The Emerging Financial Markets of China: Foreign Direct Investment

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Abstract:

This paper examines the efforts in recent years by the Government of the People’s Republic of China to increase confidence in the international financial markets, in particular direct investment. Given the enormous desire by investors to take advantage of the opportunity to invest in one of the world’s hottest economies, and China’s ever-increasing need for capital, it would appear imperative that the government provide safeguards to those desiring to invest directly in capital projects in PRC.

In fact, the Beijing government has made steady progress in this area over the past decade and is continuing this effort. This paper will outline the development of FDI in China over the past decade, the changes made in the rules regulating companies expanding their operations into China, and try to forecast the future for investors desiring investing directly in China.

I. Introduction:

For several years now, desired foreign investment has far exceeded actual capital flows to China. The attractions of investing in China are obvious: cheap labor, well-educated and diligent workforce, large and growing market, etc.

The inability of investment potential to be fulfilled has been due in large part to the lack of transparent capital markets in which both passive portfolio investment and direct investment can be executed with confidence. Reasons cited for this inability to find good opportunities are the need to carry out large investment projects jointly with Chinese partners, restrictions on securities purchases by the PRC, lack of transparency in reporting procedures, minimal enforcement of such procedures, and a disdain for the sanctity of intellectual property rights, among others.

Over time, these market failures will disappear as the Chinese government reduces its share of ownership in large state-owned enterprises (SOE), imposes and enforces accounting rules and regulations on firms wanting to be listed on the financial markets, clamps down on intellectual property piracy, loosens government controls on such sectors as banking, and relaxes restrictions on full ownership of newly-formed companies by foreign entities. Beijing will carry out these reforms both because it recognizes the advantages for the economy and because of WTO requirements.
Much of this has already begun, and the need to attract massive amounts of capital to fuel the economy will surely lead to ever greater movement toward openness. Already, shares of stock of more than 100 companies, known as B-shares, are listed on international equities exchanges. Companies desiring to be listed must conform more closely with internationally accepted practices. The desire by other companies to be listed will lead them to move aggressively to comply with international reporting standards.

But it should be noted here that transparency is not merely a prerequisite for attracting foreign direct investment. In fact most Chinese themselves have fallen victim to this lack of transparency. Both stock market and real estate market bubbles that burst over the past decade have left many Chinese nationals with a bitter taste in their mouths. And, as will be shown in this paper, the real key to China’s economic development is not FDI, but domestic investment.

This study is an attempt to examine exactly where China is today in this movement toward liberalization of foreign direct investments. It will also examine the trends in China-directed FDI over the recent past; the amount, sources, regional distribution, and quality. It will also attempt to project the likely future of FDI and to examine how large a part this will likely play in expanding the economy.

The next section examines the extent of total foreign direct investment since the onset of liberalization of the Chinese economy. The third section examines the future for FDI in light of official government pronouncements, investment plans by foreign investors, and the likely absorptive capacity of the PRC. Finally, an overall view of the “China Debate” will be given with a realistic assessment of what we are likely to see in the future.

II. The past and current situation

Growth of China’s economy and foreign direct investment has been nothing if not dramatic. GDP growth over the past twenty years has been estimated at somewhere between 6 and 10 percent, depending on what data are used. What is clear, however, is that growth in the Eastern coastal areas has been spectacular, probably double the national average.

The emergence of China as a great economic power came about as the result of decisions in Beijing to accept the virtue of unequal growth as opposed to that of absolute economic and financial equality. The architect of this new idea was Deng Xiaoping, who in the late 1970’s, pioneered "Socialism with Chinese characteristics", also known as the "socialist market economy". What this meant was a centrally-directed economy in which certain specified zones would be allowed to function independently of the rest of the country.

Following this doctrine, special economic zones, or SEZs, were developed with the assistance of national infrastructure creation but with private enterprise employing capital both domestic and foreign to generate wealth. Entrepreneurs would be allowed to keep the
fruit of their efforts and employ labor from the rest of the country that could be freed from
the excess labor pool created by decommunalization and reduced governemnt benefits.

Such areas as Shenzhen, adjoining Hong Kong, and Xiamen, across for Taiwan
were two of the earliest SEZs. This was followed shortly after by industrial and
commercial developments near Municipalities such as Shanghai, Beijing and Tianjin,
where large tracts of land were declared as SEZs.

The areas that have seen the greatest growth, both in GDP and investment, have
been confined to the Pearl River Delta (PRD, Guangdong or Canton Province), The
Yangtze River Delta (YRD Jiangsu and Zhejiang Provinces as well as Shanghai
Municipality), Fujian Province across from Taiwan and the Bohai coast urban cluster
(Hebei Province with the two municipalities located there, Beijing and Tianjin).

Any visitor to these zones cannot but be impressed by the modernity and affluence
as well as the amount of economic development still going on. It is often said that one
must visit China at least once every five years to appreciate the pace of this transformation.

In the fall of 2002 I had the good fortune to teach Finance at Webster University’s
Shanghai and Shenzhen campuses. While there I traveled a bit and was struck by the depth
and breadth of the growth that is happening. Almost everywhere one sees new high-rises,
highways, and commercial centers rivaling those in the West. It is now possible to travel
almost anywhere on modern highways at speeds of over100 kph.

Of course you still see thousands of bicyclists on the streets of Shanghai and
Beijing (not so many in Shenzhen, though), but they now must share the road with
motorists that own their own cars along with taxis and busses. Long gone are the
rickshaws that were omnipresent in the early part of the 20th century.

Look across the Huangpu River from the Bund in Shanghai and you’ll see
skyscrapers among the tallest in the world. What was not so long ago rice fields is a
sprawling metropolis of apartments, banks, hotels, and industrial parks producing some of
the most advanced technology anywhere in the world. This is Pudong, with its brand new
airport and the maglev train bringing visitors from the airport to the city at 300 kph.

But there’s another China, the China of the masses. It is estimated that nearly 700
million of China’s population are best classified as peasants. And while development in
the coastal areas has been spectacular, it has not been shared by this second group. It is
from this group that the cheap labor pool so attractive to foreign and domestic investors is
drawn. It is also this group that frightens the government in Beijing. The real challenge for
China’s future is how to spread the wealth and satisfy expectations in the hinterland.

This phenomenal growth experienced along the coast has been fueled by an
investment boom, public and private, domestic and foreign, the likes of which is almost
unprecedented in economic development history. In addition to massive infusions of
capital from the central and local (provincial and municipal) governments, there have been massive infusions of private capital from both domestic and foreign sources.

Table 1 shows official FDI figures for all of China for the past 20 years. As can be seen, FDI was relatively small until the mid-1990’s when it topped $40 bn for the first time. It has never fallen below that level since and currently is over $60 bn. Due to the downturn in the US economy, brought on by the bursting of the dot.com bubble and the various reporting scandals, China’s FDI nearly equaled that of the US for two of the years listed. In fact, earlier, unrevised figures actually showed China FDI exceeded US FDI in 2002.

Table 2 shows the growth rates of the four provinces that comprise the two river deltas: Guandong for the PRD and the three provinces that make up the YRD. As noted earlier, growth of these areas has been spectacular. Table 3 lists the utilized FDI of these same provinces, while Table 4 shows the amount and changes in GDP and value-added from industrial output for these same provinces. We can see that the FDI for these provinces for 2003 was about $42.68bn., nearly 80% of China-bound FDI.

Foreign direct investment in China may take several forms. The three primary types of investment are equity joint ventures (EJV), contractual joint ventures (CJC) and wholly foreign owned enterprises (WFOE). The last of these may be the result of either of acquisition or Greenfield investment. While in the early stages of China’s transition WFOE through acquisition was virtually prohibited by requirements of less than 50% foreign ownership, this has changed in recent years as a result of WTO membership. While restrictions still exist and permission from Beijing is mandatory, even in such areas as financial services restrictions have been greatly eased.

Despite the fact that China is by far the largest recipient of FDI among all developing countries, it still absorbs less than 10% of the world’s FDI and, on a per capita basis, investment flows into China are still below those of the rest of the developing countries. And official FDI still represents a small fraction of total investment in China; the vast majority of the estimated $400 bn. of private investment derives from domestic sources rather than FDI.

But even these relatively small infusions of investment capital seriously overstate the actual investment coming from overseas. As is often the case of FDI in developing countries, foreign capital is afforded concessionary tax consideration; in the case of China, investors’ profits are tax free the first two years and only 50% of the domestic rates for the next three years. This provides a strong incentive for national investors to disguise domestic investment using the process of “round-tripping”: under-invoicing exports and over-invoicing imports.

As an example of how round-tripping works, suppose Wang Hongwei, a PRD textile manufacturer, ships $50 million of textiles to his brother Wang Xiaozhong, who lives in Hong Kong and is billed $20 million. The $20 mn. are turned over to the Bank of China for 160 million Renminbi. These funds are used to pay the textile workers in the
Guangzhou factory. Xiaozhong in turn buys $30 million worth of machinery from their brother Dayi in Singapore and bills Hongwei for $50 million. Hongwei pays 400 million RMB to BOC and receives the $50 million to purchase the machines. In such a transaction the two outside brothers have earned profits of $30 + 20 = $50 million that are reinvested in Hongwei’s factory as FDI. For this Xiaozhong and Dayi receive a 100% tax break for the next two years and a 50% tax break for the next three years after that.

In the case of China the extent of round-tripping is quite large; it is estimated that between 30% and 50% of all inbound FDI is derived this way. Evidence comes from a comparison of official Chinese figures of incoming FDI with those compiled by the OECD of outgoing FDI to China. These figures are reinforced by the data showing the amount of FDI coming from such unlikely sources as British Virgin Islands and the Cayman Islands, favored venues for such activity. Of the official FDI inflows to China between 1984 and 2001, for instance, almost 46% came from Hong Kong and Macao alone while nearly 10% came from offshore financial centers. While some of these were legitimate external investment projects, particularly those from Hong Kong and Macao, much of them were due to round-tripping.

III. Future developments of FDI in China.

As was noted earlier, the regional impact of FDI, and investment generally, has been confined to the coastal regions of the country. This unequal pattern of growth has become a sore point both to many Chinese that have not benefited from the growth and policy-makers in Beijing. These latter are aware of the tensions that have developed as social programs have been cut and resources shifted to the newly developed areas. The possible implications of these tensions and the greater chance of another “peasant revolt” have made the central government more aware of the need to shift development to the interior of the country. Consequently, Beijing is trying to direct private investors, both domestic and foreign, toward areas that have not been the major recipients of investment in the past. But even without Beijing’s urging, rising labor costs and increased congestion and pollution in the former investment zones, have begun to move new investment inland. In 1997, for example, Chongqing, formerly part of Sichuan Province, was given provincial status as it own municipality, the largest in China with over 30 million inhabitants. Plans call for 100 billion dollars of public investment to transform Chongqing into the “Chicago of China”.

As investment moves away from the coastal areas that are well known to foreign investors, especially those from Hong Kong and Macao, it is very likely that increasingly more of the investment will come from Chinese nationals. The great wealth generated by the coastal boom and the incredible parsimony of the Chinese has created an enormous domestic pool of investment capital just looking for fertile areas in which to develop. And as the capital markets become more efficient in allocating capital to projects, we can expect to see a very independent investment environment.
Another development that is occurring today is equalization of tax treatment between domestic and foreign investors. The Beijing government has stated that it will either eliminate many of the favorable tax advantages of foreign investors or make these incentives available to Chinese nationals as well. This will tend to diminish the extent of round-tripping and increase domestic incentives to invest, further reducing the relative size of FDI to total investment in China.

As these capital markets mature, we can expect to see far more portfolio investment opportunities for foreign investors and less and less of direct investment, if not absolutely, at least as a fraction of the total. As a point of comparison, consider the case of Japan. Following World War II, Japan depended a great deal on US investment for its development. But for the past thirty years, Japan has been able to generate more than enough domestic investment to meet its needs. Prospects for China will most likely be similar to those of Japan.
Selected Bibliography


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Tables

Table 1: Foreign Direct Investment Flows by Region
(Billions of Dollars and Percentages of World FDI)

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<td></td>
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| Source: UNCTAD

Table 2: Growth of Gross Industrial Output

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<th>Jiangsu</th>
<th>Zhejiang</th>
<th>Guangdong</th>
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<td>Annual Growth 1987-1997</td>
<td>18.1%</td>
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<td>Annual Growth 1998-2002</td>
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| Source: Hong Kong Trade Development Council

Table 3: Utilised FDI of the PRD and the YRD (US$bn.)

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<td>4.27</td>
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<td>3.06</td>
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Table 4  GDP and Value-Added Industrial Output (2003)

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<th>Value-added Industrial Output (RMB bn.)</th>
<th>Average Annual Growth (% 00-03)</th>
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