Characteristics and Determinants of FDI in China after 40 Years of Reform and Opening Up

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Abstract. China has experienced a dramatic increase in FDI inflows since its adoption of the policy of reform and opening up in 1978. By utilizing foreign capitals, China has achieved great economic growth and development. This research first summarizes the status and characteristics of FDI in China after 40 years of opening up, then analyzes the factors that influencing Chinese attractiveness to FDI. Based on the characteristics and determinants of FDI in China, this work further provides suggestions for utilizing and attracting foreign capitals in the future.

Introduction

Since the implementation of policy of reform and opening up in 1978, China's economic development has made remarkable achievements, which can be attributed to China's consistent adherence to the market-oriented economy, consistent adherence to opening up and consistent efforts to develop foreign trade and economy. Foreign direct investment as one of the major forces in driving globalization and economic growth has played an important role in promoting China's economic development.

First of all, foreign direct investment is one of the important sources of fixed asset investment in China, especially in the early stage of implementing reform and opening up policy, when the construction funds are extremely scarce. Second, the rapid expansion of foreign-invested industry has promoted the process of industrialization in China. Third, foreign-funded enterprises become one of the crucial sources of tax revenue in China. Fourth, the utilization of foreign capital has created a large number of employment opportunities, accelerated the transfer of domestic labor force from the primary industry to the secondary industry and the tertiary industries, improved the quality of domestic labor force, and achieve the accumulation of human capital. Fifth, the inward FDI has promoted the optimization and upgrading of China's industrial structure. For a long time, foreign investment in China mainly focuses on the secondary industry and the tertiary industry, which plays an important role in the scale expansion and structure upgrading of these industries through expanding investment. In the secondary industry, electronic and communication equipment, machinery, transport equipment, precision machinery and other capital-intensive industries are hot industries for foreign investment, accounting for nearly 40% of the total foreign investment in the manufacturing industry. Moreover, the import and export of foreign-invested enterprises is a crucial driving factor for China's foreign trade growth. Last, but not least, FDI also contributed significantly to promote China's technological progress. Foreign-funded enterprises have created technology spillover effects by importing equipment and technology, setting up research and development centers in China directly, extending technology of product chains, providing technical assistance to cooperative enterprises and training personnel.

In summary, since the reform and opening up, China's economic development has achieved a qualitative leap, in which, the importance of inward FDI cannot be neglected. Therefore, it is of great practical and theoretical significance to summarize the experience of foreign capital utilization in the past 40 years and analyze the factors affecting the attraction of foreign capital in China.
The Status and Characteristics of FDI in China

The Total Amount of FDI Utilized in China

Since the reform and opening up, China has adhered to the policy of attracting investors from all over the world for 40 years, which has promoted the process of China’s marketization and played a significant role in China’s economic growth. From Fig. 1, we can see that the actual utilization of FDI in China has increased from 920 million dollars in 1983 to 135 billion dollars in 2018. It is obvious that the scale of FDI in China shows a continuously increasing overall trend with slightly fluctuation. 60,533 new foreign-invested enterprises were set up and the actual use of FDI in China hit a record high in 2018, which makes China ranked the second most favored destination of FDI in the world.

![Figure 1. Actual Utilization of FDI in China (Unit: US$ 10,000).](image)

Data resource: National Bureau of Statistics of China

Industry Distribution of FDI in China

Table 1 indicates that the actual use of foreign capital in agriculture, forestry, animal husbandry and fishery industry was US$ 790 million, decreased by 52.1 percent compared with 2016, and accounting for 0.6 percent of China’s total FDI, decreased from 1.3 percent in the previous year. There were 4,986 new foreign-invested enterprises in the manufacturing sector, increased by 24.3 percent compared with previous year. Foreign capital actually used in manufacturing industry amounted to US $33.51 billion, accounting for 25.8 percent of the total. 3,061 new foreign-invested enterprises were set up in the service sector, with an increase of 28.4 percent. Actual utilized FDI rocked up to US $95.44 billion, and accounting for 72.7 percent of China’s total.

<table>
<thead>
<tr>
<th>Industry</th>
<th>New Enterprises</th>
<th>Actual Use of FDI</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Growth rate</td>
</tr>
<tr>
<td>Agriculture, Forestry, Animal Husbandry and Fishery</td>
<td>579</td>
<td>29.0</td>
</tr>
<tr>
<td>Mining Industry</td>
<td>26</td>
<td>-</td>
</tr>
<tr>
<td>Manufacturing Industry</td>
<td>4986</td>
<td>24.3</td>
</tr>
<tr>
<td>Service Industry</td>
<td>30061</td>
<td>28.4</td>
</tr>
<tr>
<td>Total</td>
<td>35652</td>
<td>27.8</td>
</tr>
</tbody>
</table>

Data resource: Report on Foreign Investment in China 2018

In 2017, the industrial structure of foreign investment in China was further optimized. The utilization of foreign investment in high-tech industries increased by more than 60 percent, accounting for about 30 percent of the total, increased by 10.2 percentage points from the previous year. 5,990 new enterprises in the high-tech service sector were set up in China in 2017, increased by
81.9%, and the actual use of FDI reached US$26.07 billion, increased by 106.4% compared with 2016. Moreover, in 2017, there were 1,032 newly set up foreign-invested enterprises in high-tech manufacturing sector, and the actual utilization of FDI increased by 7.6%, rocket to US$9.89 billion.

**Regional Distribution of FDI in China**

The distribution of FDI among China’s regions remains asymmetrical, showing a marked interest of investors towards the accessible Eastern region [1]. In 2017, China continue to actively encouraged FDI to flow to the central and western regions and Northeast old industrial base, and five pilot free trade zones were set up in the central and western regions (Henan, Hubei, Chongqing, Sichuan and Shaanxi). From the accumulated data of using foreign capital, by 2017, as indicated in table 2, although the enormous regional development differences coastal and inland cities still exist, the cumulative actual use of foreign investment in central region and western region has been further improved, which is approximately $127 billion and $149.3 billion respectively, accounted to 7.9% and 6.7% of the total. Compared with 7.5% and 6.3% in 2016, the actual utilization of FDI both increased by 0.4%.

### Table 2. Regional Distribution of FDI in China by 2017.

<table>
<thead>
<tr>
<th>Region</th>
<th>Accumulative Number of Enterprises</th>
<th>Percentage (%)</th>
<th>Accumulative Actual Use of FDI (US$ billion)</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern</td>
<td>32,219</td>
<td>90.4</td>
<td>114.6</td>
<td>87.5</td>
</tr>
<tr>
<td>Central</td>
<td>16,72</td>
<td>4.7</td>
<td>8.31</td>
<td>6.3</td>
</tr>
<tr>
<td>West</td>
<td>1,761</td>
<td>4.9</td>
<td>8.13</td>
<td>6.2</td>
</tr>
<tr>
<td>Total</td>
<td>35,652</td>
<td>100.0</td>
<td>131.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Data resource: Report on Foreign Investment in China 2018

**Sources of FDI in China**

For the past 40 years, China adheres to the basic policy of opening up, continues to make active and effective use of foreign capital, substantially reduces restriction on the access to foreign capital, and continuously improves the investment environment, further enhancing the confidence of foreign investors to invest in China. From Fig. 2 and Fig. 3, it is obvious that Asia remains the major region that made investment in China. Foreign investment from North America, Oceania and Asia grew rapidly, with Asia reaching US $109.19 billion, North America US $4.29 billion, and Oceania US $1.61 billion respectively.

![Figure 2. Sources of FDI in China, 2017 – Foreign-Invested Enterprises’ Numbers.](image)

Data resource: Report on Foreign Investment in China 2018

Refer to the amount of inward FDI of China in 2017, the top investing countries/regions are: Hong Kong ($98.92 billion), Singapore ($4.83 billion), Taiwan ($4.73 billion), South Korea ($3.69 billion), Japan ($3.27 billion), the United States ($3.13 billion), Netherlands ($2.17 billion), Germany ($1.54 billion), Britain ($1.5 billion), Denmark ($820 million). Altogether, investment in China from the top
ten countries (regions) is $124.61 billion, accounting for 95.1% of the total. Among them, Danish and Dutch investment in China grew rapidly.

Figure 3. Sources of FDI in China, 2017 – Amount of FDI (US$ billion).

Data resource: Report on Foreign Investment in China 2018

Determinants of FDI Inflows in China

Labor costs, market size, agglomeration economies, infrastructure development, national policies and human capital are the main factors that attracting FDI to China. After 40 years of development, the importance of some factors may have been changed, but some influences remain dominant.

Labor Costs

In the early stage, multinational companies in China are mainly driven by the lower labor costs in China, especially in manufacture industry, in which labor costs is main costs they need to consider. China has abundant labor resources and low labor cost. This advantage has become the favorable condition and main factor for China to attract FDI. However, in recent years, on the one hand, with the improvement of China's economic development level and the increase of the domestic minimum wage standard, the price of Chinese labor keeps rising. At the same time, the aging problem is serious, and China's demographic dividend gradually disappears. In order to pursue lower labor costs, multinational companies turn to invest in Southeast Asian countries. On the other hand, foreign investment is also in the period of strategic transformation, foreign direct investment in China gradually shift from labor-intensive industries to capital and even technology-intensive industries. Therefore, the influence of labor cost on China's FDI attraction is becoming weaker and weaker.

Market Size

Market size is one of the crucial determinants for a multinational company to choose a host country. Multinational companies tend to invest in host countries with larger market size because that larger market size can provide more market opportunities and help the MNCs to achieve economies of scale. With the large population and rapid economic growth, Chinese market has proved that it is a huge potential market, which has become an important factor in attracting FDI. In the future, the attraction effect of market size on FDI will be continuously enhanced due to the increasing of national income.

Agglomeration Economies

Agglomeration economies affect the choice of FDI location through two kinds of externalities generated by external economies of scale. First, financial externality, the agglomeration of enterprises in a certain region forms an interrelated factor market, so that enterprises can acquire raw materials and labor at a low cost quickly, thus reducing the cost of intermediate inputs and improving production efficiency. This has a strong attraction for multinational companies, and the inflow of foreign capital will further strengthen the cluster effect. Second, technology externality, which is mainly manifested as knowledge spillover, can rapidly improve the innovation ability and
comprehensive competitiveness of enterprises through digesting and absorbing the spillover knowledge and technology, so as to attract FDI inflows and strengthen the agglomeration economies [2]. The cluster effects brings about the agglomeration of information, knowledge, capital and talents, forming positive externalities and economies of scale, which can reduce costs for the later foreign-funded enterprises, attract more foreign capital inflow, and thus continuously strengthen the cluster effect [3]. Without doubt, the cluster effect will become increasingly important for FDI location selection, and remains one of the most important factors for China to attract FDI.

**Infrastructure Development**

Well-developed infrastructure has a positive impact on attracting FDI, for it implies less production cost and transaction cost. For example, good transportation facilities can provide enterprises with convenient transportation conditions, the good status of network and communication infrastructure can reduce the cost of information collection and exchange. Therefore, infrastructure plays a positive role in attracting FDI. China attaches great importance to the construction of infrastructure, especially in recent years, the coverage of China's railway, highway and communication network has been greatly improved, and infrastructure plays an increasingly obvious role in attracting FDI.

**National Policies**

National policies also impose great influences in attracting FDI. For example, preferential tax policies affect the production and operation costs of foreign-invested companies. In the early stage of reform and opening up, China adopted regional tax preferential policies, which played a great role in attracting FDI flows into Special Economic Zones and Coastal Open Cities. However, in 2008, China has implemented the "integration of two taxes" and abolished the "super national treatment" policy for foreign enterprises. With China's rapid economic development, the domestic investment environment has been gradually improved, along with the attractiveness to foreign investment. As a result, the preferential policies show a relatively weak trend in attracting FDI inflows.

**Human Capital**

The attraction of human capital to FDI is increasingly obvious, and countries or regions with sufficient human capital are more conducive to the inflow of FDI. With the transformation of global production mode to high-tech manufacturing and service industry, multinational companies are increasingly in need of high-quality talents, so they will choose to invest in countries and regions with higher level of human capital. In recent years, China's education funds have been increasing, and the increase of well-educated population has enhanced its attraction to FDI. As can be seen from the industrial distribution of FDI utilization in China, FDI utilization in the tertiary industry in China has been increasing steadily, and the industries with large growth range are all industries with high demand for human capital. It can be seen that human capital accumulation plays an increasingly important role in attracting FDI now and always.

In conclusion, the national policy, labor costs are the main factors to attract FDI in China at the early stage of reform and opening up, but as China’s demographic dividend gradually disappear, the transformation of economic, the effects of cheap labor costs and preferential policies imposed on attracting FDI has weakened. However, the size of the market, the cluster effect, good infrastructure, human capital and other factors plays an increasingly important role in the process of attracting FDI.

**Future Suggestions for Attracting FDI in China**

The government should pay more attention to the construction of infrastructure to strengthen the connection between companies and reduce transportation and communication costs, especially in the central and western China.

Moreover, in order to attract more FDI flows to central and western regions and eliminate the disequilibrium among regions, the government can adopt preferential treatment to foreign-invested enterprises if they choose to locate their companies in central or western regions.
In addition, mechanisms to attract and foster talents should be established. On one hand, China can provide good conditions to attract higher level of human capital all over the world. On the other hand, China should attach importance to education, strengthen skills and education training, improve the quality of human capital, and more effectively attract the inflow of foreign investment.

Last, but not the least, optimize the industrial structure of foreign investment. China should speed up the attraction of FDI in high-tech service industry and advanced manufacturing industry, such as energy conservation and environmental protection, biological medicine, electronic communications, finance, insurance, medical treatment etc.

Summary

With the global economic recovery, foreign direct investment will continue to be active, and China will remain as one of the major engines for the growth of FDI and play an increasingly important role. After 40 years of opening up, China has achieved great success in utilizing foreign capitals and become the most favorable destination of FDI. In the future, the Chinese government should adhere to the reform and opening up policy, encourage FDI flows into high-tech industry, introduce policies to attract foreign capitals to central and western China, and utilize agglomeration economies to further improve economics growth and industry upgrade.

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