Foreign Direct Investment China

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Analysing the theories explaining the pattern of FDI in China and assessing the impact of such FDI upon the Chinese economy

Abstract

This paper aims to provide a deep insight about the general theories of Foreign Direct Investment (FDI) developed till now and seeks to analyse reasons multinational enterprises (MNE's) are spreading their operational activities across the whole world, more precisely in China. An attempt will be made to determine the extent to which the different theories of FDI in international economics explain the pattern of FDI in China through worldwide examples and famous scholars' research findings. The positive as well as negative impacts of FDI more specifically on China, who has grown from a developing country to a powerful economic giant during the last decades, are discussed in this paper.

Keywords: FDI theories, China, cost and benefits, Chinese economy

1. Introduction

During the second half of the last century, China has become the world economic giant surpassing USA to become the largest recipient of FDI in 2012 from its 11th position in 1999[1]. Total FDI inflow in China grew at unprecedented rate over the years with its FDI stock net of Balance of Payment (BOP) standing at USD 347.8 billion in 2013, making China one of the greatest beneficiaries of FDI inflows in dollar terms[2]. Through its transition from a centrally planned economy to a robust specialist market economy since 1978, China has become the benchmark model to follow when it comes to economic development. Following the adoption of more relaxed and investment friendly trade policies since its

[1] UNCTAD World Investment Report 2015
[2] World Bank Statistics, FDI stock net of BOP

accession to the World Trade Organisation in 2001, the Chinese economy has emerged as the world incontestable leader when it comes to dominating the export market[3]. A set of mixed reforms including liberalization of capital and factor markets, better fiscal and monetary policies, a flourishing private sector supported by adequate institutional support has provided the necessary ingredients to attract FDI in China over the last decades and hence China has been dubbed as the economic miracle of the 21st century[4]. This remarkable growth in China's FDI inflow has pushed scholars to investigate into the intrinsic characteristics explaining such a stupendous trend in China's FDI. Nevertheless, FDI has been a blessing in disguise for China, generating a series of benefits and drawbacks simultaneously upon the Chinese economy.

2. Methodology

Foreign direct investment is undoubtedly one of the most popular area of interest of scholars given the sheer level of importance countries attach to it to develop their economies. Nevertheless, various scholar theories and debates have mushroomed across the globe explaining the pattern of FDI around the world and questioning the efficiency of FDI as a viable development tool for nations. Hence, this paper aims to provide an in-depth analysis as to what are the most viable theories explaining FDI activities, more specifically upon the Chinese economy and whether such FDI has been an antidote to the problems faced by China during its transition towards a robust economic power. The work of famous scholars including Dunning (1973, 1980, 1998) and Hymer (1977) amongst others was fundamental in providing a deep understanding to the theories of FDI in China. The impact of FDI upon China macroeconomic indicators not restricted to employment, gross domestic

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[3] World Trade Organization database

[4] The Economist, "The China that works", September 12 , 2015

product, inflation, wage rate, infrastructural development and poverty amongst others have been thoroughly investigated. Journal publications and economic reports published by World Bank and China Statistics Bureau were vital in providing empirical evidence to the findings of this paper. The data generator section of World Bank and economic database of trading economics were extremely useful in generating the diagrams and gaining accurate records of various figures mentioned in the paper.

3. Definition of Foreign Direct Investment

With the growing amount of capital movement across national boundaries in the form of FDI activities, the need for a comprehensive and comparable standard to record the value of FDI figures has been strongly felt across the world. This also gave rise to the importance of formulating a proper definition of FDI to help scholars and statisticians to gather data for FDI records. Accordingly, the Organization for Economic Cooperation and Development (OECD) defined FDI as a cross border investment which reflects the objective of obtaining a lasting interest by a resident entity in one economy (direct investor) in an entity resident in an economy other than that of the investor (direct investment enterprise), with the benchmark of ownership sets at 10%. Hill (2011) states that the two main forms of FDI are, firstly, Greenfield investment which involves the setting up of a new plant in a foreign country, or secondly strategic mergers and alliances with a local company in that country. It is indubitable that there have been various plausible theories that can account for the burgeoning FDI in China.

4. Main Theories of FDI explaining China FDI Pattern

4.1 Capital market and Exchange rate theory

Developed by Iversen (1935) and elaborated by Aliber (1970, 1971), capital market and exchange rate are considered to be among the oldest theories of FDI. Accordingly, FDI is determined by interest rates and stability of exchange rate. Based on this, money flows across nations in the aim to gain higher return in the form of interest but exchange rate stability is a sine qua non condition, so that there is no fluctuation in the real capital appreciation. Termed as hot money movement[5], this was observed during the financial crisis of 1997 within the Asian tigers namely Thailand, Malaysia and Korea. Krugman (2012) noted short term capital movement predominated in these countries to gain interest and led to speculations which were one of the major catalysers of their economic downturn. Following the financial crisis of 2008, research findings have demonstrated that hot money inflow is increasing in China at unprecedented rate. China's foreign currency reserve has increased by USD 280.6 billion in the first half of 2008 alone[6]. The disparity in the interest rate between US and China and also the expectation of an appreciation in the Chinese Yuan have prompted investors to invest more in china to gain higher returns. While the US Federal Reserve has reduced interest rates to around 2.00% in 2007[7], the People's Bank of China increased interest on deposits to around 4.14% simultaneously[8]. This led to an incentive for investors to transfer their deposits to China to reap higher return rate and thus resulted in an increase in hot money inflow in the Chinese economy. Li Deshui, former director of China National Statistics Bureau, warns that around USD 500 billion in hot money was already

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[5] Michael Pettis and Logan Wright, Hot Money Poses Risks to China's Stability, Financial Times, July 13, 2008

[6] China's Forex Reserve Reaches USD 1.809 Trillion by June," Xinhua, July 14, 2008

[7] Data from Federal Reserve, US

[8] People's Bank of China statistical data

accumulated in China till 2008[9].

4.2 Monopolistic Theory

During the 1960's post World War II, the neo-classical theories of international trade and investment failed to provide a decent explanation of the increasing portfolio of international investment by companies in foreign countries. Accordingly Hymer (1977) developed the monopolistic theory of FDI, asserting that firms possess core advantages unique to them which local firms do not have. These may be in terms of specialist knowledge or intangible assets that give them a competitive edge globally, known as firm specific advantages. The existence of asymmetrical information about specific products encouraged firms to venture in foreign countries and set production plants to supply the market. The ability of such firms to differentiate their products gave them direct control over their pricing and selling strategies and thus proved to be a push factor, encouraging them to undertake investment in foreign locations including China and maximise returns from their specific advantages.

4.3 Internalisation Theory

Closely linked to the monopolistic theory Hymer (1977), the internalisation theory was championed by Buckley and Casson (1976) who argued that the existence of market failure provides an impetus for firms to carry out direct investment abroad to exploit these advantages. It is found that firms are always eager to exploit their core competencies and intangible assets to reap maximum marketing, commercial, financial and other long term strategic benefits. However, these firms are reluctant to penetrate foreign market through licensing or franchising as they fear valuable and sensitive information may fall in the hands of rival competitors. They prefer to undertake FDI activities them- selves and serve the

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[9] "Restless Hot Money Inflows May Worsen China's Inflation Risk, Warns Political Ad-visor," Xinhua, March 8, 2008

foreign market. For instance, IBM the US multinational, preferred to open new plants in China rather than license its production to Chinese companies due to the fact that its speech recognition technology was very valuable and a money generating asset at that time and china had no proper patent rights to allow IBM to protect its intellectual property.

4.4 Product Lifecycle Theory

Developed by Vernon (1966), its main purpose was to provide a basis of justification of the massive investment made by US companies in Western Europe, post World War II. It explains FDI through the lifecycle of a product. Vernon identified four main stages in the lifecycle of a product namely: Introduction, Growth, Maturity and Decline. In the initial stage, products are developed by technologically advanced and developed countries like US. The product is exported abroad until it reaches maturity stage, where foreign countries start to produce the same product, leading to intensive competition. Cost reduction becomes vital thereby pushing the domestic firm to invest abroad to exploit cheap factor endowments to maintain competitiveness. Hence, the developer country changes from a net exporter, to a net importer of the product (Figure 1).

Nowadays research and development phase is carried out by developed countries like US, Switzerland, Norway and production is done in developing countries such as China and Mexico. This is particularly true in the computer and mobile production. The main criticism of Vernon theory is that in modern times even the development process is carried out in developing countries like China and India, which implies that it is not necessary that all products will initially be developed in advanced countries like US, as suggested by the product lifecycle theory.

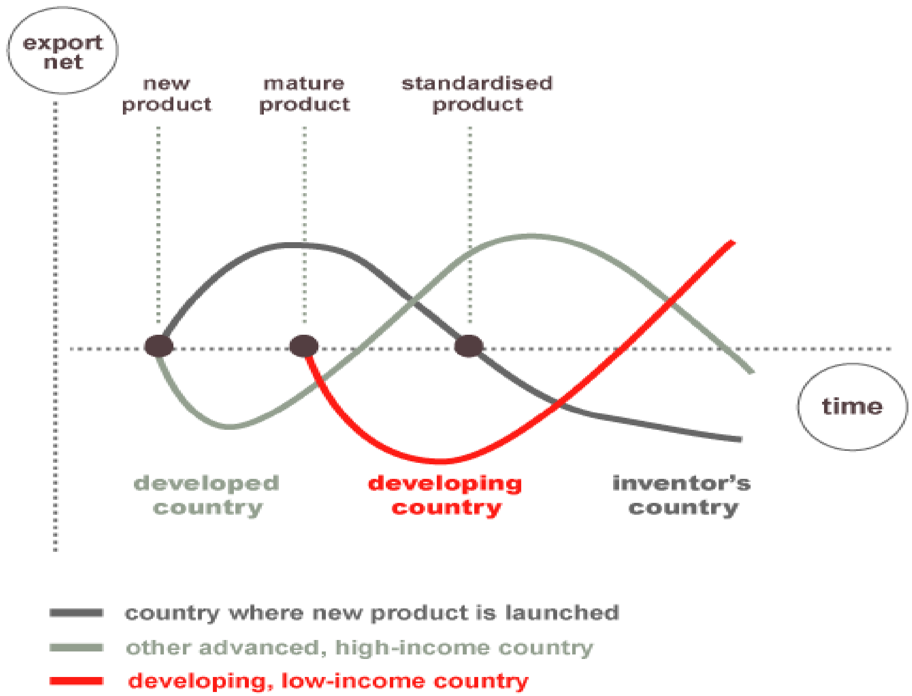

Fig. 1 Vernon product life cycle graph

4.5 Oligopolistic Theory

Knickerbocker's theory of FDI (1973) also referred to as Knickerbocker's theory of oligopolistic competition or simply the oligopolistic theory of FDI, argues that firms behave in an oligopolistic manner in the sense that they will always imitate rivals' behaviour. An oligopolistic market is one where there are very few but large firms which dominate the whole market. In such a situation firms' decisions will depend upon the actions of their rivals. The moment a rival firm sets up a plant in their exporting country, they will follow due to the fear that their export market may be at risk by rival takeovers because the opposing firm will gain more precise knowledge about the foreign market and hence will supply the overseas market with greater ease. For instance, in 1992, General Motors quickly reacted to supply the Chinese market immediately after Volkswagen was granted operating licences. In the retail industry, when Carrefour entered China in 1995, Wal-Mart of US and

Germanys Metro G instantaneously invested in new outlets in China to capture a share of the market.

4.6 Eclectic Paradigm Theory

Developed by Dunning (1973, 1980, 1998), the eclectic paradigm theory has undoubtedly put him among the most sought after scholars in explaining FDI. He amalgamated the internalisation theory, oligopolistic theory and firm specific advantage together with location theory to formulate one of the most robust theories of FDI ever developed. Dunning aimed to merge the existing isolated theories of international economics into a single theory that could explain FDI activities globally. Dunning argued that FDI is explained by ownership advantages which are intrinsic to a firm, location advantages of operating abroad and internationalisation gains. These became famous as the OLI theory from which the following 4 types of FDI were derived by Jere Behrman (1972).

4.6.1 Resource Seeking

MNCs need new resources in order to ensure continuous production runs to be able to meet the mounting world demand for their products. China has vast oil reserves and is currently the world's largest producer of coal[10], ensuring production plants with an uninterrupted and stable source of power supply. IMF (2012) also points out that China is the world largest steel producer, accounting for 45% of world global steel production in 2011[11]. China has rich reserves of iron and minerals. Having the largest population of 1.3 billion citizens[12], China has almost an unlimited supply of the cheapest labour source across the globe, which MNEs want to exploit. In the 1990's Korean companies relocated many of

[10] US Energy Information Administration
[11] World Steel Association database
[12] World Bank Statistics, China

their factories in China to take advantage of cheap but also highly productive workforce. Toyota, Citroen, General Motors and many other companies have set up production plants in China to reduce costs and gain access to vast steel supplies and many other valuable resources.

4.6.2 Market Seeking

Indeed, with a population of 1.3 billion people, China has undoubtedly become the place to expand. Such a large market enables sales growth at astonishing rate. From the simple toy makers to the car manufacturers and mobile production companies, it has become a must for companies to be present in China. Many companies are offsetting the declining demand in home market by booming demand in China and hence maintaining healthy profit margins. China economic review announced that in 2014, Volkswagen has been able to achieve a global sales growth of 12% reaching a record 3.68 million units, mainly through increased sales of vehicles in China[13]. BMW and Mercedes also witnessed stupendous sales growth of 17% and 29% respectively in China[14]. Sanyo, Hitachi and Toshiba have also opened manufacturing plants in China due to increasing demand for home appliances.

4.6.3 Efficiency Seeking

Efficiency seeking FDI occurs in the aim to exploit lower costs of factor endowments. In order to match the "China Cost", a myriad of companies shifted production from home country to China. China offers the ability to employ workers at much cheaper rates relative to other countries. China statistics demonstrated that in 2014, hourly wage in manufacturing was USD 1.36 in China compared to USD 23.32 in US[15] . USA and many other countries have preferred setting up component production plants in China and then import

[13] China Economic Review, "The numbers don't lie", January 22, 2015
[14] Ibid
[15] China bureau of Labor statistics

to minimise production and operations cost to survive amid the increasingly competitive global market. Apple and Microsoft are among the largest companies who have preferred to outsource production activities in China. In 2014, China exported USD 10 billion worth of components to US alone, reported by China export review[16]. Efficiency can also be viewed in terms of economies of scale. The sheer size of the Chinese market which generates a vast demand upon production, allows MNCs to operate on a large scale attaining the lowest point of their average cost curve.

4.6.4 Strategic Asset Seeking

Such FDI takes place to facilitate firms to achieve their long term strategic objectives. Firms seek to acquire assets that sustain or improve their ownership advantages. One example is Samsung investment in China, due to the high caliber workers in the technological sector which have become a driver of best technologies in the digital media. Secondly, to do business in China, requires firms to built "Guanxi" (Lee et al., 2001), a special network, determinant in business success. Hence, Vodafone acquired significant stakes in China Mobile, the leading telecommunication company in China, to penetrate the market. Strategic advantage can also be seen in some specific economic zone in the Guangdong provinces in China. Foreign firms that decide to locate in these specific areas, have access to up-to-date infrastructure and high quality communication network. Being near the Hong Kong port, transshipment is easy to the whole Asian region.

4.7 Political Ideology of FDI

One of the areas which still lack deep investigation in modern times is no doubt the impact of political development of a country upon the level of FDI the country attracts. History

[16] China-US trade balance statistics

bears witness that political policies adopted by governments across the world, more specifically in China, have significantly influenced FDI. With the open door policy adopted by the Chinese government to encourage FDI since its entry in WTO in 2001, FDI has been growing at a tremendous pace. The amendment of the joint venture law in 1979[17] to act as a barrier to nationalisation was viewed as an effective investment protection by potential investors. The 1999 investment contract law designed to protect the interest of investors, has also acted as a catalyser[18]. It provided adequate legal rights to all investors and allowed them to decide upon the best remedies in case of contract breaches and dispute solutions. Besides, the dual tax rate policy of 33% for local firms and 15% to 24% for foreigners (Hoek et al., 2008), adopted during 1992-2008 by the government, further encouraged investors to consider China as a viable destination in terms of foreign direct investment[19].

5. Cost and Benefit of FDI on China

5.1 Benefits

FDI has indeed played a pivotal role enabling the Chinese government with its “export growth policy”. China has vaulted past Germany to become the world’s leading exporter in 2012[20] due to its stupendous rise in export revenues standing at USD 2.2 trillion in 2013 (Figure 2). This was mainly attributable to FDI as both export and FDI increased at the same pace during that period (Figure 3) and this aggressively soaring export revenue has allowed China to maintain a consistently favorable BOP position[21]. China has been accumulating

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[17] Adopted by the Second Session of the Fifth National People's Congress on July 1, 1979

[18] Adopted at the Second Session of the Ninth National People’s Congress on 15 March 1999 and came into force on 1 October 1999

[19] World Bank, 2003; Xing, 2004; Wilson & Purushothamam, 2003; Zhang, 2002

[20] World Trade Organisation Database

[21] World Bank Statistical Data, China

huge current account surpluses reaching USD 204 billion in 2011[22]. Again this can be proved to be a FDI-led surplus as FDI grew over the years; trade surplus grew at the similar rate (Figure 4).

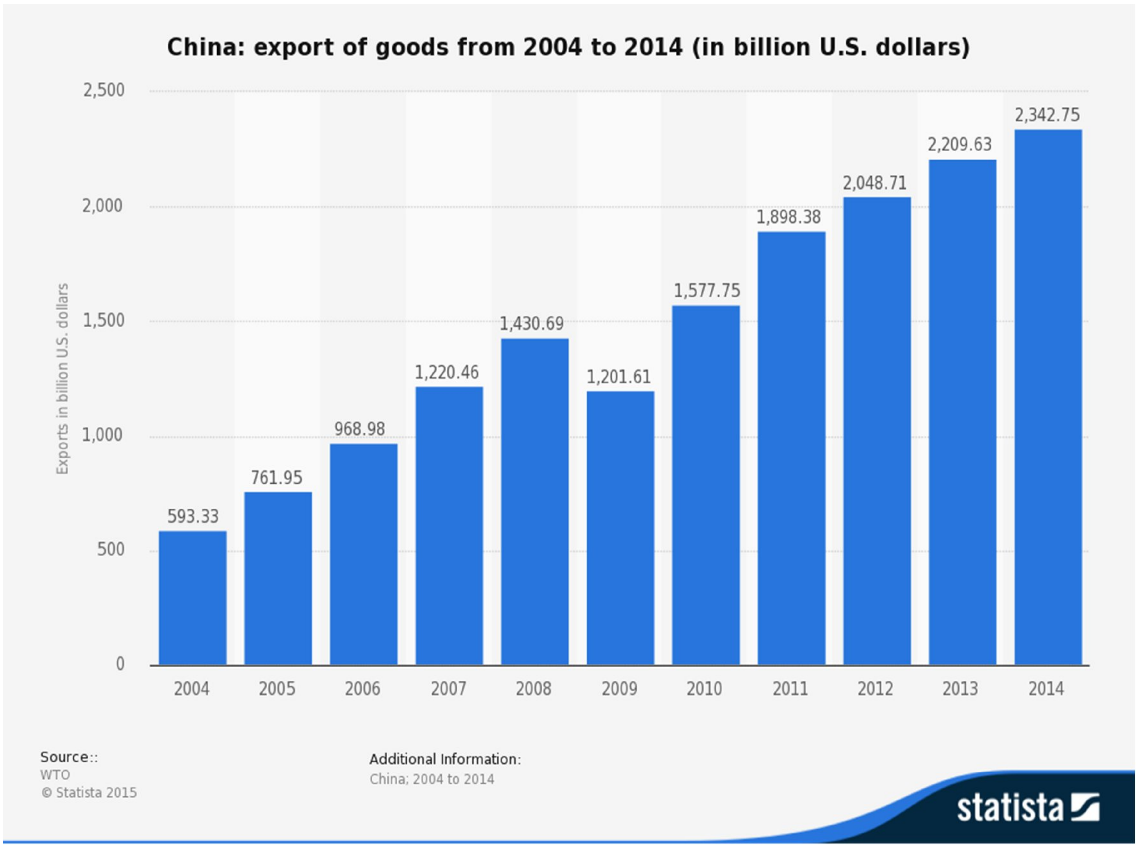

Fig. 2 China's export trend

[22] Ibid

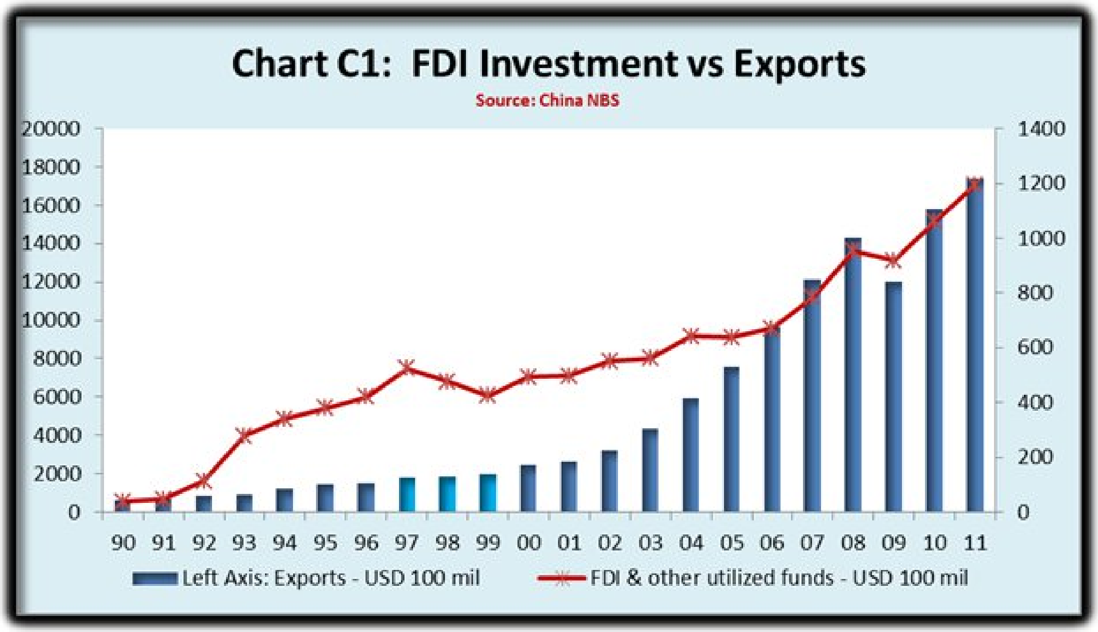

Fig. 3 China's export trend VS FDI

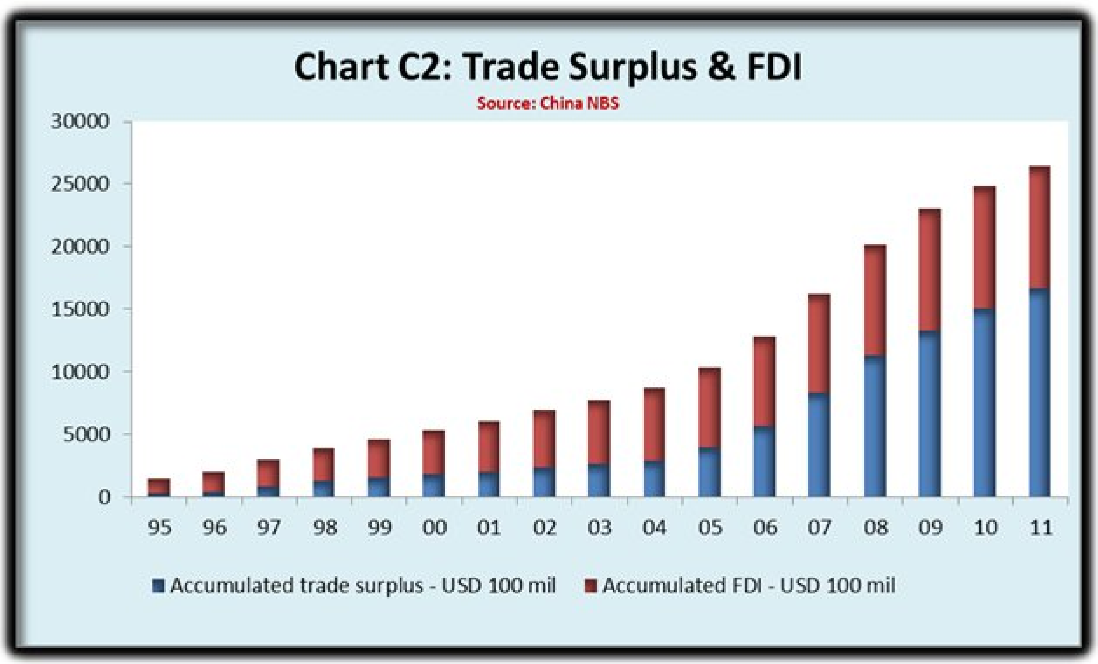

Fig. 4 China's trade surplus against FDI

Besides, FDI-led export growth has impacted positively on many economic indicators. China currently enjoys a strong and robust financial position. China's total foreign currency reserve has increased to a record USD 4 trillion[23], currently making China effectively the world's largest creditor. China also witnessed enormous GDP growth averaging around 8% compared to world average of 2.2%[24] during the last 10 years to reach a record USD 9.24 trillion in 2013 from a mere USD 2.2 trillion in 2005[25]. China's 7.1% per capita GDP growth was also significantly higher than world average of 1.1% in 2013[26].

Mounting GDP has also meant escalating tax income. Government tax revenue rose from 2 trillion Yuan in 2003 to 11.05 trillion Yuan in 2013 being above 10% of GDP[27]. This intensified the fiscal power of the government which benefited the population. Government invested billions of dollars in education. Primary education enrolment ratio improved vastly reaching 99% in 2011[28]. The infrastructural development of China also witnessed massive improvement. KPMG (2013) pointed out government invested USD 207 billion in road construction in 2012 and this directly amounted to 710,500 jobs in the construction sector[29]. Ports are being developed in the Guangdong provinces in Shenzhen, Beijing and Shanghai. Morgan Stanley (2012) pointed out the strong commitment of the government in transport development will provide 100% railway connection to all cities by 2020[30].

FDI has also generated positive impact on employment. Government has been able to maintain unemployment rate at reasonable level of 4%, much lower than many developed countries[31]. After a dip in manufacturing employment as per International Labour

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23 Data: People's Bank of China
24 World Bank Statistical Data China versus world averages
25 World Bank Statistical Data China
26 World Bank Statistical Data China versus world averages
27 Statista 2015
28 World Bank Statistical Data, China education enrolment rate
29 KPMG Report 2013 \Road construction investment in china"
30 Morgan Stanley 2012, \China Infrastructure Report"
31 World Bank Statistical Data

Organization (ILO) from 98 million in 1998 to 83 million in 2002[32], foreign investments raised manufacturing employment above the 100 million mark in 2010[33]. Manufacturing workers also benefitted from steady rise in their income from 15,000 Yuan in 2005 to above 46,000 Yuan in 2010[34]. This resulted in falling poverty rate. World Bank revealed the number of people living below USD 2 per day fell from 30% to 6% in China during the 1995-2010 period[35].

The entry of foreign enterprises in China impacted positively also on productivity and human capital. Competition forced local firms to restructure their operations and reduce cost. In terms of human capital, Japanese enterprises brought their firm specific advantages in terms of HRM techniques, Just-In-Time (JIT) and valuable knowledge in the Chinese market. Chinese locals in turn were quick to absorb this knowledge and this significantly improved their productivity and efficiency. Also 90% of companies offer formal training to employees[36]. Consequently, China's competitive advantage known as the "China cost" is unmatchable. This has further strengthened China's competitiveness on international markets.

5.2 Costs

Despite singing praises of FDI upon the Chinese economy, FDI also brought a series of problems for the population. Even with rising manufacturing wages, workers are not better off. The emergence of "sweatshops" is common in industrial areas where workers are still forced to work in dangerous and unhealthy working conditions. The "growth at all cost" policy has meant that Chinese workers work for longer hours and lead a stressful life.

[32] China Bureau of Labor statistics
[33] Ibid
[34] National Bureau of Statistics, China
[35] World Bank statistical data
[36] Ibid

Several cases of suicide have been reported among factory workers including Foxconn and Apple (Chan, 2013). In some companies, managers have ordered to install suicide nets to save workers from leaping to their death[37]. Child labour is also on the rise. ILO remarks that child labour is growing in importance in China companies among which, Samsung, the world electronic giant was found to be involved[38].

China's resource endowment advantage is disappearing. China is losing its comparative advantage in labour cost. Other developing countries like Bangladesh, Vietnam and Mexico are offering lower labour cost. Natural resource reserves are also being exhausted. China's oil field and coal reserves are depleting. As from 2007, China's consumption of fossil fuel exceeded its production[39], which implied it had to take recourse to import. Coal represents 80% of China's energy use and is harmful to the environment. A World Bank report (2012) points out that China has overtaken US as the world largest polluter and carbon emission from China is increasing. China now burns 47% of the world's coal, roughly equal to the amount used by all other countries of the world combined, the New York Times reports (2013). Air pollution in Beijing is beyond acceptable levels. Some industrial towns have been dubbed as "cancer towns" as the rate of cancer patients have gone through the ceiling due to high level of pollution[40].

Moreover, the standard of living of the Chinese citizens has not risen significantly as predicted by various theories. Standard of living is often measured by the amount of goods and services available at the disposal of the population for consumption. More investment generating higher income should have given a boost to total consumption. However, final

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[37] Dailymail Uk, Inside Chinese Sweatshop Factory, January 25th 2013
[38] ILO statistics
[39] International Energy Statistics
[40] The Guardian International, \Inside China Cancer Villages", June 4th 2013

consumption as a percentage of GDP is below the 50% edge[41]. Additionally, despite having an ageing population due to the one-child policy of the Chinese government, expenditure on health care is still below 5% of GDP[42]. Unequal distribution of income is also prevalent. Poverty seems to rise on a scale as sweeping and epic as the vast nation itself. In short, FDI has generated a “feeding frenzy” where the rich elite are enjoying the largest portion of the national cake at the expense of the general population.

FDI has been unequally directed among sectors, with manufacturing and retail estates taking the largest proportion and the agricultural sector being heavily undermined (Figure 5). Often referred to as “San Nong” or the “Three Rural Issues” (Colin, 2013); Agriculture, farmers and rural area problems still remain major concerns because these areas have benefitted the less from FDI. Several water reserves are too polluted for irrigation purposes. Underinvestment in agriculture has meant that China is sitting on a time bomb, warns the Food and Agricultural Organisation (FAO), implying that in the near future, China may struggle to meet the growing food demand of the population. Farmers in China suffers from low income and are trapped in extreme poverty. Unequal geographical development is worth mentioning. China statistics (2008) revealed 80% of FDI has been directed to Eastern urban areas and this has led to under development in western rural areas[43]. Wage gap between eastern and western workers has been increasing substantially since 2002[44].

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[41] World Bank data
[42] World Bank Statistics, China's Expenditure on Health Care
[43] National Bureau of China Statistics
[44] US Bureau of Labour Statistics, International Labour comparison

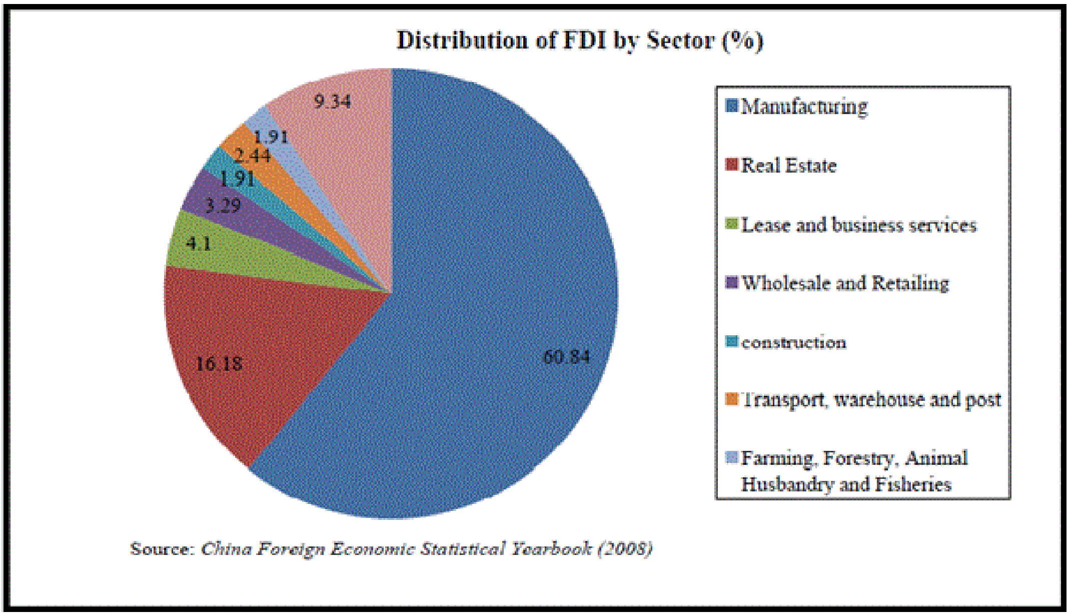

Fig. 5 Sectoral distribution of Chinese FDI

6. Trend Analysis

At the current pace of evolution, china is defying several theories of its demise. From a brief analysis of the linear trend, it can be observed that the current FDI is increasing at unprecedented rate, with FDI inflow expected to keep sky-rocketing as shown in the trend analysis (Figure 6). However political motives may hinder such growth. China growing trade surplus may spell its own doom through retaliation from foreign economies adopting austerity measures. China has in fact recently been proven guilty of currency manipulation by various countries including US and European counterparts. Hence, the rising trend in FDI as predicted by the analysis may be uncertain and with the current stock market crisis, the future may not be bright as it seems.

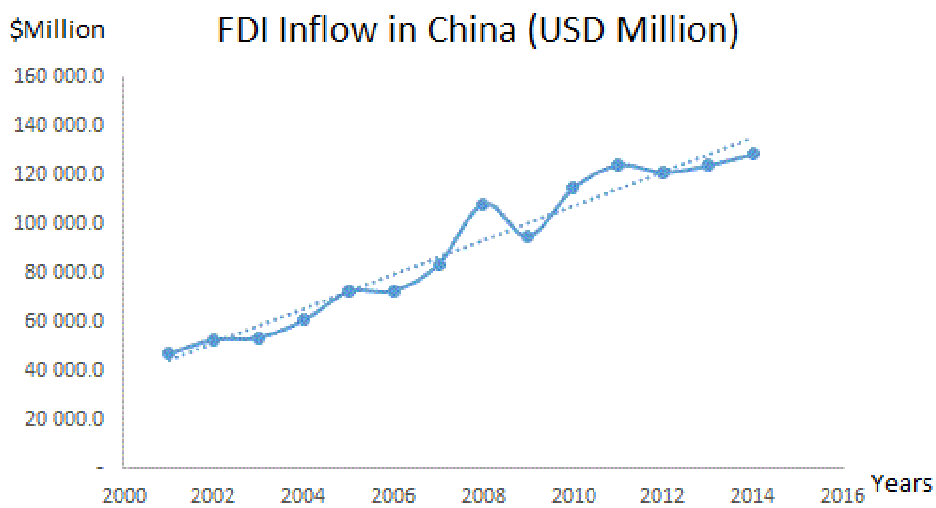

Fig. 6 Brief linear trend analysis

7. Conclusion

From our analysis, it has been proven that no single theory explains the pattern of FDI in China and each theory complements each other to give a plausible explanation of MNEs' activities. It can also be found that FDI has also been a mixed blessing for China. While it brought an overwhelming plethora of benefits to the Chinese population, it also led to a myriad of problems. Hence, FDI is undeniably a double-edged weapon. If well directed it may lift a country to new levels of prosperity, otherwise it may turn into rent-seeking motive, impoverishing the recipient nation. A well-structured framework channeling FDI towards productive investment coupled with adequate institutional support and proper supervision, will no doubt make China emerge as an Asian giant to take the mantle from US in the near future.

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