Selling China: Foreign Direct Investment During Reform Era

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Topics
• An overview of FDI developments
• Challenging conventional wisdom
• An institutional perspective
• Broad implications
AN Overview: FDI Developments

- Basic statistics:
  - 2000: $42.1 billion
  - 2001: $45.0 billion
  - 2002 (01-08): $35.7 billion over $28.8 billion same period in 2001
  - 2002 A.T.Kearney’s FDI survey: China outranked United States as the most attractive FDI destination

- Growing weight of foreign-invested enterprises (FIEs) in the Chinese economy:
  - Share of industrial output value: 27.8% in 1999 from 7.1% in 1990
  - Share of value-added tax: 16% in 1999 from 4.3% in 1992
  - Share of export: 47.9% in 2000 from 15% in 1990
An Overview: Basic Characteristics

- Characteristics of FDI inflows before 1997:
  - Low tech and labor-intensive: Much from small firms based in Hong Kong, Taiwan and Macao
  - Evenly distributed across industries, including in China’s traditional arts and crafts industries
  - Very high share of capital formation: Over 60 percent of private fixed asset investments in the mid-1990s
  - Rising FDI in labor-intensive industries but declining contract production until 1997
  - Rising FDI when China was a net capital exporter: Massive purchases of T-bonds
Challenging Conventional Wisdom

➢ Market fundamentals
  — Investment today in expectation of future profits
    • Absolute vis-à-vis relative levels of FDI
    • Why foreign firms were far more optimistic than domestic firms about the future?
    • Why market allure to foreign firms more than to domestic firms?

➢ Economizing on labor costs
  — Why such a reliance on equity financing as opposed to contract production?
  — Patterns of successful export economies, Taiwan, Hong Kong and Korea
Challenging Conventional Wisdom

- **Resource transfer rationale**
  - Mechanisms of know-how transfer in labor-intensive industries:
    - Contractual vehicle
  - Quality control: Close coordination on quality inspection on an arm’s length basis
  - Purchasing practices

- **Rule of law**
  - Contractual flexibility, not rigidity, highly valued
  - FDI = A long-term contract not desired during uncertainty
  - Labor-intensive export industries developed successfully in poor legal settings: Taiwan and Korea in the 1960s
An Institutional Perspective: Sound Macros but Bad Micros

- A.T. Kearny’s survey: Lack of entrenched competitors cited as an attractive factor
- At a given level of macroeconomic conditions, FDI is jointly determined by competitive advantages of foreign vis-à-vis domestic firms

\[
\text{Relative foreign competitiveness} = \frac{\text{Competitiveness of foreign firms}}{\text{Competitiveness of domestic firms}}
\]

- Why domestic firms are uncompetitive?
- The influence of China’s financial institutions in allocating financial and economic resources
Poor Allocative Efficiencies

- Best of the resources and market opportunities reserved for the inefficient firms, the SOEs
- Poor protection of property rights of indigenous private firms (but better property rights for foreign investors)
- Market fragmentation

Result:
- SOEs are uncompetitive because of internal constraints: poor incentives, governance problems, political control, etc.
- Private firms are uncompetitive because of external constraints: political and legal discrimination, credit constraints, market-entry restriction, etc.
- Domestic firms cannot invest across regions
Implications of Microeconomic Inefficiencies: Uncompetitiveness of Domestic Corporate Sector

- Across-the-board uncompetitiveness of domestic firms
  - Increases relative competitiveness of foreign firms across-the-board
  - FDI broadly present in many industries and regions
  - Even very small foreign firms invest actively

- Contractual difficulties in labor-intensive industries
  - Export contract = a business opportunity but without resources, eg., foreign exchange
  - Export-oriented FDI = export contract + resources
  - Poor legal status of private firms: 1) foreign vendors wary of extending buyer credit to such a firm; 2) a private firm motivated to be acquired by a foreign firm to access better legal treatment
Inefficiency-induced FDI

- Primacy of FDI as ownership arrangement
  - Wooing FDI while not allowing domestic private firms to acquire SOE assets → a disproportionate privatization role of FDI
  - A whole class of potential bidders for SOE assets excluded → A more active role of foreign firms in China’s de facto privatization drive
  - Privatization = an ownership arrangement (by definition)

- Many functions of FDI
  - Foreign firms can invest cross-regionally but domestic firms cannot: A broad geographic distribution of FDI
  - Equity financing to credit-constrained private firms to expand their businesses: Venture capital provisions in mature industries – political rather than technological risks
  - Acquiring assets from SOEs rich in assets but poor in profits: Privatization functions of FDI
Broad Implications

➢ A substantial improvement of private firms
  — Enhanced domestic competitiveness
  — Contract production now feasible:
    • Export processing increased by 67% between 1998 and 2000.
    • Direct garment exports by private firms increased 1.4 times in 1999.
  — Labor-intensive FDI decreased
  — FDI increased in absolute terms but decreased in relative terms
    • FDI only accounted for less than 20 percent private sectoral investments in 2001
  — Quality of FDI improved: More high-tech
  — A greater concentration of FDI in high value-added industries
Broad Implications

- Two contrasting growth models in China: Zhejiang and Jiangsu
  - Identical initial conditions: 1) Income level, 2) Economic openness, 3) Stock of social capital, 4) Geographic locations
  - Zhejiang: Far successful than Jiangsu and far less reliant on FDI as a growth driver
  - Identical in FDI policies but differed in their internal policies toward private firms
  - Zhejiang far more supportive of the private sector than Jiangsu
  - Zhejiang: Some of the best domestic firms in China
  - Jiangsu: Massive debt default by SOEs and failings of TVEs
Broad Implications

- China vis-à-vis India
  - Superior macro performance of China, but China endowed with some substantial advantages over India
  - Puzzle: India today boasts some of the best performing domestic firms but China is falling way behind in microeconomic performance
# RELATIVE FDI SIZE, MACROECONOMIC DEVELOPMENTS, AND FDI CONTROLS 1993-1997

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<td>27</td>
<td>50.92</td>
<td>16.4</td>
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<td>8.56</td>
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<td>10.2</td>
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<td>-1.35</td>
<td>8.8</td>
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<td>-8.5</td>
<td>5.89</td>
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<td>Canada</td>
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<td>1.71</td>
<td>7.44</td>
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<td>United States</td>
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<td>15.57</td>
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<td>Indonesia</td>
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<td>Brazil</td>
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<td>20.13</td>
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<td>7.71</td>
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<td>Thailand</td>
<td>3.76</td>
<td>37.97</td>
<td>-6.28</td>
<td>5.05</td>
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<td>Taiwan</td>
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<td>-2.7</td>
<td>5.94</td>
<td>21</td>
<td>31</td>
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<tr>
<td>India</td>
<td>2.4</td>
<td>21.15</td>
<td>-2.64</td>
<td>6.61</td>
<td>45</td>
<td>45</td>
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<tr>
<td>Korea</td>
<td>1.06</td>
<td>35.71</td>
<td>-1.78</td>
<td>3.64</td>
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<td>13</td>
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THREE MANUFACTURING INDUSTRIES WITH THE LARGEST FDI VALUES FROM HONG KONG IN THREE COUNTRIES (PERCENT)

Taiwan (1974-1979) | Industry with largest Hong Kong FDI | 52.9 | Chemicals | 28.8 | Electronics and electrical appliances | 4.7 | Garment and footwear | 13.6 | All other industries | 86.4 |

Indonesia (1976) | Industry with largest Hong Kong FDI | 55.3 | Textile | 14.6 | Chemicals | 9.2 | Metal products | 20.9 | All other industries | 79.1 |

Malaysia (1977) | Industry with largest Hong Kong FDI | 57.9 | Textile | 9.1 | Food manufacturing | 8.3 | Chemicals or electrical and electronics* | 24.7 | All other industries | 75.3 |

China (1993) | Industry with largest Hong Kong FDI | 23.4 | Electronics | 12.1 | Plastic products | 11.2 | Textiles | 53.3 | All other industries | 46.7 |

* The two industries tie at 8.3%
INVESTMENT AND PRODUCTION ROLES OF SOEs IN CHINA’S MACHINERY INDUSTRY, 1997

<table>
<thead>
<tr>
<th></th>
<th>SOEs</th>
<th>Collective firms</th>
<th>Private firms</th>
<th>Foreign-funded FIEs</th>
<th>Overseas-Chinese funded FIEs</th>
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<tr>
<td>Long-term investment/net fixed asset ratio (%)</td>
<td>19.12</td>
<td>26</td>
<td>2.03</td>
<td>3.38</td>
<td>8.21</td>
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<tr>
<td>Operating income (100 million yuan)</td>
<td>8.36</td>
<td>0.2</td>
<td>33.46</td>
<td>8.98</td>
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</tr>
<tr>
<td>Investment income (100 million yuan)</td>
<td>16.11</td>
<td>1.59</td>
<td>0.001</td>
<td>0.48</td>
<td>0.15</td>
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### FIEs’ EXPORT SHARES OF TOTAL EXPORTS IN THREE ECONOMIES (PERCENT)

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<tr>
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<tbody>
<tr>
<td><strong>Labor-intensive industries</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Garment and footwear</td>
<td>60.5</td>
<td>33</td>
<td>7.7</td>
</tr>
<tr>
<td>Leather and fur products</td>
<td>73.2</td>
<td>19.7</td>
<td>9.6</td>
</tr>
<tr>
<td>Furniture</td>
<td>75.1</td>
<td>14</td>
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</tr>
<tr>
<td><strong>Capital- or technology-intensive industries</strong></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Electronics and electrical appliances</td>
<td>83.4</td>
<td>78.8</td>
<td>50.5</td>
</tr>
<tr>
<td>Paper and paper products</td>
<td>53.4</td>
<td>91.8</td>
<td>4.54</td>
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<tr>
<td>Chemical materials and products</td>
<td>31.6</td>
<td>86.1</td>
<td>34.9</td>
</tr>
<tr>
<td><strong>All manufacturing industries</strong></td>
<td>47.1</td>
<td>29.0</td>
<td>20.6</td>
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</table>

FIEs’ share of total exports
Contract exports

Contract exports
RELATIVE POLICY TREATMENTS: A SCHEMATIC REPRESENTATION

SOE
- Favored access to credit, foreign exchange, technology
- Superior legal and political status
- Allow bankruptcies
- Woo foreign investment in heavy industries
- Further codification

FDI
- Deng’s Southern tours
- Regional FDI liberalization
- Lift some ownership restrictions
- Scale down tariff benefits
- Allow direct export
- Constitutional revision
- Private entrepreneurs welcomed into the Communist Party
- WTO accession
- Liberalization terms to be implemented

Private Sector
- More credit to non-state firms
- Shut down regional stock markets
- Limited privatization
- Bank credit quota abolished
- Allow stock market listing

Time

More favorable

Less favorable

Policy treatment

- Tax concessions
- Debt forgiveness
- But allow some privatization

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FINANCING STRUCTURE OF THE BEIJING WARNER GEAR (MILLION YUAN)

Total capitalization: 247.1

Debt: 155.7 (63%)
Equity: 91.4 (37%)

Beijing Gear:
- Equity: 91.4 (61%)
- Debt: 55.8 (39%)

Borg-Warner:
- Equity: 35.6 (61%)
- Debt: 27.6 (39%)

Equity contribution:
- Equipment: 38.3
- Inventory: 17.5
- Cash: 27.6
- Technology: 5.2