Research briefing

Leverhulme Centre
for Research on Globalisation and Economic Policy

# China still to make the most of FDI benefits

## Credit Constraints and FDI Spillovers in China

By Natasha Agarwal, Chris Milner and Alejandro Riaño

New research by GEP has questioned China's ability to maximise the benefits of the huge amount of foreign direct investment that continues to flood into the country.

FDI's potential "spillover" effects are being hampered by the nation's "structural rigidity", says the study.

Growing imperfections in China's capital market lie at the heart of the problem, highlighting the likely need for reform if the country's extraordinary economic growth is to be sustained.

China has continuously implemented policies designed to attract FDI, with Premier Wen Jiabao only recently responding to fears of global economic turmoil by restating the government's commitment to driving growth by welcoming overseas investors.

But policymakers should consider balancing this approach with one that encourages better local conditions, say the authors of the research.

### Research basis

The study focused on annual accounting reports taken from the Bureau Van Dijk's Oriana dataset, covering more than 20,000 Chinese manufacturing firms for the period 2001 to 2005.

In terms of value added these firms represent around 35% of China's total manufacturing output. They also represent approximately 18% of the country's total manufacturing employment.

Researchers analysed information including year of establishment, input costs, employment, ownership, location, fixed assets, sectoral affiliation and export sales.

The amount of FDI by sector and province was also factored in to investigate if outputs were higher or lower than they would have been without the presence of FDI.

The process enabled the study to determine the extent of a firm's dependence on external finance and to measure the effects – if any – of foreign direct investment.

### Comments and implications

Natasha Agarwal, one of the study's authors, said: "China has consistently and continuously implemented policies designed to attract foreign direct investment.

"The rationale for this frequently stems from the belief that the activities of foreign companies will eventually lead to technology-transfer and productivity gains.

"But our research shows how the credit constraints faced by Chinese manufacturing

### Key findings

- The rigidity of China's capital markets is preventing firms from enjoying the full benefits of the spillovers from foreign direct investment.
- FDI spillovers for credit-constrained Chinese manufacturing firms are lower or even negative, with those especially reliant on external finance deriving the least benefit.
- State-owned companies, despite the support of local state-owned banks leaving them comparatively free from credit constraints, fail to maximise the potential benefits from FDI, held back by inefficient management and asset allocation.
- Financial market reform, by allowing further expansion of the private sector through credit availability, may well be the next engine of sustained growth in China.
- Policymakers should balance the merit of policies aimed at attracting FDI with the merits of policies that seek to improve local conditions.

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The research found credit-constrained domestic firms do receive lower – or even negative – FDI spillovers and that the reduction in spillovers is systematically greater in sectors with higher levels of dependence on external finance.

In addition, state-owned companies, despite the support of local state-owned banks leaving them comparatively free from credit constraints, fail to maximise the potential benefits from FDI.

This indicates they are held back by pervasive managerial and asset allocation inefficiencies that prevent them from successfully realising FDI spillovers.

The findings come after figures revealed FDI in China in the first eight months of 2011 totalled $77.63bn – an increase of 17.7% on the same period for 2010.

Commentators say businesses are turning to China to bolster sales as rising unemployment and government indebtedness damp confidence in developed nations.

Agarwal said: "China has been and will continue to be one of the favoured destinations for multinational enterprises' foreign direct investment plans.

"To that end, the government continues to provide special incentives to foreign enterprises, including import duty exemptions and subsidies for infrastructure.

"Yet our research confirms that China's domestic structural rigidity remains the biggest challenge in the successful realisation of the benefits associated with FDI.

"It's already widely accepted that Chinese firms, whether large or small, face credit constraints that are completed unrelated to their expected probability of success.

"This leaves us with the question of whether the capital market in China fully allows firms to benefit from FDI – and our study provides evidences that it doesn't.

"One conclusion is that financial market reform, by allowing further expansion of the private sector through credit availability, may well be the next engine of sustained growth.

"The broader implication is that policymakers should weigh the merits of policies aimed at attracting FDI against those of policies that seek to improve local conditions.

"As well as improving access to formal finance, better local conditions not only attract foreign companies but also allow host economies to maximise FDI's benefits."

## Globalisation and Economic Policy Centre (GEP)

Based at the University of Nottingham in the UK and primarily funded by grants from the Leverhulme Trust, GEP is the major centre in Europe studying the impacts of globalisation and economic policy.

In January 2008 it opened GEP in Malaysia at the University of Nottingham's purpose-built Semenyih campus, 30km from Kuala Lumpur. In November 2008 it launched GEP in China at the University of Nottingham, Ningbo, China.

GEP is keen to promote its research work and is committed to communicating its expertise. Its academics have advised the Treasury, the OECD, the World Bank and the WTO.

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