Selling China: Foreign Direct Investment During Reform Era

(New York: Cambridge University Press, 2003)

Carnegie Endowment of International Peace
January 16, 2003

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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

$$Relative\ foreign\ competitiveness = \frac{Competitiveness\ of\ foreign\ firms}{Competitiveness\ of\ domestic\ firms}$$

- 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

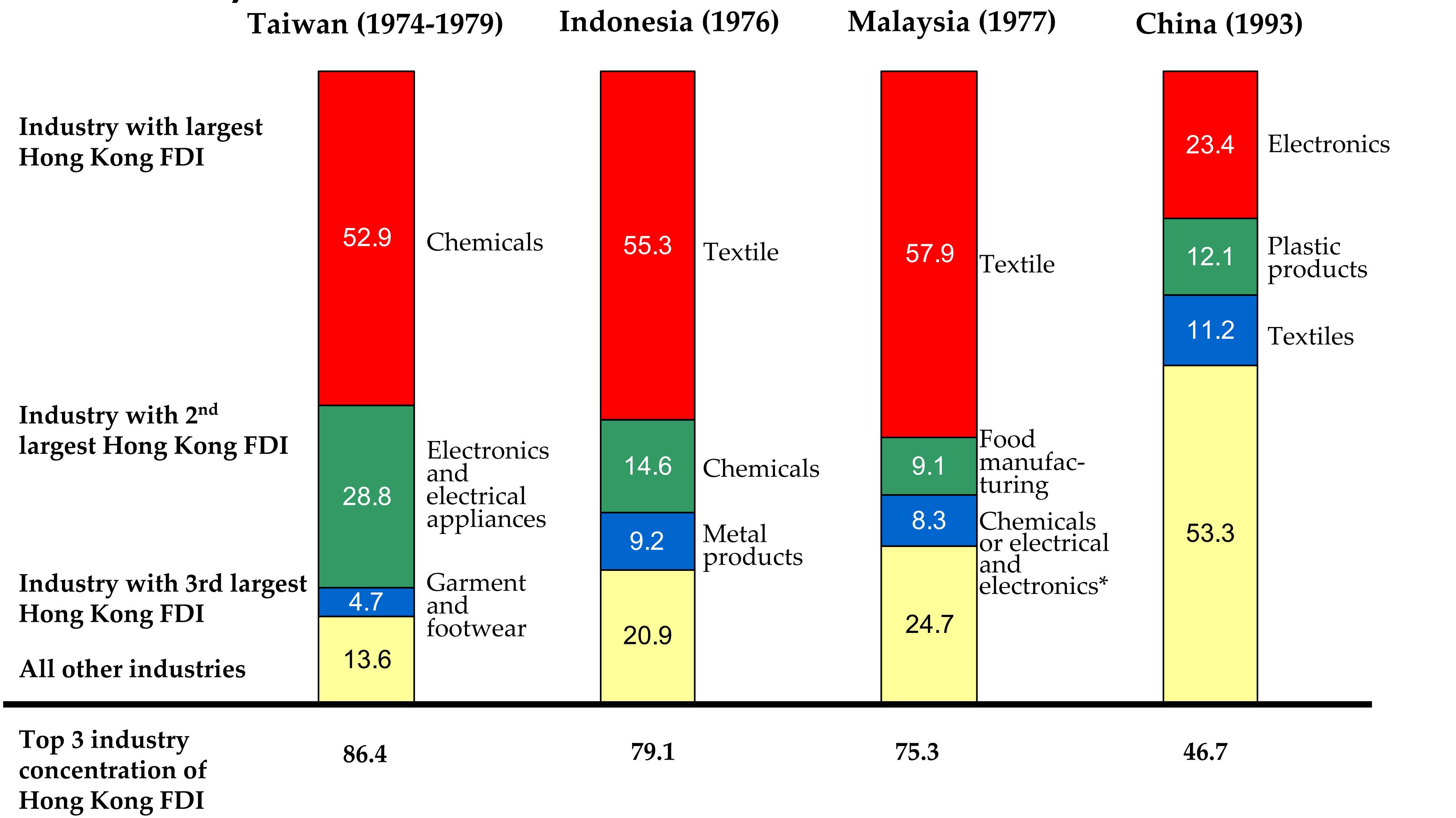
Broad Implications

- 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

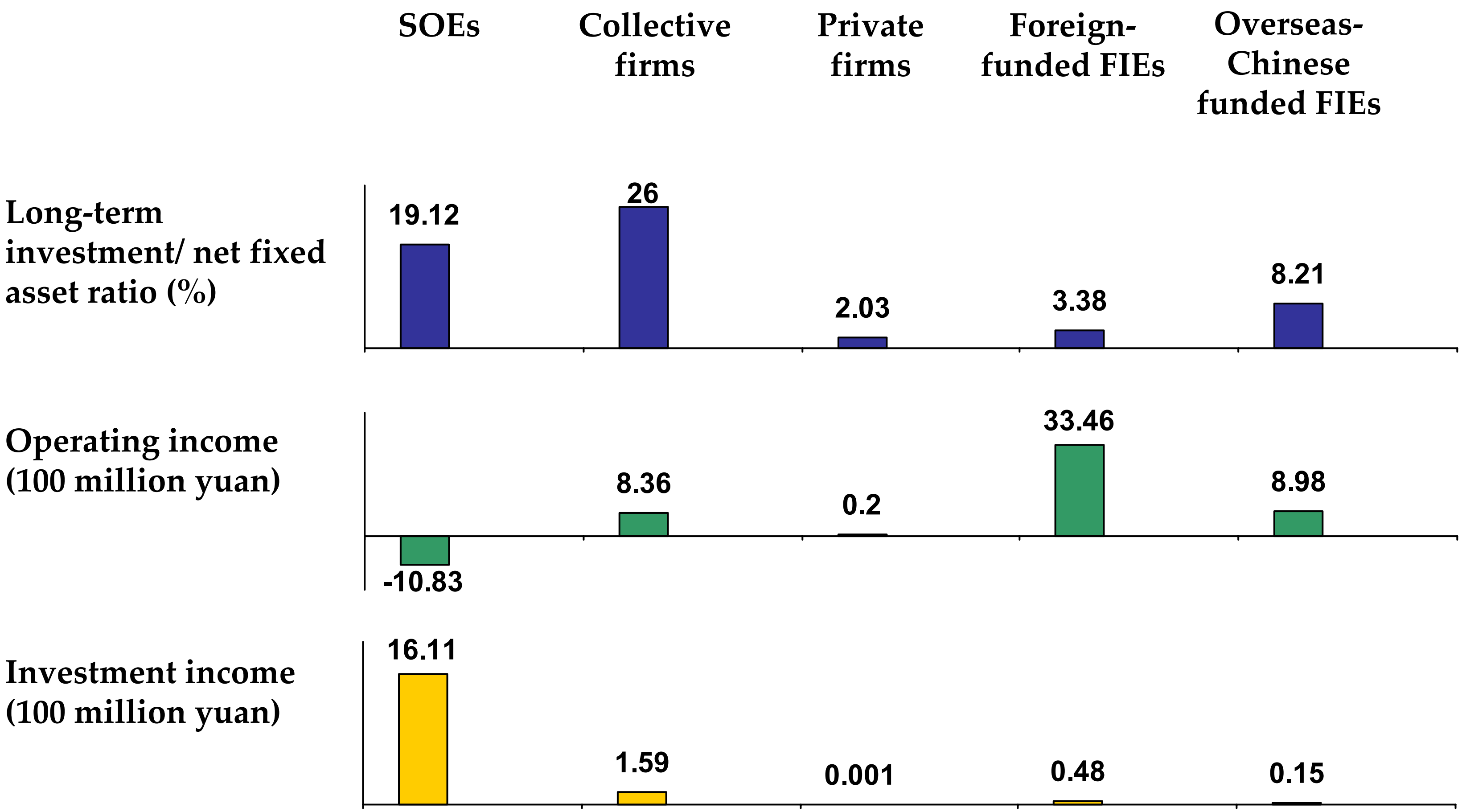
	FDI flows/gross fixed capital formation, 1993-1997 (%)	Gross domestic savings rate, 1994-1997 (%)	Current account balance/GDP, 1994-1997 (%)	Business environment for foreign investors: Ease of foreign acquisitions on 1-10 scale (country ranks out of 46 countries, 1996)	Business environment ranks, 1996-2000 (out of 60 countries)	Corruption perception rank, 1997 (out of 52 countries)
Singapore	27	50.92	16.4	7.69	6	9
Mexico	15.3	21.35	0.53	7.76	34	47
China	14.6	41.76	2.74	5.69	44	41
Malaysia	14.1	39.98	-0.75	4.73	24	32
United Kingdom	12.4	14.71	-1.61	8.56	4	14
Hong Kong	10.2	31.92	-1.35	8.8	3	18
Philippines	8.6	15.5	-8.5	5.89	35	40
Canada	8.28	20.37	1.71	7.44	5	5
United States	6.38	15.57	-1.61	8.56	1	16
Indonesia	6.14	33.5	0	6.29	46	46
Brazil	5.32	20.13	-0.77	7.71	38	36
Thailand	3.76	37.97	-6.28	5.05	30	39
Taiwan	2.78	25.6	-2.7	5.94	21	31
India	2.4	21.15	-2.64	6.61	45	45
Korea	1.06	35.71	-1.78	3.64	29	34

THREE MANUFACTURING INDUSTRIES WITH THE LARGEST FDI VALUES FROM HONG KONG IN THREE COUNTRIES (PERCENT)

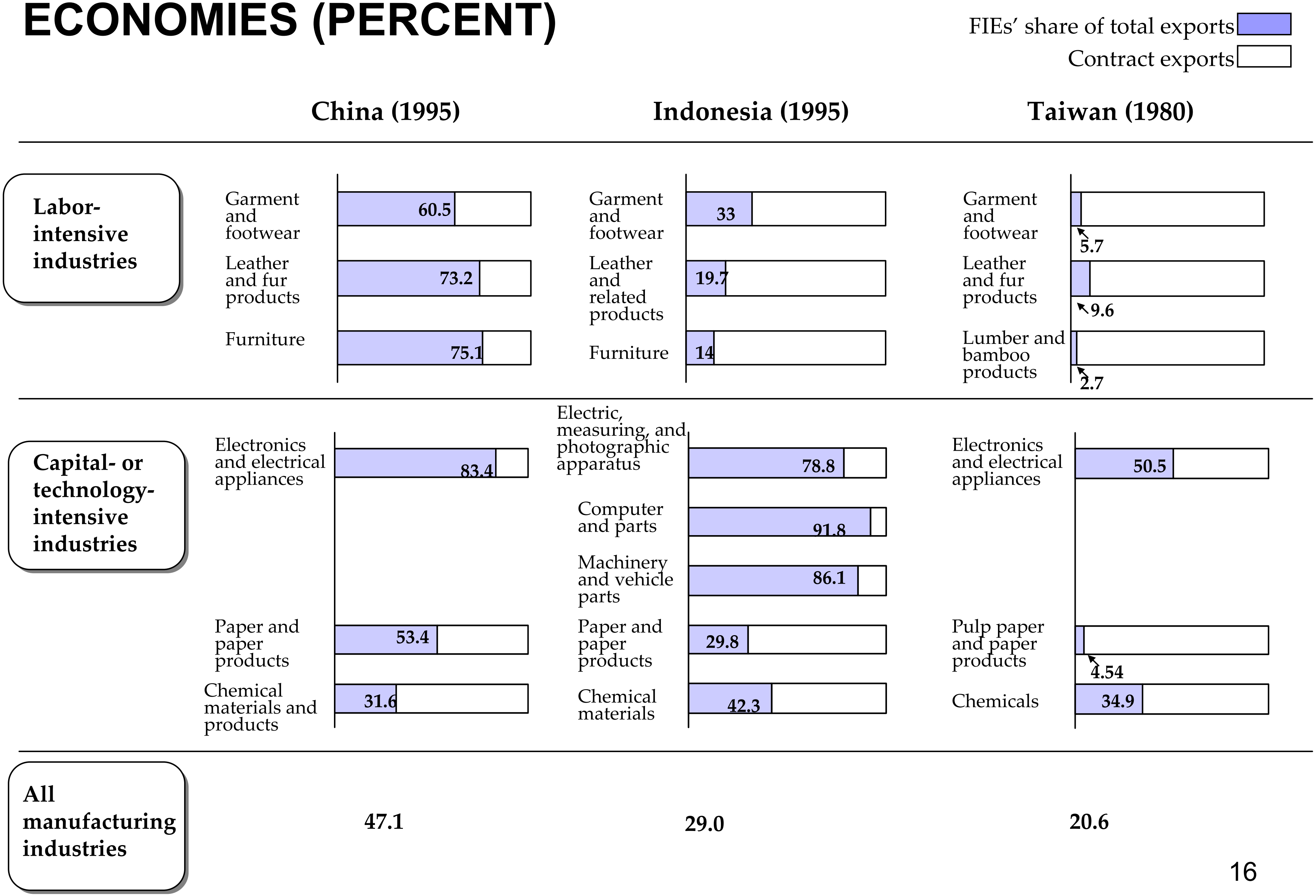


* The two industries tie at 8.3%

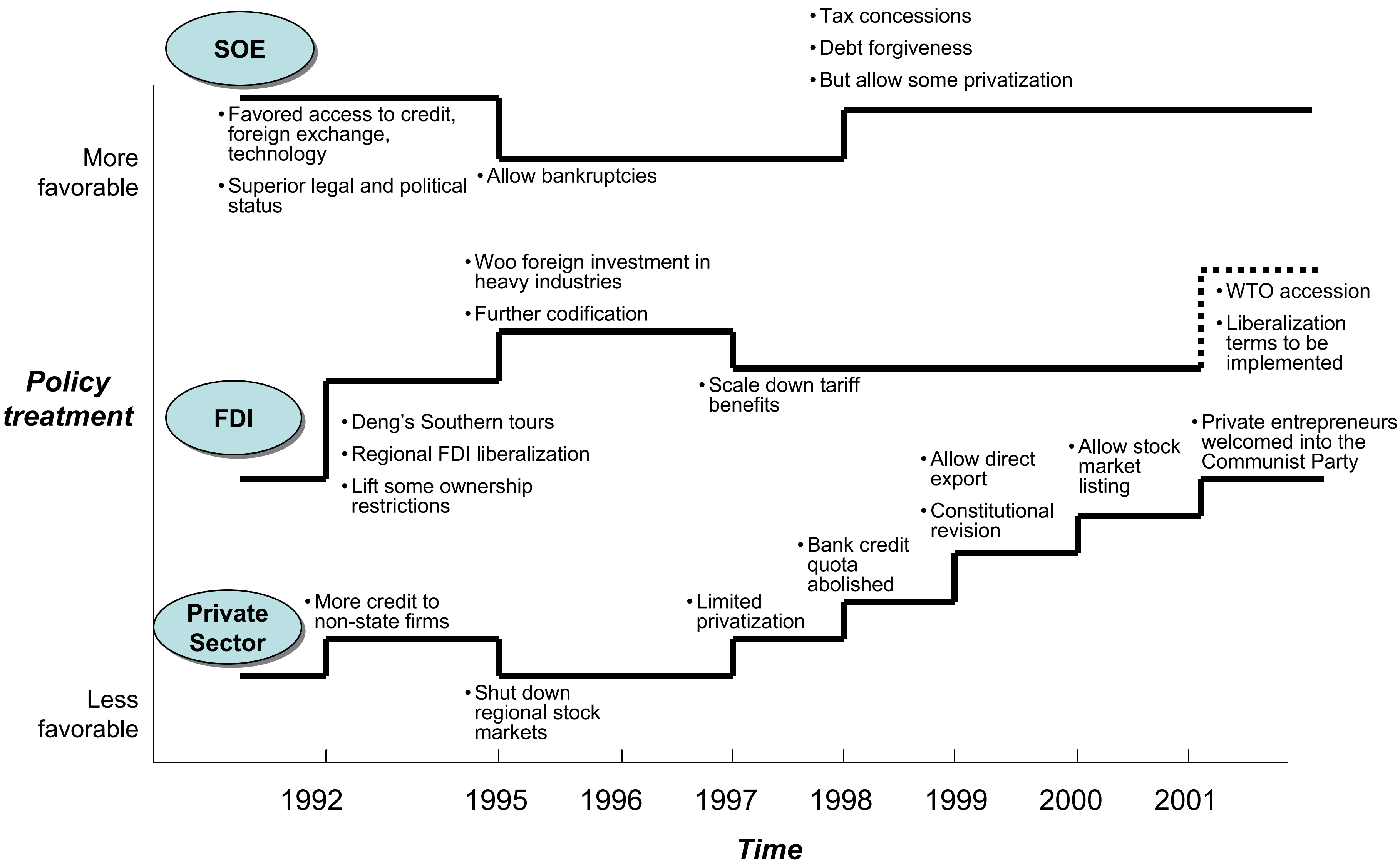
INVESTMENT AND PRODUCTION ROLES OF SOEs IN CHINA'S MACHINERY INDUSTRY, 1997



FIEs' EXPORT SHARES OF TOTAL EXPORTS IN THREE ECONOMIES (PERCENT)



RELATIVE POLICY TREATMENTS: A SCHEMATIC REPRESENTATION



FINANCING STRUCTURE OF THE BEIJING WARNER GEAR (MILLION YUAN)