The Economics of China

Foreign Investment and the Capital Account

Fall 2020

Foreign Investment and the Capital Account

- Balance of payments "accounting"[1]: trade balance (NX), current account (CA), and capital account.
    - **Trade Balance** or Net exports (NX) is equal to exports minus imports.
    - CA = NX + NFP, where NFP is net factor payments from/to abroad.
    - Also, with some manipulation, we can get that CA = Savings - Investment.
    - Moreover, CA = - Capital Account
    - So, what is the capital account?

[1] The first 2 slides are based in part on content from: Williamson, Stephen D., Macroeconomics, 5th Canadian Edition.

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- Balance of payments "accounting": trade balance (NX), current account (CA), and capital account.
  - Capital account = capital inflows - capital outflows.
  - Capital inflows occur when funds flow from foreigners into the domestic country to purchase domestic assets.
  - Capital outflows occur when funds flow out of the domestic country to purchase foreign assets.
  - Capital inflows and outflows can be either "portfolio" flows or foreign direct investment (FDI).
  - **Portfolio flows** "are capital account transactions involving **financial assets**, including stocks and debt instrument".
  - In contrast, **FDI** usually "involves the acquisition of **physical asset(s)** by a foreign" investor, and "**control over ongoing operations** by the investor".

- **FDI inflows to China**
  - 1949-1978: Insignificant.
  - After 1980s: "cautious, incremental, and geographically localized".
  - "Chinese policy changes lay behind the upsurge of investment in 1992–1993".
  - "FDI began to pour into China after 1992".
  - "China became by far the largest developing-country host of FDI, accounting for about one-third of total developing-country FDI".
  - "The global manufacturing networks created by FDI in China reshaped China and the world and continue to play a critical role in the world economy".
  - While "China opened widely to incoming foreign direct investment (FDI), while other types of capital flows were still generally restricted".

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- **"Special Zones" and FDI inflows to China**
  - Recall that four special economic zones (SEZs) were set up in 1979-1980 to attract investors to China.
  - "The SEZs exemplified the pattern of Chinese policy-making during the first era of reform...: dual- track, incremental reforms that started by creating a new system alongside...the existing one".
  - "Moreover, they are consistent with the dualistic system that was such a prominent feature of the trading regime".
  - "SEZs were part of the early development of the export-processing regime".
  - Also, "initial SEZs were similar to the export-processing zones (EPZs) that had spread in Asia since the 1970s".
  - "But the SEZs also went beyond the other Asian EPZs".

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- **China's SEZs vs. Asian EPZs**
  - How are Chinese SEZs similar to Asian EPZs?
    Please read Box 17.1 on page 428 in the textbook for similarities.
  - How are Chinese SEZs different from Asian EPZs?
    Please read Box 17.2 on page 429 in the textbook differences.

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- **Special Zones Today**
  - "By the turn of the century, there were hundreds of zones, including 6 SEZs (the 4 original ones, Hainan, and Pudong), 54 national- level economic and technological development zones, 53 nationally recognized high- tech industrial zones..".
  - "Competition among zones and regions for FDI was accepted as normal in the early stages of China's opening, but as China's domestic enterprises strengthened, the government became less interested in providing preferential treatment to foreign firms".
  - "As the potential for special treatment has narrowed, special zones have inevitably become less special".
  - However,"local governments still use the zones to attract foreign investment".

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- **Where did China's FDI inflows come from?**
    - In terms of countries, the biggest "foreign" investor in China was Hong Kong ($934 billion out of $1.8 trillion between 1985 and 2016).
    - In comparison, combined together, "United States, the EU, and Japan has accounted for only 17% of incoming FDI, about $300 billion" during that period.
    - It must be noted though, that officially, The British Virgin Islands (BVI) comes second after Hong Kong in cumulative investment.
    - Since BVI is known to be a tax haven, this could mask some of the real sources of FDI inflows to China.
    - In terms of companies, "Korean company Samsung is the largest single corporate investor in China".

- **Hong Kong, Taiwan, and the "China Circle"**
    - "The close economic association among the economies of the People's Republic of China, Hong Kong, and Taiwan warrants calling them the 'China Circle'."
    - "The basis for the emergence of the China Circle was the success of Taiwan and Hong Kong in developing labor-intensive manufactured exports during the 1960s and 1970s".
    - "The export success of Taiwan and Hong Kong began to have a much more direct effect on the mainland in the mid-1980s, when it began to drive a restructuring of East Asian production networks".
    - "The opening of China to foreign investment at this time created a dramatic opportunity to transfer labor-intensive export production to the People's Republic".
    - "In China, it required massive (foreign direct) investment from Hong Kong and Taiwan to be realized".

- **Hong Kong, Taiwan, and the "China Circle"**
    - "This process was particularly powerful in the China Circle because transaction costs for Taiwan and Hong Kong firms to operate in the PRC were low" due to being geographically close in addition to other factors.
    - This allowed Hong Kong and Taiwan to specialize in high-value services and technology-intensive production, while much of the ordinary manufacturing moved to the PRC".
    - "Hong Kong and Taiwan have both experienced substantial success in upgrading to higher-skilled activities while simultaneously experiencing steadily rising incomes and relatively low unemployment".
    - Meanwhile, China benefited in terms of export growth and technology transfer, among other benefits.

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- **The Sectoral Composition of FDI inflows**

  - "**Manufacturing** has been a much larger part of FDI inflows into China than it is for FDI inflows in the rest of the world".
  - "Manufacturing accounted for more than half of Chinese FDI inflows consistently until 2010, and 70% in 2003–2005. Only after 2012 did the share of manufacturing drop...".
  - "Real estate is the second most important sector for foreign investment, accounting for over 20% of incoming investment since 2008".
  - "Typically, less than 30% of China's incoming FDI has been in services".
  - In contrast, 55% of FDI inflows in developing countries were in the services sectors at the end of 2002.
  - "To a large extent, this can be explained by the restrictions that China has maintained on foreign entry into the most important service sectors".

- **Impact of FDI inflows on China's economy**
  - FDI inflows are sources of (real) investments.
  - However, given China's relatively high domestic saving rate, FDI inflows were **"much less significant for China" as a source investment**.
  - "During the 1993–2002 decade of peak relative importance of FDI, it accounted for over 10% of total investment annually for of ten successive years" and "for less than 3% of total fixed investment since 2012".
  - In contrast, the "**largest** and most unambiguous contribution of FDI to the Chinese economy came through its **contribution to trade**".
  - "Between 1992 and 2005, almost two-thirds of the increment to China's exports came from FIEs" (Foreign Invested Enterprises).

- **Impact of FDI inflows on China's economy**
  - In addition, "FIEs were the largest **source of new technology** in Chinese industry through the turn of the century, after which China's domestic R&D effort accelerated and surpassed the contribution from foreign investment".
  - Another impact of FDI inflows is **increased productivity for some domestic firms** that had to face and survive competition from foreign firms (as shown in some studies on Chinese industries).
  - Finally, there were **some spillovers and upgrading** through supplier relations.

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- **FDI inflows to China Today**: Changing role and significance.
  - On one hand, "FDI no longer has the transformative impact it had in the 1990s and China is, to some degree, less open to FDI than it was 20 years ago".
  - On another hand, "foreign investment still has enormous importance in China".
  - "The policies that once kept FDI bottled up in export-oriented sectors and regional enclaves are now long gone, and foreign-invested enterprises (FIEs) are deeply embedded in many sectors of the Chinese economy".
  - "Enright (2017, 37) calculates that domestic sales of FIEs surpassed export revenues in 2005, and that by 2013 domestic sales were 2.7 times that of exports".

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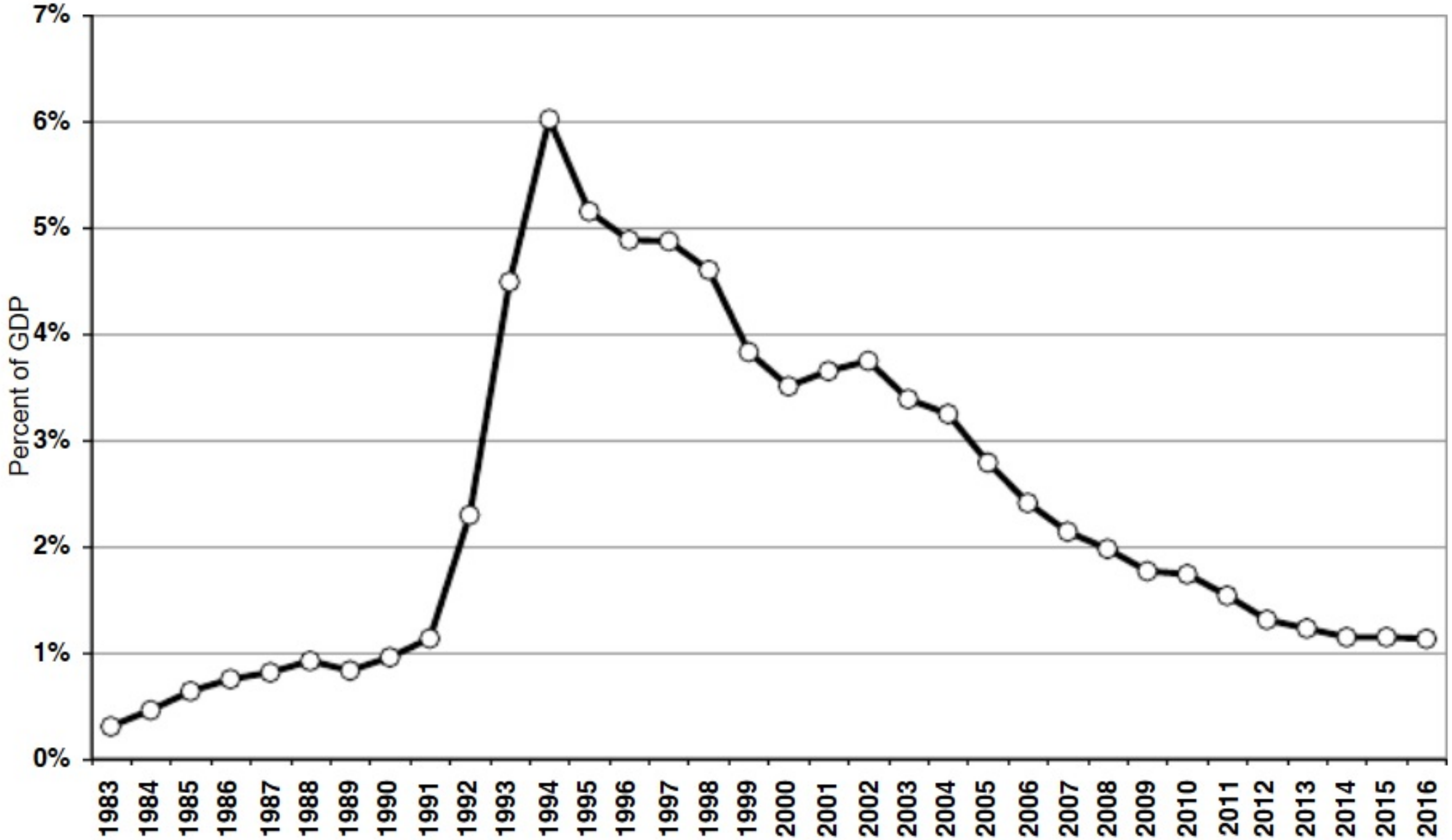

Figure 17.1
Foreign direct investment (share of GDP).
Source: *SYC* (2016, table 11-13; and earlier volumes).

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- Back to balance of payments accounting.
  - Balance of Payments = Current Account + Capital account
  - Since CA = - Capital Account, then in principle, a country's balance of payments in any given period must be equal to **zero**.
  - We said that after openning up its economy, China experienced a rapid increase in exports, more than imports.
  - As a result, China had current account surpluses each year since the mid-1990s until recently. (World Bank Data)
  - This means that China was experiencing net capital outflows throughout this period.

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- **Capital outflows: Foreign Reserves Accumulation**
  - From 2004 to 2014, "China increased its reserves from under $500 billion to $3.99 trillion".
  - "Official reserves, in order to be useful reserves, need to be in a safe and highly liquid investment".
  - U.S. (treasury) bonds have dominated the available supply of this kind of (financial) investment.
  - "Chinese policy-makers gradually achieved agreement that $4 trillion in reserves was more than China needed".
  - "They began searching for othe forms of capital outflow that can "generate higher and more stable returns".

- **Capital outflows: Sovereign Wealth Funds**
  - "China has now established two large sovereign wealth funds (SWFs), which invest for the long-term interest of the government and the nation".
  - "The China Investment Corporation had $747 billion in assets in mid-2015, while the SAFE Investment Company had $568 billion".
  - "This ranks them third and sixth, respectively, among global sovereign wealth funds (SWFI 2016)".
  - These funds "are authorized to hold considerably less liquid—and potentially much higher yielding—securities than the foreign-exchange reserve fund".
  - They invest both domestically and internationally, and "foreign assets are a significant part of their investments".

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- **Capital outflows: New Multilateral Financial Institutions**
  - China contributed 30% of the capital of "The Asia Infrastructure Investment Bank (AIIB)".
  - "The Asia Infrastructure Investment Bank (AIIB) is a new regional investment bank, similar in character to the World Bank and the Asian Development Bank".
  - " A somewhat similar institution, the BRICS Bank (recently renamed the New Bank) is expected to play a similar role for the BRICS (Brazil, Russia, India, China, and South Africa)".
  - "For China, these institutions are means to facilitate the flow of Chinese domestic saving abroad, and it is hoped that they will encourage the selection of higher-quality projects...".
  - "These new financial institutions...are envisioned to play a role alongside state-owned banks in financing infrastructure projects in China's neighboring countries" (as part of the "Belt and Road Initiative").

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- **Capital outflows: FDI outflows**
  - Initially, FDI outflows "targeted natural resources and was dominated by the state-owned enterprises (SOEs)".
  - "The 'Go Out' policy (after 2011) has lowered barriers to companies seeking to invest abroad".
  - "This intentional policy involved less government control over the outflows and a steady diversification of ownership types, as well as destination countries and sectors".
  - Hence, "private firms have begun to play a bigger role, and investment has expanded".
  - China's FDI outflows "increased extraordinarily rapidly for the past decade", and exceeded FDI inflows in 2016.
  - Recently, "China has embarked on an expensive effort of government-led technology development, and overseas acquisitions are a part of that effort".

- **Capital outflows: FDI outflows**
  - Official data show that more than 50% of FDI outflows from China go to Hong Kong, "initially"?
  - Other data show that between 2005 and 2016, " the United States was the top destination with almost $130 billion; Australia was second ($81 billion), followed by Canada ($45 billion) and Brazil ($39 billion)".
  - That being said, "China's stock of completed FDI in the United States is still only about a third of the U.S. stock of FDI in China".
  - In addition, private firms "have accounted for three-quarters of Chinese investment in the United States" since 2013.

- **Re-Regulating Capital Outflows**
  - As China lifted some restrictions on private capital outflows, this led to large "speculative" capital outflows.
  - Hence, China reimposed some regulations/restrictions on private capital outflows for the time being.
  - "Thorough financial reforms...will open an economy up to capital flows in both directions, but they can only work if they have made domestic financial markets attractive to foreign investors as well".
  - This kind of "problems that have bedeviled attempts at capital account liberalization in many developing countries".