

FDI in China

Economic Growth and Policy

Term Paper for EE469 Seminar in Development Economics

by

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1. Introduction

In 2007, China was the second largest foreign capital recipient worldwide, after the United States. It received more than \$83bn dollar, which is roughly about 5% of the world's total foreign direct investment. The capital inflows started to increase after 1980, yet FDI inflows really took off in the early '90s (see figure 1). In 2003, China's FDI inflows even surpassed the United States'; however, China's leadership was not meant to last long. Nevertheless, its FDI inflows might have contributed as much as 3 percentage points to economic growth during the '90s (Lo, 2007). In addition to that, MNCs produced more than half of China's exports in 2004 (Zhang, 2006).

However, these figures might let one forget the fact that China is a huge country (its population surpassed 1.3 billion in 2008). Comparing the FDI inflows per capita of five Asian countries (see figure 3) clearly shows that China's inflows (\$63 per capita) are still below the ones of most Asian nations, even Thailand (\$152 per capita). The question thus rises whether such a small amount is really able to stimulate economic growth to the mentioned extent.

The purpose of this paper is to assess the impact of FDI on China's economic growth. Section 2 gives an introduction to foreign domestic investment and its theoretical benefits and costs. Section 3 assesses China's current investment situation, while section 4 looks at different policies. Section 5 presents a case study about China's free economic zones and section 6 draws some concluding remarks.

2. Briefing Foreign Domestic Investment

A lot of research has been conducted on foreign domestic investment in the past. Therefore, there is much literature available on this topic. Generally, this literature can be divided into three economic traditions, which I will discuss briefly.

The tradition called neoclassical economics is usually considered as mainstream since it is associated with major international agencies such as the World Bank (Lo, 2007). The neoclassical view is that there are three impacts of FDI on economic growth. First, FDI means that additional financial resources are available. Second, FDI increases the country's foreign exchange reserves. Third, it is possible that FDI increases the productivity of the recipient country through technology spillovers.

The second tradition, the structuralist development economics, sees two possible drawbacks of FDI (Lo, 2007). First, MNCs might extend their monopolistic power in the domestic market of the recipient country due to the technological and scale advantages of the MNC over domestic companies. This increased monopolistic power will lower the competition in the domestic market. Second, FDI might distort the economic environment of the recipient country due to a unilateral investment into specific industries.

The last tradition, which is called radical political economy, has the view that “capital export from advanced countries tends to be motivated by the pursuit of cheap labour” (Lo, 2007). This leads to a deskilling of labour in developing countries since FDI will encourage those countries to specialize in cheap labour and thus their technology and skills will not improve but stay low. Another view of this tradition is that FDI coming from developed countries are motivated by a falling profitability in their home market. MNCs will then outsource their production to developing countries, which, in turn, will become more exposed to changes in the world economy (e.g. the current economic crisis).

From a theoretical point of view, there are many pros and cons regarding foreign domestic investment. It is very unclear, which tradition is most likely to apply to the Chinese economy, which is strictly regulated by the government. The following section will look on the impact of FDI on the Chinese economy in more detail.

3. China and FDI

3.1. Origin and Destination

FDI inflows to China went, to a large extent, to greenfield investments¹ (Graham & Wada, 2001). The majority of FDI come from other Asian countries, whereas the largest part origins from Hong Kong. Yet, a large part of Hong Kong money is actually investment by Chinese who direct their money through Hong Kong first (“round-tripped investment”). This is the case because Chinese policy allows incentives to foreign investments (Graham & Wada, 2001). Round-tripped investment has also been observed from Macao and Taiwan (Ali & Guo, 2005).

There are huge disparities between the regions where FDI is getting into. Most of the capital is flowing into China’s coastal areas, where Guangdong province took the largest share with 40% of total inflows (Bureau, 2005). Even though, FDI has also began to touch rural areas in the 90s, these distribution patterns still largely remain similar (Lheem & Guo, 2004).

According to Ali and Guo (Ali & Guo, 2005), FDI can be categorized into three different types:

- **Equity Joint Ventures (EJVs):** Roughly a third of total FDI went into this category in 2002. The government favors investment into EJVs, because it is believed that EJVs allow the most transfer of technology and management expertise. Moreover, MNCs hope that their local partner will assist them in serving domestic markets.
- **Contractual Joint Ventures (CJVs):** This category was popular in the 1970s; however, after 1980 its popularity diminished.
- **Wholly Foreign Owned Enterprises (WFOEs):** Another third of total FDI went to WFOEs in 2002. This category is often preferred by MNCs

¹ Greenfield investment is an expression for genuinely new investment (e.g. setting up a new production factory) as opposed to takeovers of existing enterprises (e.g. buying an existing production factory).

because it allows them to mitigate problems associated with local partners, such as property rights.

The reason why especially WFOEs are increasing their popularity is, according to Ali and Guo, that “foreign shareholders have tended to increase their investments to wield greater corporate control” (Ali & Guo, 2005). That is also why the share of total FDI of joint ventures has declined over the past few years from over 50% to roughly 30% in 2000. Recent corporate strategies are to strengthen the company’s control in the Chinese market (Ali & Guo, 2005).

3.2. Determinants of Investment

An important question is why MNCs would invest in China. Certainly, there are quite obvious facts such as cheap labor, a huge domestic market, a rapid economic growth rate, as well as a stable political and economic environment. Ali and Guo conducted an interview-based study of 22 companies in order to find the main determinants of FDI in China. Their result is quite straightforward but still noteworthy. Ali and Guo (Ali & Guo, 2005) found that the major five determinants of foreign investment are the following (in descending order):

- **Market size and growth:** This is the major factor pointed out by the authors. Certainly, “one major motivation for FDI is to seek new markets” (Ali & Guo, 2005). Since China’s economy is called the “economic miracle” and shows a steadily high growth rate combined with a population of roughly 1.3 billion, the market potential of this country is enormous. No company, which is able to capture a part of this market, would want to forgo this opportunity.
- **Government incentive policies:** China hands out incentives such as lower taxes and tariffs to foreign investors. The Special Economic Zones as mentioned in section 5 play an important role in China’s FDI policy.
- **Part of company’s globalization strategy:** As mentioned earlier, many companies enter the Chinese market to “just be there”, i.e. be part of the “economic miracle”.
- **Cheap labor cost:** In China, foreign investors try to benefit from cheap labor especially where production is labor intensive (Ali & Guo, 2005). As Ali and Guo point out “China has rich resources in labor and China has paid great attention to the education of its people, therefore, Chinese laborers are of relatively high quality and there are comparatively numerous technical personnel with average salaries at a low level” (Ali & Guo, 2005).
- **High investment return:** Obviously, many companies believe that investing in China yields a high return, or at least a higher return than in other countries. Other factors, such as the market size and growth, cheap labor as well as government incentives lead, among others, to a high return on investment.

3.3. Impacts on Economic Growth

The major contribution of FDI to China’s economy is the expansion of China’s manufacturing exports (Zhang, 2006). First, MNCs increased the export volume. Second, the foreign companies also improved China’s export structure.

Another important effect of FDI on China's economic growth was through "raising capital formation, increasing industrial output, generating unemployment, and adding tax revenues" (Zhang, 2006). MNCs employed 23 million Chinese workers in 2004, and thus contributed to lower unemployment in the country. Moreover, the share of taxes paid by MNCs was more than 20% of total tax income in China. These facts clearly show that FDI is enormously important for the Chinese economy. According to Chinese official estimations, 2.7% out of the average growth rate of 9.7% during 1980-99 came from FDI (Information, 2001).

According to Graham and Wada, "FDI has contributed significantly to Chinese economic development" (Graham & Wada, 2001). Chinese exports have grown largely due to MNCs and wages as well as income per capita have increased in regions, where FDI is concentrated. These regions, which received about 70% of total FDI inflows, are coastal provinces, namely Guangdong, Jinagsu, Fujian, and Shanghai. Therefore, "vast areas of China...have not been touched by FDI" (Graham & Wada, 2001). However, a study by Dayal-Gulati and Husain shows that FDI increased the per capita income growth in Chinese coastal regions (Dayal-Gulati & Husain, 2000). The authors are also convinced that Chinese policy is liable for the suppression of per capita income growth in regions where mainly state-owned enterprises are prevalent. FDI could actually be much more beneficial to rural areas; however, Chinese economic policy is not favorable towards FDI in that regions. Section 4 will talk about this issue in more detail.

According to a study conducted by Lemoine (Lemoine, 2000), nearly all growth of China's exports can be attributed to MNCs. These MNCs engage, to a large extent, in export processing and are therefore not well integrated into the Chinese economy (Graham & Wada, 2001). Most of their activity is concentrated in a few labor-intensive industrial subsectors. Lemoine argues that FDI might create jobs but that other positive externalities that usually come along with FDI, such as technology transfer, are very unlikely to happen (Lemoine, 2000).

Zhang, who analyzed the impact of FDI on growth at provincial levels during 1992 to 2004, concludes that "[t]he direct impact and spillovers of FDI on income growth are significantly positive" (Zhang, 2006). Like Dayal-Gulati and Husain, he finds that the coastal region is favored, because of FDI policy. Lheem and Guo conclude that "at the national level...economic growth is a result of both internal forces...and external forces (large foreign capital inflows" (Lheem & Guo, 2004). Furthermore, they find that at the regional level, FDI affects economic growth as well and that FDI contributes to steady economic growth and social development in the central and the western regions (Lheem & Guo, 2004).

3.4. Drawbacks

Yet, there are also drawbacks of the huge FDI inflows into China for the economy. Standard economic theory predicts firms to behave selfish and only for their own interest. MNCs thus will only invest abroad if they can benefit from the situation; therefore, FDI could be a mechanism by western countries and their companies to exploit developing nations. Zhang points out that, first, FDI "might actually lower domestic savings and investment" (Zhang, 2006), yet, according to the

Solow growth model, the savings rate has a huge impact on a country's growth rate. The presence of FDI might give Chinese people the feeling that investment is high and that there is less need for further investment or savings. However, if FDI inflows decrease or if some capital is suddenly reversed (e.g. short-term investment), it could harm the economy. Second, FDI could "reduce China's foreign-exchange earnings on both current and capital accounts" (Zhang, 2006); foreign firms own a stake in China's economy and demand part of the output as their profit, which will be deducted from the balance of payments. Third, companies might use higher transfer prices in order to transfer profit to their home country; they might also have a higher degree of investment, since the Chinese government encourages investment, which will lead to lower taxable profits. Last, the development of local know-how may be undermined by the technology provided by MNCs. There might be no need for locals to develop skills, since these skills are already existent in the market. Yet, if these skills are solely foreign owned, the Chinese economy will not benefit much from it in the long run.

There are other arguments that emphasize possible negative impacts of FDI on the Chinese long-term national welfare. According to Zhang, MNCs might drive out domestic competitors due to their superior technology (Zhang, 2006). However, the Chinese government knows how to protect its own companies and its market very well. I do not think that China is in danger of losing its domestic market to MNCs. Another argument is that FDI has an uneven impact on Chinese economy. That is true, since most FDI is concentrated in a certain region and in certain industrial sectors. Nevertheless, I believe that having a positive impact in some regions is better than having no impact at all, since wealth might spread out from the coastal regions to the more rural areas. Zhang also argues that MNCs might "influence government policies in directions unfavorable to China's development" (Zhang, 2006). Yet, I find that much influence has drawn China to the right direction, meaning opening its economy and allowing more competition (see section 4). Moreover, bad MNC behavior has been punished in their home countries. Nike, for example, needed to supervise its labor better after the company has been accused of using child labor to produce. Therefore, it actually set a positive example in China; other companies have and will follow. Lastly, MNCs could lay their hands on Chinese assets and thus gain control over China's economy and politics. As I argued before, China has shown its ability to protect itself against intruders very well. I therefore do not think that MNCs could be a threat to China's sovereignty.

3.5. Overall Effects

China seems to a rare exception when it comes to the extent of positive influence of FDI on the economy. As Rodrigo Aramburu and I have shown in a presentation about capital flows, many countries have failed to show overall positive effects of FDI. Many studies show positive effects of FDI on the enterprise, where the money is flowing into, as well as its domestic suppliers. However, there is often a negative effect on competing companies. Therefore, the overall effect seems ambiguous in many countries. Yet, China clearly shows a positive impact (see section 3.3) despite its possible negative effects (see section 3.4).

The most convincing explanation I found comes from Zhang saying that China, with its “large country-size, strong government, massive FDI from overseas Chinese, and effective FDI strategy...[has] a great bargaining power over multinational corporations such that China could be able to maximize gains from FDI and to minimize negative effects of foreign-invested enterprises” (Zhang & Shunfeng, Promoting exports: The role of inward FDI in China, 2000). China is thus able to mitigate possible negative impacts of FDI on their economy. First, as I have shown above, China’s market size is the most important factor why MNCs enter the market. Therefore, the bargaining power over these companies is high. China can impose policies on MNCs without losing a large amount of investment. Other countries might not be able to negotiate favorable deals (favorable for the country) because MNCs would just invest in another country, where the deal would be better for the firm. Second, China’s centrally planned economy allows them to set standardized policies for all foreign investors without facing resistance from the public or minority parties.

In the next section I will take a more detailed look at China’s policy regarding FDI. I will also try to give recommendations if necessary.

4. Policy

4.1. FDI Laws

China regulates FDI inflows very strictly. The Chinese government couples policies that are favorable to the MNC to policies that are (or at least that are supposed to be) favorable to the country.

For instance, a MNC gets huge tax deductions if it produces products for a specified market. MNCs that export their goods do not need to pay value added taxes. Yet, if they sell those goods on the domestic market, those taxes do apply. Moreover, a MNCs that buys its supply goods from a domestic supplier faces less taxes than if it buys the goods from a foreign supplier. According to a study conducted by Long (Moran, 2005), it is more profitable for a company to use domestic supplier.

Another policy is that the government couples an entry of a MNC into the domestic market with the import of advanced technology. The Chinese government hopes that with this tactic, the country’s economy gains access to technology quickly.

Also, the condition to enter a joint venture with a local enterprise is often used with the goal to transfer technology and knowledge. Especially in the car industry, foreign MNCs such as VW or Fiat, ended up in a – successful – partnership.

As shown in section 3, FDI flows mostly into the Chinese coastal regions. The rural areas are more or less untouched. One major factor, why MNCs are not investing in rural areas is that the market situation is different than from the market prevalent in SEZs. SEZs, as section 5 will show, offer a quite free market situation whereas the rest of China is still centrally planned to a large extent. Therefore, MNCs fear that the government will hamper their actions if they are

located in rural areas. Another important factor is that the coastal regions offer well developed infrastructure compared to rural regions. MNCs will find it comfortable to make use of that infrastructure. Moreover, in well-developed regions there are industrial clusters, which include various firms throughout the entire production process. It is therefore much easier for MNCs to get input goods as well as find distributors or exporters since all companies are located in the same area. Furthermore, such industrial clusters stifle competition and might lead to better conditions and quality. Clearly, as least in the past, MNCs have had enough incentives to prefer coastal regions to rural regions. In the future, cost might increase in coastal regions and some MNCs might dare to step into the rural areas. Yet, China needs to change its economic policy in those regions to change the current situation (section 4.3 will talk about policy recommendations).

The next section will take a look at whether the current economic policies benefit the Chinese economy.

4.2. Effects on Economic Development

The Chinese government often conditions the entry of a foreign company into the domestic market with certain goals. These goals can be to achieve performance requirements, the use of local suppliers, to be located in specific areas, or to partner with a domestic company by setting up a joint venture. However, the effectiveness of these requirements is questionable. Graham and Wada, for example, believe that “China has to some extent foregone one of the major sources of benefit of FDI, notably the dynamic gains that come from greater competition” (Graham & Wada, 2001). In the past years, especially after joining the WTO, China's regulation has softened. Nevertheless, the government still tries to avoid competition between foreign and domestic companies. However, competition forces companies to improve their productivity in order to be able to compete with new entrants. If entries are heavily regulated, existing companies do not face that pressure. This is one of the reasons, if not the main one, why Chinese state-owned enterprises (SOE) often lack competitive productivity. The government makes sure that no foreign company will operate in the same market as the existing SOE.

Another issue regarding those requirements is that they “tend to be at best ineffective and often counterproductive” (Graham & Wada, 2001). First, since China is still behind Western standards when it comes to the enforcement of intellectual property rights, MNCs are scared to import high-end technology. This is also true for joint ventures, which are enforced by the government, such that the MNC will not reveal its knowledge at nearly any price.

There are some MNCs that operate in the food processing and transport subsector even though China does not have any comparative advantage in these sectors. Thus, according to Lemoine, the purpose of these companies is mainly to serve the domestic market (Lemoine, 2000). The Chinese government wants to substitute imports and therefore permits MNCs to serve the domestic market. In order to overcome the non-competitiveness in these subsectors, the government imposed a high tariff on these products, such that only the locally produced goods are bought. However, “in the absence of real competition, foreign-

controlled enterprises can be every bit as slack as domestically controlled firms” (Graham & Wada, 2001), meaning that China is unable to improve its comparative advantages in these sectors because these tariff walls do not permit any competition and thus do not force any company to improve its productivity. Nevertheless, it might be possible, in the future, that this FDI will transform the existing industry, including SOEs, towards a more productive and efficient one.

In 1992, per capita inflows were over 40 times higher in Beijing and Guangdong than in rural areas (Bureau, 2005). According to Lheem and Guo (Lheem & Guo, 2004), one major factor contributing to this uneven region distribution is that China’s open-door policy has been applied primarily in the coastal region (see section 5). This policy, lower taxes and tariffs as well more liberal markets in the affection region, is very favorable to MNCs because it reduces their transaction costs. MNCs thus are very likely to invest in that particular region, which results in the fact that “China show[s] very uneven distributional patterns” (Lheem & Guo, 2004). By changing their policy, or by applying it to other areas (especially poor ones), rising income equalities could partly be lowered.

4.3. Recommendations

Yet, Graham and Wada point out three obstacles since this transformation requires “in some cases quite fundamental reforms” (Graham & Wada, 2001).

First, China needs to clearly formulate and enforce intellectual property rights. Having and enforcing patent laws increase a firm’s incentive to research and develop new technology since the firm can, at least for some time, harvest the rent itself. If now laws exist, other firms could just simply copy the technology and the researching firm would not have an advantage even though it has already spent researching cost. The Economist reports that the number of patents granted in China are increasing drastically (The Economist, 2009). Moreover, also the quality of patents is improving. Higher quality means that the patent can be enforced more easily, which results in more lawsuits. Therefore, China is actually doing the right steps since the country “wants to be the brains as well” (The Economist, 2009).

Second, China’s judiciary system needs to be reformed to be more independent, fair and less corrupt. In the previously mentioned study by Ali and Guo, the major obstacle of investing in China is the incomplete legal system (Ali & Guo, 2005). However, there will be a lot of political and personal resistance towards a more independent judiciary system. This is because many influential people are enjoying a favorable position in the Chinese political environment. However, with increasing wealth of the Chinese middle-class and with a growing entrepreneurship, the local demand for a more just legal system will grow and eventually trigger a change in China.

Third, the economy needs to be deregulated, i.e. the government should keep its hands away from commercial decisions. The authors further think that an “overhaul of Chinese revealed preferences towards competition” (Graham & Wada, 2001) is required (as suggested earlier in this text, China dislikes competition).

Possibly, China could lower its barrier of entry in the domestic market. This would increase competition; yet SOEs would coercible suffer from this lowering, because, as mentioned earlier in this text, these companies are often not competitive by international standards. It appears to be a vicious circle: The Chinese government imposes strict barriers of entry in order to protect their SOEs, which are not competitive because they are protected by the government. Graham and Wada suggest a “program of precompetitive deregulation” (Graham & Wada, 2001) meaning that the Chinese government should change their policy to be more precompetitive. They admit that the economy would need “time to adjust” (Graham & Wada, 2001) and the adjustment would impede large costs to the economy; SOEs, for example, would need to layoff a huge number of employees in order to become more efficient.

Another possible policy change pointed out by Graham and Wada (Graham & Wada, 2001) is that China should allow foreign takeovers especially of SOEs. This could lead to a quicker improvement of these enterprises but would reveal the inefficiencies much quicker as well. Therefore, the costs of adjustment would probably need to be borne over a shorter amount of time than under the previous policy adjustment. However, only this year Coca Cola’s attempt to take over Huiyuan, a Chinese soft drink manufacturer, was denied by the Chinese government. This clearly shows that China has not opened its economy to an extent as discussed above.

5. Special Economic Zones

5.1. Historical Background

In 1978, the China’s Communist party decided to change the way its economy is developing by economic reform and a policy of open economy. Part of this reform was the establishment of Special Economic Zones (SEZs). By 1980, four major SEZs had been installed:

- Guangdong Province: Shenzhen, Zuhai, Shantou
- Fujian Province: Xiamen

The experiment of SEZs were extended in 1984, when the government announced that the open policy was to be extended to large areas inside the country as well as 14 coastal cities. As an effect, “[e]conomic and technical zones were installed in these coastal cities” (Ota, 2003). One year later, in 1985, the open policy was further extended which resulted in the creation of three Open Economic Zones (OEZs):

- Pearl River Delta
- Southern Fujian Delta
- Yangze River Delta

These OEZs, similar to the SEZs, have been equipped with “incentives to promote export production and inflow of foreign capital” (Ota, 2003). These regions offered outstanding conditions and political status in favor of the development of export-oriented economy.

In this section, I will solely focus on SEZs, for most research focuses on them and there is more data available on SEZs than on OEZs.

5.2. Policy

Originally, the SEZs were “intended to serve as a place for testing new reforms of enterprise management, finance and labor matters” (Ota, 2003), whereas this experiment was meant to be extended to larger parts of the country if proved successful. The main goal of the SEZs was, according to Ota (Ota, 2003), to promote FDI by giving incentives such as lower taxes, lower tariffs, and less restrictions regarding labor market and government control.

The location of the four SEZs mentioned above was chosen by their close proximity to Taiwan and Hong Kong, because both, Taiwan and Hong Kong, offer a superior infrastructure as well as financial and political system, from which SEZs could make use of. Investors could, for example, easily visit a SEZ site during their stay in Hong Kong. If the site was located in the countryside of China, the trip to visit the SEZ would be much more stressful and could discourage foreigners from investing in China. Another consideration for these locations was to “confine the possible disruptions of the SEZs within the existing orders” (Ota, 2003), since the Chinese government (correctly) anticipated that the income gap between SEZs and rural regions would quickly become very large.

According to Ota (Ota, 2003), the SEZs were created to serve the following purposes:

1. Transfer of high-technology industries
2. Acquisition of modern technology and management expertise
3. Creation of employment
4. Earning of foreign exchange through promotion of exports
5. Promotion of economic development and regional development
6. Creation of economic links with developed countries (e.g. with Hong Kong or Taiwan)
7. Experiment of new economic reform with market forces
8. Setting-up of a link between the economic hinterland and overseas

To achieve these goals, SEZs were assured autonomy from the central planning by the Communist party, as well as simplified administration. This seems a puzzling environment, since the government thus created a “market environment in the zones, while maintaining intensive control mechanisms for the rest of the economy” (Ota, 2003). However, the industry within SEZs was not meant to interfere with the existing domestic industry, since the emphasis within SEZs was placed on export.

5.3. Economic Performance

The economic performances of the four SEZs were, compared to the national average, impressive. Table 4 shows that the annual GDP growth in Guangdong was 14.4% and in Fujian even 23.9% between 1979 and 1995, whereas the national average for that period lies at 9.8%. Also, the industrial production grew at a much higher rate in the SEZs than in the rest of China. According to official

values, nearly 90% of total FDI inflows went to China's coastal regions between 1985 and 1992 (Bureau, 2005). Moreover, solely Guangdong absorbed nearly 40% of total inflows. The province's share of national GDP rose from 5.1% in 1978 to 9.3% in 1995 (Bureau, 2005). Additionally, its share of total national exports rose from 14.2% in 1978 to over 37% in 1995.

The most remarkable SEZ in Guangdong province is the Shenzhen site. Its GDP rose by 35200% between 1980 and 1996, whereas its population "only" increased tenfold. Its gross industrial output even rose by 134200% in the mentioned time period. I estimated that the average annual growth rate of industrial output of Shenzhen is about 80%, which is incredible, especially when compared to the 21.7% of the whole Guangdong province, which is still higher than the national average of 14.9%.

Also the smaller Fujian province underwent a period of strong economic growth between 1980 and 2000². Due to its reform-and-open policy, the province was able to attract much more FDI than before. Between 1980 and 1990 (before large part of the reforms had taken place), the growth rate of FDI inflows stood at about 17% annually. This number jumped during the five-year period starting in 1990 to astonishing 131%. FDI inflows even increased further during 1995 to 2000 at a rate of 150% annually.

Ota claims "this rapid growth was achieved predominantly by an increasingly huge inflow of FDI [which]...brought forth a rapid increase in export" (Ota, 2003).

6. Conclusions

As this paper shows, FDI clearly has a positive impact on China's economic growth. That FDI has contributed up to 2.7% of annual GDP growth seems plausible; yet, those are official estimates, which might euphemize the role of FDI in China's economy in order to justify FDI favoring policies. Nevertheless, FDI seems to be, all in all, beneficial to the Chinese economy.

The question arises why China managed to turn FDI into a positive instrument, whereas other countries (e.g. Peru) have failed to achieve that. Considering the factors, why MNCs invest in China, it is obvious that the country has some unique offerings to make. The most important factor is China's huge market size and extraordinary growth rate. MNCs thus just want to be part of the 'economic miracle' and are willing to accept restricting policies or circumstances. Therefore, especially market size and economic growth, among other factors, translate into political power that the Chinese government can exercise over MNCs.

China has the advantage of a centralized government, which allows that complex economic decisions can be implemented without political resistance. Therefore, the Chinese government was able to attract FDI through favoring policies. Other countries were not able to implement and especially enforce such laws because of opposition (i.e. being scared of foreigners). Moreover, despite these inflows,

² I do not want to imply that its economic growth has ended. I do not have the necessary data available to evaluate its performance for the year 2001 and onwards.

China is able to direct FDI in the desired direction and thus protect their domestic market from any intruders. Yet, the experience of the Special Economic Zones clearly shows that a free-market model is able to stimulate economic growth to a much larger extent than the central planned economy is able to do. The growth rate of SEZs was way beyond the national growth rate, which speaks for the economic model implemented at SEZs.

That is one of the major critiques on China's FDI policies, which is basically restricting FDI, and the following economic growth and technological development, to certain regions (namely the coastal region). By further opening their economy, especially the rural areas, China would be able to improve living standards of poor people and to decrease the huge income gap between rich and poor regions. Yet, the free-market model seemed to come under pressure due to the recent recession in developed countries, especially the United States. China seems to be prouder of their economic system and due to the West's recession, the government might probably be able to defend their system for a longer period of time. Also, recent interventions by the government to prevent a takeover by the Coca-Cola Company clearly show that China still intends to regulate their economy to a large extent. By trying to limit competition, China's domestic protected enterprises will suffer in the long run, since these firms do not feel any pressure to improve efficiency and productivity.

Further research needs to examine the role of FDI in rural areas and why exactly China is blocking competition from entering in markets that traditionally have been served by domestic enterprises. One reason might be that those domestic enterprises would need to lay-off a large percentage of their workforce in order to become as competitive as international companies. That might increase dissatisfaction among citizen against the government, which in turn increases upheavals in the country. The government certainly tries to prevent such events by any means. Another reason might be that Chinese people, especially people holding a high position in the party, are afraid of foreign intruders. These foreign investors might try to gain a controlling position in the country in the future. Chinese people might simply be scared to 'sell the country' to Westerns, which might try to impose and enforce their political system, religion or language to the Chinese population. Yet, these thoughts have not been tested as far as I know. Further research would need to examine these topics in order to come up with better recommendations regarding Chinese policy and MNCs' behavior when entering the Chinese market.

7. Appendix

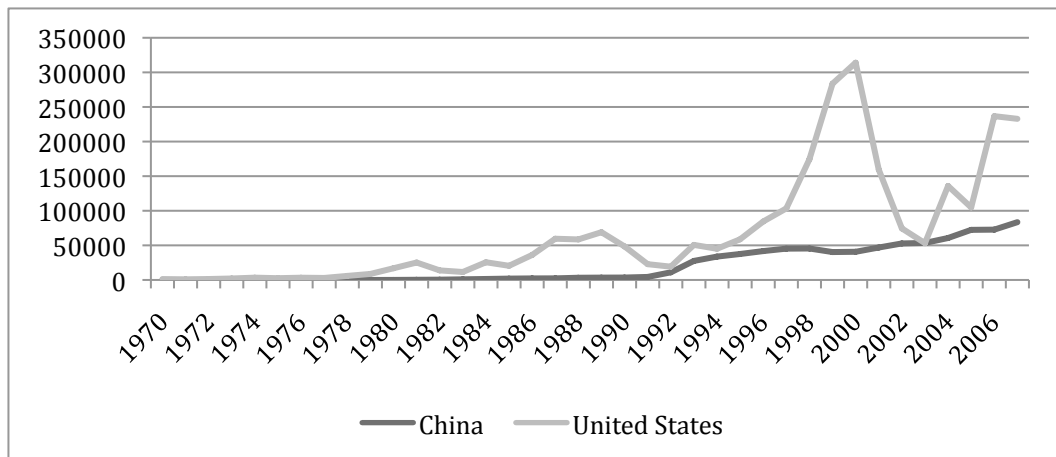


Figure 1: Annual FDI Inflows (in \$ millions). Source: UNCTAD.

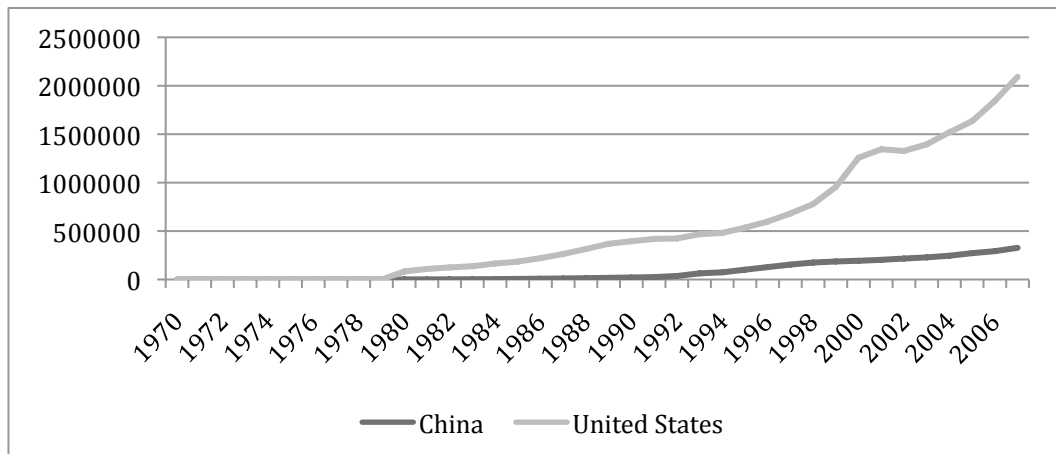


Figure 2: FDI Stock (in \$ millions). Source: UNCTAD.

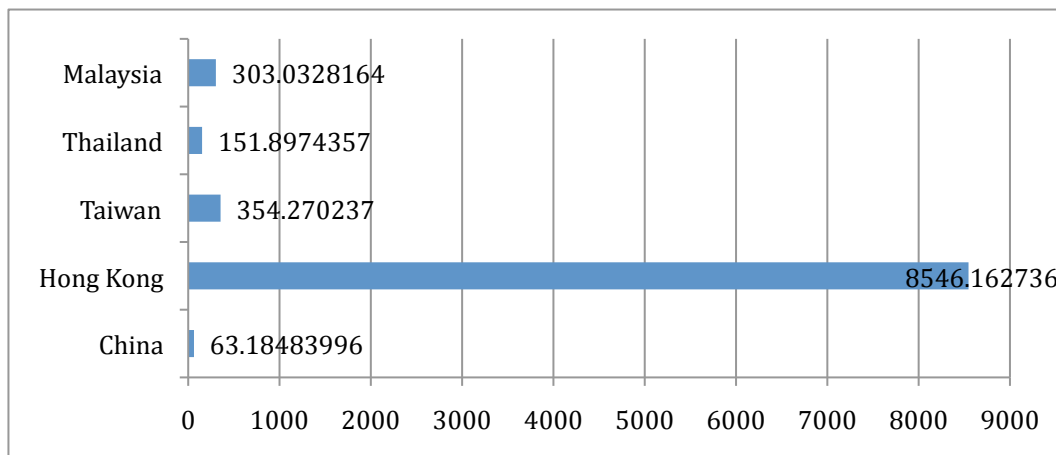


Figure 3: FDI Inflows per Capita (in \$). Source: UNCTAD.

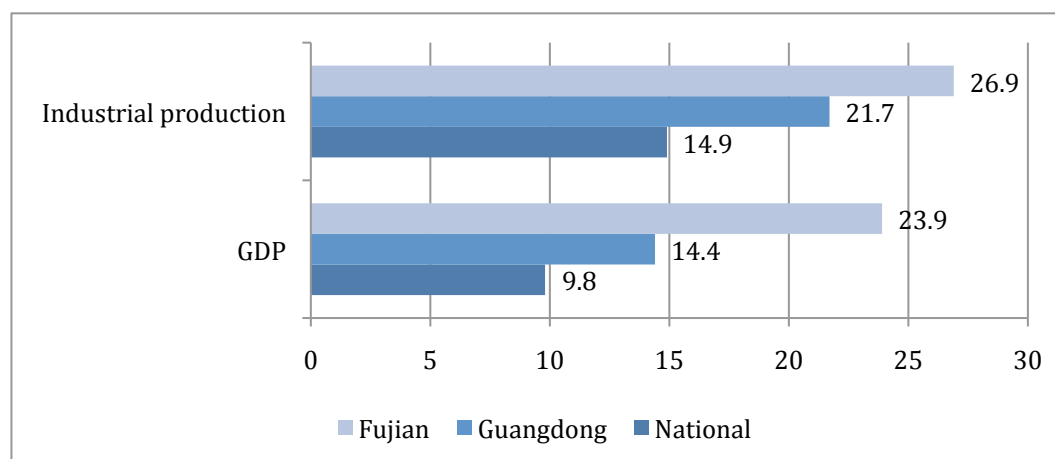


Figure 4: Annual average growth rates (1979-1995). Source: (Bureau, 2005).

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