This paper provides a comprehensive review of foreign direct investment in China over the last three decades. It reviews the growth, sources and distribution of FDI in China and analyses factors determining FDI inflows. It summarises the contributions of FDI to the Chinese economy in terms of economic growth, total factor productivity, exports and technology progress. Finally, the paper discusses potential impacts of FDI in China on the rest of the world in terms of FDI-competing countries and FDI source countries.

The largest recipient of foreign direct investment (FDI) among all developing countries, China received a cumulative total of USD854 billion in FDI from 1979 to 2008 and benefitted tremendously from both tangible and intangible assets associated with FDI inflows. In fact, in the modern history of economic development, no other country has ever benefitted, and continues to benefit, from FDI as much as China. There is a consensus among academic scholars specialising in the Chinese economy that, over the last three decades, FDI has been a critical engine driving the Chinese economy. In literature pertaining to the growth of the post-reform Chinese economy, and policy discussions about China’s successful transition towards a market-oriented economy, FDI has always been one of the focal points.

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The influx of FDI greatly alleviated the severe shortage of capital at the start of China's economic reforms and substantially facilitated its capital formation process. Through contributions to capital formation and growth of total factor productivity (TFP), FDI in China contributed directly to China's sustained high economic growth since the beginning of the economic transition in 1978. It is estimated that foreign-invested firms accounted for about 40 per cent of China's GDP, and without FDI, China's GDP growth would have been 3.4 per cent lower.

Moreover, foreign-invested firms have performed an essential role in promoting China's exports. Switching from an inward-looking development policy to an export-led one represents one of the fundamental dimensions of China's economic reforms. This strategy has been very successful. China's exports grew rapidly and reached USD1,429 billion in 2008. Looking at Chinese export data by producer type reveals that foreign-invested firms have been the major contributor to the drastic export expansion. They accounted for almost 55 per cent of China's total trade. Today, made-in-China products are available around the world and are increasingly taking larger percentages of market share. However, most of these products are sold under brand names owned by foreign firms or distributed directly by large foreign retailers such as Wal-Mart and K-Mart. Few carry brand names owned by indigenous Chinese firms. It is the technologies, product designs, brand names and distribution networks of multinational enterprises (MNEs) that have removed hurdles to made-in-China products, helped these products enter the world market and strengthened the competitiveness of Chinese exports.

FDI has also facilitated structural changes and enhanced the value-add of Chinese exports. For instance, 85 per cent of Chinese high-tech exports were produced by foreign-invested firms in China. In 2005, China's intra-industry trade with Japan increased to 34 per cent of the total trade from less than six per cent in 1980. Japanese-affiliated manufacturers in China contributed substantially to the rising intra-industry trade.

The presence of foreign-invested firms, either wholly foreign-owned or Sino-foreign joint ventures, intensified the competition in China's domestic market, improved the efficiency of the economy, and propelled state-owned enterprise (SOE) reform and China's transition to a market-oriented economy. Technology transfers and spillovers associated with FDI inflows have substantially facilitated technological innovations and the productivity growth of Chinese firms, thus enhancing their efficiency and competitiveness.
FACTS ABOUT AND IMPACTS OF FDI ON CHINA AND THE WORLD ECONOMY

While FDI has been promoting the growth and reshaping the structure of the Chinese economy, it has also affected the welfare of other countries, which are either competing with China for limited FDI, or are sources of FDI. Given the huge size of the Chinese economy and relatively large scale of FDI flowing into China, the potential impacts on other economies raise serious policy debates. For countries trying to attract FDI, for instance, major concerns arise over whether China’s gains in FDI are at the expense of these countries and whether FDI flowing into China crowds out that going to other countries. For FDI source countries, particularly industrialised countries, the phenomenon of de-industrialisation and industrial hollowing-out are possible consequences of FDI flowing into China.

Growth, Sources and Regional Distribution of FDI in China

Growth of FDI Inflows
Opening China to FDI was an integral part of China’s “open door” policy adopted at the launch of the economic reforms in 1978. Despite the tight control on foreign portfolio investment, the Chinese government began to actively promote direct investment from abroad. Faced with a severe shortage of capital, in particular foreign exchange, and SOEs with outdated technologies and limited production capacities, the Chinese government decided to make use of FDI as a means to offset capital deficiency, acquire advanced technology and production know-how, and promote exports.

To eliminate the institutional hurdles to foreign investors and establish a proper legal environment, a law on Chinese-foreign joint ventures was promulgated in 1979. To give more choice and control to foreign investors, in 1986, the Chinese government passed a law on wholly foreign-owned enterprises, which officially permitted foreign investors to establish and operate their companies independently. Cautious and uncertain about the consequences of integrating the Chinese economy with the global economy, the Chinese government opened limited areas to foreign investors by establishing four special economic zones (SEZs): Shantou, Shenzhen, Zhuhai and Xiamen in 1980. The SEZs served as sites for experimentation. Their success in attracting FDI, promoting exports and regional economic growth led to the further opening of 14 cities in 1984, and eventually the whole of China to foreign investors in the late 1990s.
YUQING XING

Figure 1 illustrates the annual trend of FDI from 1985 to 2008, during which there was drastic expansion. In the 1980s, the scale was relatively small due to limited regions and industries being opened to foreign investors, relatively poor infrastructure and the underdeveloped legal environment. In addition, China had been isolated from the rest of the world for more than 30 years. Foreign investors were initially cautious about investing in China. By 1990, annual FDI into China was only USD3.5 billion, about 1.7 per cent of global FDI and 10 per cent of FDI into developing countries (see Figure 4).

Figure 1. Annual FDI in China, 1985–2008

The first FDI boom occurred after 1990. FDI jumped to USD11 billion in 1992, more than triple that of 1990. The rapid growth continued and FDI reached a peak in 1998 with USD45.5 billion. One reason for the surge in FDI was Deng Xiaoping’s tour to the southern provinces in 1992 which encouraged local governments to open up further to foreign investors. This had the effect of accelerating China’s institutional reform towards economic integration with the world economy. Another important factor was the cumulative devaluation of the Chinese yuan from 1989 to 1994. The
wealth and production cost effects associated with the devaluation reduced relative costs of labour and intermediate inputs, and greatly enhanced China’s competitiveness for FDI.

Due to the Asian financial crisis, which dampened the economic growth of China’s major FDI source countries, such as Korea and Japan, FDI grew less than one per cent in 1998 and declined in the following years. By 2000, annual FDI inflows had shrunk to USD40.7 billion. The growth momentum, however, resumed in 2001 and FDI rose to USD46.8 billion, 15 per cent higher than in 2000. By 2008, another record high of USD92.4 billion was reached. The expansion of FDI after 2001 was driven mainly by official entry to the WTO in November 2001, upon which China committed itself to further trade liberalisation by abolishing quotas, slashing tariffs, removing red tape and providing national treatment to foreign companies. The WTO accession led to the opening of banking, insurance and retailing, thus stimulating FDI inflows, in particular domestic market-oriented FDI. To expand production capacity to serve the Chinese market, Japanese companies in the transportation equipment industry drastically increased their direct investment into China. Their investments rose from 10.1 billion yen in 2000 to 176 billion yen in 2004, making transportation equipment the top sector in terms of direct investment from Japan. An empirical analysis by Walmsley, Hertel and Lanchovichina suggests that WTO membership significantly boosted FDI into China.¹

Sources of FDI

China’s sustained high growth and the potential of becoming one of the largest markets have lured entrepreneurs and investors from the world over. By 2006, there were 274,863 foreign-invested firms with a total registered capital of USD946 billion. Hong Kong is the leading FDI source for China (see Table 1). From 1985 to 2008, cumulative FDI from Hong Kong amounted to USD346.9 billion, about 40.6 per cent of the total FDI stock. Geographic proximity and the cultural linkage between the Mainland and Hong Kong are the major reasons. These factors generally reduce transaction costs and lower asymmetric information barriers for investing in China. The large scale of

“round tripping” FDI between the Mainland and Hong Kong also contributed to the exceptionally high FDI from Hong Kong. This refers to investments originating from the Mainland, channelled to Hong Kong and then invested back in the Mainland. It is estimated that about half of the FDI from Hong Kong is actually round tripping FDI. It meant the evasion of China’s strict control on capital outflows and tax benefits available only to foreign investors before China’s entry to the WTO. As China gradually opened to the rest of the world, the dominance of Hong Kong as the leading source of FDI decreased substantially. From 2001 to 2008, FDI from Hong Kong amounted to USD178.2 billion, or about 35 per cent of the total, which was much less than before.

As the largest capital exporting country, Japan is China’s second largest contributor of FDI. From 1985 to 2008, Japanese MNEs cumulatively invested USD64.7 billion, or 7.6 per cent of the total FDI during the period. The US ranked third with USD55.1 billion cumulative FDI, or about 6.4 per cent of the total. There was very little FDI from Taiwan and Korea before 1990. However, Taiwan emerged as the third largest investor from 1991 to 2000 with USD25.8 billion, or about 7.9 per cent of the total FDI. From 2001 to 2008, Korea emerged as the third largest FDI source with a total of USD31.5 billion in investments, tripling that made by Korean companies from 1991 to 2000.

### Table 1. Major Sources of FDI in China, 1985–2008

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<td></td>
<td>Value (Billion USD)</td>
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<td>Value (Billion USD)</td>
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<tr>
<td>The World</td>
<td>15.9</td>
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<td>4.0</td>
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*Sources: China Statistical Yearbooks and author’s calculations.*
FACTS ABOUT AND IMPACTS OF FDI ON CHINA AND THE WORLD ECONOMY

The scale of direct investment from European countries is relatively small compared with that of Japan and the US. Despite the fact that Germany was the world’s third largest economy from 1985 to 2008, its FDI in China amounted to only USD15.5 billion, or about 1.8 per cent of the total, and even less than half of the FDI from Singapore. FDI from the UK maintained roughly the same level as that of Germany. FDI from France was even smaller, at about USD8.6 billion, or about one per cent of total FDI in China. The great geographical distance between Europe and China likely contributed to the relatively small size of direct investment from European countries.

Regional Distribution of FDI
While China has become one of the prime destinations for FDI, the distribution of FDI within the country has been extremely biased towards the coastal areas. There are many factors determining the regional distribution, such as initial level of economic development, quality of human resources and infrastructure. The institutional design of China’s economic reforms, which governed the pace of reform across regions, also performed a critical role in the location decision of foreign investors. In the late 1990s, the central government finally permitted inland areas to grant preferential policies to foreign investors. The four SEZs enjoyed the advantage of first entry in attracting FDI, which in turn encouraged more FDI, leading to a virtuous cycle of FDI inflows. Additionally, compared to port cities, the landlocked inland areas were disadvantaged by distance and time barriers. Poor infrastructure and relatively low levels of industrialisation also hindered the attraction of FDI to inland areas. Yu, Tan and Xin examined the role of preferential policies in worsening income imbalances across China and found that the preferential policies were a dominant factor in determining regional FDI disparity.²

Table 2 summarises the distribution of FDI among three regions: eastern, central and western, from 1985 to 2008. It also indicates the FDI in selected municipal cities and provinces of the eastern region. Over this period, the east received USD876 billion in direct investment, accounting for 83.5 per cent of the total FDI in China, while the central and western regions received only 13.6 per cent and 2.9 per cent, respectively. Guangdong Province alone

absorbed USD212.7 billion, or about 20.3 per cent of China’s FDI during the period, making it the top FDI destination. Jiangsu ranked second with USD161.5 billion, close to the combined FDI in both the central and western regions. In terms of per capita FDI, the disparity across regions has also been very high. Shanghai was number one with USD4,414 per capita FDI, while that of the eastern regions as a whole was USD1,534. By contrast, FDI per capita in the central and the western region was only USD320 and USD105, respectively.

The excessive concentration of FDI in the eastern region substantially widened regional income disparity, a prominent challenge faced by the Chinese economy. Regions with more FDI have benefitted substantially from both the tangible and intangible assets of FDI, and thus have grown much faster than areas with less or no FDI. Xing and Zhang used both parametric and non-parametric methods to show that the uneven distribution of FDI in China has been a significant factor widening regional income disparities. In examining factors contributing to China’s regional income disparity, Wan, Lu and Zhou found that FDI contributed considerably to regional disparity, and

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the share rose over time.⁴ Fujiata and Hu, and Wei, Yao and Liu reached similar conclusions.⁵

Impact of FDI on the Chinese Economy

**FDI and Economic Growth**

According to neo-classical growth theory, economic growth is underpinned by capital, labour and total factor productivity (TFP). Unambiguously, FDI has become an integral part of China’s capital stock, thus directly contributing to economic growth. From 1985 to 1994, the relative importance of FDI as a part of the Chinese economy’s capital formation rose substantially. By 1994, FDI accounted for 17 per cent of annual fixed asset investment, up from only two per cent in 1985. As the economy continues to grow, the share of FDI in total fixed asset investment has gradually declined since 1995. From 1995 to 2002, however, FDI still accounted for more than 10 per cent of total fixed asset investment every year (see Figure 2).

![Figure 2. FDI as Percentage of Fixed Asset Investment](image-url)

Source: Calculations based on various issues of the *China Statistical Yearbook*.

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Numerous studies have tested the causality between FDI and China's GDP growth. The results generally support the hypothesis that inflows of FDI contributed significantly to GDP growth. The growth of TFP accounted for one-third of China's economic growth from 1978 to 2004 and FDI has been recognised as one of the major sources driving TFP growth in China. Technology transfers and spillovers are the two major channels for FDI to enhance the growth of TFP. Yao and Wei estimated that roughly one-third of China's TFP growth was due to FDI. Madariaga and Poncet examined the FDI/growth nexus at the regional level and found that regional economic growth benefitted not only from direct investment but also investment in surrounding areas.

**FDI and Exports**

In 2008, China's exports reached USD1,429 billion, up from only USD24 billion in 1981. Switching from an inward-looking industrial policy to an export-led economic growth policy was the major institutional change for the drastic expansion of trade. In the process of implementing the export-led economic growth strategy, FDI has performed a critical role in promoting China's exports. Lacking capital, technology, marketing channels and brand name recognition have made it difficult for Chinese exports to enter the world market, in particular the markets of industrialised countries. With the entry of multinational enterprises (MNEs) which utilise China as a platform for exports, China has been integrated into global production chains. Combining the advantages of MNEs in technology, brand names and marketing networks, the low cost made-in-China products have been able to enter the world market and compete with products from other countries.

The trade statistics suggest that the impressive export growth of China over the last three decades has been mainly the result of export-oriented FDI. In 1985, the exports of foreign-invested firms were merely USD0.3 billion, or about one per cent of China's total exports. By 2008, these exports surged to USD791 billion, or almost 55 per cent of the total (see Figure 3). In 1998, the first year after the Asian financial crisis, exports of Chinese domestic

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firms decreased 4.8 per cent while those of foreign-invested firms grew 8.1 per cent. It was foreign-invested firms which made the overall export growth positive. Without FDI, China’s export led-economic growth strategy would not have been as successful.

Foreign-invested firms have not only enhanced the volume, but also the structure, varieties and quality of Chinese exports. According to OECD data, China has emerged as the largest exporter of information communication telecommunication (ICT) products, surpassing Japan’s and the US’. ICT products are usually considered high value-added products. What is the secret to China’s achievement in ICT exports? Export-oriented FDI is the obvious answer. In 1998, China’s high-tech exports were USD20.3 billion, of which foreign-invested firms produced 73.7 per cent. By 2005, high-tech exports rose to USD218.3 billion, or about 29 per cent of China’s total exports that year. The share of foreign-invested firms in high-tech exports jumped to 88 per cent. In 2008, foreign-invested firms exported USD354 billion, or about 85 per cent of China’s total high-tech exports (see Table 3). Enhancing

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bilateral intra-industry trade between China and FDI source countries implies another contribution of FDI to China’s exports. Intra-industry trade generally occurs between two similar trading partners such as industrialised countries. Associated with rising inflows of FDI, intra-firm trade between foreign-affiliated firms in China and their parent firms abroad also increases. Intra-firm trade between parent firms and their foreign affiliates usually falls into the same industry categories due to the availability of specific capital and technologies in both parent firms and their foreign affiliates. China’s intra-industry trade with Japan accounted for 34 per cent of the Sino-Japanese bilateral trade in 2004 while it was less than six per cent in 1980. The rising intra-industry trade is largely attributed to Japanese direct investment in China.

**FDI and Productivity Growth**

Increasing capital formation and TFP in the Chinese economy represents the contribution of FDI only at the macro level. At the micro level, Chinese industries and individual firms also benefit from FDI inflows in terms of productivity growth and technology innovations. The intangible assets associated with FDI, such as advanced technology, production know-how, management skills, etc., are also the target of FDI host countries. The “market for technology”
strategy unambiguously indicates the intention of the Chinese government to acquire advanced technologies through FDI inflows. Given the USD852 billion FDI stock, a critical question to ask is whether or not FDI has stimulated productivity growth in Chinese domestic firms.

Li, Liu and Parker employed value-added per worker as a proxy for firms’ productivity and showed that the presence of foreign firms and the competition between local and foreign firms gave rise to productivity spillover effects on local Chinese firms.9 For SOEs, the competition represents the major source of the spillover while private firms mainly benefited from demonstration and contagion effects associated with the presence of FDI. Chuang and Hsu used firm-level data from the 1995 Third Industrial Census of China to investigate the spillover effect. They showed that there exists a significant technology spillover effect. In particular, the spillover effect on firms which have a high technology gap with foreign firms is higher than that on firms which have a low technology gap.10 Hu and Jefferson separated spillovers into the short and long run, and demonstrated that the effects are negative in the short run, but positive in the long run due to the exit of non-competitive local firms and the learning effects of the survivors.11

Given the existence of the spillovers, local firms will determine the extent they can benefit from the technology spillovers. Private firms tend to enjoy relatively more spillovers than SOEs. A firm’s investments in R&D and human resources are also likely to affect its absorption capacity on the spillovers. It is interesting that the origin of FDI and the structure of foreign-invested firms in China may also play a role in the process of technology spillovers. Abraham, Konings and Slootmaekers suggest that spillovers are more likely to arise from Sino-foreign joint ventures than from wholly foreign-owned firms.12 FDI from Hong Kong and Taiwan has led to higher spillover effects than that from the rest of the world.

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Factors Attracting FDI

A great deal has been written about factors determining FDI in China. SEZs, preferential policies, high economic growth, market size, rich labour endowment, exchange rates, geographic proximity and cultural links are identified as major determinants.

With an average of 10 per cent annual real GDP growth, China has been the fastest growing economy in the last three decades in the world. Real GDP growth is usually considered a proxy for the real rate of return to capital. It is straightforward to conclude that sustained rapid economic growth represents one of the most important factors determining FDI in China. Empirical studies of the nexus between FDI and economic growth in China have consistently proven the systematic linkage. China's huge population of 1.3 billion has played two distinctive roles in facilitating FDI. First, it has functioned as a huge pool of labour supply to global capital. When China opened to the rest of world, there was an immediate increase in global labour supply and the relative return of capital to labour. As a consequence, MNEs searching for low production cost locations rushed to China and used it as a production base for the world market. For instance, FDI from Japan, Hong Kong and Taiwan has typically been mainly export-oriented and driven by cost-cutting motives. Second, with rising income, China's huge population will in future also create the largest single market. In 2008, China's GDP amounted to USD4.3 trillion, making China the third largest economy. Its imports reached USD1,133 billion. The large consumer market has also motivated market-oriented FDI flowing into China. US affiliates in China sold about 75 per cent of their products to the Chinese domestic market and their local sales in 2004 reached USD38 billion, even higher than total US exports to China.

Cheap labour is another essential FDI determinant. By relocating production facilities to China, MNEs can fully utilise China's comparative advantage in labour intensive sectors. In addition to the relatively abundant labour endowment, the yuan's cumulative devaluation performed a critical role in attracting FDI, in particular export-oriented FDI, to China. Xing argued that China's exchange regime played a critical role in strengthening China's competitiveness for FDI. Measured in foreign currencies, the yuan's cumulative devaluation not only reduced production costs in China, but also raised the relative wealth of foreign investors, thus stimulating direct
FACTS ABOUT AND IMPACTS OF FDI ON CHINA AND THE WORLD ECONOMY

investment in China.\textsuperscript{13} Furthermore, the yuan’s devaluation against the US dollar made China more competitive than FDI-competing countries which also pegged their currencies to the dollar. Japan’s switching of FDI from its traditional destination of the ASEAN-4 (Indonesia, Malaysia, Philippines and Thailand) in the early 1990s to China was partially fuelled by the sharp devaluation of the yuan.

Geographic proximity and cultural linkages with FDI sources have been crucial. Geographic proximity has reduced transportation and communications costs between parent firms and their Chinese affiliates. Sharing a similar culture and languages has smoothed business negotiations and lowered uncertainties and risks. Hong Kong, Japan, Taiwan and Korea, which are the neighbouring economies of China, together accounted for 59 per cent of cumulative FDI in China from 1985 to 2008. Moreover, Hong Kong, Singapore and Taiwan, which share the same culture as China, accounted for 51 per cent of the total. Gao estimated that China’s FDI would be 45 per cent lower if its economic centre was located at New Delhi, and 70 per cent lower if located at New Delhi and without the cultural link with FDI source countries.\textsuperscript{14}

Incentives and promotion policies also contributed to China’s success in attracting FDI to China. Among the policies implemented by the government, SEZs and preferential policies such as tax incentives have been considered one of the most effective instruments. Ng and Tuan investigated the effectiveness of China’s FDI-promoting policies based on the experience of Guangdong. Their empirical analysis shows that preferential tax provisions have been one of the most effective promotion policies.\textsuperscript{15} SEZs have provided a set of preferential policies to foreign investors. Compared with other policy instruments, the positive effects of SEZs on FDI have been much higher.

Impact on the World Economy

Attracting FDI has been given a high priority in the economic development agendas of almost all developing countries. FDI is considered a shortcut to


\textsuperscript{15} L. Ng and C. Tuan, “FDI Promotion Policy in China: Governance and Effectiveness”, \textit{The World Economy} 24, no. 8 (2001): 1051–74.
solving the problem of capital shortage and overcoming technological gaps. As more and more foreign companies are attracted by China’s rapid economic growth, huge consumer market and relatively low wage workers, an issue for FDI-competing countries is whether continuing FDI to China has been occurring at the expense of these countries.

Figure 4 compares FDI in China with that of the world and developing countries from 1981 to 2008. Clearly, China’s share increased substantially from less than one per cent in 1981 to 13 per cent in 1994. Against all developing countries, China’s share grew even more dramatically. In 1981, China accounted for just one per cent of all FDI flowing into developing countries. By 1994, more than one-third of FDI in developing countries had been channelled to China. Even though China’s share decreased after reaching its peak in 1993, China still absorbed 18 per cent of total FDI flowing into the developing world. Simple descriptive statistics may imply that FDI into China crowded out that going to other developing countries. However, empirical studies show contrasting results and conclusions.

Figure 4. *FDI in China in Comparison with the World and Developing Countries*

![Chart showing FDI in China in comparison with the world and developing countries from 1981 to 2008.](chart_url)

*Source:* Calculated by the author based on the UNCTAD database.
Xing and Wan analysed the competition for FDI between China and the ASEAN-4 in the context of Japanese FDI in the manufacturing industry.\textsuperscript{16} They found that China’s share jumped to 45 per cent from five per cent between 1990 and 1995 while the share of ASEAN-4 shrank to 38.5 per cent from 66 per cent. They examined crowding-out effects on each of the ASEAN-4 countries over nine manufacturing industries and reached the conclusion that rising Japanese FDI in China was a result of FDI diversion from ASEAN-4. Chantasasawat \textit{et al.} found that there exists a negative correlation between China’s FDI inflows and the shares of other Asian economies.\textsuperscript{17} Garcia-Herrero and Santabarbara sought to learn if FDI into China was being diverted from Latin American countries.\textsuperscript{18} Their empirical results showed that Mexico was negatively affected before 2001 and that the impact on the region as a whole was not significant.

Using aggregated FDI data of 14 Asian countries from 1984 to 2002, Mercereau examined whether rising FDI into China had been at the expense of other Asian countries.\textsuperscript{19} The analysis indicates that except for Singapore and Myanmar, FDI in China was not a diversion from that of other low-wage countries. Eichengreen and Tong argued that FDI flows into China may in fact have played a complementary role to FDI going to other Asian countries, as the latter produces intermediate inputs for the Chinese market.\textsuperscript{20} Their empirical results, however, suggest that FDI into European countries may have been diverted to China due to the shift in marketing concentration of MNEs, especially auto industries. Athukorala also argued that China did not crowd out FDI inflows into other Asian countries.\textsuperscript{21}

\textsuperscript{19} B. Mercereau, “FDI in Asia: Did the Dragon Crowd Out the Tigers”, IMF Working Paper, WP05/189, 2005.
Global capital mobility is driven by the tendency for countries to chase high returns. MNEs investing in China have also gained from their direct investment. For FDI source countries, however, the extent of FDI to China that will affect the welfare of these countries has generated many debates. Industrial “hollowing-out” is a typical hypothesis. Before the Japanese economy recovered from more than a decade of economic stagnation in 2002, there was concern that Japanese FDI into China would cause a hollowing-out of the Japanese domestic industry and possibly undermine the long-term economic growth of Japan. An OECD study suggested that Japanese affiliates in China had a significant negative impact on Japanese domestic employment.²² American FDI into China was partially to blame for widening the trade deficit with China, as the FDI in China was considered a substitute for US exports to China. As more and more Taiwanese firms relocate their production capacities and R&D activities to the Mainland, it is argued that Taiwan also faces a risk of industrial hollowing-out.²³

On the other hand, some studies suggest that the negative effect could be non-existent. Branstetter and Foley used firm-level data from 1989–2004 to examine whether US multinationals that expanded employment in China had cut their employment at home or in other places.²⁴ They concluded that “firms that expand in China are almost as likely to expand employment domestically as they are to cut it. This evidence is not what one would expect if growth in China were strictly displacing activity in the US”. A theoretical study by Kim suggests that by relocating low-skill industries in China, neighbouring countries may benefit in the long term if their labour could be relocated to high-skill industries after transitional unemployment.²⁵

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Concluding Remarks

China’s success in attracting FDI has been unique and unprecedented, but the role of FDI in the process of China’s economic development over the past three decades has been complicated. Without doubt, China has been the largest beneficiary of FDI inflows and the country has certainly gained from it. China’s experiences can serve as a model for many transitional economies, which have been actively promoting FDI for their economic development. As Chinese labour costs gradually increase and the yuan continues to appreciate against the US dollar, China may lose its competitiveness in attracting export-oriented FDI. Markets seeking FDI will gradually dominate as the size of the economy continues to grow. Coping with the transition from export-oriented FDI to market-oriented FDI may be a new challenge for the Chinese economy. Further rigorous studies are needed.