government's violent suppression of the movement, a number of Western countries imposed economic sanctions on China in 1989.

With the lifting of economic sanctions by France in 1990, the economic and to some extent, the political environment in China gradually normalized. Between 1990 and 1993, China recorded uninterrupted and significant growth in pledged investments. From only U.S. \$ 6.6 billion in 1990, pledged investments surged to U.S. \$ 111.7 billion in 1993. The unprecedented investment boom in the early 1990s can be attributed to several factors. First, regulations concerning foreign investors

¹ China's inconvertible currency was a major problem for joint ventures in the mid-1980s, especially those producing for the domestic market and hence not earning foreign exchange. Sourcing of foreign exchange for the purchase of imported goods and repatriation of profits was difficult. The issue occupied center stage with the dispute between American Motors and the Chinese authorities with regard to Beijing Jeep.

had been sufficiently codified by the start of the 1990s. Second, liberalization of the foreign exchange and financial markets continued, albeit gradually, and in 1994, the dual-currency system was abolished. Third, sectoral restrictions on foreign direct investments were also loosened. Previously restricted sectors, namely, finance, retail and construction, were opened up. Huge foreign capital went into the real estate boom of 1992-1993. These years also witnessed the opening of branches of foreign banks and fashion and food retail outlets.

In addition to the above-mentioned internal developments, external factors contributed to the surge of foreign investments into China in 1991-1993. Hong Kong investors were joined by large waves of investments from Taiwan and South Korea as political constraints in dealing with China were substantially reduced in these two countries. Taiwanese were finally permitted by their government to transact business with the Mainland. South Korea, on the other hand, established diplomatic links with China. Economic conditions in the two countries were highly favorable for outward investment flows. With continuing surpluses in Taiwan's current account, foreign exchange reserves accumulated. This excess supply of foreign exchange and capital easily found their way into China immediately after political restrictions were eased. The economic motivation that governed the behavior of the Taiwanese and South Korean investors were the same as that of the Hong Kong investors. Their objective was to utilize China's big pool of low-cost labor and combine it with their production and marketing expertise to realize profits. Flows from other Asian countries likewise fuelled the investment boom in China in the 1990s. Excess supplies of foreign exchange in Japan arising from huge trade surpluses and the appreciation of the Yen were recycled into direct investment outflows from the second half of the 1980s. Prior to the 1990s, however, much of this Japanese capital was going to Southeast Asian countries. It was only in the early 1990s that Japan became cognizant of the potential of China.

The investment boom in the early 1990s was followed by an intense overheating of the Chinese economy. This necessitated stabilization efforts which were accordingly initiated in mid-1993 but prematurely relaxed later that year after some initial success. The consequent resurgence of inflation prompted the Chinese authorities to resume and intensify efforts to achieve macroeconomic stability. This explains the drop in pledged foreign investments in 1994 and 1996 and the relatively weak rebound in 1995 which had made the 1993 investment peak in China unsurpassed until 1996. The decline in approved foreign investments in 1994 was also largely because of the government's policy to restrain the construction boom.

Foreign investment inflows into China were relatively more stable in terms of actual amounts invested. From the inception of the foreign investment law to 1996, direct foreign capital inflows continuously posted positive growth, averaging 45 percent per year. As in the contract amount, the most significant expansion took place in the early 1990s, specifically 1992 and 1993 during which period actual foreign investments grew 6-fold to U.S. \$ 27.5 billion from only U.S. \$ 4.4 billion in 1991. Despite declines in pledged investments, actual investments continued to register strong gains in the succeeding years. In 1996, foreign capital inflows amounted to U.S. \$ 41.7 billion. And at the end of that year, the cumulative amount of utilized direct foreign investments in China reached a total of U.S. \$ 174.9 billion.

Table I.1 Direct Foreign Investments in China

Year	Number of Contracts	Contract Amount		Utilized Amount		Ratio (%) Contract to Utilized Amount
		US \$ Millions	% Growth Rate	US \$ Millions	% Growth Rate	
1979-1982	922	6,010	-	1,166	-	19.4
1983	470	1,732	-	636	-	36.7
1984	1,856	2,651	53.1	1,258	97.8	47.5
1985	3,073	5,932	123.8	1,661	32.0	28.0
1986	1,498	2,834	-52.2	1,874	12.8	66.1
1987	2,233	3,709	30.9	2,314	23.5	62.4
1988	5,945	5,297	42.8	3,194	38.0	60.3
1989	5,779	5,600	5.7	3,392	6.2	60.6
1990	7,273	6,596	17.8	3,487	2.8	52.9
1991	12,978	11,977	81.6	4,366	25.2	36.5
1992	48,764	58,124	385.3	11,007	152.1	18.9
1993	83,347	111,736	92.2	27,515	150.0	24.6
1994	47,549	82,680	-26.0	33,767	22.7	40.8
1995	37,011	91,282	10.4	37,521	11.1	41.1
1996	24,556	73,276	-19.7	41,726	11.2	56.9

Source: China Statistical Yearbook, various issues

The last column of Table 1 gives the ratio of the amount of investments as stated in the contracts to the actual amount invested. On the average, about 44 percent of the contract amount was turned into actual investments. The rate at which agreed investments were realized exceeded 60 percent in 1986 to 1989. It was highest (66 percent) in 1986, the year the amount of foreign investments in new contracts dropped by more than 50 percent. The same can be observed of the decreases in contract amounts in 1994 and 1996. In these two years, the ratio of realized investments to the contract amount was notably higher than the average for the whole period.

1.2 Sectoral Distribution

The biggest recipient of direct foreign investments in China is Industry. This is in line with the thrust of the development strategy of the government. Two major obstacles in China's path to economic growth are its inadequate supplies of domestic savings and foreign exchange. These two constraints are addressed through the participation of foreign investors in export-oriented industries. The substantial share of Industry also reflects the concern and interest of the majority investors who are the overseas Chinese in Hong Kong and Taiwan. These investors are more into small- to medium-scale manufacturing entities producing for exports.

In 1991, 9 out of 10 foreign investors went to Industry. In that year, 11,620 joint venture contracts were finalized for Industry. In terms of the contracted amount of investments, Industry accounted for about 80 percent of the total. Trailing way

behind were all the other sectors. Though Real Estate, Public Utilities and Services' share was only 3 percent in terms of number of contracts, in terms of investment amount it accounted for a significant 12 percent, implying higher capitalization in this sector.

The share of Industry was reduced substantially but remained the highest in 1993. Its share fell slightly below 50 percent in terms of value of investments. A substantial part of its previous share was taken away by Real Estate, Public Utilities and Services which accounted for almost 40 percent of the amount of investments. This figure reflected the boom in hotel, infrastructure and housing complex development in China during this period. Corresponding to this was the increased share of Construction in terms of both number and amount of contracts. Also notable was the improved share of Commerce, Food Services, Material Supply and Marketing.

The slow-down in investments in real estate and infrastructure development, helped by government straightforward efforts to discourage and limit them and redirect foreign capital to export-oriented manufacturing concerns, led to the much reduced share of the sector, as well as that of the related sector Construction in 1996. These shares were regained by Industry. Though still lower than in 1991, the share of Industry climbed to two-thirds of total direct foreign investments in 1996.

Not much change can be observed in the shares of Agriculture and Forestry, and Transportation and Telecommunications.

Table I.3 shows the extent of foreign participation in terms of registered capital in the different sectors. About 61 percent of total registered capital of all enterprises with foreign capital in 1993 was contributed by the foreign partner. The last column of the table indicates that the ratios for the individual sectors do not deviate substantially from the over-all average. Foreign participation was highest for Real Estate, Public Utilities and Services where foreign equity was around 69 percent of registered capital. The lowest ratio of 57 percent was posted by Industry. As mentioned earlier, Industry was dominated by overseas Chinese investors who had more connections in the Mainland and who were more open to greater Chinese participation.

1.3 Geographical Distribution

There has not been a significant redistribution of foreign direct investments between the open coastal cities and the interior regions over the years. In 1983, 178 out of 188 joint ventures equivalent to 98 percent of the total amount of investments were located in Beijing and the open coastal areas. 103 of these or about half in terms of the investment amount were in the four special economic zones (SEZs), namely, Shenzhen, Zhuhai and Shantou in Guangdong, and Xiamen in Fujian. Shenzhen alone cornered 87 of these enterprises with foreign capital or about a fourth of the total value of direct foreign capital inflow in that year. The inland regions, on the other hand, only had ten of these joint ventures, accounting for a mere 2 percent of total foreign investments.²

² Almanac of China's Economy (1984), second table on p. 339 in Long Chucai's article entitled "Joint Ventures Involving Chinese and Foreign Capital in China".

Table I.2 Direct Foreign Investments in China by Sector (Contract Amount)

Sector	1991		1993		1996	
	Number	Value US \$ M	Number	Value US \$ M	Number	Value US \$ M
Agriculture, Forestry, Animal Husbandry, Fishery & Water Conservancy	310	198	1,741	1,228	812	1,139
Industry	11,620	8,593	56,365	50,737	18,280	50,486
Construction	67	122	3,062	3,544	387	2,001
Transportation, Post &Telecommunication Services	64	95	852	1,382	196	1,599
Commerce, Food Services, Material Supply & Marketing	240	190	5,238	5,051	1,655	2,346
Real Estate, Public Utilities & Services	374	1,336	11,551	42,557	1,961	12,850
Other Sectors	235	263	3,993	4,441	1,265	2,854
Total	12,910	10,797	82,802	108,940	24,556	73,275
Shares in Percent						
Agriculture, Forestry, Animal Husbandry, Fishery & Water Conservancy	2.4	1.8	2.1	1.1	3.3	1.6
Industry	90.0	79.6	68.1	46.6	74.4	68.9
Construction	0.5	1.1	3.7	3.3	1.6	2.7
Transportation, Post &Telecommunication Services	0.5	0.9	1.0	1.3	0.8	2.2
Commerce, Food Services, Material Supply & Marketing	1.9	1.8	6.3	4.6	6.7	3.2
Real Estate, Public Utilities & Services	2.9	12.4	14.0	39.1	8.0	17.5
Other Sectors	1.8	2.4	4.8	4.1	5.2	3.9
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: China Statistical Yearbook 1998, Statistic-Utilization of Foreign Capital

By 1987, the share of the inland regions had improved to 14 percent while the share of Beijing and the coastal regions was reduced to 86 percent. Since 1987, however, the share of Beijing and the coastal areas had almost not changed to give way for more foreign investments in the interior regions. In 1996, 84 percent of total foreign capital was still being directed towards Beijing and the open coastal cities and provinces.

Table I.3 Capitalization of Registered Enterprises with Foreign Capital by Sector, 1993

Sector	Registered Capital US \$ M	Foreign Capital US \$ M	Ratio (%) Foreign to Registered Capital
Agriculture, Forestry, Animal Husbandry, Fishery & Water Conservancy	3,813	2,462	64.57
Industry	147,476	84,026	56.98
Geological Survey & Exploration	35	20	57.14
Construction	4,902	3,284	66.99
Transportation, Post & Telecommunication Services	4,628	2,826	61.06
Commerce, Food Services, Material Supply & Marketing	12,157	7,496	61.66
Real Estate, Public Utilities & Services	67,015	46,431	69.28
Other Sectors	5,605	3,637	64.89
Total	245,631	150,182	61.14

Source: China Statistical Yearbook 1996

A change in the distribution, however, was taking place within the coastal regions. In the 1980s, foreign direct investors were heavily concentrated in the four original SEZs, three of which including Shenzhen, the biggest, were in Guangdong. Nearly half of realized direct foreign investments in the 1980s went to Guangdong. Though the province's share had been greatly reduced in the 1990s, it had remained to be the recipient of the biggest slice of the DFI pie in China. Guangdong's lead position was due to a large extent to the performance of the two SEZs, Shenzhen and Zhuhai. Initially, the surge of foreign investments in these two SEZs came from overseas Chinese in Hong Kong. These involved small investments in labor-intensive manufactured goods for exports. Heavy investments in infrastructure as well as positive attitude of local officials and the workforce towards DFI in Shenzhen and Zhuhai also attracted larger joint ventures in less labor-intensive industries and transnational companies from Japan, the United States and European countries, the types of investments that initially would only go to either Beijing, China's capital and first industrial base or to Shanghai, a coastal city second to Beijing as an international and industrial center.

The third SEZ in Guangdong, Shantou, was less successful as it was not as strategically located as Shenzhen and Zhuhai. The success of Shenzhen and Zhuhai as a production base for labor-intensive manufactured goods for exports typical of direct investments from Hong Kong spread as well to other parts of Guangdong, particularly the areas in the inner Pearl River Delta: Baoan, Zhongshan, Dongguan, Shunde and Nanhai. Dongguan, for instance, became the leading center for export processing in China.

Table I.4 Direct and Other Foreign Investments in China by Province/City of Destination (Utilized Amount)

Province/City	1987	1990	1993	1996
Value in US \$ Millions				
Beijing	106	279	667	1,553
Coastal	1,436	2,873	22,093	33,797
Tianjin	133	37	524	2,153
Shanghai	214	174	3,160	3,941
Liaoning	91	257	1,279	1,738
Hebei	10	44	397	830
Shandong	65	186	1,874	2,634
Jiangsu	86	134	2,844	5,210
Fujian	55	320	2,867	4,085
Guangdong	737	1,582	7,556	11,754
Hainan	-	103	707	789
Guangxi	45	36	885	663
Interior Region	241	284	4,582	6,530
Total	1,783	3,436	27,342	41,880
Shares in Percent				
Beijing	5.9	8.1	2.4	3.7
Coastal	80.5	83.6	80.8	80.7
Tianjin	7.5	1.1	1.9	5.1
Shanghai	12.0	5.1	11.6	9.4
Liaoning	5.1	7.5	4.7	4.1
Hebei	0.6	1.3	1.5	2.0
Shandong	3.6	5.4	6.9	6.3
Jiangsu	4.8	3.9	10.4	12.4
Fujian	3.1	9.3	10.5	9.8
Guangdong	41.3	46.0	27.6	28.1
Hainan	-	3.0	2.6	1.9
Guangxi	2.5	1.0	3.2	1.6
Interior	13.5	8.3	16.8	15.6
Total	100.0	100.0	100.0	100.0

Source: China Statistical Yearbook, various issues

In the 1990s, the dominance of Guangdong as a site for foreign investors diminished remarkably. From 46 percent in 1990, its share to total direct foreign investments fell to only 28 percent in 1996. This shift was brought about by a number of factors. One was the high wage rates in Shenzhen and Zhuhai and other parts of the province where economic growth had proceeded very rapidly.³ Another was the

³ In 1985, Shenzhen's wage index of 310.0 and Zhuhai's 250.0 were the highest in China. The indices for the other two SEZs, Xiamen and Shantou, were 165.0 and 140.0, respectively. Guanzhou, also in Guangdong, had the third highest wage index of 179.5 while Shanghai's index was 153.7. (B. Li and D. Spinanger, *The Economic Policy Environment and Foreign Direct Investment in the PRC: 1979-1985*, Pacific Rim Institute of Comparative Economic Studies, July 1988, p. III.28.)

increasing effort of other regions, especially those in the coastal areas with similar locational advantages as Guangdong, to attract foreign investors by offering similar incentives. The reduced share of Guangdong in foreign investments could also be a reflection of the emerging ability of the local firms in the province to provide the inputs previously provided by foreign investors and of greater use of other forms of cooperation with foreigners.⁴

Foreign investors' attention shifted to the other coastal provinces, namely, Fujian, Jiangsu, Shandong and Hebei, as these provinces began to offer investment incentives and a business climate comparable to the SEZs. Fujian, lying next to Guangdong and origin of many overseas Chinese, saw its share in DFI more than tripled from 3 percent in 1987 to 10 percent in 1996. From only 5 percent in 1987, Jiangsu was able to capture 12 percent of DFI in 1996. Shandong and Hebei's shares, on the other hand, expanded from 4 to 6 percent and from 1 to 2 percent, respectively, during the same period.

Fujian is the site of Xiamen, the fourth SEZ. Xiamen's pull factors for foreign investors came from its industrial base and good harbor. Its proximity to Taiwan and the resemblance of its dialect to that of Taiwan made Xiamen an attractive location for Taiwanese investors. In the 1980s, Taiwanese citizens were prohibited from engaging in business and economic relations with China. The easing of this restriction in the 1990s led to massive flows of Taiwanese capital into Xiamen.

Foreign capital flows to Jiangsu, likewise, did not peak until the 1990s. Despite the extent of industrial activity in the province, Jiangsu had the largest provincial product accounting for about 10 percent of China's output and the south-west part of the province was the light-industrial heartland of China, it seized only a small share of DFI in the 1980s. Two joint venture contracts were approved in 1981, one in 1982 and another in 1983 but only two became operational before the end of 1983. The foreign investment boom of 1984-1985 brought more foreign entrepreneurs to Jiangsu. The number of joint ventures in operation, however, remained low at thirty by the end of 1986. Foreign investors' attention started to be diverted to Jiangsu from Guangdong in 1987-1988 so that by the end of 1988 over 175 joint ventures were operational.⁵ This was the offshoot of the provincial authorities' November 1986 investment incentive package that went beyond the national provisions and was more generous than the packages offered by other provinces. In terms of the amount of realized DFI, the surge came after 1990. Starting from just 4 percent of the realized amount of foreign investments in China in 1990, Jiangsu's share increased to 12 percent in 1996.

Shanghai was the location for pioneer joint ventures. In 1987, Shanghai was next to Guangdong as site for DFI. Shanghai is the consular, business and commercial center of China and thus, has a large international community. The early DFIs in the province were large service-sector projects such as hotels and apartment complexes. Being a leading industrial city, Shanghai got the first large high-profile industrial DFIs such as the Schindler, Bell, Pilkington and Volkswagen projects. Shanghai was also able to attract a good portion of the export-oriented, relatively

⁴ R. Pomfret, 1991, *Investing in China: Ten Years of the 'Open Door' Policy*, Harvester Wheatsheaf, London, 1991, p. 83.

⁵ Pomfret, 1991, Table 5.6, p. 92.

smaller-scale joint venture projects with Hong Kong entrepreneurs. This enabled the province to retain its importance as DFI hosts until the 1990s. In 1996, Shanghai still accounted for a substantial one-tenth of total DFI in China despite the sprouting of other coastal locations. This could be attributed to a number of factors. One is the existence of port facilities in the city. Another is the creation of three Export Development Zones (EDZ) and the introduction of new foreign investment incentives better than those provided by national legislation in 1986. This second factor paved the way for the entry of the SEZ-type, small to medium-scale joint ventures into Shanghai from the late 1980s. A third reason is the wage factor. In 1985, Shanghai's wage index of 153.7 was just half of Shenzhen's.⁶ Further, Shanghai has a long tradition of entrepreneurship with close connections with overseas Chinese in Hong Kong as several of the city's businessmen fled to Hong Kong when the Communists took over the Chinese government.

Beijing, the capital city of China and an industrial, commercial and international city like Shanghai, is another site for the pioneer and larger joint ventures. The distinctive feature of DFI in this city is the high concentration of service industries, the most prominent of which are the large hotel projects such as the Great Wall Hotel.⁷ It failed to attract the non-service, export-oriented joint ventures and hence by 1996, its share to total DFI had been reduced to 4 percent. Partly to blame for this was the heavy bureaucracy in the capital city.

1.4 Source Countries

The biggest source of foreign investments in China is Hong Kong. By the end of 1983, 128 out of a total of 198 joint venture projects in China were undertaken by Hong Kong investors.⁸ These were mostly small manufacturing entities capitalized at less than U.S. \$ 1 million. Hence, in value terms, they amounted to only U.S. \$ 47 million or 23 percent of the total in China of U.S. \$ 207 million. From 1984 to the first half of the 1990s, Hong Kong accounted for more than half of the amount of direct and other foreign investment flows to China. The 1984-1985 foreign investment boom in China was helped by the rapid growth of small joint ventures which were mostly located in Guangdong, the province adjacent to Hong Kong. These were mostly Hong Kong firms transferring their export activities into China in reaction to higher wages and land rents in Hong Kong and to the appreciation of the U. S. dollar with which the Hong Kong dollar was pegged. These investment flows from Hong Kong continued and, together with capital from Taiwan and South Korea, brought about the unprecedented investment boom in China in the early 1990s. Hence, throughout the ten-year period 1987-1996, realized Hong Kong investments increased more than ten times from U.S. \$ 1.8 billion to U.S. \$ 20.9 billion.⁹

⁶ Li and Spinanger, 1988.

⁷ Pomfret, 1991, p. 85.

⁸ Long Chucai (1984), third table, p. 339.

⁹ Note, however, that inward DFI from Hong Kong may be overestimated as capital of Chinese origin is reportedly recycled and disguised as DFI to take advantage of special tax and incentives to foreign investors. A WB estimate put recycled capital of Chinese origin or disguised DFI to be around 25 percent of gross DFI in 1992 (WB Discussion Paper, 1993).

Table I.5 Direct and Other Foreign Investments in China by Region/Country of Origin (Utilized Amount)

Region/Country	1987	1990	1993	1996
Value in US \$ Millions				
Hong Kong & Macao	1,809	2,118	18,032	20,852
Taiwan	-	-	3,139	3,482
Japan	267	520	1,361	3,692
Korea	-	-	381	1,504
United States	271	461	2,068	5,051
Europe	124	182	794	3,013
Southeast Asia	37	65	1,005	3,185
Indonesia	-	1	66	94
Malaysia	-	1	91	460
Philippines	4	2	122	56
Singapore	22	53	492	2,247
Thailand	11	8	234	328
Others	139	409	991	1,356
Total	2,647	3,755	27,771	42,135
Shares in Percent				
Hong Kong & Macao	68.3	56.4	64.9	49.5
Taiwan	-	-	11.3	8.3
Japan	10.1	13.8	4.9	8.8
Korea	-	-	1.4	3.6
United States	10.2	12.3	7.4	12.0
Europe	4.7	4.8	2.9	7.2
Southeast Asia				
Indonesia	-	0.0	0.2	0.2
Malaysia	-	0.0	0.3	1.1
Philippines	0.2	0.1	0.4	0.1
Singapore	0.8	1.4	1.8	5.3
Thailand	0.4	0.2	0.8	0.8
Others	5.3	10.9	3.6	3.2
Total	100.0	100.0	100.0	100.0

Source: China Statistical Yearbook, 1988 and 1998

Statistics-Utilization of Foreign Capital

Hong Kong investments are typically small to medium-scale manufacturing ventures engaged in labor-intensive export activities. The Hong Kong partner brings in the design and in most cases the materials. They take charge of quality control and export marketing. This arrangement involves minor capital requirements but quick returns. The SEZs in Guangdong, particularly Shenzhen, are the favorite sites. In 1993, Guangdong captured 40 percent of the DFI contract amount from Hong Kong. Fujian got 11 percent followed by Shanghai's 6 percent. Hong Kong investors had

82 percent of their capital placed in the coastal regions in 1993, higher than the national average of 81 percent.

Table I.6 Direct Foreign Investments in China by Country of Origin & Province/City of Destination, 1993 (Contract Amount)

Province/City	Hong Kong & Macao	Taiwan	Japan	United States Of America
Value in US \$ Millions				
Beijing	4,057	585	167	738
Coastal	59,939	7,239	2,229	4,383
Tianjin	1,026	288	113	338
Shanghai	4,481	530	370	599
Liaoning	2,080	307	359	384
Hebei	1,052	185	45	135
Shandong	3,650	911	231	593
Jiangsu	5,407	1,697	543	973
Fujian	7,795	1,549	107	264
Guangdong	29,252	1,136	379	631
Hainan	2,379	382	43	310
Guangxi	2,817	254	39	156
Interior Region	9,109	1,708	395	974
Total	73,105	9,532	2,791	6,095
Shares in Percent				
Beijing	5.5	6.1	6.0	12.1
Coastal	82.0	75.9	79.9	71.9
Tianjin	1.4	3.0	4.0	5.5
Shanghai	6.1	5.6	13.3	9.8
Liaoning	2.8	3.2	12.9	6.3
Hebei	1.4	1.9	1.6	2.2
Shandong	5.0	9.6	8.3	9.7
Jiangsu	7.4	17.8	19.5	16.0
Fujian	10.7	16.3	3.8	4.3
Guangdong	40.0	11.9	13.6	10.4
Hainan	3.3	4.0	1.5	5.1
Guangxi	3.9	2.7	1.4	2.6
Interior	12.5	17.9	14.2	16.0
Total	100.0	100.0	100.0	100.0

Source: China Statistical Yearbook, various issues

Economic relations between China and Taiwan were not officially allowed until the late 1980s. Prior to the official permission, only informal and indirect transactions were carried out via a third economy, usually Hong Kong. Both China and Taiwan changed its stance toward each other in the 1980s. China shifted from one of a hardline military liberation policy to a peaceful unification policy. It was

thought that the prospect of economic gains and economic dependence would draw Taiwanese to the idea of unification. The business climate were made more favorable to Taiwanese investors with special privileges granted to them. In Taiwan, democratization and the removal of martial law had led to the gradual easing of restrictions on economic relations with China. In 1987, Taiwanese were officially allowed to visit China. Importations from China have been admitted since 1989 and export and investment flows to China have been officially recognized since 1990.

With the change in the political climate between China and Taiwan, economic forces were able to determine the course of relations between the two. Within the economy of Taiwan, three major push factors for direct investments abroad appeared. First was the sharp appreciation of the N.T. dollar versus the U.S. dollar in the second half of the 1980s as a result of the huge trade surplus. In 1986, Taiwan's trade surplus had climbed to almost 20 percent of GDP. As a consequence, the N.T. dollar-U.S. dollar exchange rate fell from 40 in 1985 to 26 in 1989. Second was the rapidly increasing wage rate. This was both the direct effect of the 1983 Labor Law and the offshoot of the expansion of the Taiwanese economy, specifically of the service sector, in the second half of the 1980s. Third was the increase in land prices in Taiwan. Not only did it force new investors to go abroad but the sale of land at high prices enabled old firms and landlords to have the funds for foreign investments.¹⁰ China, on the other hand, had abundant supply of labor at low wages as well as low land prices and rent to offer. All these economic considerations, together with locational advantages and historical and cultural ties, led to the surge of Taiwanese investments into China. In 1993, Taiwan was already the second largest source of foreign investments in China, accounting for more than 11 percent of the total.

Most Taiwanese investors in China are into manufacturing. Between 1990 and 1992, 73 percent of approved Taiwanese investments went to the manufacturing sector while only 14 percent went to finance, insurance and real estate industries. Within the manufacturing sector, the majority of Taiwanese investments are concentrated in the traditional export industries of Taiwan such as electrical and electronic machinery and appliances, food, metal products, plastic products, wearing apparel and miscellaneous products.¹¹ Proximity to Taiwan makes Fujian and Jiangsu the location of choice for Taiwanese investors. The Fujian dialect is also very similar to Taiwan's and many Taiwanese are of Fujian origin. Taiwanese investments, however, are more geographically spread than Hong Kong's which was heavily concentrated in the province of Guangdong. In 1993, approved Taiwanese investments in Jiangsu and Fujian were 18 and 16 percent, respectively. Next in line were Guangdong with 12 percent and Shandong, 10 percent. Taiwanese investments in the interior regions were also relatively more significant. In 1993, the interiors' share in Taiwanese investments was 18 percent, higher than the ratios for the other major investors, Hong Kong, Japan and the United States.

Japanese investors were seen as rather slow in taking part in the investment boom in China. The first joint ventures with Japan were established in 1980, Hitachi's color television factory in Fujian and Otsuka's medical products firm in Tianjin. During the first five years of the opening of China, only 13 of the 198 joint

¹⁰ Pochih Chen and Chak-yuen Kan (1997).
¹¹ Ibid, p. 130.

ventures or a mere 7 percent were of Japanese origin.¹² In value terms, cumulative investments from Japan by the end of 1983 amounted to only U.S. \$ 18 million or 5 percent of the total, thus, making the Japanese investment project smaller than the average project size for all investors. Japanese investments gradually increased from the latter part of 1983 as both Chinese and Japanese governments undertook measures to make the business climate in China more conducive to Japanese investors. Examples of these measures include the 1983 tax treaty between Japan and China to avoid double taxation and the enactment of laws on brands and patents. Hence, for the year 1987, actual Japanese investments amounted to U.S. \$ 267 million which was about 10 percent of the total.

The scenario in Japan in the 1980s was similar to those of Taiwan and Hong Kong – the strengthening of the yen, huge surpluses in the current account, and the high costs of labor and land. These factors, together with the growing protectionist sentiments against Japan-produced goods in the West, drove the Japanese firms out of Japan and into low-cost bases for export production in countries in Asia.¹³ Initially, that was in the late 1980s, much of the Japanese capital was going to Southeast Asia, particularly, Thailand, Malaysia and Indonesia. It was only in the 1990s that Japanese firms started to be strongly interested in investing in China. In 1990, actual Japanese investments in China amounted to just half a billion U.S. dollars. In 1996, the amount had reached U.S. \$ 3.7 billion. Unlike Taiwanese and Hong Kong investments which were concentrated in China, the excess funds in Japan were distributed among several Asian countries.¹⁴ A number of reasons could be cited for Japanese firms' rather delayed and moderate entry into China. The socio-political uncertainties surrounding the business environment in China deterred many of the prospective Japanese investors in the 1980s. Despite the promulgation of the reform and open-door policy and the Joint Venture Law, regulations concerning foreign investors' operations were vague. There were numerous bureaucratic problems. There was the question on political stability as manifested by the June 1989 Tiananmen Square incident. Social infrastructure in electricity, transportation and communication systems were deficient. Further, Japanese investors wanted to first see that sound macroeconomic management take root in China. The development gap between China and Japan is also much wider compared to the gap between China and Taiwan or Hong Kong and hence, the vertical production complementarity is much less.

Japanese investments are dispersed among several coastal provinces. Shanghai is the biggest recipient in terms of the number of contracts, followed by Beijing. These locations have the industrial and commercial base, the infrastructure and a large international community necessary and important to non-ethnic Chinese investors like the Japanese. Liaoning, with its heavy industries base, captured about 13 percent of the approved amount of Japanese DFI in 1993. Substantial Japanese investments are also directed to Jiangsu, Guangdong and Shandong. Majority of

¹² Long Chucai (1984).

¹³ Palanca-Tan (1999).

¹⁴ China's share in Japan's DFI in Asia had increased significantly in the 1990s. In Japan's fiscal year (FY) 1991, the share of China was 10 percent; Indonesia, 20; Malaysia, 15; Thailand, 14; and Hong Kong, 16. In FY 1993, China's share rose to 24 percent but the shares of the other Asian countries remained substantial: Hong Kong; 19; Malaysia, 12; Singapore, 10; Indonesia, 10; and Thailand, 9. In the early 1990s, as the economy and the political situation in the Philippines stabilized, the country was also able to attract some Japanese direct investments (about 3 percent).

Japanese firms are engaged in electric/electronic machinery and textile production. These two sectors, together, made up about 60 percent of the aggregate number of Japanese-invested firms as of 1994.¹⁵

The Americans and the Europeans were earlier than the Japanese to respond to the call for investments by China. These western investors were responsible for the large joint venture projects that accounted for the lion's share of the total amount of foreign investments during the first five years of the Open-Door policy. Hence, although the U.S. investors (21 cases) and the European investors (16 cases) represented only about one-fifth of the cumulative number of projects by the end of 1983, they contributed almost half of the investment amount. Actual investments from both the U.S. and Europe continued to expand in the 1980s and the 1990s. In 1996, the U.S. was second only to Hong Kong, providing 12 percent of actual DFI. Europe's 7 percent share was not far below Taiwan's 8 percent. U.S. and European investments, like Japan's, are more into capital-intensive activities (e.g.: pharmaceuticals, chemicals, automobiles, telecommunications and industrial and commercial equipment and machinery) and hence require greater capitalization.¹⁶ They are less oriented toward the export market and therefore, have less incentive to locate in the SEZ areas.

Among the five Southeast Asian nations, the Philippines and Thailand were the first to invest in China. By the end of 1983, there were already five joint venture projects with Philippine partners in China, infusing some U.S. \$ 42 million. Thailand had one with a measly amount of U.S. \$ 0.27 million. Investments from Southeast Asia, likewise, accelerated in the 1990s, with the bulk being contributed by Singapore. Singapore's share in DFIs to China grew continuously from only 1 percent in 1987 to more than 5 percent in 1996. Malaysia's involvement turned more active relative to the three other Southeast Asian countries towards the middle part of the present decade.

1.5 Type of Arrangement

Direct foreign investments in China can be classified into three major types: equity joint ventures, contractual joint ventures, and wholly foreign-owned enterprises. An equity joint venture is a limited company jointly funded through equity by Chinese and foreign investors. The investing parties share profits or losses in proportion to their respective equity shares. The contractual joint venture, also referred to as "cooperative venture", allows for the Chinese partners to contribute resources such as land, labor, local equipment and facilities instead of financial equity. The foreign partners, in addition to funds, may contribute technology, major new equipment and materials. The contributions as well as the operation and management responsibilities of the Chinese and foreign partners are stated in the contract. In a contractual joint venture, profits and losses are divided according to a ratio also stated in the contract. A wholly foreign-owned enterprise is a company with no Chinese equity participation. It can either be a branch of a foreign company

¹⁵ Kinoshita, Toshihiko (1997).

¹⁶ Seven large joint ventures with U.S. and European partners during the 1979-1983 were located outside the SEZs and were capitalized at over U.S. 10 million each. These included Schindler Elevators, Pilkington Glass, a Swedish pharmaceutical company, a Belgian subsidiary of Bell Telephone, Beijing Jeep and two hotel projects. Pomfret (1994).

or an entirely new and independent enterprise formed by a foreign company or a group of individuals who are non-Chinese citizens. The foreign owners are fully responsible for profits and losses.¹⁷

The type of arrangement by which direct foreign investments entered China had significantly changed over the years. Until 1983, contractual joint ventures had dominated, accounting for about 82 percent of investments in terms of the number of contracts and 88 percent in terms of the contract amount. The foreign partners in these contractual joint ventures were mostly of Hong Kong origin who wanted to take advantage of low wages and low land prices in China. These Hong Kong investors were more familiar with the culture and practices of their fellow Chinese in the mainland and were more open to enter into detailed negotiations with them. On the part of the Chinese partners, a contractual joint venture arrangement appeared to be a better and more feasible option initially since it would not require from them cash outlay. Equity joint ventures accounted for about 14 percent of the number of contacts and 6 percent of the amount during 1979-1983 while the corresponding shares of wholly foreign-owned enterprises were 4 and 7 percent.

Equity joint ventures became increasingly important from 1985 and was the assumed form for the majority of direct foreign investments in China in the 1990s. The number and value of wholly-foreign owned investments likewise rose from 1987 and by 1996, about a third of direct foreign investments in terms of both number and value were of this type. The share of contractual joint ventures, on the other hand, shrank to 12 percent of the number and 20 percent of the value of foreign investments. Two reasons are cited for the increased use of the 100 percent foreign-equity type of investments.¹⁸ First is the inclination of Taiwanese investors, an important source of foreign capital in the 1990s, to control their own companies rather than cooperate with partners. Second, wholly foreign-owned arrangements involve less costs and time as long and tedious negotiations about financial capital, technology and management contributions of the partners in contractual and equity joint ventures are avoided.

2. Outward Direct Foreign Investments

China's outward direct investments were much less significant than the inflows, the ratio of outward to inward DFI being only 0.7 percent in terms of number of contracts and 0.5 percent in terms of amount of investments. For every 1,000 investors in China, there is only one Chinese investor abroad and for every US \$ 1,000 foreign investments in China, there is only US \$ 1 of Chinese investment in other countries. Nevertheless, Chinese capital has flowed into other countries since it started its 'Open Door' policy.

¹⁷ A fourth type, joint development venture, is specified in DFI accounts in China. Joint development ventures are simply joint venture projects in oil exploration. Chinese and foreign partners do not share profits but oil resources. Oil output of the venture is divided among the partners in accordance to the contract. Since joint development venture is just a minor category in terms of the number and value of contracts and investment of this type are made only in some years, some reports, including this paper, combine this category with contractual joint ventures.

¹⁸ Mee-Kau Nyaw (1997).

Table I.7 Direct Foreign Investments in China by Arrangement Type

Type	1983(a)		1990		1993		1996	
	US \$ Mil.	% Share	US \$ Mil.	% Share	US \$ Mil.	% Share	US \$ Mil.	% Share
Number of Contracts								
Joint Ventures	188	14.2	4,056	56.1	53,488	64.6	12,628	51.4
Contractual(b)	1,085	81.8	1,316	18.2	10,789	13.0	2,866	11.7
Joint Ventures								
Wholly Foreign-Owned Enterprises	53	4.0	1,856	25.7	18,525	22.4	9,062	36.9
Total	1,326	100.0	7,228	100.0	82,802	100.0	24,556	100.0
Contract Amount								
Joint Ventures	340	5.5	2,628	41.5	54,423	50.0	31,876	43.5
Contractual	5,370	87.6	1,258	19.9	25,384	23.3	14,590	19.9
Joint Ventures								
Wholly Foreign-Owned Enterprises	420	6.9	2,442	38.6	29,134	26.7	26,810	36.6
Total	6,130	100.0	6,328	100.0	108,941	100.0	73,276	100.0
Utilized Amount								
Joint Ventures			1,876	57.9	14,966	57.4	20,754	49.7
Contractual			663	20.5	4,905	18.8	8,365	20.0
Joint Ventures								
Wholly Foreign-Owned Enterprises			703	21.7	6,219	23.8	12,606	30.2
Total			3,242	100.0	26,090	100.0	41,725	100.0

Source: Almanac of China's Foreign Economic Relations and Trade, various issues
Notes on the Table

(a) Cumulative

(b) Contractual Joint Ventures include Cooperative Development (cooperation with foreign countries in offshore oil development) and Cooperative Operations (joint production with foreign countries).

From 1979 to 1985, investing overseas could be undertaken only by state-owned import and export corporations under the umbrella of the Ministry of Foreign Economic Relations and Trade (MOFERT), and provincial and municipal international economic and technological cooperation enterprises regulated by the Commission for Foreign Economic Relations and Trade. Within this seven-year period, Chinese capital went into 185 non-trading enterprises overseas. Chinese investments summed to US \$ 154 million which was roughly 62 percent of total investment amount in the contracts. Most of these investments were in the form of joint venture and were located in developing countries. Few of the Chinese overseas enterprises were concerned with manufacturing activities. They were mainly in catering, engineering, finance and insurance, and consultancy.¹⁹

In 1985, a directive that expanded the scope of enterprises eligible for overseas investments was issued by MOFERT. With the new directive, all enterprises, both public and private, can apply for permission to establish subsidiaries

¹⁹ Tseng and Mak (1996), pp. 145-146.

in other countries if they possess sufficient capital and technical and operation know-how, and if a suitable foreign partner can be found.

The 1985 directive resulted in enhanced Chinese investments overseas so that by the end of 1990, there were a total of 801 Chinese-invested enterprises in the world, involving about US \$ 1.2 billion of Chinese capital. This meant an additional 616 enterprises in 1986-1990, more than 3 times the number in 1979-1985. In terms of dollar value, the additional amount of Chinese investments of US \$ 1.1 billion was almost 7 times of the 1979-1985 value. Chinese capital accounted for about 50 percent of the total amount of investments. It was during the period 1986-1990 that Chinese investors started to engage in manufacturing activities. The industries into which Chinese capital flowed became diversified, including metallurgy and minerals, petro-chemicals and chemicals, electronic and light industry, transportation, finance, insurance, medicine, and tourism. It was also during this period that the rise of big Chinese transnational corporations such as China National Metals and Minerals Import and Export Corporation and China National Chemical Import and Export Corporation was witnessed.²⁰

In the 1990s, the Chinese government encouraged instead of just allowing outward direct foreign investments. Top ranking national and local officials publicly expressed the need for Chinese businesses to explore international markets and expand operations overseas to further strengthen themselves and to avoid discriminatory measures imposed by the host government, as well. The Chinese government sponsored and organized seminars and workshops on business opportunities abroad, on how to establish overseas subsidiaries, and on ways and means of improving overseas business operations. As a result, Chinese companies continued to expand outwardly with additional 1,184 overseas subsidiaries established between 1991 and 1996. Chinese capital infused in these overseas business undertakings was US \$ 943 million, representing 44 percent of the total investments.

Table I.8 Approved Overseas Investments of China

	1979-1985	1986-1990	1991-1996	Total
Number of Enterprises	185	616	1,184	1,985
Total Investments (US \$ M)	249	2,146	2,122	4,517
Chinese Investments				
Value (US \$ M)	154	1,055	943	2,152
% of Total Investments	61.8	49.2	44.4	47.6

Source: Almanac of China's Foreign Economic Relations and Trade, various issues

The biggest recipient of Chinese overseas investments in terms of number of enterprises is the United States. Up to 1996, the United States had attracted 238 Chinese investors, representing 12 percent of the total number. The large share of the European bloc was due mainly to Russia, which until 1996 had hosted 227 Chinese-invested enterprises, just a few firms less than that of the United States. Hong Kong and Macao combined ranked third with a total of 191 Chinese-invested entities by 1996. Of the five Southeast Asian countries, Thailand had attracted the most number, 134, of Chinese investments, accounting for a substantial 42 percent of the total for

²⁰ Tseng and Mak (1996), p. 146.

the region. The Philippines compared very poorly with Thailand, with the least number in the region, only 29, of Chinese-invested ventures. In terms of the value of Chinese investments, Canada, though hosting only 77 Chinese enterprises, ranked first with US \$ 371 million of Chinese capital or 17 percent of the total. A close second and third were the United States and Australia accounting for 16 and 15 percent, respectively, of the total value of Chinese overseas investments. It can be inferred from the data that Chinese enterprises in Canada and Australia were much bigger than those of the other countries. Russia, on the other hand, had the smaller Chinese-invested projects as its value share of 4 percent was way below its share of 11 percent in terms of number of enterprises. The Chinese investors in Southeast Asia likewise appeared to be relatively smaller. The most important Southeast Asian recipient, Thailand, accounted for 3 percent (half of the region's share) of the total value of Chinese investments while the Philippine share was a measly half of a percent point.

Table I.9 Approved Overseas Investments of China by Country/Region of Destination 1979-1996

Country/Region	Number of Enterprises		Chinese Investments		Ratio (%) Chinese Capital to Total
	Number	% Share	Value US \$ M	% Share	
Hong Kong & Macao	191	9.6	257	11.9	58.4
United States	82	4.1	15	0.7	34.9
Europe	238	12.0	352	16.4	74.3
Southeast Asia	395	19.9	157	7.3	46.7
Indonesia	321	16.2	134	6.2	34.3
Malaysia	33	1.7	18	0.8	37.5
Philippines	64	3.2	25	1.2	43.1
Singapore	29	1.5	10	0.5	35.7
Thailand	61	3.1	15	0.7	28.3
Australia	134	6.8	66	3.1	32.4
Canada	91	4.6	325	15.1	26.4
Others	77	3.9	371	17.2	53.0
Total	590	29.7	541	25.1	60.0

Source: Almanac of China's Foreign Economic Relations and Trade 1997/1998

The last column of Table I.9 gives the proportion of Chinese capital in total investment by country of destination. First in this criterion was the United States where the Chinese investors contributed almost three-fourths of total capital on the average. Chinese participation in European and Canadian ventures was approximately 50 percent. Chinese investors, on the other hand, were the minority in joint ventures in all of the 5 Southeast Asian countries, infusing only about a third of the total capital. Remarkably, the Chinese stake in the big venture projects in Australia was just 26 percent, the lowest in the least.

II

Factors Affecting Direct Foreign Investment Flows

1. Determinants of and Motivations for DFI

There exist a number of excellent theoretical and empirical analyses on the factors that affect the size, distribution and structure of DFI flows between countries. The different factors discussed in these studies can be grouped into the determining factors (host-country perspective) and the motivating factors (home-country perspective). The home-country variables, the economic conditions and policy factors in the source countries, determine the potential supply of DFI. The characteristics of and the business environment in alternative host countries, on the other hand, determine the direction of the available supply of direct foreign capital.

1.1 Host-Country Variables

Host-country variables include macroeconomic and microeconomic factors relevant to investment decisions, policy formulations that directly or indirectly alter the incentive-disincentive scheme for DFI, investment support factors, and risk factors.

1.1.1 Macroeconomic Factors

The Accelerator Principle of Investments derives that the increase in capital stock is directly proportional to expected output. Expected output is approximated by the size of the market. Gross Domestic Product (GDP), in turn, can be used as an indicator of the size of the market. In accordance with this basic investment formulation, most studies on DFI postulate a positive relationship between DFI and output growth in the host-country. A qualification, however, must be made. The size of the market and its potential growth are likely to influence only those DFIs that are geared towards production of goods and services for the domestic market. Access to a large domestic market is important only to import-substituting DFI.

For DFIs that aim to produce for the world market, the relevant macroeconomic variable is the exchange rate. The real exchange rate, defined as the price in real terms of the foreign currency the host-country uses for its international transactions, affects the international competitiveness of producers in the host countries. An increase in the real exchange rate implies a real depreciation of the host-country's currency while a decline implies a real appreciation. The concepts of overvalued and undervalued currencies refer to situations in which the real exchange rate is considered to be "too high" and "too low", respectively, in relation to the "correct" or "equilibrium" level. An overvaluation/undervaluation of the host-country's currency makes goods and services produced in the host country more/less expensive than goods and services produced elsewhere. If the exchange rate does not equalize production costs among different countries, there is a potential disincentive/incentive for DFI to flow into the country with an overvalued/ undervalued currency.

1.1.2 Microeconomic Factors

The decision to invest is a microeconomic concern. The single most important consideration in any firm's decision to invest is the prospect for higher profits. Profit maximization, given a target output level, is tantamount to cost minimization. Assuming that a market, whether domestic or external, is guaranteed, profitability will just depend on the cost functions. Most DFIs, either domestic market-oriented or export-oriented, are driven away from their home countries by rising production costs, important components of which are labor and raw material costs. Differences in wages and raw material prices reflecting relative factor endowments among prospective hosts influence the direction of DFI.

1.1.3 Policy Factors

These refer to all government actions that directly or indirectly alter the incentive structure for DFI. Fiscal incentives such as preferential tax rates and investment allowances and subsidies are offered to encourage DFIs. Lower tax rates or outright tax exemptions improve after tax profits. Investment allowances and subsidies, on the other hand, lowers the effective cost of capital build-up to the firm.

Other government actions or policies, though unintended, can influence the size, direction and structure of DFI flows. The host country's trade policy can provide profit opportunities for foreign investors. The type of trade policy that a country pursues indicates the type of DFI that the country attracts. A protectionist trade policy, for instance, shelters domestic production from international competition and hence, encourages the establishment of import-substituting DFIs. Accordingly, domestic market-oriented DFIs may be concentrated in highly protected sectors. Policies that facilitate export activities, on the other hand, will attract more export-oriented DFIs.

The exchange rate policy of the host country is also an important consideration for DFIs. As discussed earlier, a policy that supports an undervalued exchange rate can lead to more DFI inflows. Liberalization of the foreign exchange market may be necessary to attract DFIs as they engage more extensively in international transactions such as importations and profit and income remittances.

1.1.4 Investment Support Factors

Investment support factors pertain to the availability of infrastructure as well as suppliers and service industries. Sufficient networks of roads, ports, airports, telecommunication facilities, and energy and material suppliers are required for DFIs' operations in the host country to be profitable. A country with poor infrastructure may have difficulties in capturing a significant amount of DFI.

1.1.5 Risk Factors

Foreign investors measure risks in terms of the political conditions in the host country. Political instability is associated with production disruption, confiscation or damage to property, threats to personnel, and changes in macroeconomic management or the regulatory environment.

1.2 Home-Country Variables

1.2.1 Macroeconomic Factors

The macroeconomic variables that affect outward investments include income, the exchange rate and the balance in the current account. High income growth rates result in high savings rate which implies more investment funds.

A surplus in the current account is another form of savings which is generated by the economy from external trade transactions. Trade surpluses do not only generate funds for investment spending, they also make available foreign exchange for outward investments.

1.2.2 Microeconomic Factors

Excess funds or external surpluses alone do not result in outward investments. Firms undertaking investments abroad must be internationally competitive. Outward investments require some special firm-specific competitive advantage to overcome the intrinsic cost disadvantages of overseas operations. This competitive advantage may be in production technology, management, marketing, access to world markets, etc.

1.2.3 Policy Factors

Outward investments may also be policy-induced. Deregulation of the foreign exchange and financial markets in the home country facilitates the movement of capital and can encourage outward investments. Fiscal policies such as heavy taxation of profits and business activities as well as export taxes may also encourage firms to locate elsewhere to escape the burden of taxation in the home country. Recently, environmental regulations in the developed nations have also been very prohibitive. Abatement costs for compliance with environmental standards may augment costs to such extent that production in the home country becomes less competitive.

1.2.4 Demonstration Effects

Demonstration effects such as the bandwagon effect operate among the smaller foreign investors which are often more risk-averse and whose information about the prospective host country is limited. The relative attractiveness of prospective host countries as sites for DFI is indicated by the actual choices made by earlier and bigger investors. Expectations also tend to be self-fulfilling as the massive inflows of DFI result in increased economic activities.

1.2.5 Other Factors

Specific factors such as historical circumstances, cultural familiarity and geographical proximity may be important considerations for the smaller foreign investors. For these small country investors, transactional and information-cost factors are significant determinants of the direction of DFI.

2. China's Inward Investments

2.1 China's Share in the Global Supply of DFI

How has the emergence of China as a host for direct foreign investments affected foreign capital inflows in the ASEAN countries, specifically, the Philippines, Thailand, Malaysia and Indonesia? Have the massive flows of inward investments in China drained the supply of foreign capital in the four ASEAN countries?

Though China began to open its doors to foreign investors in 1979, it was not until the 1990s that big waves of foreign capital arrived at its shores. From 1991 to 1996, in a span of merely five years, inward direct investments in the country grew ten-fold. Remarkably, DFI flows into China posted strong growth rates despite volatility in the global supply of investments during the same period. The contraction in the world stock of DFI in 1991, 1992 and 1996 appeared to have adversely affected to a greater extent the industrial countries. Like China, the developing countries as a whole enjoyed consistently increasing inward DFI although the average annual growth rate for the entire group of 26 percent was much lower than China's 61 percent. A different picture emerges when one looks at the four ASEAN countries individually. With the exception of Indonesia, all experienced a volatile pattern of investment inflows as in the global case, recording negative growth rates in three of the six years. Table II.1 therefore reveals contrasting scenarios on DFI developments for China and the three ASEAN countries, the Philippines, Thailand and Malaysia. The investment boom in China during the period was clearly not paralleled by similar developments in the three ASEAN countries.

The very favorable trend of inward investments in China was likewise reflected in terms of shares to global DFI. In 1990, only 1.5 percent of the global supply of foreign capital went to China. By 1996, China's share had significantly increased to 12 percent. This could have explained to a large extent the increase in the share of developing countries in global DFI from 14 percent to 39 percent during the period. The shares of Indonesia and Malaysia likewise posted improvements from 1990 to 1996 while that of the Philippines was barely maintained and Thailand's was reduced slightly. It can therefore be said that the much improved share of China did not eat on the shares of its four ASEAN neighbors, nor on the share of the developing countries as a group. If crowding-out had indeed taken place, it had been at the expense of the industrial countries whose share dipped by about 10 percentage points from 1990 to 1996. The greater magnitude of the increase in China's share relative to the magnitude of the drop in the industrial countries' share and the positive growth in the global supply of DFI may be indicative of new stocks of DFI generated by China's "Open-Door" policy. Indeed in the early 1990s, export surpluses in the newly industrialized countries of Asia, particularly Taiwan and Hong Kong, were recycled into additional supplies of global DFI specifically directed to China.

The trade-intensity framework can also be employed in the analysis of DFI flows.²¹ Interests and preference of investing countries in particular host countries may be indicated by the investment-intensity index. The index is defined as the ratio

²¹ This was first done by Pangetsu (1980) and (1987).

of the share of the j th source country in total inward DFI of the i th recipient country to the share of the j th source country in the global supply of investments. Since the objective is to compare source countries' investments in China and the four ASEAN countries, the total supply of DFI in China and the four ASEAN countries, instead of the global supply of DFI, is used for the denominator of the formula.

Table II.2 Intensity Index of Investment in China and the ASEAN-4

Source Country/Region	1986	1990	1994	1995	1996
In China By					
United States	122	184	87	84	95
Japan	51	55	62	52	42
Asian NIES	165	144	127	186	146
European Union	73	42	-	48	58
ASEAN-4	62	10	98	85	50
In the ASEAN-4 By					
United States	81	88	112	110	104
Japan	143	107	136	129	148
Asian NIES	43	94	75	48	62
European Union	124	108	-	132	134
ASEAN-4	133	113	101	109	141

Source: JETRO

Table II.2 presents estimates of intensity indices of investments from two source countries, namely United States and Japan, and three source regions--the Asian Newly Industrialized Countries (NIEs consisting of South Korea, Taiwan, Hong Kong and Singapore), the European Union (EU), and the ASEAN-4 into China and the ASEAN-4. The intensity index of investments in China from the Asian NIEs was greater than 100 for all the years sampled indicating stronger interests and attention accorded to China relative to the ASEAN-4 by this economic bloc in general. The intensity index of United States investments in China, on the other hand, exceeded 100 in 1986 and 1990 but fell below 100 in 1994-1996, implying diminished American interests in China in the mid-1990s. The calculated intensity indices of investments from Japan, the EU and ASEAN-4 reveal stronger interests of these countries/regions in the ASEAN-4 bloc relative to China.

Table II.1 Inward Direct Foreign Investments

Country/Region	1990	1991	1992	1993	1994	1995	1996	Average
Growth Rates (%)								
China		25.2	155.5	146.6	22.8	6.1	12.1	61.4
Philippines		2.6	-58.1	443.0	28.5	-7.1	-35.0	62.3
Thailand		-1.8	4.9	-14.6	-24.3	51.4	13.0	4.8
Malaysia		71.4	29.6	-3.4	-13.3	-4.8	22.9	17.1
Indonesia		35.6	19.9	12.8	5.2	106.2	42.5	37.0
Developing Countries		23.6	19.0	47.2	23.8	6.5	33.6	25.6
Industrial Countries		-32.4	4.3	15.9	2.6	44.6	1.1	6.0
World		-17.4	-0.5	17.7	16.0	27.5	-0.7	7.1
Shares to Global DFI (%)								
China	1.5	2.3	5.8	12.2	12.9	10.7	12.1	8.2
Philippines	0.2	0.3	0.1	0.5	0.6	0.4	0.3	0.3
Thailand	1.0	1.0	1.1	0.8	0.5	0.6	0.7	0.8
Malaysia	1.0	2.1	2.7	2.2	1.7	1.2	1.5	1.8
Indonesia	0.5	0.8	0.9	0.9	0.8	1.3	1.9	1.0
Developing Countries	14.4	21.6	25.8	32.3	34.5	28.8	38.8	28.0
Industrial Countries	72.6	59.5	62.3	61.4	54.3	61.6	62.7	62.1
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: World Investment Report, various issues

In Table II.3, the intensity indices of investments from each of the Asian NIEs are shown. The ASEAN-4 bloc is likewise segregated both as source countries and recipient countries. This is done to determine individual countries' interests in China as well as in each country of the ASEAN-4. In the mid-1990s, investors from the United States and Japan manifested greater preference for Thailand and Malaysia. The high intensity index of investments from the Asian NIEs in China in the mid 1990s was largely due to Hong Kong. Singapore appeared to be more interested in Thailand, Malaysia and Indonesia. Remarkably, the intensity index of investments from the Philippines was high for China but very low for its fellow ASEAN countries. Indonesia displayed equally strong interests in China and the ASEAN-4 economies. Among the ASEAN nations, Malaysia appeared to be the least motivated to invest in China in 1994 and 1996.

Table II.3 Intensity Index of Investment in China and ASEAN-4 Countries

Source	China	Philippines	Thailand	Malaysia	Indonesia	ASEAN-4
1994						
United States	87	340	263	131	49	112
Japan	62	44	437	156	66	136
Asian NIES	127	46	37	79	87	75
Korea	54	16	13	91	197	143
Taiwan	91	104	73	230	95	108
Hong Kong	154	32	9	20	67	50
Singapore	63	46	174	169	127	134
European Union	-	-	-	-	-	-
ASEAN-4	98	445	61	5	95	101
Philippines	159	-	42	4	58	45
Thailand	159	546	-	23	11	45
Malaysia	49	564	96	-	146	148
Indonesia	207	5	0	0	-	0
1996						
United States	95	39	243	195	25	104
Japan	42	28	225	129	122	148
Asian NIES	146	74	94	80	44	62
Korea	81	28	166	94	102	116
Taiwan	109	9	274	59	23	93
Hong Kong	206	121	5	0	15	13
Singapore	54	30	143	282	106	138
European Union	58	156	145	45	149	134
ASEAN-4	50	157	19	7	224	141
Philippines	204	-	-	45	15	15
Thailand	37	30	-	1	257	152
Malaysia	53	30	28	-	222	139
Indonesia	102	263	121	127	-	98

Source: JETRO

2.2 The Investment Climate

2.2.1 Income Growth

The Chinese economy has continuously expanded since its adoption of market-oriented policies and its "Open-Door" policy. With the explosive growth of its domestic economy in the 1990s, China has emerged to be the world's fastest growing market which multinationals can not afford to ignore.

Table II.4 shows real GDP growth rate for China, the ASEAN-4 countries and the world. Throughout the period 1981-1996, only China posted double-digit growth

rates that averaged 11 percent per year, more than thrice the worldwide average. Thailand, Indonesia and Malaysia likewise performed quite impressively better than the global average but still a little way below China's record. The Philippines, on the other hand, was at the tail end, with a growth performance below the world average.

Table II.4 Real GDP Growth Rate (%)

Year	China	Philippines	Thailand	Malaysia	Indonesia	World
1981-1990 (Ave)	10.3	1.0	7.9	5.2	5.8	3.1
1991	9.2	-0.6	8.5	8.7	8.9	1.8
1992	14.2	0.3	8.1	8.0	7.2	2.8
1993	13.5	2.1	8.3	9.0	7.3	2.7
1994	12.6	4.4	8.9	9.1	7.5	4.1
1995	10.5	4.8	8.7	1.1	8.2	3.7
1996	9.6	5.5	6.7	8.8	7.8	4.1
1991-1996 (Ave)	11.6	2.8	8.2	7.5	7.8	3.2

Source: ADB Asian Development Outlook 1997 and 1998

2.2.2 Labor Costs

An important factor that explains the influx of export-oriented DFI in China, particularly from overseas Chinese, in the 1980s is its abundant supply of low-cost labor. Wages per employee for the manufacturing sector in China were only a fraction one-fourth of ASEAN wages from 1980 to 1986. Wages in the Philippines were lower than the ASEAN average but still significantly higher--about thrice the Chinese wages. Indonesian wages were about double Chinese wages. Remarkably, Malaysian and Thai wages exceeded the over-all average for the ASEAN during the period.

To factor in differences in labor productivity among the countries, one can look at labor cost per unit of good produced (wages divided by value-added). Though the gap between China and the ASEAN countries narrowed in terms of unit labor cost, China's average of 0.15 for 1980-1986 was still much lower--only about half of the ASEAN unit labor cost average.

2.2.3 Policy Factors

Investment Incentives. Foreign investments are allowed into China to acquire the financial capital, foreign exchange and technology necessary for the country's pursuit of economic development. Hence, policies are particularly undertaken to lure foreign investors. The approach adopted involves: (1) the provision of incentives, largely administrative and fiscal to foreign investors and (2) the gradual liberalization of the trade and exchange regimes.

Considering the gigantic size and specific conditions of the Chinese economy, the introduction of incentives has been phased by region, starting with the coastal provinces and then pushing forward into the inland regions. This is done through the setting up of special zones within which a generous package of incentives are offered

to make the economic and political environment conducive to foreign investments. The first step was the establishment in 1980 of the four Special Economic Zones, Shenzhen, Zhuhai and Shantou in Guangdong, and Xiamen in Fujian.²² This was followed by the designation of 14 cities as open coastal cities and the establishment of 11 Economic and Technological Development Zones (ETDZs) in 1984 and 1985. The Yangtze River Delta, Pearl River Delta and Xia-Zhang-Quan triangle region in south Fujian were designated as Coastal Economic Open Areas also in 1985. In 1988, another SEZ was established in Hainan. Thereafter, a number of river-side and inland capital cities and border economic cooperative areas have been opened.

Table II.5 Average Wages and Unit Labor Costs in the Manufacturing Sector

	China	Philippines	Thailand	Malaysia	Indonesia	ASEAN
Average Wages (US \$)						
1980	548	1,127	-	2,078	743	1,487
1981	479	1,241	-	2,200	897	1,680
1982	434	1,301	2,230	2,501	1,066	1,947
1983	462	1,349	-	2,794	905	1,959
1984	438	1,180	2,362	3,020	879	2,121
1985	384	1,258	-	3,084	921	1,861
1986	377	1,285	1,729	2,957	877	1,774
Average	446	1,249	2,107	2,662	898	1,833
Unit Labor Cost (US \$)						
1980	0.15	0.22	-	0.28	0.21	0.25
1981	0.15	0.25	-	0.31	0.21	0.27
1982	0.15	0.33	0.20	0.32	0.25	0.27
1983	0.16	0.21	-	0.30	0.27	0.29
1984	0.15	0.20	0.22	0.29	0.24	0.25
1985	0.15	0.23	-	0.30	0.24	0.29
1986	0.16	0.21	0.21	0.30	0.23	0.25
Average	0.15	0.24	0.21	0.30	0.24	0.27

Source: NAPES Database

Special administrative measures to facilitate the entry of foreign capital are implemented in these special zones. Government officials of the zones are given larger and flexible economic management power, project approval power and some legislative power. Special foreign investment centers exist to extend assistance to foreign investors.

A generous package of fiscal incentives are offered in the special zones. In the taxation of profits, foreign enterprises enjoy a number of concessions. First, tax rates for foreign firms' profits are lower. Second, they are exempted from income tax payment for two years in the case of productive enterprises and one year for

²² Southern China was chosen as the starting point because of its long history of external contact and the existence of a transportation network that extends to both the international markets and the inland regions.

service enterprises.²³ After the exemption period, productive enterprises are entitled to a 50 percent reduction of the tax rate for three years while the service enterprises get the 50 percent reduction for two years. For technology-advanced enterprises, the rate reduction period may be extended for another three years. In the case of enterprises exporting at least 70 percent of their production, the tax rate imposed after the period of exemption and reduction is only 10 percent. Further, profit remittances are not taxed.

Foreign firms are likewise exempt from many trade and indirect taxes. Imports of machine and equipment, spare parts and raw materials by foreign enterprises are exempted from custom duties and the consolidated industrial and commercial tax²⁴. Foreign firms also do not pay export duties and indirect taxes for their exports. Domestically-sourced materials²⁵ used by foreign firms for their export products are also not levied value-added taxes. Special economic zones are treated as separate custom areas and foreign enterprises in the zones are exempt from import licensing.

Though the tax reforms initiated in 1994 have aimed at equalizing the tax burden and creating a level playing field for all domestic enterprises and eventually, foreign enterprises, the tax concessions given to foreign firms have remained attractive. The new enterprise income tax of the 1994 reform, for instance, did not affect the foreign-funded enterprises. And although the tax reforms of 1994 had subjected the foreign-funded enterprises to new indirect taxes, before they could ever be fully implemented in 1998, new regulations on exemptions were announced. Moreover, by the beginning of 1998, China started considering extending very favorable terms to direct foreign investors in the central and western parts. The inland regions appear to be ready to offer foreign investors preferential measures that are equivalent or better than those in the coastal zones.

Table II.6 is a checklist of incentives offered to foreign investors in China and the ASEAN-4 countries. The incentive package of the Chinese government appears to be comparable and in some respect better than those of the ASEAN-4. Specifically, China scores better in regard to basic rights and guarantees to investors, tax and tariff concessions and assistance extended to foreign investors.

Trade and Foreign Exchange Policies. Trade and foreign exchange policies in China have been shaped to a great extent by the need to address DFI concerns and problems. From a fully centrally planned trade structure in 1949-1978, the foreign trade regime in China evolved towards decentralization and greater openness with the 1979 Equity Joint Venture Law allowing joint ventures to export and import directly on their own account. To make the business environment more attractive to foreign investors, a system of duty exemptions and concessions for DFI exports and imports have been provided as discussed earlier.

²³ Productive enterprises must have invested at least US \$ 10 million and registered an operation period of more than ten years to be eligible for the income tax exemption and rate reduction. For service enterprises, amount of investments and operation period must be at least US \$ 5 million and ten years, respectively.

²⁴ The consolidated industrial and commercial tax has been classified under the new VAT in the Tax Reform of 1994.

²⁵ Exceptions are crude oil, petroleum and a few state-designated items.

Table II.6 Comparative Investment Incentives

	China	Philippines	Thailand	Malaysia	Indonesia
<i>Basic rights and guarantees to investors</i>					
Guarantee against expropriation	✓	✓	✓	✓	✓
Guarantee against losses due to:					
1) nationalization	✓	-	✓	✓	✓
2) damage caused by war	✓	-	-	✓	✓
3) inconvertibility of currency	-	-	-	-	✓
Remittance of foreign exchange earnings and payments	✓	✓	✓	✓	✓
Repatriation of capital	✓	✓	✓	✓	✓
<i>Protection schemes and priorities given to investors and aliens</i>					
Employment of aliens	✓	✓	✓	✓	✓
Patent protection	✓	✓	✓	✓	✓
Preference in the granting of government loans	-	-	✓	✓	-
Protection against unjust					
1) import competition	-	-	✓	✓	✓
2) government competition local competition	-	-	✓	-	-
	-	✓	✓	✓	✓
Real-estate ownership by alien investors	✓	-	✓	✓	-
<i>Exemptions from taxes and Tariff duties</i>					
Capital gains tax	✓	-	✓	✓	✓
Corporate income tax	✓	✓	✓	✓	-
Taxes on imported capital goods	✓	✓	✓	✓	✓
Taxes on imported raw materials	✓	✓	✓	✓	✓
Taxes on royalties	✓	-	✓	✓	-
Withholding tax on interest on foreign loans (tax credit)	✓	-	-	✓	✓
Other taxes and fees	✓	✓	✓	-	✓
<i>Deductions from taxable Corporate income</i>					
Accelerated depreciation allowance	✓	-	-	✓	-
Carry forward of capital allowance during the relief period	-	-	-	✓	-
Carry forward of loss	✓	-	✓	✓	✓
Export allowances/deductions	-	-	✓	✓	-
Deduction of					
1) organization expenses	✓	-	✓	✓	✓
2) pre-operating expenses	✓	-	✓	-	✓
Reinvested profits	-	-	-	-	-
Investment allowance	-	✓	-	✓	-
<i>Tax credits (direct reduction from Corporate income taxes)</i>					
Investment tax credits	-	-	-	✓	-

Tax credit on domestic capital					
Equipment	-	✓	-	-	-
Other tax credits	✓	✓	-	✓	✓
<i>Extension of incentive availment period</i>	✓	✓	-	✓	-
Special incentives					
To multinational companies	-	✓	-	-	-
To exporters	✓	✓	✓	✓	✓
To offshore banking units	-	✓	-	✓	-
Other laws granting benefits to foreign investors	✓	✓	✓	-	-
Assistance to investors					
Joint venture brokerage	✓	✓	✓	✓	✓
Technical assistance	✓	-	✓	✓	-
Processing of application and other requirements	✓	✓	✓	✓	✓

Source: SGV, Comparative Investment Incentives (1987)

The reform of China's policy of currency inconvertibility was rather delayed and came only after foreign investors expressed frustration and disappointment as they encountered difficulties in obtaining foreign exchange for their importations, and salary and profit repatriation. Realizing the adverse impact of this foreign exchange regime on the entry of foreign capital, the Chinese authorities established in 1986 a dual exchange system, with an official rate that was adjusted periodically and a market-determined rate set in the Foreign Exchange Adjustment Centers, also referred to as the swap centers. Under the dual exchange system which was in effect until the end of 1993, foreign enterprises were allowed to retain all their foreign exchange earnings and to engage in the purchase and sale of foreign exchange in the swap markets. Domestic enterprises and Foreign Trade Corporations were required to surrender their export receipts at the official exchange rate but received retention quotas in proportion to their exports. The retention quotas, which entitled the owner to purchase foreign exchange at the official rate, could be traded in the swap market and hence provided additional supplies of foreign exchange at market rates to foreign investors. The exchange system was further liberalized in 1994 with a single exchange rate determined in an interbank market, the foreign-owned firms being allowed to hold their foreign exchange receipts in foreign currency accounts and the requirement to obtain approval for the purchase of foreign exchange for trade and trade-related transactions being abolished.

2.3 Regression Analysis

Regression analysis was done to establish the statistical significance of the determinants of DFI in China as discussed in the preceding sections. Host country variables included in the equation are China's GDP growth rate (CGDP) to represent the market size, the ratio of China's wage rate to ASEAN wage rate (WR) to represent the cost advantage of China, the exchange rate (XR) to capture exchange risk factor, and a dummy variable (DUM) for the policy factor. The world GDP growth rate (WGDP) is used to depict the supply of outward investment funds. The regression results are summarized in Table II.7. DFI inflows in China are positively related with China's GDP and world GDP; and negatively related with the wage ratio, as hypothesized. The sign of the exchange rate coefficient is positive, implying that

devaluation encourages inflow of DFI, a result consistent with previous empirical studies.²⁶ The effects of CGDP, WGDP and the exchange rate are shown to be statistically significant.

3. China's Outward Investments

Both push and pull factors influence decisions of Chinese businesses to invest overseas. One push factor at work since the early 1990s is the Chinese government's encouragement of such overseas undertaking manifested through public pronouncements and through sponsorships of seminars and workshops aimed at educating and assisting potential overseas investors. With the explosive growth of the Chinese economy in the 1990s, Chinese enterprises are able to realize huge profits and generate excess funds for overseas investments. In order to strengthen them further, the Chinese government is pushing them to set up subsidiaries abroad. Overseas operations enable the Chinese firms to acquire information on foreign technology and markets, and be familiar with and exposed to international competition.

Foreign exchange controls in China have also served as push factors for outward DFI. The inconvertibility of the Chinese currency prompted Chinese firms to set up subsidiaries overseas to retain earnings in foreign currency. Though this motive has diminished in importance with the new policy of full convertibility of the renminbi, Chinese firms have continued to use their subsidiaries to avoid the long application procedure for remittance of foreign currency out of China as well as other administrative controls regarding use of foreign currency.

Table II.7 Regression Results: Factors Affecting DFI Flows in China

Variable	Run 1	Run 2
Constant	-290.82 *(-2.07)	-293.93 (1.91)
CGDP	6.01 *(2.07)	7.01 *(2.25)
CGDP(-1)	1.30 (0.42)	-0.11 (-0.03)
WGDP	54.81 **(10.84)	52.71 **(9.86)
XR	24.44 *(2.16)	22.42 (1.82)
WR	-30.95 (-1.50)	-166.32 (-0.25)
DUM	-246.63 (-0.41)	
R2	0.98	0.97
F	**34.92	**34.27

Notes: Number of observations = 13, t-statistics in parentheses

* Significant at the 10 % level of confidence

** Significant at the 1 % level of confidence

²⁶ Wang (1995), p. 133.

There also exist microeconomic, firm- and industry-level, push factors. China has competitive advantage in certain production technologies such as that of the defense industry. A specific example of this push factor at work is the case of Northern Industry, a conglomerate under the Ministry of Defense. An army tank assembly plant in Malaysia was set up by Northern Industry. It has also diversified into civilian industries, applying the same technology in its metal-processing plant in Singapore.²⁷

Host-country variables influencing China's outward DFI include market, profit variables (cost and price), and policy factors. Market reasons are of various forms and degrees. One is to improve shares in the foreign markets. A number of Chinese manufacturing firms establish marketing and distributing firms in their export markets to have better control of distribution channels for their goods so as to increase their market shares. China Southern Glass Co. utilized this marketing strategy in the United States and Australia. A second market-oriented pull factor is penetration of a regional market. A pharmaceutical conglomerate in Shenzhen chose to locate in Thailand because it was eyeing the triangle region of Thailand-Cambodia-Burma for its market. The promotion of exports of capital equipment from China is another market-related factor. A fish processing firm was set up in Africa with Chinese capital with the secondary objective of exporting fishing vessels from China.

In the case of China's outward DFI, cost savings arise mainly from raw materials and transportation, not labor, cost components. Though China is a country abundant in natural resources, it is deficient in certain natural materials such as rubber and timber. Hence, Chinese firms locate in countries where their essential raw materials in short supply in China can be sourced most easily and cheaply. A Chinese cosmetic factory, for instance, is in Thailand because of its abundant supply of the essential oil used in cosmetic production. Another Chinese firm, a furniture factory, is also in Thailand because of its rich timber resources. A third example for this resource factor is the Chinese-invested fish processing plant in Alaska.

For distant foreign markets such as the United States and/or for certain bulky goods (relative to the price), transportation cost becomes a major component of cost and this becomes an incentive for investing in the export market. The bottling plant in the United States owned by a Chinese beverage factory falls under this category. This is also the case for the health drink plant put up in Thailand by a Chinese pharmaceutical firm.

The second profit variable, price, is something specific to China's present position in the world market. Some Chinese businesses establish subsidiaries abroad because their products command higher prices when manufactured elsewhere. This is the reason cited by a Chinese thermos factory and a Chinese battery manufacturer for locating in Hong Kong.

The policy factor is significant for many Chinese investors in African and North American countries which offer generous packages of tax incentives. Chinese capital also enter countries with discriminative trade policies. To avoid the high

²⁷ Examples cited in this section are taken from the survey on the motives of China's outward DFI in Tseng and Mak (1996), P. 152-157.

import tax on rubber shoes in Malaysia, for instance, a joint venture rubber shoe factory was set up in Malaysia. In Mauritius, a garment factory was acquired by a Chinese investor to circumvent the quota restrictions of the United States for China's garment exports.²⁸

4. DFI Flows Between China and the Philippines

4.1 Philippine Investments in China

Among the ASEAN-4, the Philippines was the first to take note of the potential of China. One of the earliest investors from the Philippines, one of the four set up before 1988, was San Miguel whose target was the large domestic market of China. As with other ASEAN countries, a significant proportion of Philippine investors in China are ethnic Chinese. The economic and peace and order conditions in the Philippines appear to encourage these Chinese Filipino investments in the Mainland. Filipino Chinese began to invest in China during the economic crisis years of the mid-1980s following the Aquino assassination of 1983. The period coincided with the rapid liberalization of the Chinese economy which offered prospects for higher returns on investments. In the early 1990s, the series of kidnappings in the Philippines that victimized a large number of ethnic Chinese pushed many of the Chinese Filipinos into bringing their capital as well as their children to China. An international school was even set up by Filipinos in Xiamen to cater to the educational needs of Chinese Filipino children sent there for security reasons.²⁹ The peace and order problem was coupled by the acute power shortage that plagued the Philippines at about the same time. These explain to a large extent the peaking of Filipino investments in China in 1993.

China's growing economy and policy variables such as the generous foreign investment incentives and the development of the Xiamen SEZ in Fujian have served as the pull factors for Chinese Filipino investments. Chinese Filipinos have invested in manufacturing, real estate development, hotels, department stores and banking in anticipation of huge short- and long-term profits. Most of the Chinese Filipinos still have relatives in Fujian. The Chinese Filipinos capitalize on transactional costs advantages arising from cultural familiarity and kinship ties, referred to as "homeland mentality" by some political economy experts in the Philippines. The most successful of the Chinese Filipino investors are those with big capital such as Tan, Sy, Ty and Gokongwei. The small- and medium-sized investments are reportedly not earning much or just surviving because of fierce competition. They remain to be in China, though, because of their relatives there. Chinese Filipino investors, both small and big, claim that one of the reasons for their investments in the Mainland is for them to be of some help to their "homeland".³⁰

²⁸ The United States impose no export quota restrictions for Mauritius-made garments.

²⁹ Chong-Carino (1994).

³⁰ Lim (1999).

4.2 Chinese Investments in the Philippines

China started to generate some excess funds that could be channeled into overseas investments and its government began to be liberal and to a certain extent supportive of such external undertakings in the late 1980s and the early 1990s, the period during which the Philippine economy was stagnating while those of Thailand and Malaysia were on the upswing. Accordingly, Chinese capital surged into the direction of Thailand and Malaysia and trickled only in the Philippines. Hence, from 1979 to 1996, China's statistics recorded only 29 counts of approved investments to the Philippines. The Philippine Board of Investments (BOI) records, likewise, reveal very limited investments from China, with figures not significantly different from zero until 1988. From 1990 up to the end of 1993, BOI listed only 6 approved Chinese-funded investments, all of which except for one—the New Philippine-China Group Development Corporation, were small-sized investments amounting to less than US \$ 500,000. The unstable political and economic environment in the Philippines during the period scared foreign investors away, including the Chinese. Investments from China began to pick-up in 1994 as the Philippine economy showed signs of recovery and stability. In this year, two large-scale Chinese-funded investments were approved by the BOI. Both were power generation projects, reflecting the needs of the Philippine market at that time and the comparative advantage of China (relative to the Philippines). It was also in 1994 that government-initiated business delegations from China visited the Philippines. In January of that year, a business mission led by Deng Xiaoping's son-in-law explored investment opportunities in the Philippines in the areas of finance, construction materials and real estate. That was followed by a visit of China's Minister of Foreign Trade and Economic Cooperation and other top ranking economic officials in October. Exploratory business missions continued to arrive in the Philippines in the succeeding years. There were expressed interests in the areas of port development, cement production and appliance manufacturing.³¹

³¹ Jianren (1995), p. 19.

III

Effects of Direct Foreign Investments in China

1. Export Expansion

The Product Cycle Model provides a dynamic framework for the link between trade and foreign investments. In the initial stage of the cycle, the product, developed and produced in a developed country, is exported to a less developed economy. As the product becomes standardized and its markets in the less developed country expand, the product is produced in the less developed country through DFI for local sale. Over time, cost advantages in the less developed country result in the closure of capacity for the product in the developed country (which moves on to new products) and the product is exported from the less developed country to the developed country.³²

In line with the Product Cycle Theory, Kojima argues the trade-orientedness of Japanese outward foreign investments. He argues that direct foreign investments that result in the orderly transfer of industries from countries losing comparative advantage to those countries which still possess advantage in such industries are trade-creating and welfare-enhancing for both investing and host countries.³³

In the case when DFIs in export-oriented production are particularly encouraged, the simple production theory explains the positive correlation between direct foreign investments and exports. The introduction of superior production technologies through DFI works towards increasing the competitiveness of the host country's exports in the world market.

Export-oriented foreign investments are particularly encouraged in China to ensure the continuous supply of foreign exchange necessary to sustain economic growth. Has China been successful in directing investments to export-oriented industries? The following table reveals the impressive expansion in China's exports. From 1984 to 1996, total export receipts of China increased almost six-fold from only US \$ 26 billion to US \$ 151 billion, growing at an average rate of 16 percent per year. Exports of foreign-invested enterprises grew at a much faster rate of 74 percent per year on the average so that by 1996, exports of foreign-invested enterprises was more than 500 times the 1984 level. The rapid growth of DFI exports was remarkably sustained until 1996 despite the abrupt deceleration in over-all export performance during the year. Consequently, the share of foreign-invested enterprises in China's exports rose continuously from less than 1 percent in 1985 to a substantial 41 percent in 1996--nearing half of China's export receipts.

³² R. Vernon (1966).

³³ K. Kojima (1978).

Table III.1 Exports of Foreign Invested Enterprises in China

Year	Total Exports		DFI Exports		Ratio (%) DFI Exports To Total
	US \$ Millions	% Growth Rate	US \$ Millions	% Growth Rate	
1984	26,140		115		0.4
1985	29,091	11.3	320	178.3	1.1
1986	30,683	5.5	480	50.0	1.6
1987	40,147	30.8	1,200	150.0	3.0
1988	47,308	17.8	2,460	105.0	5.2
1989	59,277	25.3	4,920	100.0	8.3
1990	62,400	5.3	7,800	58.5	12.5
1991	72,024	15.4	12,100	55.1	16.8
1992	85,294	18.4	17,400	43.8	20.4
1993	91,782	7.6	25,240	45.1	27.5
1994	121,010	31.8	34,713	37.5	28.7
1995	148,780	22.9	46,876	35.0	31.5
1996	151,060	1.5	61,506	31.2	40.7
Average		16.1		74.1	15.2

Source: China Statistical Yearbook

A regression run of total exports versus the amount of inward investments in China reveals a significantly high correlation coefficient of 90 percent. The result also indicates a significant positive effect of foreign investment inflows on exports—every US \$ 1 of DFI inflow generates US \$ 2.55 of exports:

Regression Results: Dependent Variable = Exports

	coefficient	t-statistics
constant	41,683.64	7.41
DFI	2.55	9.44
R-squared		0.8998
F		89.7847

2. Capital Formation

Direct capital inflows, as a source of investment funding, have the potential to increase income via the supply and demand sides. On the supply side, DFIs imply expansion of capital stock and hence, an increase in the productive capacity of the economy. DFIs are also often associated with technology transfer in both production and management which results in more efficient use of productive resources. The expansion in demand for capital goods coming from foreign investors may not be substantial as a significant portion of their capital requirement may be imported. DFI, however, may lead to the development of supplier industries (backward linkages) and may likewise stimulate increases in other expenditure items (forward linkages) such as consumption (through its employment-generation effect) and exports (for export-oriented DFI).

The supply-side effect of foreign investments may be the dominating factor in income growth relative to the demand effect. DFIs are tantamount to capital formation and hence, expansion in the productive capacity of the economy. A spectacular build-up of capital has taken place in China since it opened its doors to foreign investors. Gross capital formation expanded 13 times from only RMB 200 billion to RMB 2.7 trillion, an average annual growth rate of 23 percent. That DFIs contributed substantially to this capital build-up is clearly reflected in the increase in the ratio of DFI to GCF (third column of Table III.2). From a negligible share of 0.3 percent during the early years of the “Open-Door” policy, the share of foreign investors in capital formation in China continuously increased to 15 percent in 1994. DFIs’ share in China’s capital expenditures remained substantial despite the slow-down in the inward flow of foreign investments in the mid-1990s.

Table III.2 Contribution of DFI to China’s Gross Capital Formation

Year	Utilized DFI Inflows (Y Billions)	Gross Capital Formation (Y Billions)	GCF Growth Rate (%)	Ratio of DFI to GCF (%)
1979-1982	2	640		0.3
1983	1	200		0.6
1984	3	247	23.5	1.2
1985	5	339	37.2	1.4
1986	6	385	13.6	1.7
1987	9	432	12.2	2.0
1988	12	549	27.1	2.2
1989	13	609	10.9	2.1
1990	17	644	5.7	2.6
1991	23	752	16.8	3.1
1992	61	964	28.2	6.3
1993	159	1,500	55.6	10.6
1994	291	1,926	28.4	15.1
1995	313	2,388	24.0	13.1
1996	347	2,687	12.5	12.9
Average			22.8	5.0

Source: China Statistical Yearbook 1998

3. Employment

The effect of foreign investments on the over-all employment picture in China can only be minimal as they account for less than 1 percent of total employment and just about 2 percent of urban employment. Nonetheless, direct foreign investors have made important contributions to job creation in China. With the investment boom of the early 1990s, employment in foreign-funded enterprises increased by 30 percent in 1993 and another 41 percent in 1994. The impressive record continued until 1995 during which DFI employment grew by 26 percent. By 1996, there were a total of 5.4 million jobs generated by foreign-funded enterprises, more than double the jobs in 1992 of 2.2 million. Consequently, the share of FFEs to total Chinese employment rose from 0.3 percent in 1992 to 0.8 percent in 1996 while their share to urban employment increased from 1.3 to 2.7 percent.

The expansion of employment associated with DFIs becomes more significant if put in the context of contracting employment in state-owned enterprises (SOEs) and urban collectives. Indeed, foreign enterprises have helped absorb redundant labor displaced with the gradual rationalization of SOEs and urban collectives whose share to over-all employment figures had accordingly dropped. Table III.3 further reveals that workers of FFEs are better paid than those of SOEs and urban collectives. Generally, wages in FFEs are twice those of urban collectives and 50 percent more of SOEs.

Table III.3 Employment and Average Wages in China

	1992	1993	1994	1995	1996	Ave.
Employment (10,000 persons)						
Total	65,554	66,373	67,199	67,947	68,850	
Rural	48,313	48,784	48,786	48,854	49,035	
Urban	17,241	17,589	18,413	19,093	19,815	
State-owned	10,889	10,920	11,214	11,261	11,244	
Urban Collective	3,621	3,393	3,285	3,147	3,016	
Foreign-funded	221	288	406	513	540	
Hong Kong, Macao, Taiwan	83	155	211	272	265	
Others	138	133	195	241	275	
Average Wage (Yuan)						
Urban	2,711	3,371	4,538	5,500	6,210	
State-owned	2,878	3,532	4,797	5,625	6,280	
Urban Collective	2,109	2,592	3,245	3,931	4,302	
Foreign-funded						
Hong Kong, Macao, Taiwan	4,740	5,147	6,376	7,484	8,334	
Others	4,347	5,315	6,533	8,058	9,383	
Employment (Share to Total, %)						
Total	100.0	100.0	100.0	100.0	100.0	100.0
Rural	73.7	73.5	72.6	71.9	71.2	72.6
Urban	26.3	26.5	27.4	28.1	28.8	27.4
State-owned	16.6	16.5	16.7	16.6	16.3	16.5
Urban Collective	5.5	5.1	4.9	4.6	4.4	4.9
Foreign-funded	0.3	0.4	0.6	0.8	0.8	0.6
(Share to Urban, %)	1.3	1.6	2.2	2.7	2.7	2.1
(Growth Rate, %)		30.3	41.0	26.4	5.3	25.7
Average Wage (Proportion of Urban Wage, %)						
Urban	100.0	100.0	100.0	100.0	100.0	100.0
State-owned	106.2	104.8	105.7	102.3	101.1	104.0
Urban Collective	77.8	76.9	71.5	71.5	69.3	73.4
Foreign-funded						
Hong Kong, Macao, Taiwan	174.8	152.7	140.5	136.1	134.2	147.7
Others	160.3	157.7	144.0	146.5	151.1	151.9

Source: China Statistical Yearbook 1998

Regional wages given in Table III.4 likewise indicate wage gaps between FFEs and non-FFEs. In the SEZ regions and the coastal cities where most DFIs are located (85 percent), wages are above the over-all average. Shanghai, Beijing and Guangdong with three of the five SEZs offer the highest wages in China. Wages in the interior regions which account for just 15 percent of DFIs are 10 to 30 percent lower than the over-all average.

Table III.4 Average Wages in China by Region, 1996

	Wage (Yuan)	Proportion of Total (%)
Total	6,210	100.0
Special Economic Zones Region	7,096	114.3
Guangdong	9,127	147.0
Fujian	6,684	107.6
Hainan	5,476	88.2
Beijing and Coastal Regions	6,691	107.7
Beijing	9,579	154.3
Tianjin	7,643	123.1
Shanghai	10,663	171.7
Liaoning	5,269	84.8
Hebei	5,286	85.1
Shangdong	5,809	93.5
Jiangsu	6,603	106.3
Guangxi	5,397	86.9
Jilin	5,370	86.5
Heilongjiang	4,564	73.5
Zhejiang	7,413	119.4
Interior Regions	5,084	81.9
Shanxi	5,183	83.5
Inner Mongolia	4,716	75.9
Anhui	5,175	53.3
Jiangxi	4,852	78.1
Henan	4,924	79.3
Hubei	5,099	82.1
Hunan	5,100	82.1
Sichuan	5,156	83.0
Guizhou	4,917	79.2
Yunnan	6,231	100.3
Tibet	1,087	17.5
Shaanxi	4,882	78.6
Gansu	5,882	94.7
Qinghai	6,513	104.9
Ningxia	5,635	90.7
Xinjiang	5,987	96.4

Source: China Statistical Yearbook 1998

4. Income Growth

The two decades of the 1980s and the 1990s witnessed the rapid growth of the Chinese economy that stemmed from the country's "Open-Door" policy. From 1978 to 1996, real GDP grew by 444 percent. On a per capita basis, real GDP in 1996 rose to more than four times the 1978 level. Industry, the sector housing much of the DFIs (about 70 percent), led this growth, expanding by 674 percent during the period. Construction, which was opened to DFIs in 1991 and which made a major contribution to the unprecedented investment of the early 1990s, grew by 548 percent. Primary industries comprised about 25 percent of China's GDP but received only 2 percent of DFIs. The primary sector grew by only 146 percent during the period.

Table III.5 gives the yearly growth rates of GDP and DFI. High GDP growth rates are accompanied by high DFI growth rates. The years during which China's GDP grew at double-digit rates coincide with years of massive DFI inflows, 1984-1985, 1987-1988 and 1992-1994. The first big waves of foreign investors arrived in China after laws and guidelines governing DFIs were formulated in 1983 and 1984. The entry of large multinationals from Europe and the United States triggered a bandwagon effect in 1984 and 1985. The second wave came in 1987 and 1988 as generous incentives were offered to foreign investors for the first time. The third investment boom, unparalleled by the first two, led to three consecutive years of very high growth. Increase in direct foreign investment inflows were sustained, albeit to a less degree, after 1994. Remarkably, GDP growth, though also lower, remained impressive.

Table III.5 DFI (Utilized Amount) and GDP Growth Rates (%)

Year	DFI	GDP
1984	97.8	14.6
1985	32.0	13.5
1986	12.8	8.3
1987	23.5	11.6
1988	38.0	11.3
1989	6.2	4.1
1990	2.8	3.8
1991	25.2	9.2
1992	152.1	14.2
1993	150.0	13.5
1994	22.7	12.6
1995	11.1	10.5
1996	11.2	9.6

Source: China Statistical Yearbook and Almanac of China's Foreign Trade and Relations

Data on per capita GDP by region are likewise reflective of the role played by DFI in China's economic growth. Per capita GDP in Shanghai, second only to Guangdong as recipient of DFI, was almost four times the national average. Beijing and Tianjin, a coastal city, recorded per capita GDP in 1996 more than double the over-all average. Guangdong's and Fujian's, home to the first four SEZs, were about 50 percent higher. In general, coastal regions posted per capita GDP above the national average while those of the interior regions fall short of the average.

Table III.6 Per Capita GDP by Region, 1996

	Per Capita GDP (Y)	Proportion of Total (%)
Total	5,634	100.0
Special Economic Zones Region	7,716	137.0
Guangdong	9,513	168.8
Fujian	8,136	144.4
Hainan	5,500	97.6
Beijing and Coastal Regions	9,370	166.3
Beijing	15,004	266.3
Tianjin	12,270	217.8
Shanghai	22,275	395.4
Liaoning	7,730	137.2
Hebei	5,345	94.9
Shangdong	6,834	121.3
Jiangsu	8,447	149.9
Guangxi	4,081	72.4
Jilin	5,163	91.6
Heilongjiang	6,468	114.8
Zhejiang	9,455	167.8
Interior Regions	3,783	67.1
Shanxi	4,220	74.9
Inner Mongolia	4,259	75.6
Anhui	3,881	68.9
Jiangxi	3,715	65.9
Henan	4,032	71.6
Hubei	5,122	90.9
Hunan	4,130	73.3
Sichuan	3,763	66.8
Guizhou	2,093	37.1
Yunnan	3,715	65.9
Tibet	2,732	48.5
Shaanxi	3,313	58.8
Gansu	2,901	51.5
Qinghai	3,748	66.5
Ningxia	3,731	66.2
Xinjiang	5,167	91.7

Source: China Statistical Yearbook 1998

To further establish the extent of the contribution of direct foreign investments to China's growth, a model that specifies output growth (CGDP) as a function of the production inputs: the growth rate of labor (L), the investment rate (GCF/Y) and technology (represented by the constant term) is formulated. To isolate the effect of direct foreign investments, capital formation (GCF/Y) is segregated into domestic savings (S/Y) and foreign inflows (DFI/Y). The results of the regression runs are given in Table III.7. The first estimated equation shows the significant positive effects of labor growth and capital formation on China's GDP growth. The magnitude of the coefficients reflects the relatively stronger impact of capital formation on China's growth. For every 1 percent point increase in the investment rate, China's GDP growth rate increased by 2.4 percent points on the average during the period considered. The second equation which separates the effect of direct foreign investments reveals that much of the growth impact of capital formation was contributed by direct foreign investments. The coefficient of domestic savings rate in the second equation, although positive, is statistically insignificant. The coefficient of DFI/Y, on the other hand, is highly significant and strongly positive (slightly higher than the coefficient of the rate of capital formation). A value for the correlation coefficient of around 0.50 is expected as the model has not been specified to capture all the factors that affect GDP growth. Demand variables, for instance, are not entered into the model. It may be necessary to note here that DFI, also shown to be greatly contributing to exports, is expected to have indirect income effects via the export demand effect.

Table III.7 Regression Results: Effect of Inward DFI on China's GDP Growth

Variable	Run 1	Run 2
Constant	-31.70 **(-2.27)	-22.82 (1.43)
L	0.96 **(2.88)	1.30 **(2.87)
GCF/Y	2.41 **(2.88)	
S/Y		0.66 (1.55)
DFI/Y		2.79 **(3.11)
R2	0.48	0.54
F	***5.15	**3.90

Notes: Number of observations = 14, t-statistics in parentheses

* Significant at the 10 % level of confidence

** Significant at the 5 % level of confidence

*** Significant at the 1 % level of confidence

IV

Summary and Conclusions

The objectives of Chinese authorities in opening the country's door to foreign investors were many-fold. Taking off from a very low income base in 1979, domestic savings were not sufficient to fuel growth. Nor were its reserves of foreign exchange adequate to finance imports of capital goods and production inputs necessary to increase productivity and expand output. Foreign investors were also expected to introduce new management and production technologies that would make China internationally competitive. Further, the promotion of foreign investments particularly in export-oriented sectors was aimed at ensuring, not just a one-time, but a continuing flow of foreign exchange into the country. Has China been successful in achieving these objectives?

Since the enactment of the Equity Joint Venture law in 1979, big waves of foreign investments have arrived in China. From 1979 to the end of 1996, a total of US \$ 175 trillion capital had actually been invested in China by foreign entities. This figure was just less than half of the total pledged amount of US \$ 469 trillion. The rate of growth of DFI was extremely impressive—an annual average of 57 percent in terms of contract amount and 45 percent in terms of utilized amount. By 1996, inflows of direct foreign investments were 275 times of 1983's level.

A number of internal and external factors contributed to this remarkable record. Opportunities offered by China's potentially expansive market was an important drawing force for direct foreign investments. The market size factor represented by the rate of growth of the Chinese economy was shown to have a statistically significant positive effect on inward DFI in China. China's abundant supply of low cost labor was a pull factor for the early small- to medium-scale export-oriented overseas Chinese investors.³⁴ The regression analysis further revealed that the devaluation of the renminbi had a significant positive effect on DFI. The favorable influence of economic-related variables in China was greatly enhanced by policy variables. Policy played a catalytic role in attracting foreign investors to China. The package of incentives offered to foreign investors in special zones matched and even surpassed those offered by competing economies such as the ASEAN-4. Chinese authorities manifested much sensitivity to the needs of foreign investors. Liberalization of trade and foreign exchange policies in China had evolved largely in response to and in accordance with the concerns of DFI. By the start of the 1990s, the world had been convinced of China's commitment to its "Open Door" policy and to the establishment of a politically and economically conducive business environment and hence, the unprecedented investment boom of the early 1990s.

External factors were likewise at play in the investment boom in China. Economic conditions in the source countries dictated the available supply of funds for outward investments. As a general indicator of this factor, world GDP growth rate was included as one explanatory variable in the DFI equation. The relationship turned out to be strongly positive. A sizeable proportion of investments in China came from

³⁴ The regression analysis of the second section yields a negative relationship between the wage rate and DFI, as hypothesized.

Hong Kong, Taiwan and South Korea. The accumulation of trade surpluses in these countries in the late 1980s up to the early 1990s made available the foreign exchange that was recycled into DFI outflows to China. These capital movements were facilitated by improved political relations of these primary source countries with China.

A host of other non-economic and non-policy factors explained foreign investments in China. Historical, cultural and geographical affinity made the transaction costs of business in the Mainland lower for overseas Chinese. This was a relevant motivational factor for investments from Hong Kong and Taiwan which accounted for 60 to 70 percent of DFIs in China as well as for the ethnic Chinese investors which comprised a significant portion of investments from the ASEAN.

Direct foreign investments flowed massively into China, as hoped. Had DFI delivered as expected? The impressive export performance of China, an annual growth rate of 17 percent, was contributed largely by foreign investors, whose export receipts grew by 74 percent per year. In 1996, foreign-funded enterprises produced nearly half of total Chinese exports, a big leap from their share of less than 1 percent in 1985. A spectacular build-up of capital had also taken place in China since the foreign investors arrived. Gross capital formation expanded at a rate of 23 percent per year. About 13 percent of these capital expenditures were undertaken by foreign funded enterprises in the 1990s, a sharp improvement from their negligible share of 0.3 percent during the early years of the "Open Door" policy. It was also shown statistically that capital formation particularly by DFIs had a significant positive effect on GDP growth of China which posted double-digit rates in most of the "open door" years. These growth records were translated into 5.4 million higher paid jobs in FFEs which made up for contracting employment in state-owned enterprises and urban collectives.

With its initial success, Chinese authorities appear to be bent on continuing and expanding the scope of the "Open Door" policy. Though the tax reforms initiated in 1994 have aimed at equalizing the tax burden for all domestic and eventually foreign enterprises, policies towards foreign investors have remained very favorable. Chinese authorities have even come up with new positive measures for direct foreign investments since 1998 such as value-added tax exemptions, further simplification of DFI screening and approval procedures, and guarantee and better protective measures for DFI interests.³⁵ On several occasions, top ranking officials have publicly declared government's intention to further improve the environment for foreign investments and to invite aggressively DFI. Furthermore, Chinese authorities have already started to attract foreign investors to the inland regions. The central and western regions of China are now offering DFI incentives that are equivalent and sometimes better than those in the coastal regions.

Though China too has been hurt by the Asian economic crisis, its toll has been much less. The drying up of funds in China's DFI source countries, mostly Asian, have resulted in the decline in DFI in terms of contract number and amount since 1996. Actual DFI inflows, on the other hand, have started to slow-down since 1995 but did not decrease in absolute terms until last year, 1998, thanks to the fresh and

³⁵

Tateishi (1998).

large-scale investments made by European and American transnational companies. Accordingly, income growth in China has remained solid, a decent 7.8 percent in 1998, despite the deceleration since 1995.

What are the implications of these developments in China on the ASEAN-4 countries? Has the emergence of China as a host for direct foreign investments affected foreign capital flows in the ASEAN-4? There are no indications that DFIs in China have crowded-out DFIs in the ASEAN-4. The much improved share of China in the global supply of DFI has not been accompanied by reductions in the shares of the ASEAN-4, nor of all developing countries as a group but of the industrial countries. The greater magnitude of the increase in China's share relative to the magnitude of the drop in the industrial countries' share and the positive change in the global supply of DFI are indicative of new stocks of DFI generated by China's "Open Door" policy. Moreover, China's opening has presented new opportunities for the ASEAN-4. Two-way DFI flows between China and the two ASEAN countries, Thailand and Malaysia, became important in the early 1990s during which all three economies were on an expansionary trend. Remarkably, complementation in several respects, namely, material endowment, labor skills, technology, and market needs have been found. Thai firms have gone to China to escape the rapidly increasing cost of labor and land in Thailand as well as to penetrate the enormous Chinese market. Chinese firms, on the other hand, have gone to Thailand for sourcing of certain raw materials and getting access to a regional market. Similar examples of active and profitable cooperation between China and Malaysia could be cited. Examples of flows between China and the Philippines may not be as numerous. Despite the fact that the Philippines was the earliest among the ASEAN-4 to invest in China, a positive trend was not established due to the several crises the Philippines went through from 1983 up to the early 1990s. As the Philippines stepped onto the path of recovery in the mid-1990s and as it has continued to manifest greater resiliency to the Asian crisis as China, talks of economic cooperation have been initiated. Government-supported business delegations have been sent between the two countries to explore opportunities. Certainly, complementation similar to those with Thailand and Malaysia exists.

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