Foreign Direct Investment in China

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Since late 1978, China has carried out massive economic reforms in an effort to restructure their economy to be more market-oriented. Foreign Direct Investment (FDI) was one of the main pillars of reform. The government has gradually liberalized its restrictions on FDI in order to reap the rewards of foreign investment: technology transfer, modern management skills, and foreign exchange. The results of the reforms have been extraordinary. Thousands of multinational corporations have invested in China, bringing with them billions of dollars in FDI. In order to continue to attract foreign investment into China, the government is now pursuing WTO membership. As China prepares to enter the WTO, it has had to make a number of commitments to modernize and restructure its centrally planned economy. If these policies are implemented as agreed to in the U.S.-China WTO Agreement of 1999, there is great potential for China to continue to attract multinational corporations and foreign direct investment in record amounts.

China has already revised their laws and regulations in order to allow foreign direct investment and entice multinational organizations to invest. The government’s first move to open the Chinese economy to foreign investment was taken in 1979 with the Equity Joint Venture Law, which allowed the legal entry of FDI and provided a statutory basis for the establishment of joint ventures in China. Investment was allowed only in designated Special Economic Zones (SEZs), and was encouraged through tax incentives. As investment grew, it became apparent that additional laws on FDI were needed, and in 1983 they issued another law which provided greater details on all the aspects of joint venture operations. The government also agreed to extend investment beyond the original SEZs in 1984. In order to do so legally, the
government was forced to recognize the private sector as a supplement to their socialist economy, and they granted private enterprise legal status. The government continued to reform their regulatory framework through the passage of the Foreign Exchange Balance Provisions and the Encouragement Provisions in 1986. These laws facilitated FDI and allowed firms to solve their foreign exchange problems. Beginning in 1994, China conducted a new round of foreign exchange management reform. They abolished the official exchange rate and adopted a market rate. They also abolished the exchange quota retention system. Further reform came in December 1996, when the government announced that it would adopt IMF article A, removing all remaining restrictions on foreign exchange transactions. Beginning in December 1996, the currency would be convertible (Chen, 1997). All of these reforms strengthened the regulatory framework and increased investor confidence in the market.

Many multinational corporations have taken advantage of China’s reformed economy to enter into the Chinese market. Many of the companies that have expanded into China have moved production facilities in order to tap into the abundant supply of cheap labor to make export products. Others have come in an effort to penetrate the Chinese market of 1.3 billion consumers. Although many companies have been successful, some have not achieved the gains they expected. Whirlpool is one example of a firm who had to cease manufacturing for the Chinese market after finding it could not compete with domestic companies who make similar products and charge less (The Economist, September 23, 1999). However, some of the later entrants have done more thorough research on the Chinese economy. Kodak is one example. In the past three years, they have invested more than $1.2 billion into factories acquired from ailing Chinese film manufacturers. Now China is Kodak’s second largest market for consumer film and paper. Motorola has also been successful, and has captured one-third of the country’s
cellular phone market. Other companies, like General Motors, have found success in forming joint ventures with local manufacturers (Businessweek, April 16, 2001). The presence of multinational corporations is helping China to quickly become a leading manufacturer of low and high technology products.

The multinational corporations that have entered China have brought an enormous amount of foreign direct investment (See Appendix A). FDI is pouring in from countries all over the world (See Appendix B). The annual rate of increase in FDI averaged more than 40% over the early 1990s, and peaked in 1993 at 175% (Mastel, 2000). The total value of foreign direct investment rose from almost zero in 1978 to between $40 billion and $50 billion in the past couple of years. Thus far, approximately $320 billion has been invested into the Chinese economy (OECD website). China is now the third largest recipient of FDI in the world, and the highest among developing countries.

In order to encourage the presence of multinational corporations and the investment they bring into China, the government recognizes that further reform is needed. In addition, they believe that entry into the WTO is the most effective way to encourage change and bring China into the global marketplace. A Businessweek article from earlier this week noted that “after two decades of steady but halting reforms, Beijing is now racing to dismantle the last vestiges of a command economy” (April 16, 2001). Although they have made significant progress in the past 20 years, there is still a long way to go before their economy can be characterized as market-driven and open. Therefore, the government is implementing another wave of reforms so that they will be eligible to join the WTO by the end of this year.

In the November 1999 U.S.-China WTO Accession Agreement, China agreed to the following reforms:
• China will phase in trading rights and distribution services over three years, and will open up sectors related to distribution services, such as repair and maintenance, warehousing, trucking and air courier services (U.S.-China Business Council).

• China has committed to allow foreign direct investment in its telecommunications industry for the first time. Two years after accession they will permit 50% foreign equity share participation for value-added services (including e-mail, Internet, voice-mail). Five years after accession the government will allow 49% foreign equity share for mobile and data services. Geographical restrictions on this investment will be eliminated (United States Mission to the European Union).

• Increased access in banking, insurance and securities will be phased in over five years, culminating in full market access in all activities and regions. They have also promised national treatment for foreign banks and minority ownership in domestic securities firms and most insurance businesses (Lardy, 2000).

• China will allow increased access for professional services, including accounting, consulting, engineering, medical and information technology (Lardy, 2000).

• China will eliminate trade and foreign exchange balancing, local content and export performance requirements, and refuse to enforce contracts containing those requirements. They will not condition import approval or investment licenses on performance requirements (United States Mission to the European Union).

• China has committed to implementing the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIP) immediately upon accession and with no transition period. The TRIPs agreement is the best way to combat piracy of U.S. software and create a healthy environment for the development of China’s software industry. Under the TRIPs
agreement, the U.S. software industry will be better able to enforce its intellectual property rights in Chinese Courts (United States Mission to the European Union).

The reforms that China has committed to in its agreement with the United States will strengthen the regulatory framework and open the country to foreign investment. If the government carries out these reforms, investment should continue to pour in: “As China improves the transparency of its trade regime to meet the standards set by the WTO and give more secured access of Chinese goods in the overseas market, more foreign investors would seek to establish export-manufacturing operations on the mainland” (Hong Kong Trade Development Council). Opening up distribution will attract retailers, and the opening of banks, insurance and telecommunications will attract additional inflows. As the economy continues to shift from a command to market-based system, investment is expected to follow.
Appendix A: Value of FDI Inflows

Source: The Economist, April 7, 2001
Appendix B: Composition of FDI

Source: *The Economist*, September 23, 1999
Bibliography


