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THE IMPORTANCE AND EVOLUTION OF FDI INFLOWS IN CHINA

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Abstract:
Foreign Direct Investment (FDI) produce a plethora of positive direct effects on the host countries, such as additional resources and capabilities, added tax revenues, and GDP growth. Furthermore, they link the host economy to the global marketplace and improve the balance of payment. Apart from these direct effects, there are also many indirect consequences that must be taken into consideration, such as new management styles, new work culture, and more dynamic competitive practices. The sustained flow of FDI into developing nations is without a doubt an important stimulus for economic growth. In the present paper, the main objective is to present the inward FDI in China over the last 5 years, while highlighting the impact of the pandemic on the investment inflow. To achieve this goal, I have explained the importance of FDI inflows in the economic development of a country, I presented China's macroeconomic performance in recent years, and finally, I performed an analysis of the evolution of FDI inflows in China for the period 2017 – 2021. Regarding the methodology used, I have elaborated quantitative research, by collecting information and data from China`s national statistics, international statistics, and from specialized literature. The hypothesis of the research is that despite being the country where the pandemic broke out, China managed to remain an attractive place for foreign investors.

Keywords: *China, FDI inflow, economic growth*

JEL classification: *F21, I18, O53*

1. Foreign direct investment, definition, importance, and evolution

Economists distinguish between two types of foreign investment: foreign direct investment and foreign portfolio investment. According to the Corporate Finance Institute, foreign direct investment (FDI) represents an investment from a party in one country, into a business or corporation in another country, with the intention of establishing a lasting interest, which represents at least 10% of the voting power in a firm. On the other hand, foreign portfolio investment is an investment that implies the purchase of securities and other financial assets, such as stocks, bonds etc., by investors from another country. (CFI, 2022). Before 1914, long-term portfolio investment was more important than FDI, as the latter was relatively short-term. After the Second World War, FDI began to grow extensively, with the US being the main source, and the favorite target in the 1980s and 1990s. Compared to foreign portfolio investment, FDI is nowadays viewed as one of the more stable sources of private international investment that has a positive role to play in supporting long-term sustainable development.

FDI can be undertaken by institutions, corporations, and individuals, and can be made by establishing a subsidiary of a domestic firm in a foreign country, acquiring or merging with an existing foreign company, or starting a joint venture partnership with a foreign company. Companies resort to FDI for many different reasons, each being very important. A first reason could be the desire to look for growth opportunities through market diversification. Foreign markets offer opportunities to sell products that cannot be obtained on the national market, moreover, they can extend the marketable life of products or services that have reached maturity on the home market. Increasing sales helps companies benefit from economies of scale, respectively to reduce their average production cost. The larger the business, the more the cost savings. An equally important reason in the business world would be to obtain a higher profit margin. Less intense competition in the foreign market, combined with strong demand, give companies the opportunity to apply higher profit margins. Proximity to the sources of supply is also very important, so companies active in extractive industries such as oil, mining and forestry, invest in the

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countries where the raw materials are located. Internationalization helps companies to have access to production factors, such as capital, technology, managerial skills, and labor force at lower costs or of higher quality. Regardless of the reason behind internationalization, FDI allows companies to benefit from many opportunities on foreign markets.

Besides the advantages felt by the companies, FDI can also stimulate the target country's economic development. Foreign direct investment in developing countries can create jobs, develop technology and new productive capacity. When it involves firms with international coverage, it can help local firms access new international markets through the intra-firm trade linkages generated by the operations of multinational enterprises. (OECD, 2014). One of the main benefits of FDI is the creation of new jobs in the host country, as investors build new companies. This leads to a decrease in the unemployment rate, an increase in the standard of living of the population and lifting people out of poverty. Most of the time, foreign companies offer more advantageous salaries compared to local companies, so more jobs and higher wages contribute to the national income increase. The development of human capital resources is another big advantage of FDI. The knowledge and skills obtained by the workforce through training, increases the overall education and human capital within a country. The human resource thus remains in the country, specializes in the workplace, receives an attractive salary, no longer having to emigrate. To attract FDI, countries seek to offer a competitive tax environment, without neglecting the revenues obtained by the state through taxes collected from investors. The greater the number of companies that invest in a country, the greater the number of their employees and the greater their financial performance, the greater their contribution to the state budget.

Despite many benefits, there are still some negative effects of FDI on the host country. On one hand, once a large firm invests in a country, it may drive out local businesses that cannot compete with its lower prices. Another concern is the negative impact on the environment of the host country, for example in China studies show that FDI has significantly worsened air quality and that the effect is more significant in big cities (Liu S., Zhang P., 2022). Last but not least, critics are worried that the move toward giving foreign investors unfettered access to global markets will undermine the sovereignty of host governments. In the context where Walmart's turnover is higher than the GDP of many countries, studies reveal that in some cases, states have lost a significant share of sovereignty to multinational authorities (Bezuidenhout H., Kleynhans E., 2015)

Despite FDI importance for both investors and host countries, the past three decades have demonstrated that this type of investment can be volatile. The growth in FDI inflows, powered by investment in services as well as manufacturing, was brought to a halt in 2000, due in part to the bursting of the dot-com bubble. Secondly, in 2009, foreign direct investment inflows fell by approximately 35% during the first two years of the global financial crisis that emerged in 2007-2008. Since then, FDI inflows have been unstable (Fig. 1) fluctuating, with no clear trend emerging. It registered the third decrease in 2018, largely due to the US tax reform which prompted US parent companies to repatriate large amounts of earnings held with foreign affiliates. The lowest level in the last 15 years, both in terms of inflows and outflows, was registered in 2020, due to the COVID-19 crisis.

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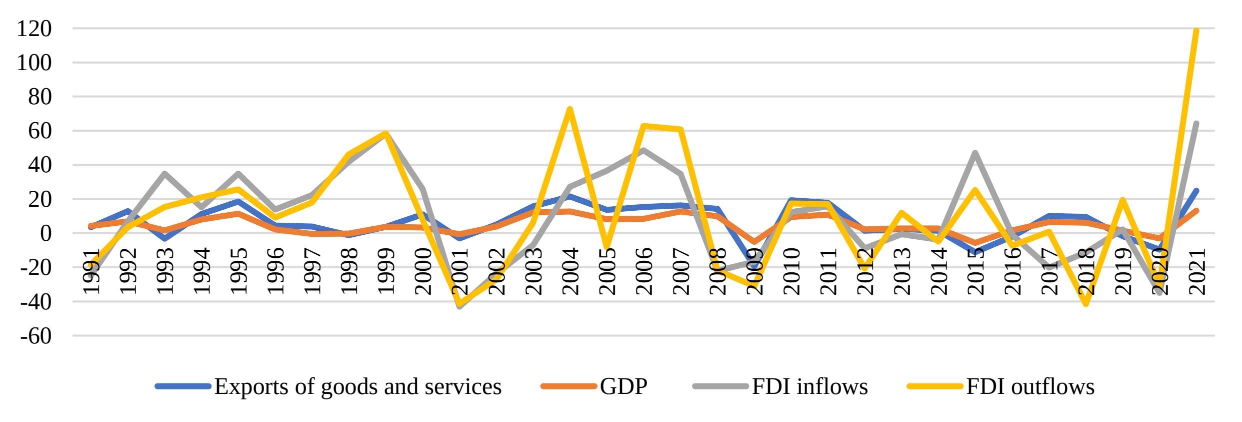
Figure 1: World indicators 1991 – 2021 (growth rate)



Source: The World Bank, Data (a), 2022; The World Bank, Data (b), 2022; UNCTAD (a), 2022

Despite these fluctuations, since 1990 the flow of FDI has accelerated faster than the growth in the world trade and the world output. A first reason cound be rising protectionism worldwide, as FDI is seen as an opportunity to avoid trade barriers. The trade war generated by the protectionist measures taken by the Trump administration, and UK`s decision to leave the European Union generated a lot of pressure on executives. Another reason that favored the spread of FDI was globalization, which facilitated the development of international business. Globalization represents a spread of ideas, principles, culture on a global scale, embraced by more and more people. Globalization also means a deterritorialization, the territory does not disappear but it becomes less and less important in the relations between people. Time and space have become less important obstacles in human interaction as technologies have made communication and distance between people easier and faster. In this context, many firms see the whole world as their market and seek to be present in as many countries as possible with the help of FDI. Advances in the field of information and communications technology have been a remarkable facilitator of cross-border investments, significantly reducing international operating costs. Also, the integration of world financial markets made it possible for internationally active companies to raise capital, borrow funds and engage in foreign exchange transactions much easier and faster.

Thirdly, it must be emphasized that much of the increase in FDI has been driven by the political and economic changes that have been occurring in many of the world's developing nations, also facilitated by the World Trade Organization (WTO). The general shift toward democratic political institutions and free market economies has encouraged FDI. Across much of Asia, Latin America and eastern Europe, economic growth, economic deregulation, privatization programs that are open to foreign investors, and removal of many restrictions on FDI have made these countries more attractive to foreign multinationals. (Hill C., 2022). The tendency of governments in these regions to reduce barriers to trade and investment has accelerated internationalization. The loosening of government control and the privatization of some state-owned companies encouraged economic efficiency and attracted massive foreign capital into their national economies. Many emerging markets have transitioned over time from being producers of low-value-added goods to sophisticated, competitive producers and exporters of premium products such as electronics, computers, and aircraft.

2. China`s economic progress

Between 1949 and 1970, China was an autarchic state, which was based entirely on its own resources. Chinese Communist Party (CCP) leaders feared that interaction with foreigners would affect the country's culture and corrupt its politicians, so they banned foreign investment and restricted foreign trade. Disastrous central planning destroyed agriculture and industrial productivity. Thereby, constrained by the economic challenges the country faced, at the end of the 1970s, the political leaders reconsidered their decisions. In 1978 China opened its market to the world and instituted the Law of Joint Ventures Using Chinese and Foreign Investment.

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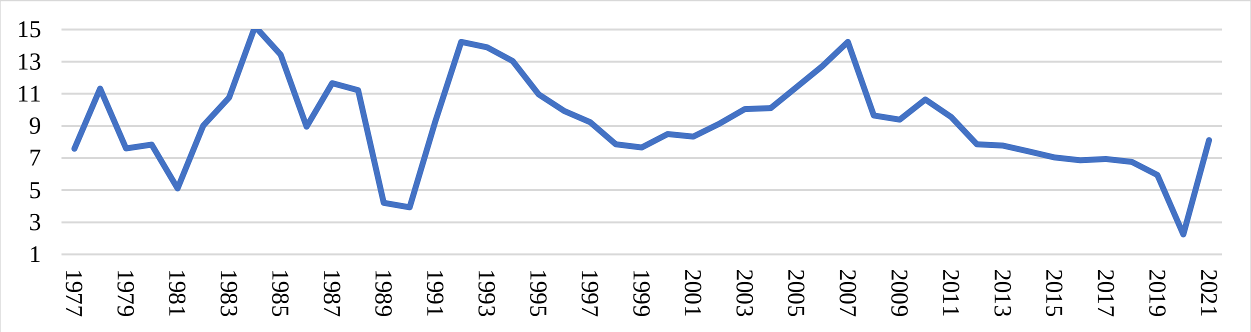
The incorporation of China into the world capitalist economy has resulted in 800 million people being lifted out of poverty (The World Bank, 2022), while there has been a large growth in the middle class. During this period, it made great progress in the field of health and education, the Human Development Index increased from 0.5 in 1990 to 0.761 in 2019, placing the country in 85th place in the world (Human Development Reports, 2022). China has evolved from being an assembler of parts to having its own dynamic industries and world-beating corporations. It has accumulated the greatest financial reserves in the world (The World Bank, Data (c), 2022) while building infrastructure across the developing world, through the strategy `China Belt and Road Initiative`. Since it has opened its market to the West, it had enjoyed sustained economic growth, with an annual average rate of 9.2% (Fig. 2), being in second place in the world in terms of GDP, starting with the year 2010 (The World Bank, Data (b), 2022). Also, the country`s GDP per capita increased since 1978, moving China into the ranks of middle-income countries (The World Bank, Data (d), 2022).

Figure 2: China, GDP growth (annual %)

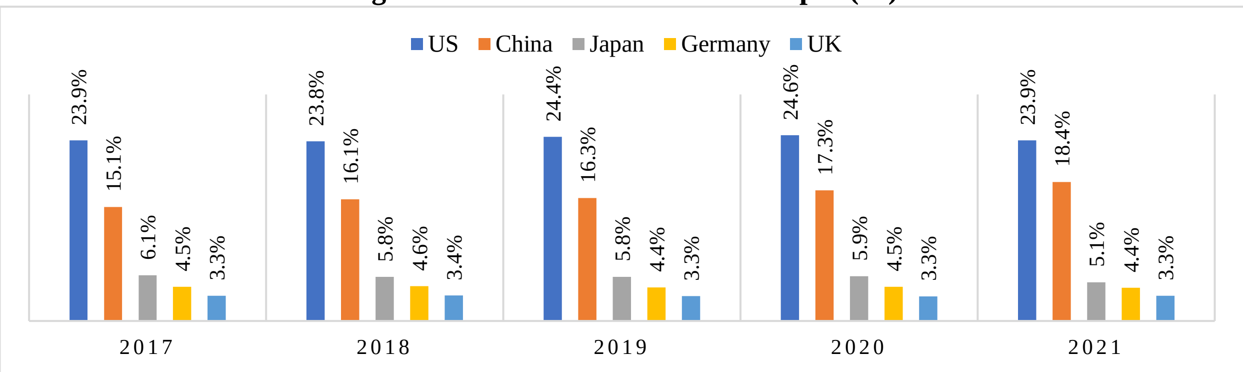


Source: (The World Bank, Data (e), 2022)

China's economic liberalization has led to an increase in exports, China becoming the largest exporter of goods in the world since 2009 (Jahn M., 2021). In the last 5 years, including during the COVID-19 pandemic, China managed to grow slowly but surely the share of the world output, as can be seen in Fig. 3. Even though all G8 countries (World Bank, Data, The World Bank, Data (e), 2022) and EU member countries, except for Ireland (Eurostat, Data, 2022), recorded an economic decline in 2020, China managed to register a GDP increase of 2.2%. The way China managed to deal with the virus that killed more than 2 million people, once again strengthens China's position as the dominant economy in Asia.

Unlike Western governments that lowered borrowing rates and handed out money to consumers, China kept interest rates relatively higher and focused on restarting factories as in January and February 2020, the country`s industrial production registered an unprecedented 13.5% decline. In the context of the new Omicron wave, in April 2022, China recorded a new drop in industrial production of -2.9%, a lower level compared to early 2020, managing to recover very well (Trading Economics, 2022).

Figure 3: The share of the world output (%)



Source: The World Bank, Data (b), 2022

In China, small and medium-sized enterprises (SMEs) account for 80% of non-government employment, contributing substantially to the country`s economy. These companies were affected both by the trade war between the US and China, as well as the government's restrictions during the pandemic. Access to financing has become more and more difficult and expensive, which is why the Chinese government has taken measures. During the pandemic years, the Chinese government avoided `flooding` the market with liquidity and used fiscal and monetary measures to avoid the devastating impacts of the pandemic and stabilize the economy.

From a fiscal point of view, China has turned to waivers, refunds and reductions to corporate income tax, value-added tax, and individual income tax, applied to small businesses and companies in industries that were particularly hard-hit by the pandemic. Moreover, local governments, raised money by means of special-purpose bonds (SPBs), which they invested in infrastructure and other public projects within their jurisdiction, meant to boost the country`s economic growth.

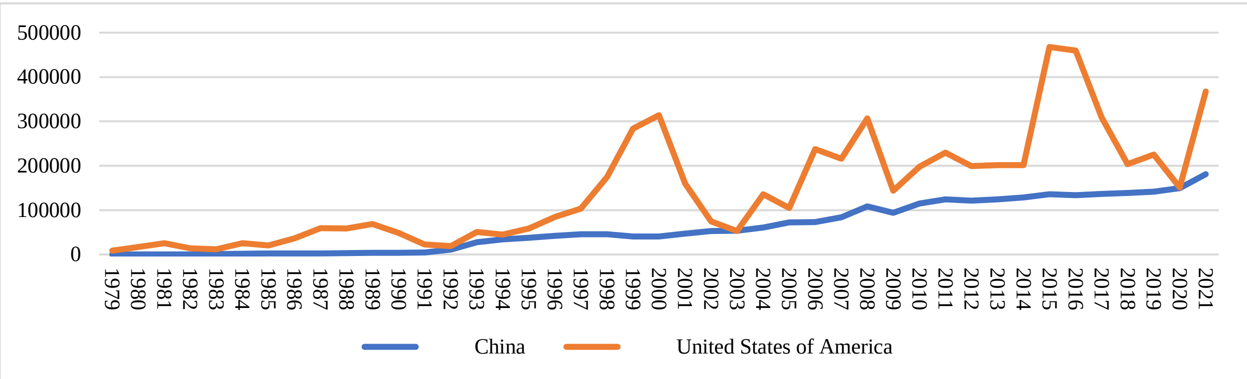
In regard to monetary policy, The People's Bank of China (PBoC) implemented a series of measures meant to maintain the liquidity in the banking system and to provide low-cost lending. PBoC managed to increase liquidity by reducing the reserve requirement ratio (RRR) in January, March and April 2020 which allowed the banks to provide more credits and pump a total of CNY 1.75 trillion ($245 billion) into the banking system. Moreover, the PBoC reduced the reverse bond repurchase agreement rate in February and March 2020 and the loan prime rate (the benchmark interest rates charged by commercial banks for their most creditworthy customers) in February and April 2020.

The five key commercial banks in terms of equity and market share in China, which are state-owned, received explicit directives from PBoC Governor, Gang Yi, to sacrifice profits to benefit corporate borrowers, helping reduce their borrowing costs. The banks were called to sacrifice 1.5 trillion yuan ($212 billion) in profits to finance cheap loans, cut fees, defer loan repayments, and grant more unsecured loans to help small businesses survive the downturn caused by the coronavirus lockdown. (Yeung G., 2020)

3. FDI inflows in China

China's economic growth has attracted in recent decades substantial foreign investment. Since 1980s tens of thousands of companies, of every sort, size and nationality have entered China, attracted by the market potential, consumer demand and labor productivity. Total FDI, almost non-existent in 1980, reached $181 billion in 2021, making China the second largest recipient of foreign direct investment in the world, after the US. There the inflows of FDI registered an inconstant evolution over the last 50 years, being affected by the global crises, whereas in China, they registered a small but steady increase from year to year (Fig. 4).

Figure 4: Inward foreign direct investment, annual (million $)



Source: UNCTAD STAT, 2022

And yet why do companies invest in China, regardless of the global context? A very important reason lies in the decision that the Chinese leadership took to move the economy away from a centrally

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planned socialist system to one that is more market driven, moving progressively toward greater free market reforms. Before joining the WTO in 2001, the average import tariffs in China were 15.4%. At these high tariffs, it was expensive for companies to serve the market through exports, so FDI was necessary if a company wanted to take advantage of the country's huge potential.

In 2020, the average import tariff in China was 5.3% (The World Bank, Data (f), 2022), and the Most Favored Nation (MFN) tariff rate was 7,6% (The World Bank, Data (g), 2022), still above the average rate in many developed countries. This level remains high especially due to the trade war with the US, so avoiding import tariffs was and is an important motivation for companies to invest in China. To reduce the administrative barriers to trade and liberalize its foreign trading system, starting with 2005, China began removing quota and licensing requirements from most imports. At the beginning of 2022, only 14 categories of commodities, including ozone-depleting substances and key used mechanical and electronic products, were subject to import licensing control. (Poon C. H., 2022)

A great opportunity that companies have in China is the huge and largely untapped market, China being the country with the largest population in the world, respectively 1.4 billion people (The World Bank, Data (h), 2022). In China, companies have access to a skilled, hard-working, relatively cheap workforce and quick access to the resources needed in the supply chain. This market isn't limited to the local population, but to all other nations with which China has signed free trade agreements. Free Trade Agreements (FTAs) represent another way China opened to the outside, an approach to integrate into global economy and strengthen economic cooperation with other countries. Currently, China has 24 FTAs under construction, among which 16 agreements have been signed and implemented already. (Ministry of Commerce People`s Republic of China, 2022)

Another reason why companies invest in China is the combination of relatively inexpensive labor and tax incentives, particularly for enterprises that establish themselves in the special economic zones. Currently, in China, there are 21 special economic zones (SEZ), or free trade zone (FTZ) as they are also called, the first being created in Shanghai in 2013. The reason for which these SEZs were created was to support and promote foreign direct investment in various industries and in various regions. In these regions, goods may be stored, handled, processed, re-exported, without the intervention of the local customs authorities.

The companies registered in these SEZs benefit from lower taxes and better economic conditions for their business, such as: lower corporate tax rates, import tax exemption until goods are moved out of the SEZ/warehouse, no fees for converting major currencies, a fast and streamlined customs clearance, a hub of transportation, pick and pack and logistic service providers nearby, a faster VAT refund. (Cremailh V., 2021)

In the first year of the COVID-19 pandemic, global foreign direct investment were strongly affected, recording a 35% decrease compared to 2019 (Table. 1). This was the lowest level since 2005, not even during the financial crisis of 2008-2009 such a decrease was recorded. The collapse of FDI inflows in 2020 was much larger compared to the global GDP decrease of 3.3% (The World Bank, Data (e), 2022) or to the world trade in goods and services decrease of 12% (World Trade Statistical Review 2021, 2021). The restrictive measures adopted by governments to prevent the spread of the pandemic, as well as the uncertainty about the future, have stopped the investment projects carried out by multinationals.

As can be seen in Table 1, the most affected were the developed countries, where the decrease in FDI was 58%, while developing countries registered a decrease of only 10%. In the US the FDI inflows decreased by 33% to $151 billion, mainly because of a reduction in reinvested earnings. China did not follow this trend, as in the first year of the pandemic it recorded a 5.6% increase in FDI inflows to $149 billion, ranking 2nd, very close to the leading US. Most of the attracted funds went in high-tech industries, ICT and pharmaceutical industries. China`s performance was due to the way in which the country managed to keep the pandemic under control, to the rapid GDP growth recovery, investment facilitation efforts and continuing investment liberalization.

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Table 1: FDI inflows 2017 – 2021 (billion $)

Region/economy	2017	2018	2019	2020	2021
WORLD	*1.632*	*1.448*	*1.480*	*963*	*1.582*
Developed economies	937	753	764	319	745
Developing economies	694	694	716	643	836
Asia	*501*	*496*	*511*	*518*	*618*
Europe	*513*	*398*	*404*	*80*	*219*
North America	*331*	*240*	*275*	*174*	*427*
South America	*103*	*103*	*110*	*50*	*88*
Africa	*40*	*45*	*45*	*38*	*82*
United States	309	203	225	151	367
China	136	138	141	149	181
Hong Kong, China	110	104	73	134	140
Singapore	82	73	106	75	99
India	39	42	50	64	44

Source: UNCTAD (b), 2022

In 2021 global FDI inflows returned to their pre-pandemic level, registering a 64% increase compared to 2020. The largest increase was recorded among the countries most affected by the COVID-19 pandemic, respectively developed countries, by 143%, but failing to outrank FDI inflows from developing countries (Table 1). FDI inflows in China increased by 21% in 2021, the highest increase recorded in the last 10 years, the country remaining the major catalyst of FDI inflows to Asia. Despite significant uncertainty surrounding developments related to geopolitical and commercial tensions, MNEs continue to invest heavily in China, considering it an indispensable strategic market. They are also encouraged by its rising purchasing power, well-developed infrastructure, and generally favorable investment climate.

4. Conclusions

Following the research carried out, we can conclude that the hypothesis from which we started has been verified. In the last 5 years analyzed, China managed to rank 2nd in the world in terms of FDI inflows, and in the first year of the pandemic, thanks to the decisions adopted by the government, the country reduced the gap to the leading US by $2 billion. By analyzing the ease of doing business in China, we found that in 2020, China was in 31st place, out of 190 economies analyzed (Table 2). From year to year, China's position at the global level has improved, as in 2006 it was on position 91 and in 2016 on position 84.

Table 2: Ease of doing business in China, ranking, 2020

	China – 31st place
Starting a business	27
Dealing with construction permits	33
Getting electricity	12
Registering property	28
Getting credit	80
Protecting minority investors	28
Paying taxes	105
Trading across borders	56
Enforcing contracts	5
Resolving insolvency	51

Source: Doing Business (a), 2020

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China`s central government has the ongoing ambition to improve the competitiveness of the country`s economy. For example, from 2006 to 2020, China has substantially improved the process of obtaining a construction permit, halving the number of necessary procedures from 36 to 18. Moreover, in recent years, China has implemented business tax reforms with impressive results. In 2006 businesses in Shanghai spent 832 hours per year on average to prepare, file, and pay taxes, having to make 37 payments, while in 2020, these metrics have been reduced to just 138 hours per year and 7 payments. (Doing Business (b), 2020).

China has modernized the IT infrastructure to increase efficiency, reduces physical interactions between tax officials and taxpayers, and eliminate the physical exchange of cash. Also, in the last 4 years implemented a series of measures, which simplified corporate income tax, labor taxes, value added tax declarations, and e-delivery of invoices. Only in 2020, out of the 10 areas of the Ease of doing business indicator (Table 2), China improved 8 of them. China's sustained efforts to create a more welcoming business environment and to facilitate the opening of businesses in the country have resulted in a more attractive environment for investors and increased FDI inflows.

And yet, to increase the degree of attractiveness for foreign investors, China must adopt many other reforms. Despite the spectacular growth of GDP in recent years, China still lags developed nations in the wealth and sophistication of its consumer market, which limits the opportunities for foreign companies. For example, in 2021, the level of GDP per capita in China was only $12,556.3 (The World Bank, Data (d), 2022). Also, income disparities among different regions have become starker, as income and wealth in China are concentrated in a few more developed regions, especially in the coastal provinces. In 2017, income per capita in Beijing and Shanghai were over four times higher than that in the country`s poorest provinces. (AMRO, 2019)

Investing in China is not easy also due to the country`s political and legal system. China controls the degree and conditions under which it participates in the global economy and the foreign actors it allows to access its domestic market. The Chinese state is not a liberal one: the government under the control of the Chinese Communist Party (CCP), practices `state capitalism`, in which economic activity is undertaken by the state. The level of corruption in China is quite high, but it is noteworthy that it is making progress from year to year.

According to the Corruption Perceptions Index (CPI), in 2021, China was in 66th place out of 180 analyzed countries, recording a score of 45, while in 2014 it recorded a score of 36 (0 - highly corrupt, 100 - very clean) (Transparency International (a), 2021). The Corruption Perceptions Index (CPI) measures how corrupt each country's public sector is perceived to be, according to experts and businesspeople. It covers bribery, diversion of public funds, misuse of authority, excessive red tape, officials using their public office for private gain without facing consequences, ability of governments to contain corruption in the public sector, nepotistic appointments in the civil service, legal protection for people who report cases of bribery and corruption etc. (Transparency International (b), 2021)

Apart from the still highly regulated environment, many local joint-venture partners are inexperienced, opportunistic, or simply operate according to different goals. Joint ventures, the most widely used form of foreign business in China, are still very risky. For example, a state-owned local partner may not agree with a strategy to reduce costs through massive layoffs, if the national strategy is to reduce unemployment. Another problem that Western countries must take into account when investing, is the protection of intellectual property. Even if the government is making progress in this regard, there is a history of intellectual property not being respected in China. In joint-venture deals, the Chinese partner can become a strong rival after gaining access to Western technology and expertise. However, despite these disadvantages, the cost of missing the fast-expanding Chinese market exceeds the potential risks. Staying out of China in hopes of keeping the intellectual property safe it is not an option.

In the near future, the growth rate of FDI inflows in China is predicted to be lower compared to the performance recorded in 2021, due to the uncertainty regarding the COVID-19 pandemic, the war in Ukraine, food and fuel price increases and climate disturbances. Given that new waves of COVID-19 will break out in China, the lockdown measures taken by the government could play a significant role in global value chains (GVCs) and forward depress the global FDI inflows.

Some MNEs may re-shore or diversify away from China because of rising labor costs and the need to improve supply-chain resilience. Other reasons that may keep some investors away could be country`s close ties with Russia in the current military context, the geopolitical tensions and the human rights violations reported by the UN (United Nations, 2022). However, the substantial flow of market-seeking FDI in China, particularly by MNEs in services and high-tech sectors, is cushioning any negative trend in efficiency-seeking FDI. China is, and will remain for many years from now, a very attractive market for foreign investors.

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