Factors Attracting FDI Inflow in China

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Abstract

The purpose of this article is to highlight the important determinants of FDI inflow in China. This article attempts to answer the question: "What are the important factors attracting FDI inflow in China?" It is concludes that market size, growth in Chinese economy, low labor cost, quality infrastructure, open policies to international trade, economic policies tax policies and exchange rate are important factors of FDI inflow in China. Theoretically, it will fill the gap in the literature and help to the economists and investors to understand that why FDI inflow is increasing in China.

1. Introduction

Foreign Direct Investment Inflow (FDII) is playing very crucial role in the economy development of the country. It may be defined as an investment that is made to gain long term interest in organization running its operation in an economy other than its own. The FDI relationship is formed between parent company and an affiliate (at least one) operating in any foreign country.

In 1980s, china adopted open door policy that boomed FDI inflow in china since then. During 1979 to 1983, the inflow of foreign direct investment in China remained limited. In 1982 and in 1983, the FDI inflow was $430 million and $606 million with an annual inflow of $518 million. The FDI inflow in china began to increase from 1984 and an annual FDI inflow rose from $1256 million to $4366 million from 1984 to 1991 and annual FDI inflow growth rate remained within the range of 3%-38%. The FDI inflow in china accelerated since 1992. The annual FDI inflow rose from $11,156 million in 1992 to $87,286 million in 2006. With the exception of 1999, (having annual growth rate -10.14%) the annual growth rate of FDI inflow in china remained positive. However, in 1998 and 2000, the rates were slightly positive i.e. 0.45% (1998) and 2.63 %(2000). This temporary poor performance was the consequence of Asian financial crisis. However, in 2001 the annual growth rate of FDI in flow in China rose to 11.77% and FDI inflow enhanced to $47052 million that was the highest in china history. In 2005, there was a dramatic increase in FDI inflow in china that rose to $86,071 million with an annual growth rate of 41.32%. The annual FDI inflow during the third period was $47,775 million.

Table 1 The Average Annual Inflow in Three Periods (million US $)

Period	Average Annual Inflow
1982-1983	518
1984-1991	2693.25
1992-2006	4777.67

Source: Statistics Bureau of China

The mainland China has become the largest FDI recipient in developing countries. In 2006, China received 18% of the total FDI inflow to developing countries and 5.32% of the world FDI inflow being $69.47 billion dollars. Until 2006, China has received FDI inflow $293 billion that constituted 9.27% of that of all developing countries and 2.44% of the world (UNCTAD 2007).

The purpose of this article is to highlight the important determinants of FDI inflow in China by answering the question: "What are the important factors that attract FDI inflow in China?" This study is organized as: introduction is described in section 1; Section 2 contains the literature review; Determinants of FDII are explained in section 3; and conclusion is stated in section 4.

2. Literature review

Many theoretical as well as empirical studies are conducted on determinants of FDI inflow e.g. theoretical studies include: (Kohlhagen, 1977); (Cushman, 1985); and (Froot & Strein, 1991), and empirical studies include: (Klein, 1994); (Goldberf & Kolstad, 1995); and Kiyota & Urata, 2004). The previous studies on the determinants of inward FDI to China identified high GDP growth rate, large population that provide huge market, economic labor and many other economic factors such as infrastructure, taxes and depreciation of Yuan against other country's currency as important determinants *of FDI.*

Many studies identified Political stability, economical labor, large market size, prejudiced and discriminatory policies, and geographical propinquity as important factors attracting FDI in China (e.g. Lardy (1995), Henley et al. (1999), and Zhang (2001)). Greaney (2003) conducted a study on Japan and China and identified that Japan targeted China for FDI because of depreciation of Yuan against Yen for reverse import. Additionally, the adoration of made in china can be attributed to the devaluation of its currency in early 1990s with other factors (Xing & Zhao, 2008). Ekholm et al. (2003) and Dyeople (2003) identified three factors in host country that attract FDI i.e. cost of trade, cost of transportation and technology.

Branstetter and Feenstra (2002) explained that it is the political openness that attracted FDI in china. Cheng & Kwan (2000) described that large market size and good infrastructure are the attractive factors to FDI in china. Moore (1993) concluded that large market size and growth in GDP were among the most important determinants of FDI by German firms from 1980 to 1990. Wheeler (1992) identified the market size of the host country is one of the major determinants of FDI by the US firms. China made dramatic progress in FDI inflow that induced many researchers to explore the determinants of this rising FDI inflow.

Helpman (1984) reported that level of liberalization of the host country determines the level of FDI. Kravis and Lipsey (1982) and Edwards (1990) also identified the relationship between FDI and political openness. Cushman (1985), Froot and Strein (1991), and Kohlhagen (1977) identified the relationship between FDI and exchange rate. Goldberg (2009) also identified exchange rate behavior as an important determinant of FDI in China. These studies conducted that FDI inflow decreased due to appreciation of the host country currency.

Kohlhagen (1977) found that depreciation in the foreign currencies induce the MNEs to expand their production in foreign countries for exporting to the domestic market. Cushman (1985) also concluded that depreciation in foreign currencies expands FDI inflow by decreasing production cost. Froot and Strein (1991) stated that wealth of foreign investors is increased in real terms by the appreciation of the foreign currency, encouraging them to buy more domestic assets thus increasing FDI.

3. Determinants of FDI Inflow in China

3.1 Chinese Economy- Size, Growth and Prospects

The primary objective of market oriented FDI is to sell goods and services to the host country's market. Market oriented FDI may be aimed to make the good use of new markets. The prospect of future growth in market, size of the market, and extend to which the host country is making progress are the predominant factors for attracting market oriented FDI. The host country with these characteristics offers opportunities to MNEs to make the best use of their ownership advantages. A large size market in host country is positively related with profitable investments. It is empirically exhibited by previous studies that market size positively affects FDI inflow in China.

The foreign investors are bestowed greater investment opportunities and are provided a number of markets in the host country due to emergence of local economies thus building their confidence. The positive relation between FDI inflow and market size is corroborated by (Dees, 1998) (Fung, 2000), and (Zhang & Song, 2000). Market size is not only the determinant of market oriented FDI, it also attracts export oriented FDI by providing massive opportunities of economies of scale.

The population of china is about 1341.41million and international investors believe Chinese market is the greatest market in world. Since last many years, people of china have continuously increasing purchasing power with dramatic economic growth that attracted market oriented FDI in China. GDP growth rate of china has been increased to 10.3% in 2010. The future estimates for China are also prospect that will keep China remain attractive market for FDI. According to forecasts for the 2016, government revenue is estimated 20.361% of GDP, GDP growth rate is estimated 9.525%, GDP in US$ is estimated US$ 11,220.17, per capita GDP is perceived to be US$ 13,729.03 and investment is believed to be 44.485% of GDP that currently is 48.774% of GDP in 2010.

Table 2 Chinese Economic Indicators

Indicators	2006	2007	2008	2009
Population in Thousands	1311020	1317885	1324655	1331460
Population Growth (Annual %)	0.6	0.5	0.5	0.5
Land Area (sq. km)	9327480	9327480	9327480	9327480
GDP Growth (Annual %)	12.7	14.2	9.6	9.1

Revenue, Excluding Grants (% of GDP)	10.1	16.8	11.1	-----
GDP per Capita	2069	2651	3414	3744
Market capitalization of listed companies (Current US$ 000)	2426325822.8	6226305290	2793612600	5007646096.8

Source: http://data.worldbank.org/indicator/CM.MKT.LCAP.CD

3.2 Natural Resources

China has massive energy reserves and one of the largest producers of oil and fuel and coal in world. Due to over consumption, china has to import oil and fuel. The coal industry of China is the largest in the world. However, it faced the problem of oversupply. Additionally, minerals and iron are very cheap in China.

Agricultural land of China as a percentage of total land area 56.0%, arable land is 11.6% of land area in 2008. Irrigated land is 10.2% of land area in 2006. Freshwater withdrawal is 549.76 cu km/yr per capita including 7% for domestic use, 26% for industrial use and 68% for agricultural use in 2000. Although these factors attract FDI but their attractiveness is gradually decreasing due to globalization and technological advancement.

3.3 Labor

The literature has identified low labor cost and high level of unemployment as important factors to attract FDI (Huber & Pain, 2002); (Wheeler & Moody, 1992); and (Barrell & Pain, 1997). The role of low labor cost in China to attract FDI inflow has been demonstrated in the literature (Liu et al. (1997); Dees (1998); Wei and Liu (2001). Low labor cost works as magnate for China to attract FDI. China has large labor force with relatively less labor cost. Moreover, this labor force is educated and highly skilled and technological expert, particularly at low level, due to measures taken by Chinese government. Following table shows the labor force and unemployment rate in China from 2006 to 2009.

Year	Labor force	Unemployment rate (%)
2006	766,465,175.9	4.1
2007	771,078,937.7	4.0
2008	776,880,961.3	4.0
2009	783,157,007.2	4.3

It is argued that in case of FDI, particularly export oriented, efficiency wage rate is an effective tool to determine labor cost. It is empirically acknowledged that good advantages are available to china in efficiency wage rate. Literature evidences that MNEs for the purpose of exploiting the benefits of low labor cost, either partially or entirely have shifted their manufacturing operations in China.

Zhang (2000) concluded that as MNEs from Hong Kong are mostly in labor intensive industries therefore low labor cost more significantly attracts FDI from Hong Kong than from US. However, there is negative relationship between wage rate and FDI inflow in a country. Zhao and Zhu (2000) also found positive relation between these two variables where MNEs is more interested in quality of labor. More expensive the labor is more skilled labor is perceived. Low labor cost not always attracts FDI in China. Some researchers also found that FDI inflow in china is adversely influenced by low labor cost phenomena (Coughlin & Chen, 1997); (Wei et al., 1999); and (Wei & Liu, 2001). Sun et al. (2002) found positive relation between FDI and labor cost before 1991 and negative relation thereafter.

3.4 Infrastructure – Technological, Physical And Financial

If the country has achieved minimum level of infrastructure, the literature evidences the positive relationship between growth rate and inward FDI (Ozturk et al. 2007). It is also empirically proved that more the physical infrastructure and telecommunication facilities available in host country more will be the FDI inflow. Same results are seen with respect to technological infrastructure. For several years, China is focusing on developing technological infrastructure and physical infrastructure with the particular focus on the advancement of technological industries with the object of attracting FDI. Following figures show the quality of infrastructure in percentile. 100% denotes best and 0% denotes worst and China is ranked very much high than other developing countries.

Table 3 Quality of Infrastructure

Quality	Percentage
Quality of Overall Infrastructure	56%
Quality of Roads	62%
Quality of Railroad	79%
Quality of Ports	59%
Quality of Air Transport	44%
Quality of Electricity Supply	49%
Quality of Telephone Lines	65%
Overall	65%

Source: World Economic Forum, BOFA Merrill Lynch Global Research 28 May 2011

3.5 Openness to foreign trade and easy accessibility to foreign markets

China is the most successful among Newly Industrialized Economies (NIE) of Asia in terms of advancement in exports. For this purpose, China promulgated policies for the promotion of exports and opened doors for the international investors. Moreover, tariff on imports reduced to 17.6%% from 42.9% from 1992 to 1997 and in 2010 the tariff rate is 4.2%. China also initiated preferential policies for boosting up foreign trade.

However, there are many non tariff barriers that impede the foreign trade-of china. A short term tool to attract FDI may be the import promotion policies that that increase competition among the investors thus increasing investment by the existing investors for initiating new technology. In terms of accessibility to international markets, China has also some merit. Export-oriented FDI aims to use particular and specific resources at a lower real cost in foreign countries and then to export the output produced to the home country or to third countries. Even though the most important location factors for export-oriented FDI are resource endowments, research found that China has a relatively attractive and strategic geographic position in that its territory is huge and offers access to other Asian countries and the Americas.

3.6 Regulatory Framework

China has conscientiously attempted to create favorable legal model for business. China has introduced numerous amendments in rules and regulations for the promotion of FDI. It has been liberalizing the policies relating to FDI by eliminating the restrictions from some fields in which FDI is prohibited or limited. Moreover, china has been implementing reforms for

the reconstitution and reduction of the government owned sectors since mid 1990s while inviting the foreign investors to participate in restructuring process.

Even after taking into account all recent Chinese measures, significant work still lies ahead to further improve the legal system for the market economy. The existing legal basis, legislation procedure and operating mechanism have not yet fully shifted to the needs of market economy. Various types of FDI recipients should come out in front. Privately owned enterprises have received a limited share of FDI. Further efforts are expected to bring FDI inflows into these enterprises in line with the efforts of SOEs to further co-operate with potential foreign investors. Employment figures show that foreign direct investments in enterprises in villages and small towns have been considerable. Chinese efforts to comply with the international standards in its preparation for accession to the WTO will certainly expedite the reform policy.

3.7 Economic Policy Coherence

China is very much interested to make the policies to maintain the economic growth. In 1999, growth rate of China was 7.1% and in 2000 it was about 7.3-8.5%. In accordance with Five Year plan of China of 2001 to 2005, the growth rate of China will not be less than 7%. The plan not only achieved the objectives during 2001-05 but also from 2006-10 the growth rate maintained at 8%. This plan also determine the projected level of GDP for 2003 and 2005 i.e. USD 1300 billion to USD1500 billion. Following table show the stability of China policies with reference from 2000-09.

Table 4 Stability of China Policies

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
GDP (Billion $)	1198.4	1324.8	1453.8	1640.9	1931.6	2256.9	2712.9	3494.0	4521.8	4985.4
GDP Growth Rate (Annual %)	8.4	8.3	9.1	10.0	10.1	11.3	12.7	14.2	9.6	9.1

Source: World Bank Indicators

3.8 Investment Protection and Promotion

We see no case in China since 1979 when foreign investment is expropriated by the Chinese government. Joint Venture Law was meliorated to prohibit the nationalization for the protection of the investors. The Contact Law 1999 also introduced provisions for the protection of the FDI by providing safeguard to the legal rights of domestic as well as foreign investors with the intention to promote FDI.

The visit of Deng to the southern coastal areas and Special Economic Zones resulted in the execution of FDI policies evenly throughout the country. China adopted rules and regulations that are designed for the encouragement of FDI inflows. Additionally, China introduced several investment progressing policies.

The SEZs in China offer tax incentives for the promotion of FDI. Free ports have also been established for this purpose. There are some incentives that are not automatically provided to the foreign investors. These are provided to them only after negotiation with the government authorities. These incentives encompass concession in taxes and duties etc. export oriented FDI and technological based projects are provided special incentives. There are certain sectors that are prioritized (transportation, communications, energy, metallurgy,

construction materials, machinery, chemicals, pharmaceuticals, medical equipment, environmental protection and electronics).

3.9 Tax

Many studies have empirically identified the relation between taxes and FDI. The relationship between FDI and taxes are identified by (Hartman, 1984), (Hines, 1997, 1999), and (Mooij & Ederveen, 2003). Bartik (1985) found that the decision of FDI location is dependent upon tax rate. Chinese government provided tax incentives for the development in FDI.

During 1980 to 1993, Chinese government introduced many tax incentives including reducing tariff barriers and income tax etc. In 1994, a tax system was introduced that uniformly apply to all investors whether they are domestic and foreign investors. MNEs were granted tax refund program for five years. Additionally, some sectors such as agriculture, resource exploitation, and infrastructure, export-oriented and high-technology industries are preferred for providing incentives for the promotion of FDI. MNEs are encouraged for the reinvestment of profits earned by them with FDI in China. For this purpose, MNEs are provided 40% tax refund provided these are reinvested within the geographical boundaries of china for the minimum period of 5 years. Additionally, 100% refund may be provided to the investors in high-tech industries and export oriented FDI.

3.10 Distance and Exchange Rate

This factor is commonly discussed in literature (e.g. Wei (1995); Liu et al. (1997); and Wei and Liu (2001)). There is a distance between the two countries. More cultural disagreements are likely between them which may hinder the investment decisions. The distance also has effect on shipping cost and is favorable for horizontal FDI and is unfavorable for vertical FDI.

Froot and Stein (1991) conducted a study on Japanese FDI in US during the phase 1989 to 1991. The study found that depreciation in Japanese Yen encouraged the MNEs to acquire more assets in US. Klein and Rosengren (1992); and Blonigen (1997) conducted research on Japanese FDI in US for the period o f1975 to 1992. They concluded that depreciation in the dollar value increased the Japanese FDI in US particularly in industries with firm specific assets. He found that 10 % dollar depreciation raised FDI by 18% to 32% in Research & Development manufacturing sectors. However, Japanese green-field investment with no firm specific asset did not disclose the aforesaid relationship between FDI and dollar depreciation.

Cline (2005) found that Ranmingbi is depreciated by 43% with regard to US dollar. In 1981 exchange rate reform was presented in China that caused real depreciation of Yuan (Zhang, 2001). The Yuan remained undervalued during 1978 to 1997. The real depreciation of Yuan encouraged foreign investors to acquire more assets in china and to exploit economic labor (Liu et al., 1997), (Dees, 1998), and (Wei & Liu, 2001).

Quere et al. (1999) conducted a comprehensive study on FDI by 17 countries in 42 emerging economies and concluded that FDI stock reduced by 0.23% due to 1% appreciation in local currency. The above study also found that FDI decreased by 0.63% by 1 point amplification in exchange rate volatility. However, it was observed that the emerging countries' domestic economy at the same time suffers from a positive inflation due to the investing countries.

Therefore, to prevent the real exchange rate from appreciation indicate that the nominal exchange rate must depreciate periodically, which will induce some volatility

There are few studies about relationship of FDI with exchange rate volatility in China. However, there are empirical studies on the impact of exchange rate volatility on the exports of China that is closely related with FDI inflow. These studies found that there is a negative relationship between exchange rate volatility and exports in china (Chou 2001).

As one of the policies to further attract FDI into China, it is often suggested that China open new investment sectors. With the saturation of traditional industry, new momentum should be made by further opening the priority sectors such as automobile, chemicals, electronics and agriculture, and by allowing FDI in other areas such as finance, and other service sectors which are areas which can create a new wave of FDI in China.

4. Conclusion

The purpose of this study is to highlight the most important determinants of FDI inflow in China and found that large size market, growth in Chinese economy, future prospects about Chinese economy, waste natural resources, cheap labor, quality infrastructure, open trade policies, regulatory reforms, easy access to foreign market, foreign investors protection, favorable tax policies and depreciation of Yuan have been the main factors that attract FDI inflow in China. This study will provide the future researchers the basic information about important factors attracting FDI in China and assist them to conduct detailed study separately on individual factors.

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