17 Foreign Investment

For more than a decade China has been one of the world's most important destinations for FDI. Investment began to pour into China after 1992, and annual inflows have been over 40 billion dollars since 1996. Trending steadily upward, FDI inflows were at 63 billion dollars in both 2004 and 2005. These inflows are by far the largest of any developing country and have remained remarkably stable and robust despite substantial fluctuations in the Asian and global economies. China has accounted for about one-third of total developing-country FDI inflows in recent years. There is no doubt that the global manufacturing networks created by FDI in China will continue to play a critical role in the world economy.

Three distinctive characteristics have marked investment in China over the past decade. First, foreign direct investment has been the predominant form in which China has accessed global capital (as opposed to portfolio capital or bank loans). Second, an unusually large proportion of Chinese FDI inflows are in manufacturing industry, as opposed to services or resource extraction. Third, FDI inflows have predominantly come from other East Asian economies, especially Hong Kong and Taiwan. In each of these respects, China diverges from average world patterns. Each of these characteristics reflects the dominant role played by the cross-border restructuring of export-oriented production networks that originally developed in other, neighboring East Asian economies. These topics make up the first sections, and the main subject matter, of this chapter.

However, the distinctive characteristics of foreign investment in China thus far may not be a good guide to the future. The later sections of this chapter cover the new patterns that we can expect to see emerging. In the first place, the predominance of FDI reveals that China has not made much use of other forms of foreign investment. Thus China has considerable unexploited potential to tap world savings. Moreover, China's entry into the WTO, on December 11, 2001, began the process of liberalizing

access to many service sectors that had previously been off-limits to foreign businesses. Finally, since late 2002 there has been evidence of the beginning of significant capital inflows to China outside of FDI. These inflows are surprising, however, in that they have come before the formal liberalization of the Chinese capital account. In section 17.6 we examine the Chinese balance of payments to trace the emerging patterns of capital inflows.

As pointed out in Chapter 16, investment and trade are closely linked, in China and in the global economy. This chapter delves into investment in greater detail, showing the concrete ways in which China has become integrated into the global economy. Section 17.1 sketches the importance of FDI in the Chinese economy. Section 17.2 focuses on SEZs in order to trace some of the key policy reforms that opened up the foreign investment regime. Section 17.3 discusses the investment regime today, tracing the interaction among policy, regulation, and legal infrastructure, and moving to the impact of WTO membership. Section 17.4 outlines the particularities of China's investment regime: we examine the importance played by other East Asian economies in investment, and above all, in section 17.5 the three tightly linked "China Circle" economies: Hong Kong, Taiwan, and China. The final section looks at overall patterns of capital inflow. It shows the sectoral composition of FDI inflows and argues that the impact of WTO will be biggest precisely on FDI in the service sectors, such as finance, trade, and distribution. The chapter concludes with a brief look at China's balance of payments.

17.1 FDI IN THE CHINESE ECONOMY

China decided to accept foreign investment in 1978 and broke sharply with socialist orthodoxy in establishing SEZs in 1979 and 1980. Subsequently, through most of the 1980s, policy and institutional changes were more cautious, incremental, and geographically localized. Incoming FDI grew steadily through the 1980s and wrought important changes in the regional economies of Guangdong and Fujian. Nationwide the impact of FDI was moderate until the early 1990s. As Figure 17.1 shows, beginning in 1992–1993, the stream of incoming FDI turned into a flood. Investors from Hong Kong and Taiwan moved in first and became quantitatively most important. Developed-country investors followed close behind, and FDI inflows became large enough to fundamentally transform the Chinese economy.

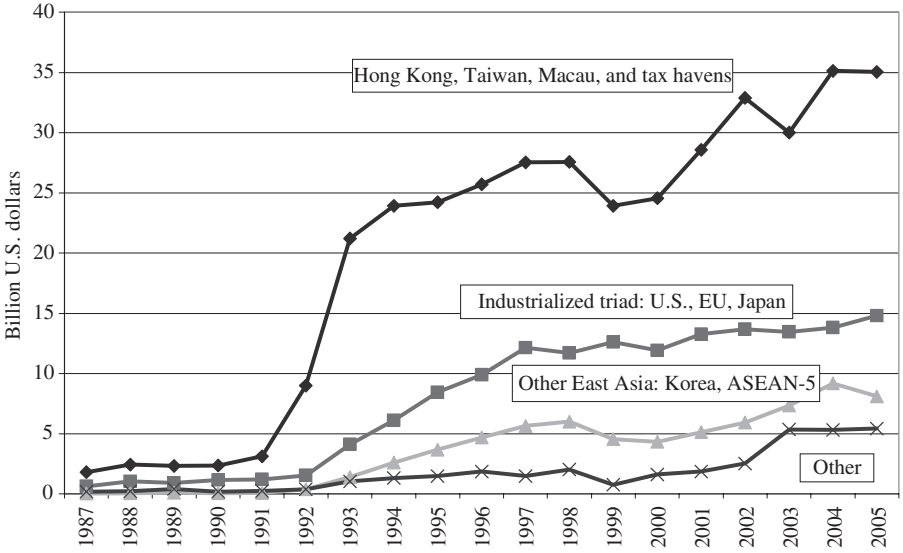

Figure 17.1
Main sources of FDI in China

What changed in 1992 to unleash a flood of foreign investment into China? Chinese policy shifts were signaled by a string of remarkable speeches Deng Xiaoping made during a famous "Southern Tour" in the spring of 1992. This was one of the last times that Deng placed his personal stamp on Chinese policy, hoping to rehabilitate the reform agenda and dissipate investor uncertainty created by economic retrenchment after the 1989 Tiananmen debacle. But grand policy pronouncements often have little impact on economic developments. Why was this one so momentous? Two factors made the difference. First, for more than a decade China had been gradually building credibility with foreign investors, gaining experience while liberalizing and building institutional infrastructure. However, the impact of these measures had been muted by concerns about China's future after the Tiananmen incident. When Deng succeeded in relieving the anxiety about China's overall policy direction, foreign investors responded quickly because the institutional foundations and FDI friendly policies had already been put in place. Second, up until that time China had largely confined incoming FDI to export manufacturing, and access to the Chinese market had been dribbled out to only a few selected foreign firms. From 1992, China began selectively opening its domestic marketplace to foreign investors. New sectors—especially real estate—were opened to foreign participation, and manufacturers were increasingly granted

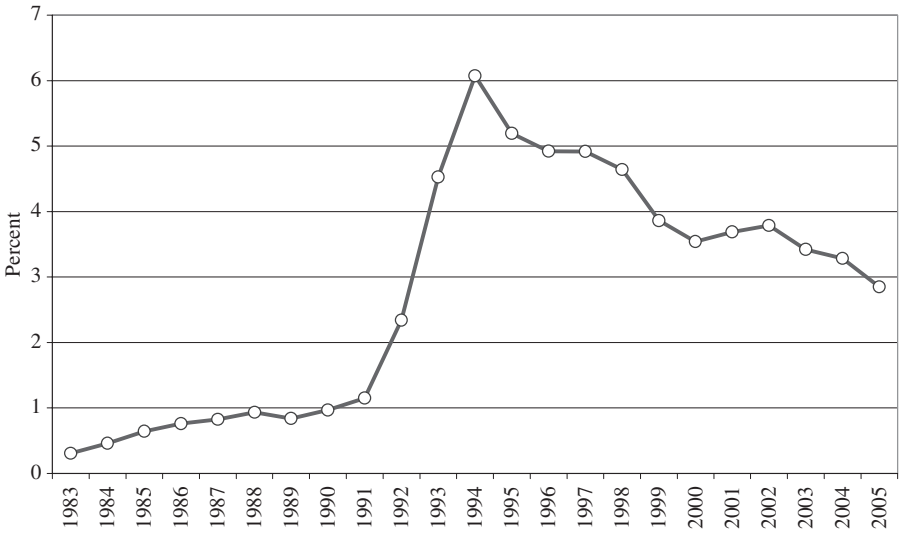

Figure 17.2
Foreign direct investment as a share of GDP

rights to sell their output on the Chinese market. For the first time the huge potential size and rapid growth of the Chinese market played a direct role in attracting foreign investment.

Figure 17.2 shows foreign direct investment as a share of Chinese GDP. During the 1980s, FDI never exceeded 1% of GDP, but inflows crept steadily upward, finally exceeding 1% in 1991. FDI briefly exceeded 6% of GDP in 1994, but it then settled back to 5% of GDP and has grown more slowly than nominal GDP since then. Averaging 4% of GDP between 1996 and 2002, inflows slipped below 3% of GDP in 2005 for the first time since 1992.[1] These figures clearly place China in the category of countries that are relatively open to incoming FDI. They contrast sharply with the "Northeast Asian" pattern of China's development forerunners, Japan, Korea, and Taiwan. Incoming FDI was always considerably less than 1% of GDP in Japan and Korea during their periods of most rapid growth, and only slightly more in Taiwan. In recent years FDI inflows into Korea (especially) and Japan and Taiwan have increased. However, FDI inflows have never amounted to as much as 2% of GDP in

1. The FDI/GDP ratio is useful for international comparisons because we have normalized the value of FDI by dividing it by GDP. However, the ratio is also influenced by fluctuations in the valuation of GDP. The trends shown in Figure 17.2 are accentuated by devaluation of the official exchange rate in 1994 and real appreciation between 1994 and 1997.

Japan, Korea, or Taiwan. Instead, China's reliance on FDI has been of a similar magnitude to the developing Southeast Asian economies of Malaysia, Thailand, the Philippines, and Indonesia, where inflows around 4%–6% of GDP have been common. Some Southeast Asian countries have struggled to sustain FDI inflows of this level since the Asian financial crisis of 1997–1998. Generally speaking, though, China fits into a "Southeast Asian" pattern in which economies are quite open to FDI, particularly in export-oriented manufacturing, notwithstanding different degrees of protection in trade policy. Indeed, the similar levels of development and policy orientation have led many to perceive China and the Southeast Asian countries as being in competition for a limited total amount of FDI since 1998.

Some regions of China are in fact even more open to FDI than a "typical" Southeast Asian nation. Inflows into Guangdong and Fujian, scaled to GDP, were of course well above the Chinese national average. For the 11 years from 1993–2003 the average annual incoming FDI/GDP ratio was 13% for Guangdong and 11% for Fujian. Other open coastal areas were only a step behind Guangdong: Inflows to Shanghai averaged 9% of GDP, and those to Jiangsu and Beijing averaged 7%. These inflows were sufficiently large to transform these regional economies.

FDI's impact is multifaceted. First, FDI contributes to overall investment and structural change. The total amount of FDI is large: In 2004, the cumulative inflows of actually realized investment surpassed $500 billion. However, because China's own domestic saving rate is so high, China is less dependent on FDI for saving than many countries, in fact, less dependent than the average developing country. According to UN figures, all developing countries, excluding China, experienced incoming FDI equal to about 15% of their total gross fixed capital formation in 1999–2001. As Chapter 6 discussed, China's domestic saving and investment rate is extremely high, and gross domestic capital formation surpasses 40% of GDP. Thus incoming FDI in 1999–2001 accounted for 11% of total capital formation in China, less than the average. Moreover, China's GDP growth has been even more rapid than the growth of FDI inflows, so the share of FDI in GDP has been gradually drifting downward (see Figure 17.2).

However, FDI brings a bundle of management experience, marketing channels, and technology, along with the basic inflow of resources. Indeed, by definition, foreign direct investment includes some control over the production process, and thus some transfer of management expertise. FDI has become China's predominant source of technology transfer. As Chapter 15 described, China has run an activist program of technology development since the mid–1980s. Notwithstanding, the transfer of technology to production facilities in China by multinational corporations has clearly overshadowed all other

forms of technology development since 1993. Moreover, Chapter 16 has described the central role that FIEs played in China's export expansion in the 1990s. After 1992, almost two thirds of the increment to China's exports came from foreign-invested firms. Thus, FDI has played an important role in industrial growth, technology transfer, and trade expansion.

17.2 "ZONES": THE GRADUAL LIBERALIZATION OF THE INVESTMENT REGIME

One of the peculiarities of China's FDI landscape is the proliferation of special investment zones of various kinds. The establishment of the first SEZs in China, in 1979, was a strikingly visible signal of commitment to economic opening. In subsequent years China has marked every major wave of liberalization with the establishment of a new batch of zones. Even today, although special zones are less special than before, much foreign investment is still located in zones of various kinds, and the rules of business are still subtly different inside the zones. Why does Chinese policy have this proclivity for special zones? The preference is consistent with the dualistic system that was such a prominent feature of the trading regime (Chapter 16). Zones permitted incremental progress within a rigid system.

Politicians in Guangdong began to lobby for a special zone during 1978, even before the adoption of national reform policies. Endorsement by Beijing in 1979, and, crucially, by Deng Xiaoping, meant that the SEZs became a symbol of the government's commitment to external liberalization. Zones permitting foreign businesses free operation in China were inevitably sensitive, because of China's history of foreign concessions (Chapter 2). Zones were easily portrayed by conservatives opposed to economic reforms as a derogation of China's sovereignty. Precisely for this reason, the establishment of the SEZs served as a powerful commitment device. By demonstrating to foreign businesses that China would maintain an open environment in a specific, easily monitored location, the SEZs enhanced the credibility of the reform process. At the same time, zones played a powerful symbolic role whenever the reform policies were contested: on two subsequent occasions (1984 and 1992), Deng Xiaoping traveled to the Shenzhen SEZ and endorsed its operation, as a prelude to a further wave of liberalization.

The initial SEZs were similar to the EPZs that had spread in Asia since the 1970s: they were regions in which foreign investment was encouraged by lower tax rates, fewer and simplified administrative and customs procedures, and, most crucially, duty-free import of components and supplies (Box 17.1). Thus

Box 17.1
How Chinese SEZs are Similar to Asian EPZs

China's special economic zones are a type of EPZ. The first EPZ in Asia was established at Kaohsiung in Taiwan in 1965. By the 1980s there were 35 EPZs in Asia, and most countries had them. A strikingly successful example has been the Penang Free Trade Zone in Malaysia, which initiated the development of Malaysia's substantial electronics industry. All Asian EPZs offer an essentially similar set of incentives for investors. First, components and raw materials can be imported duty-free and without administrative formalities, and exports leave the zone without export or sales taxes. Thus the zones are "outside" the country in which they are located, insofar as normal customs procedures are concerned. Second, company income tax holidays are typically granted for a period of three to 10 years. Third, the administrative procedures are streamlined, often through a "one-stop shop" coordination of permits, and usually through exemption of restrictions on foreign ownership and employment of foreign nationals that might apply in the rest of the economy. Fourth, the zone itself often operates as a commercial entity, building infrastructure and supplying utilities—often at a subsidized rate—to the foreign firms.

Asian EPZs offered a way to move toward export promotion without fundamentally overturning the structure of protection in place for domestic manufacturers. EPZs produced benefits in terms of employment created and foreign exchange earned, but at a cost of giving up significant tax revenues and forgoing potential linkages to the remainder of the domestic economy. Many EPZs started slowly and ended up costing more than initially envisaged, but the policies have typically been seen as ultimately successful in most of the countries that tried them. EPZs initially attract "footloose" investors in such sectors as garments and electronics assembly because of low wages and easy conditions for moving goods in and out. To varying degrees, some zones have been able to move beyond a few initial industries and contribute to broader-based process of industrialization. Chinese SEZs share all these fundamental characteristics with other Asian EPZs.

the SEZs were part of the early development of the export-processing regime described in Chapter 16. Yet the SEZs also went beyond the other Asian EPZs (Box 17.2). Because they also served as test beds for domestic economic reforms, they inevitably had a broader role to play in China's economic evolution. Wholly owned foreign subsidiaries were permitted in the SEZs long before they were allowed elsewhere. Moreover, since each of the four initial SEZs was intended to appeal to an economically significant group of overseas Chinese who were potential investors (Chapter 1), they served as important channels to outside groups. For all these symbolic and systemic reasons, the SEZs had great importance to China's economic reform. The SEZs also exemplified the pattern of Chinese policy-making during the first era of reform (as described in Chapter 4): dual-track, incremental reforms that started by creating a new system alongside, or in the interstices of, the existing one. The SEZs were not immediately successful. In relation to the high hopes they had inspired, the SEZs got off to a slow start. Foreign investment (especially high-tech investment) was initially disappointing, and infrastructure construction was expensive. The SEZs were attacked for facilitating smuggling and

Box 17.2
How Chinese SEZs are Different from Asian EPZs

Chinese SEZs were bound to be "more special" than other Asian EPZs (Chan, Chen and Chin 1986; Chu 1986). Other Asian EPZs were established in economies that were basically market economies, albeit sheltered from world markets and competition by ISI policies. Chinese SEZs were created in a planned, bureaucratic economic system, so the difference between the "rules of the game" in the SEZs and those in the domestic economy was bound to be large.

- The SEZs often served as "laboratories" for experiments with economic reforms. For example, Shenzhen SEZ was an early pioneer of both flexible wage systems (no limits to incentive payments) and tender bidding for construction projects. Experiments with development of land markets through leasehold, as well as equity markets, were significant innovations pioneered in Shenzhen during later phases of reform.
- The SEZs were governmental bodies with unusually high levels of autonomy compared to EPZs. During the early years SEZs were allowed to retain much of the tax, customs, and foreign-exchange revenues generated within the zones.
- The SEZs had multiple functions: They were seen as "windows" on the world, absorbing advanced experience in technology, administration, and business. Shenzhen in particular has been developed as a "comprehensive" site, including tourism, housing, and other services for Hong Kong people.
- Chinese domestic enterprises have also had a substantial incentive to invest in the SEZs. By setting up their own subsidiaries—even if they are not joint ventures with foreign businesses—Chinese domestic enterprises enjoy greater administrative flexibility, lower tax rates (15% income tax rather than 30%), and less complicated access to the outside world.

Reflecting their multiple roles and greater importance to the domestic economy, it is not surprising to find that China's SEZ are much bigger than other Asian EPZs, as the following table shows:

Size of China's SEZs and Asian EPZs (square kilometers)

	Initial 1980 Size	Size in 1990
Shenzhen	327.5	327.5
Zhuhai	6.8	121.0
Shantou	1.6	52.6
Xianmen	2.5	131.1
Kaohsiung, Taiwan		0.7
Penang, Malasia		1.2
Batam Island, Indonesia		36.6
Bataan, Philippines		3.4

corruption. At the same time, FDI quickly began to leak out into the surrounding countryside. The EP agreements being signed with small firms throughout the Pearl River Delta sometimes involved foreign businesses providing equipment and technology and being repaid with finished product (a type of FDI). Thus, early in the reform process, investment from Hong Kong began to find its way into many parts of Guangdong Province, beyond the SEZs. This was no less important for being composed of many small-scale transactions.

Reformers were not prepared to allow their standard-bearers to languish. When a second wave of liberalization began in 1984, it was signaled by a visit to Shenzhen SEZ by Deng Xiaoping, in which he proclaimed Shenzhen a successful experiment. Fourteen new "Open Cities"—including Shanghai—were designated along the coast, and all set up Economic and Technological Development Zones (ETDZs) that offered many of the same provisions as the SEZs. Moreover, they were authorized and encouraged to bargain aggressively with potential foreign investors to facilitate investment inflow. Shanghai quickly approved the application of the 3M corporation to set up a wholly owned subsidiary, even though there was no provision in Chinese law for foreign ownership outside the SEZs at that time. A dramatic proliferation of "zones" began. Hainan Island, in its entirety, was designated a SEZ, and the existing SEZs at Zhuhai, Shantou, and Xiamen were expanded enormously. Broad swaths of territory were declared open to foreign investment, including substantial rural areas. The Pearl River Delta in Guangdong, the Yangtze River Delta around Shanghai, and a swath of coastal Fujian near the Xiamen SEZ were opened to investment. A total population of 160 million was included among these newly open areas. Since the rural areas had few SOEs, the implication was that the foreign investors were encouraged to set up subsidiaries and joint ventures with rural collectives that would make use of low-cost rural labor outside the framework of the planned economy. Moreover, the opening of so many areas inevitably implied that local officials would be in competition to attract foreign investors and would offer competing packages of preferential policies.

At the beginning of the 1990s a third wave of opening of the Chinese economy was announced by . . . the creation of another SEZ. The Pudong (East Shanghai) special zone served as an advertisement, as well as a commitment device, by creating an SEZ in the heart of China's most developed region for the first time. Slightly larger than Shenzhen, the Pudong Development Zone possessed a population of 1.1 million even before development began. Moreover, 18 new ETDZs were approved in 1992–1993, as well as a new type of zone, the high-technology development zone. These

zones signaled both a commitment to reform and a shift in regional policy because zones moved north and inland. Urban real estate was opened up to foreign investment attracting massive inflows, especially from Hong Kong. A central government document (1992, No. 4) allowed experiments in retail and many other service sectors. Cumulatively, these measures sent a strong message that investment was welcomed and that administrative restrictions were being reduced. They set the stage for the large role played by FDI since 1993.

By 2003 there were well over 100 investment zones recognized by the central government. There are six SEZs (the four original, Hainan, and Pudong), 54 national-level ETDZs, 53 nationally recognized high-tech industrial zones, and 15 Bonded Zones (in which commodities can be legally parked "outside" the country's customs borders). Some of these overlap, but in addition there are hundreds of zones run by local governments without central support. Seventeen of the national ETDZs were established between 2000 and 2002 in the interior of China, as if to correct an oversight. By this time China had launched the Western Development Program, so it was natural to extend ETDZ privileges to the western interior provinces. Now, every province has at least one zone. Bold, fragmented, open to outside investment, but with a strong role for government: SEZs typify much of the Chinese transition process.

17.3 THE INVESTMENT REGIME TODAY

China has a generally favorable regime for foreign investors today. Taxes are moderate; investment protection agreements are in place with most countries, and an apparatus for arbitration is available; and most legal provisions are adequate in principle. The currency is convertible in the current account, and there are few problems with repatriation of profit. The most striking features of the investment regime are its relatively decentralized nature and the high degree of discretion retained by government officials. While the formal requirements are not onerous, every investment contract has to be approved by some government level. In most other East Asian countries approval is also required, but there is a single investment approval board that passes on all proposed FDI projects in the country. In China, by contrast, approvals can be granted by literally hundreds of local investment boards. Provinces and zones (of various kinds) usually have the authority to approve projects valued at up to $30 million, and even county governments are able to approve smaller projects (below $10 million).

In practice, this decentralized regime often favors the foreign investor. Foreign investors can play localities off against each other in search of a favorable package. Localities have strong incentives to attract foreign investors through lower taxes, even beyond the statutory concessions. Eager municipalities may provide concessionary terms on land-rental and utility rates. Sometimes local governments collude with investors to classify large projects as multiple small projects in order to evade central government monitoring. Foreign investors, in turn, have strong incentives to survey options in different localities and exploit the particularities of the investment system. For example, the statutory enterprise income tax rate in China is 33% (30% national plus 3% local). However, productive enterprises in SEZs and ETDZs are to be taxed at 15%, and coastal cities and provincially established zones may set the rate at 24%. In fact, these rates are merely baselines. Enterprises that export more than 70% of their output and enterprises designated as "high-technology" may enjoy further reductions, although not, in theory, below 10%. Moreover, within zones (but sometimes outside as well), a tax holiday is granted for the first two years an FIE is profitable, and tax rates are half the long-term rate for years three to five. Needless to say, these provisions provide enormous scope for bargaining about tax rates and other financial provisions.

While these multiple provisions may benefit the foreign investor, they also create difficulties. It is not always clear who has the ultimate power to approve a given set of tax rates or land-use agreements. Because regions compete, foreign investors may have to navigate surprisingly uncooperative and complex relationships between different regional or sectoral authorities. Moreover, the quality of local government services varies enormously. Some local governments display high levels of professionalism, while others are hobbled by corruption, lack of training, and lack of oversight and transparency. Problems with the enforcement of intellectual property rights (IPR) are also legion in China. National laws and regulations are reasonable, but local governments in many cases have no incentive to enforce national regulations, and they may have powerful incentives to violate them. Navigating the complex institutional environment can be costly for foreign investors.

The contractual forms in which FDI is embodied in China have evolved steadily toward modes that permit the foreign investor a higher level of control. In the early 1980s, FDI was dominated by contractual joint ventures (JVs) and joint development projects. Contractual JVs are flexible agreements of association that do not necessarily create an enduring legal entity, and they are particularly useful in situations in which investment is combined with some kind of service agreement, such as hotels. Profit can be divided among the

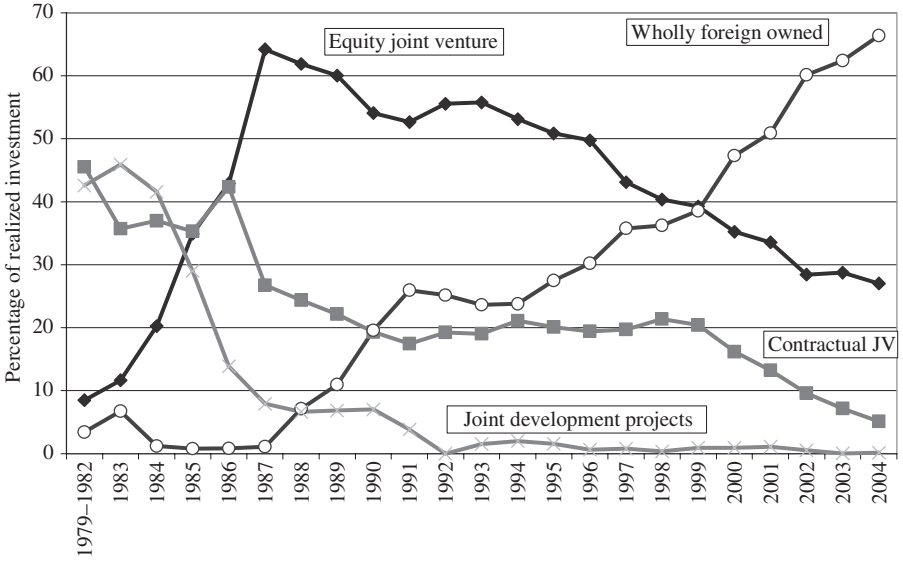

Figure 17.3
Modes of FDI in China

contracting parties in any form that is mutually acceptable. Joint development projects are a form of contractual joint venture tailored to oil exploitation. After the mid–1980s, China began to strongly encourage the use of equity joint ventures (EJVs), which became the dominant mode of investment. As Figure 17.3 shows, from 1987 through 1996 more than half of incoming FDI was in the form of EJVs. EJVs create a new legal entity in which the foreign and domestic firms have a stake. Their predominance during this period reflected the commonly held beliefs (on the foreign side) that long-term partnerships were necessary to operate in the Chinese environment and (on the Chinese side) that such partnerships would facilitate the sharing of information and technology. In practice, the "marriages" that made EJVs were often unhappy ones. Foreign investors found that their incentives were not always closely aligned with those of their Chinese partners, particularly when those partners were SOEs. While foreign managers were primarily concerned with earning profit or establishing market share, Chinese managers were often concerned with maintaining employment, building a larger firm, and accessing foreign technology. As China evolved toward a market economy, foreign investors increasingly felt they could operate independently, without the assistance of a Chinese partner and without the conflicting motives so often involved in an EJV. Foreign investors have increasingly prefered wholly owned subsidiaries. Chinese regulations—reflecting disappointment on the Chinese side as well with the success

of these ventures—have evolved to accommodate these preferences. The share of FDI in the form of wholly owned subsidiaries of foreign companies has climbed steadily, and in 2004 it accounted for exactly two-thirds of total realized FDI inflows.

17.4 SOURCES OF INVESTMENT IN CHINA

As seen in Figure 17.1, FDI to China falls into four large fairly stable source groups. By far the largest is that made up of Hong Kong, Taiwan, Macau, and free ports or tax havens (which will be discussed later). The economic relationship among China, Hong Kong, and Taiwan is discussed further in the following section. Hong Kong is indisputably the biggest investor in China, accounting for 42% of the cumulative total in 1985–2005, according to official figures. These data show officially recorded inflows from Hong Kong and Taiwan easing off after 1998, but investment from various tax havens increased dramatically at the same time. In 2005, $12.3 billion in incoming FDI was from companies domiciled in the British Virgin Islands, Bermuda, the Cayman Islands, and other tax havens. From other sources we know that Taiwan businesses send substantial investment to the Cayman and virgin islands and other "free ports." Hong Kong businesses face their own political risks and motivations for transiting investment through a third location. In general, then, it is defensible to consider investment from these tax havens along with Taiwan and Hong Kong investment. When we do so—as in Figure 17.1—we see that investment remained fairly stable, around $25 billion, through 2001, before ticking up to $35 billion annually in 2004–2005. In the entire 1985–2005 period, Hong Kong, Taiwan, Macau, and all tax havens have accounted for 60% of total FDI in China. If half the tax haven investment originates with Hong Kong and half with Taiwan, they accounted for 47% and 12%, respectively, of cumulative investment in China, making them first and second.[2]

The developed-country triad of the United States and Canada, Japan, and the European Union (EU) accounted for 25% of the cumulative FDI in China in 1985–2005. This is an unusual feature of China's experience: worldwide, developed countries accounted for 92% of FDI in 1998–2002. The relative weight of each leg of the developed-economy triad regions is comparable at

2. Tax havens such as the Cayman and British Virgin islands are also popular choices for incorporation of high-technology start-up businesses in China itself. Creation of an offshore vehicle facilitates the financing of new ventures by both Chinese and offshore investors. Thus some portion of FDI from tax havens may reflect domestic Chinese investment. Since these high technology ventures are themselves often the protect of cross-national networks of entrepreneurs it is not certain how large the domestic component is compared to the investment from Taiwan and Hong Kong.

around 8% investment each (1985–2005). The United States was the third most important investor in China (after Hong Kong and Taiwan) through 2002, but U.S. investment has been on a downtrend since then. Judging by economic size and proximity, it is surprising that Japanese investment in China is not much larger than it is. Japan's GDP is six times as big as those of Korea, Taiwan, and Hong Kong put together, but Japanese investment in China is only one-eighth the total of those three. The prolonged Japanese economic stagnation during the 1990s is the main explanation for the limited amount of Japanese investment in China, combined with a relatively pessimistic appraisal of Chinese prospects that prevailed in Japanese commercial circles during the late 1990s. Since 2003 both the Japanese economy and the Japanese view of China have improved substantially. Despite political frictions between China and Japan, Japanese investment in China has surged. In 2005, Japan invested $6.5 billion in China, more than twice the $3 billion by the United States. The potential Japanese economic impact on China has only begun to be realized. In recent years, the EU has also been a somewhat larger investor in China than the United States, accounting for $5 billion in 2005.

Among other Asian investors, Korea and Singapore are by far the most important. Korean investment in China started late but it has grown extremely rapidly. In 2004 Korean investment soared $6.25 billion, vaulting past both the United States and Japan, before settling back to $5 billion in 2005. (Note the slightly bizarre result that, according to official data, the top three investors in China in 2004, in order, were Hong Kong, the British Virgin Islands, and Korea.) The more prominent role of both Japan and Korea in FDI in China may mark an important new stage of industrial restructuring. Both Japan and Korea invest heavily in northern provinces such as Shandong, Liaoning, and Jilin. This northward shift of economic dynamism could have a profound impact on the Chinese economy, potentially reversing the relative economic decline of the Northeast.

Hong Kong is not just the largest investor in China: Its role is special in almost every respect. In the first place, on July 1, 1997, the former British colony of Hong Kong became a Special Administrative Region (SAR) of China. Thus China's largest foreign investor is in fact not even foreign. However, there are abundant reasons to treat Hong Kong as "foreign," beyond habitual practice. Hong Kong has a dramatically different economic and administrative system from China; it has a much higher level of economic development that the rest of the mainland; the SAR government has decision-making authority over virtually all important economic decisions, including trade regulations; and, recognizing this fact, Hong Kong has long been an

independent member of some international organizations, including the WTO. Given these factors, the classification of Hong Kong as a foreign investor in China is a welcome triumph of common sense.

From the 1950s through the 1970s, Hong Kong grew from a trade entrepôt to a manufacturing, finance, and trade center of formidable efficiency. As Hong Kong continued to grow in the 1980s, it was natural that manufacturing firms would seek additional space outside the crowded center city. But because Hong Kong itself is so small, urban growth inevitably meant relocation of firms a few miles away to China. When a Hong Kong factory moves to the suburbs, it creates "foreign" investment. Hong Kong's proximity to China also means its investors tend to have better information about policy changes inside China than do investors in other countries. Hong Kong businesses move quickly to take advantage of new opportunities in China when policy shifts. As a result, Hong Kong's share of incoming FDI is especially high immediately following new liberalization measures in China. Hong Kong was the source of more than 60% of China's incoming FDI after each of the three waves of liberalization described earlier: in 1979 (initial opening), 1987 (Coastal Development Strategy), and 1992, when it reached a phenomenal 68% share. Other foreign investors only gradually catch up to Hong Kong's inside information. The early mover advantages that Hong Kong businesses have seem likely to persist in the near future. On January 1, 2004, the Closer Economic Partnership went into effect between the PRC and the Hong Kong SAR. The partnership holds that Hong Kong firms—including Hong Kong subsidiaries of multinational corporations—will enjoy earlier access to some of the sectors being opened up in China as part of WTO accession (section 17.6.1).

Hong Kong is the home of many subsidiaries of corporations based elsewhere. There are about 1,000 foreign-company regional headquarters in Hong Kong (256 from the United States, 198 from Japan, and 106 from China). In some cases, investment originating elsewhere may be channeled through Hong Kong and show up in the data as Hong Kong investment. Parent companies located in China sometimes channel investment from their subsidiaries back into China, or even create subsidiaries for this purpose: so-called round-tripping. Chinese firms may be motivated by the desire to gain access to concessionary tax and other advantages enjoyed by foreign-invested firms, as well as to the autonomy and anonymity that come from channeling funds through Hong Kong subsidiaries. But here we must be careful. One of the peculiarities of the Hong Kong economy is that it has long been the headquarters of a number of large firms that are owned by Beijing. Firms such as China Resources and China Merchants (owned by the Chinese Ministry of Commerce and Ministry of Transportation, respectively) have been active in Hong

Kong for 50 years. These firms are big investors in China, but it would be a mistake to reduce their activities to simple "round-tripping." The relationship is in fact a more complex one with a much longer history. Recently these relationships have become even more complicated with the rise of investor companies headquartered in offshore tax havens. Increasingly global companies are sometimes difficult to pin down to a single home economy.

17.5 THE CHINA CIRCLE

The close economic association among the economies of the PRC, Hong Kong, and Taiwan warrants calling them the China Circle. The basis for the emergence of the China Circle was the success of Taiwan and Hong Kong in developing labor-intensive manufactured exports during the 1960s and 1970s, particularly to the U.S. market. Both economies produced an enormous range of light, labor-intensive manufactures: beginning with plastic flowers in Hong Kong, extending through a vast range of sporting and travel goods, to the huge garment and footwear sectors. This success had an important demonstration effect on China from the beginning of the reform era, because Chinese policymakers observed their success and sought to emulate and repeat it through economic reform. The export success of Taiwan and Hong Kong began to have a much more direct effect on the mainland in the mid–1980s, when it began to drive a restructuring of East Asian production networks. Exporters found increasing wages and costs (including land costs) and currency realignments creating "push" to move production to lower-wage locations. At the same time, capabilities were rapidly upgrading in both Taiwan and Hong Kong: educational levels soared, supply of engineering and scientific manpower increased, and commercial and financial experience accumulated rapidly. Attracted to higher-skill and higher-remuneration occupations, they were "pulled" away from traditional labor-intensive manufacturers, whose managers had no choice but to look around for other locations.

The opening of China to foreign investment at this time created a dramatic opportunity to transfer labor-intensive export production to the PRC. This development, described in the preceding chapter, was part of a worldwide trend toward increasing intraindustry trade. The trend toward the geographical dispersion of production chains leads to an increasing share of international trade that is made up of intermediate and capital goods, and to increasing FDI to build the required networks. This process was particularly powerful in the China Circle because transaction costs for Taiwan and Hong Kong firms to operate in the PRC were low. Proximity, aided by common language and customs, made doing business on the mainland easy and cheap, once

the mainland's economic system opened up. Moreover, low transactions costs made it possible to initially move only the most labor-intensive—typically low-skilled—stages of production onto the mainland, while retaining other activities in Hong Kong or Taiwan. Production chains were quickly created that crossed political boundaries and allowed Hong Kong and Taiwan to specialize in high-value services and technology-intensive production while much of the ordinary manufacturing moved to the PRC.

This restructuring moved remarkably quickly for traditional labor-intensive manufacturing, such as garments and footwear, and was basically completed by the early 1990s. For example, Taiwan firms moved their footwear production to the mainland, and in the United States imported shoes from China "displaced" imported shoes from Taiwan. A similar restructuring of the electronics industry began around 1990. It has been followed by many successive waves of relocation, of which the most recent—and one of the most dramatic—has been the transplantation of the notebook computer industry during 2002–2003. In the personal computer (PC) and components industry, production of keyboards and power supply units (the most labor-intensive products) were the first to move to the mainland, because the cost advantages were most marked. They were followed by production of monitors and motherboards, and a steadily expanding range of IT hardware products.

The previous chapter pointed out that foreign-invested firms accounted for 88% of China's high-technology exports. A look at the largest high-technology exporters can give us further insight into this process. Of the top 10, shown in Table 17.1, nine are foreign-invested firms. All of the foreign firms are from either Taiwan (four) or the United States (five). In fact, both U.S. and Taiwan firms are linked in the same global production networks. For example, Dell is the seventh-largest high-tech exporter, but No. 1, Quanta, from Taiwan, is also

Table 17.1
Top exporters of high-tech products, 2003

Chinese company	Parent company	Parent home	Export value (billion U.S. dollars)
1. Tech-Front Shanghai	Quanta	Taiwan	5.2
2. Hongfujin Precision Industry	Hon Hai	Taiwan	4.2
3. ASUStek Computer Suzhou	ASUStek	Taiwan	3.2
4. Motorola China	Motorola	U.S.	2.8
5. Great Wall International	Great Wall/IBM	China/U.S.	2.6
6. Dongguan Export Processing	Dongguan	China	2.6
7. Dell China	Dell	U.S.	1.7
8. Mingji Diantong	BenQ	Taiwan	1.7
9. Intel Shanghai	Intel	U.S.	1.6
10. Seagate Wuxi	Seagate	U.S.	1.5

"Export value" refers to value of high-technology exports only.

the largest single external supplier of computers to Dell. Moreover, with the exception of Motorola, all these high-value exporters are engaged in assembling valuable components into high-value final products. Computers and laptop computers make up a big share of the total; contract manufacturing of a range of final products accounts for most of the rest. Even Intel operates a testing and packaging facility in Shanghai and imports the actual chips that are processed there (Jiang 2004).

As manufacturing production has moved to the China mainland, the southern coastal provinces have been industrializing rapidly, while Taiwan and Hong Kong have to some extent deindustrialized. The Hong Kong industrial labor force, which peaked just below one million, had declined to 172,000 by June 2003. In Taiwan the manufacturing labor force reached a peak in 1987 of 2.8 million, but then leveled off and was at 2.59 million at the end of 2003. Meanwhile, in the two provinces of Guangdong and Fujian the industrial labor force increased from 6 million in 1985 to 11 million at the end of 2001. Between them, Hong Kong and Taiwan have lost about a million manufacturing jobs, while Guangdong and Fujian have gained about five million. In fact, these data probably understate the total number of new manufacturing jobs in Guangdong and Fujian. There have been major flows of immigrants from other parts of China into these provinces, and some immigrants working in the informal sector are not captured in official employment statistics.

Hong Kong and Taiwan have both experienced substantial success in upgrading to higher-skilled activities, while simultaneously experiencing steadily rising incomes and relatively low unemployment. Hong Kong's restructuring has been especially thorough, as it has shed many industrial functions altogether and moved into greater specialization in services, particularly finance, transport, and telecommunications. In Taiwan restructuring within the manufacturing sector itself has been the most impressive feature. Total manufacturing value added has continued to grow, even as manufacturing employment has dropped. Taiwan has moved into technologically more sophisticated products while shedding low-technology products. Thus the upgrading of skills occurred in opposite and symmetrical ways in Hong Kong and Taiwan. Hong Kong moved out of manufacturing and into a variety of business services, such as finance, marketing, and accounting. Taiwan has been quite successful in improving technological capacities and moving into production and export of commodities at much higher technological levels, yet it seeks also to become a business-operations and financial center. Both experienced dramatic success through the late 1990s; both were buffeted by the economic turbulence of the late 1990s and post–2001 global economy; both seem to be recovering today.

17.6 FDI IN CONTEXT

The preceding pages have made clear that FDI has had an enormous impact on China, transferring manufacturing capability, jobs, and export markets to China. The close integration of China and other East Asian economies—especially the China Circle economies of Taiwan and Hong Kong—has created extremely competitive, flexible, and low-cost manufacturing networks. Looking to the future, the challenge for China will be to expand the benefits receiving from openness to foreign investment. That expansion should come in terms of the sectors open to foreign participation and the modes of foreign participation.

17.6.1 Sectoral Composition of FDI: The WTO Impact

Manufacturing is a much larger part of FDI inflows into China than it is for FDI inflows in the rest of the world. Manufacturing accounted for 70% of Chinese FDI inflows in both 2003 and 2004. Manufacturing accounted for only 38% of the stock of FDI in developing countries at the end of 2002 (and even less, 32%, in developed countries), while services accounted for 55%. By contrast, services in China accounted for only 27% of FDI inflows in 2003. Moreover, other kinds of investment—portfolio investment and bank lending—have been relatively unimportant in China through the present. Manufacturing accounted for 62% of registered foreign capital at the end of 2002. To a large extent, this emphasis is explainable in terms of the restrictions that China has maintained on foreign entry into the most important service sectors. China's accession to the WTO involves commitments to dramatically lower most of these barriers. Indeed, arguably, the impact of WTO membership will be most dramatic in opening service sectors, even more than the impact on trade, which had already been substantially liberalized by the time of accession. However, this impact is not yet evident in the investment numbers. On the contrary, the share of investment in manufacturing has actually increased slightly in recent years. As Chapter 6 noted, China's comparative advantage in manufacturing has remained strong while, in parallel fashion, India's momentum in service exports is accelerating.

Three service sectors that account for large proportions of FDI inflows in all developing countries (and their shares in total inflows 2001–2002) stand out: wholesale and retail trade (7.4%), transport and telecommunications (8.0%), and finance (11.5%). In China, by contrast, incoming FDI in the service sector is highly concentrated in real estate, specifically in property development. This sector accounted for 10% of total investment in 2003. By contrast,

wholesale and retail trade (2.1%), transport and telecom (1.6%), and finance (0.4%) are clear underperformers. These three sectors together account for 27% of world developing-country inflows (including China) but only 4% of inflows into China itself (SYC 2005; 648; UNCTAD 2004).

These are the sectors where WTO commitments will have the biggest impact. Wholesale trading rights—previously off-limits to foreign firms—were being granted during the 2003–2005 period. Transport and telecommunications sectors are being opened to minority foreign ownership during the 2005–2008 period. Financial sectors are being progressively opened to foreign participation, with an important milestone coming in 2007, when the banking market is opened to foreign participation. These changes will drive further expansion and significant structural change in Chinese FDI inflows. A new wave of internationalization and restructuring will begin.

17.6.2 Modes of Capital Inflow

In the early 1980s borrowing from governments and international organizations was the most important form of capital inflow to China, and banks have been important since the mid–1980s. But since 1993 these have been overshadowed by FDI. One reason for the predominance of FDI, of course, is that until very recently China's financial markets were virtually closed to portfolio investment (Chapter 19). In addition, though, Chinese policy-makers initially displayed a preference for direct investment, primarily because it brought technology and commercial expertise as well as capital. As a result—and because of concern that foreign debt might not be well managed—China maintained strict controls on foreign borrowing through most of the 1990s. As a result, foreign borrowing has been a small part of overall capital inflows. At the end of 2003, China's total foreign debt was a manageable $194 billion (14% of GDP), compared to $403 billion in foreign-exchange reserves. Of the total debt, $77 billion was short-term borrowing (considered more risky) and $52 billion was borrowed from governments or international organizations (considered the least risky, and often borrowed at concessionary rates).

China has maintained restrictions on capital account convertibility. That is, while an exporter or importer can freely convert RMB to foreign exchange with presentation of trade documents, individuals and businesses cannot simply buy or sell large amounts of domestic or foreign currency. In theory, therefore, we should expect other kinds of capital flows reflected in the balance of payments to be quite small. However, this expectation is false. Despite the nominal lack of convertibility on the capital account, liquid capital flows to and from China are in fact quite large. Inspection of the balance of payments reveals that there is considerable fluctuation in the direction and also the rel-

ative size of different payments components. In part, this reflects the fact that data on specific components of the balance of payments are simply not very accurate. But in part it reflects the fact that individuals and businesses, in the absence of capital account convertibility, utilize many different channels to move money into and out of China. The standard way to look at the balance of payments is to break it down into the current account (payments for goods and services) and the capital account (transfers of assets). When there is a surplus in the private transactions in the balance of payments, it must (by definition)be equal to the accumulation by the Central Bank of official foreign exchange reserves. If collected data do not show this equality, a term for "errors and omissions" will be added to the data to make it balance. In China, errors and omissions are large and change direction (Prasad and Wei 2005). Moreover, China's foreign exchange reserves have soared from U.S. $286 billion at the end of 2002 to $819 billion at the end of 2005.

One way to simplify this complexity is to divide the balance of payments in a nonstandard way into three components: the balance of trade in goods and services, inflows of foreign direct investment, and everything else. In this classification, we have fairly reliable data for the first two components, and the third component is checked by the definitional requirement that all the components of the balance of payments equal official reserve accumulation. This third component, then, includes everything from the capital account except FDI inflows, plus two items from the current account (remittances and profit from investments), as well as errors and omissions. It covers all the flows of liquid capital into and out of China. These three components are expressed, as a percentage of GDP, in Figure 17.4. The result is quite striking. The balance of trade has been positive and above 2% of GDP since 1996, but jumped in 2005. FDI inflows have been stable, around 3%–4% of GDP since 1996. But the "all other" component has been huge and highly volatile. From 1997–2000, this corresponds to net outflows of liquid capital over 6% of GDP annually. Then, remarkably, flows turned around, and in 2003 surpassed 5% of GDP inflow. Capital outflows, by this definition, were $80 billion in 1997, and capital inflows were $72 billion in 2003. Clearly, these flows are influenced by expectations of devaluation (in the outflow period) or appreciation (since 2003). These flows resemble those experienced by the countries of East Asia afflicted by the Asian financial crisis (1997–1998) in their size and instability. The difference is that those countries, to varying degrees, all have open capital accounts. The remarkable thing is that the capital flows from China look just like those from other countries, notwithstanding the fact that theoretically China has capital controls. Obviously, the capital controls do not work. The most powerful argument for China to liberalize its capital account is not that

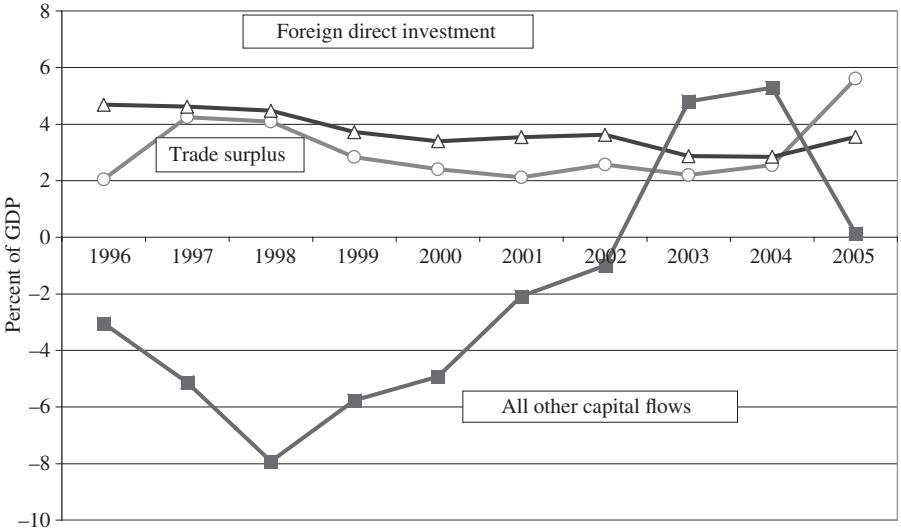

Figure 17.4
China's balance of payments

capital account liberalization is necessarily better, but that a legal, regulated open capital account might function better than a hidden black or grey market with de facto openness (Prasad, Rumbaugh, and Wang 2005).

17.7 CONCLUSION

The volatility of capital flows during the Asian financial crisis of 1997–1998 highlights another aspect of China's reliance on FDI. Even though China was exposed to volatile flows of financial capital like other East Asian economies, China enjoyed a more reliable inflow of FDI at the same time. The investors behind FDI inflows had made a long-term commitment, and in any case their assets were not of a type that could be quickly liquidated. The greater share of "patient capital" in China's foreign investment left it less vulnerable to financial crisis.

The challenge for China over the next five years will be to move to a greater openness while maintaining some of the advantages the existing regime has provided. The predominance of FDI among China's external capital sources is exceptional; it implies that China's "openness" as measured by exposure to FDI is greater than its openness in other dimensions. We should be wary of excess reliance on a single indicator, and we should anticipate that further

waves of liberalization are ahead. Those waves will make China's service sectors more open to investment and also make China more susceptible to potentially destabilizing flows of liquid capital. At the same time, global manufacturing networks will continue to use China as a production base with steadily expanding capabilities.

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The Ministry of Commerce hosts an excellent Web site, in English, on foreign investment in China. See http://fdi.gov.cn/main/indexen.htm.

Sources for Data and Figures

Data cited are for actually utilized incoming foreign direct investment, including "other" investment which is part of EP contracts or compensation trade. (Overseas share issuance has not been included.) For international comparisons of foreign investment see UNCTAD. UNCTAD (2004) provides the comparative data on services. Source does not give 2005 figure for "other" investment, which has been estimated, and equals about 5% of total FDI.

Figure 17.1: *SYC* (2005, 644–45) and earlier volumes. Updated from fdi.gov.cn.

Figure 17.2: *SYC* (2005, 643) and earlier volumes.

Figure 17.3: *SYC* (2005, 643) and earlier volumes. Updated from fdi.gov.cn.

Figure 17.4: Balance of payments tables in standard formats are available at *SYC* (2005, 82) and www.pbc.gov.cn. Service trade, investment income, and remittances have been consolidated with all capital flows, except FDI and errors and omissions, to create a single conglomerate category. See text for discussion. Updated from SAFE (2006).

Table 17.1: Ministry of Commerce, Department of Science and Technology. "Top 50 Exporters of High-Technology Products in 2003." Accessed April 4, 2004 at kjs.mofcom.gov.cn/article/200403/200403001923071.xml.

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