The rise in China's FDI: myths and realities

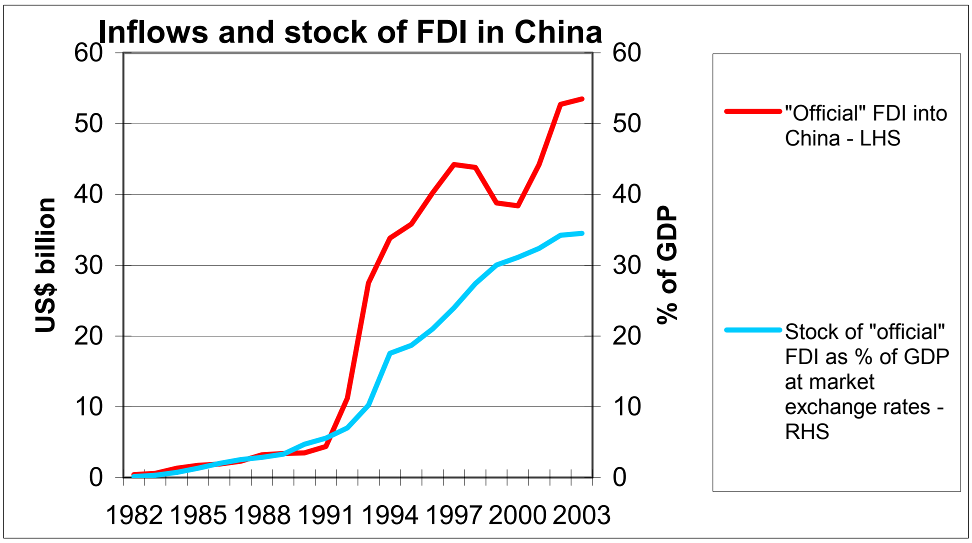
A conference paper by Alex Erskine

This paper suggests that the reality may be more awesome than the myths surrounding China's FDI.

Especially over the past decade, the reported inflows of foreign direct investment (FDI) into China have stood out while other destination countries have faced more difficult times.

China's annual FDI inflows and the stock – a simple cumulation of inflows since 1982 – as a % of GDP are set out in Chart 1.

Chart 1.



Source: Erskinomics

As the top line in the chart shows, Chinese FDI inflows have risen impressively from a very low base, recently exceeding US$50 billion annually. The stock now approaches US$500 billion, and – as charted – is 34% of China's GDP at market exchange rates.

In one year, 2002, China even topped the league table for inflows of FDI, briefly overtaking the habitual winning destination, the USA.

Thus, in comparsion to its economic size and despite its late start in opening up to accept inward investments, China's FDI stock is already broadly in line with UNCTAD estimates of the developing country average and higher than the global average of around 22% of GDP.

Meanwhile, the economic and financial crisis in much of Asia in 1997 and 1998 brutally interrupted investment decisions and the climate for capital flows, resulting in a significant downturn in the pace of FDI inflows into the affected countries, even while the surge in reported FDI flows into China strengthened.

This has led to fears of a "great sucking sound" in South East Asia, as earlier foreign direct investment (FDI) is withdrawn and flows to China, and no new FDI inflows are received. At the margin some previous FDI has moved, withdrawn especially – according to anecdote – from Indonesia, and no doubt new FDI decisions do look more to China.

Does this mean the paranoia is justified?

We need to exercise caution. The reality of the FDI flows into China is rather different to the officially-reported data and the graphic headlines.

One problem is that the Chinese FDI data is overstated[1]. Since the early 1990s, researchers with the IMF, World Bank and other international institutions have developed an evolving view that about a quarter or more of China's officially-recorded FDI is in fact not FDI at all. Instead it is mainland Chinese monies that have flowed out to access better financial, regulatory and legal services and "round-trip" by returning to China as apparent FDI to access the fiscal incentives and improved investor protection offered in China to foreign investors.

There is of course no firm data. An intrinsic secrecy surrounds "round-tripping" as it involves avoidance and evasion of rules and regulations. But there is certainly room for statistical doubt.

For instance, a 2003 OECD report cited the large gap between FDI flows from OECD member countries into China as reported by China (in the period under question, US$77 billion) and by the OECD countries themselves (US$39 billion).

Analysts also point to the numerical coincidence (and rising share) of China's FDI inflows from Hong Kong, the British Virgin Islands and other tax havens and the outflows recorded as "errors and omissions" in China's balance of payments.

The most enduring truth in economics is that people respond to incentives.

There are incentives to take funds out to escape from a poor regulatory environment where investor protection is in its infancy, incentives to secure improved regulatory arrangements and greater investor protection in more favourable foreign jurisdictions and incentives to re-invest in Chinese businesses as funds sourced from abroad.

Incentives offered by the mainland to foreign investors certainty provide a motive to route funds generated on the mainland via Hong Kong or elsewhere back into China as FDI to gain access to these privileges. The attractions include a corporate tax rate applied to Foreign Invested Enterprises (FIEs) of 15% for three years, after a two year tax holiday once they have recorded a profit, compared to a standard 33% rate for domestic firms, as well as duty-free concessions for imported equipment, improved land use rights and other advantages.

There are several avenues used to implement the exit leg of the "round trip" from the mainland. These outflows collectively are often pejoratively termed "capital flight", though not all are motivated by escaping from China ahead of a foreign exchange crisis. The most prominent means has probably been the age-old practice of under-invoicing for exports and over-invoicing for imports, and the even more old-fashioned practice of smuggling. In addition, funds have certainly flown out of the mainland to capitalise "Red Chip" Initial Public Offerings of mainland companies in Hong Kong.

About ¼ of flight capital later returns ("round-trips") as FDI when opportunities emerge[2].

There are also some more straightforward errors in the Chinese FDI statistics, which lead to overstatement. These no doubt will be ironed out over time as the statistical serve improves. For instance, the reported data includes PRC-based equity investment in FIEs as FDI, whereas the international standard is to only count funds from abroad.

While some have hoped (and even have expected already) to see "round-tripping" diminish as enforcement of exchange controls by China improved, the latest – June 2004 – analytical assessment, from the Asian Development Bank Institute's Geng Xiao, has concluded that "round-tripping" has previously been underestimated. He estimates it has contributed, and is contributing, around 40% of reported Chinese FDI inflows, in a range of 26% to 54%.

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[1] Unless indicated otherwise, estimates of the overstatement of FDI inflows into China are from Geng Xiao "Round-Tripping Foreign Direct Investment in the People's Republic of China: Scale, Causes and Implications" Asian Development Bank Institute Discussion Paper No. 7, June 2004.
[2] Frank R. Gunter "Capital Flight from China: 1984-2001" China Economic Review, forthcoming, referenced by ADBI 2004.

Applying Xiao's estimates to official Chinese data, the annual "official" inflows of around US$50 billion might deflate to an inflow of around US$30 billion and the cumulative stock that is actually FDI may only be US$300 billion, rather than close to US$500 billion. The overstated inflows and capital stock exist, but they ought not be classified as FDI.

What are the implications of the "round tripping"?

Xiao surmises that "the pattern of capital flight and round-tripping FDI is largely a statistical issue and has little implications on efficiency or resource allocation". But this seems itself to understate the full implications.

On one hand, China has gained enormous publicity for its FDI inflows, which continually has served to undermine the claims for a "share of foreign investors' minds" put forward by other Asian competitors. Instead they have discouraged themselves by imagining the "great sucking sound".

On the other hand, this "success" may be a cost to China and its longer-term growth and development, even though some individuals have enjoyed a private benefit. One obvious danger is that Chinese policy-makers may believe the "good news" and delay necessary reforms.

China's accession to the WTO in December 2001 requires the termination of preferential incentives for FIEs and the imposition of a unified tax system applicable to all corporates irrespective of origin. But implementation is unclear. Unification is currently mooted for 2006, and a 24-28% rate has been speculated, but the details are still lacking. In any event, the existence of the "round-tripping" shows the Chinese regulatory landscape can be greatly improved.

It would not be useful if China's competitors were to simplistically accept that FDI inflows to China have been overstated. They may decide to relax their efforts to compete. The metaphorical "great sucking sound" may yet emerge, even if it has been more myth than reality so far.

Consider this: If Chinese inflows are deflated by deducting apparent "round-tripping", then at market exchange rate estimates of GDP China's stock of inward is well below the developing country benchmark and probably even below the global average of 22% of GDP. If so, the world's businesses probably do not have as much exposure to Chinese fixed assets and the cheap mainland labour supply as they may see as appropriate. In future any such under-weighting will have to be corrected.

The potential shortfall is very likely to be even greater. The international best practice for converting current price GDP of a range of countries to a common currency is to use Purchasing Power Parity (PPP). Market exchange rates can be very distorted, even for long periods. By contrast, PPP has long-term mean-reverting properties – essentially it serves as an "economic truth". PPP exchange rates are especially appropriate for a long-run analysis of economic potential of developing countries.

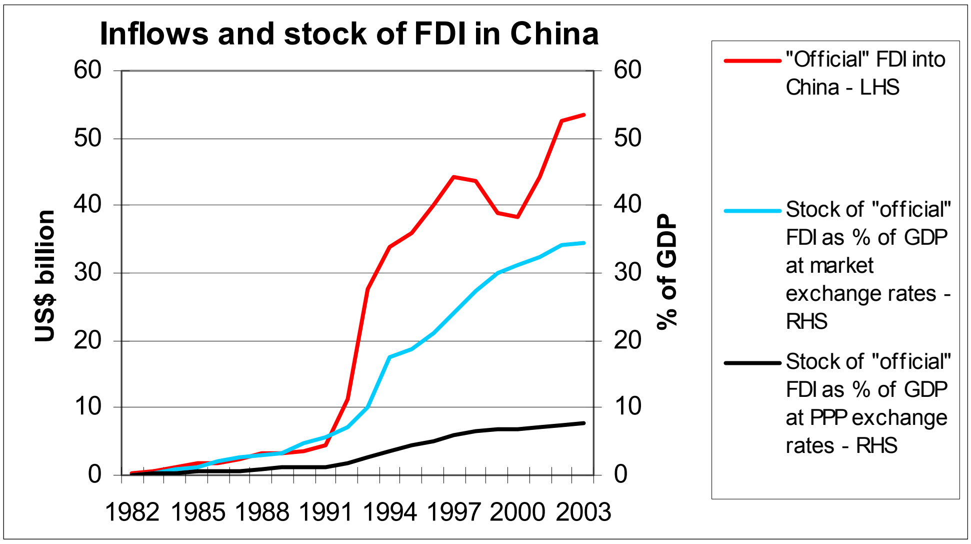
If we allow a short theoretical diversion, developing countries that being successful almost always do so from achieving an improvement in productivity in the tradeables sector exposed to international competition. This gain is almost bound to flow into the non-tradeables sector that is sheltered from international competition, either through faster price rises or through an appreciation in the nominal exchange rate. Both would produce a rise in the real exchange rate[3]. In practice, this is manifest as a closure of the usual gap between the initial very competitive nominal exchange rate and PPP. China's market exchange rate is undervalued by more than 4 times according to IMF's assessment of PPP[4].

[Note that this is not an argument for immediate appreciation of the Chinese currency. It is instead a long-term assessment that may be resolved by a mix of shifts in relative inflation rates and by productivity growth, as well as by nominal exchange rate moves.]

Using PPP to gauge the size of China's economy, it would seem that the world's businesses are not merely underweight but massively short of productive assets in the Chinese economy. The "official" stock amounts to only 7.7% of China's GDP when valued in PPP US$ – see the lowest line in Chart 2.

[3] This is the "Balassa-Samuelson" effect familiar to development economists.
[4] See the IMF International Financial Statistics on-line edition.

Chart 2.



Source: Erskinomics

If "round-tripping" were deducted, the stock of "genuine" FDI might amount to only 5% of Chinese GDP valued at PPP exchange rates, and possibly less. Thus, a sustained high level of "genuine" FDI inflows lies ahead as China continues to globalise and the economy grows and regulations improve.

At the same time, "round-tripping" FDI inflows can be expected to decline. At present the large Californian pension fund manager CalPERS restricts its overseas asset allocations to qualified markets, and China does not qualify. Though this directly affects portfolio investment in China, it seems clear that improved investor protection in China – which might attract CalPERS to lift its restrictions, would also serve to encourage domestic Chinese capital to remain for investment at home

Let us summarise the drivers of this switch from "round-tripping" to "genuine" FDI inflows, as follows:

- The drivers of reduced "capital flight" seem likely to include expectations of nominal appreciation of China's currency, which have already turned round from habitual fears of depreciation, and future improvements in the protection of domestic Chinese investors.

- A reduction in "round-tripping" FDI would seem to mainly rely on the move to the unitary tax system and reduced concessions for FIEs.

- There are several potential drivers of increased "genuine" FDI, including development of deeper and more efficient financial institutions and capital markets in China, which depend on more extensive adherence to the rule of law; continued expansion of developing country and developed country MMCs, which therefore will look at expansion into China; and some longer-term convergence between China's PPP and market exchange rate.

The twist in the tail of this story is that the surge in capital inflows into China as "genuine" FDI appears to have a long way to run. Other countries ought not relax their efforts to compete for FDI simply because China may have overstated its success in attracting inflows to date. Improving the climate for business in every country remains a priority.

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