FOCUS

CHINA » Europe's debt crisis and the US's budget troubles have served only to further strengthen China's position

Enter the dragon

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Firestarter: China is at the fiery heart of the global market

main points

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» Investment from overseas amounted to $8.45bn in August alone, an 11.1 per cent improvement on the previous year

» One common criticism is that domestic conditions, particularly the nature of local financial markets, may limit Chinese firms' capacity to maximise FDI's benefits. Between 1984 and 2004 the total stock of FDI in China amounted to $562.1bn

» Policymakers should weigh the merits of policies aimed at attracting FDI against the merits of policies that seek to improve local conditions

"China is right at the centre of the world market," declared Guo Zhuqing, chairman of the China Construction Bank, during September's World Economic Forum meeting in Dalian.

With business leaders from around the globe practically falling over themselves to prove as much at the event, few dared to argue.

Figures released just a few days earlier also suggested it was no idle boast. Foreign direct investment in China in the first eight months of 2011 totalled $77.63bn (£48.19bn), an increase of 17.7 per cent on the same period in 2010. In August alone, according to the Ministry of Commerce, investment from overseas amounted to $8.45bn, an 11.1 per cent improvement on the previous year.

That foreign direct investment (FDI) has been crucial to China's extraordinary economic rise is beyond dispute. The government has consistently implemented policies designed to attract more FDI, and premier Wen Jiabao was quick to use the latest statistics to restate a commitment to promoting growth through the continued opening of the Chinese economy to overseas investors.

The rationale for increased efforts to appeal to foreign firms often stems from the belief that, in addition to the direct capital inflows and employment that accompany it, FDI generates positive externalities in the form of productivity gains, technology transfers, the introduction of new processes, managerial skills and know-how, employee training, international production networks and access to other markets. These 'spillovers', as they are known, are not automatic and might occur through various channels such as imitation, skills acquisition, competition and exports.

Domestic conditions

Yet, the doubts surrounding the dragon's ability to sustain its meteoric ascent through the relentless courtship of FDI persist. One common criticism is that domestic conditions, particularly the nature of local financial markets, may limit Chinese firms' capacity to maximise FDI's benefits.

It is universally recognised, for example, that China's state-owned enterprises (SOEs) enjoy substantial financial backing in terms of loans and grants from state-owned banks. Until 1998, when the constitution was changed, these banks were instructed to lend exclusively to SOEs, and even now they deem private businesses riskier.

In 2003 a World Bank investment climate survey concluded Chinese firms had much less access to formal finance than firms in any other Asian country examined at that point. Companies with more than 100 employees obtained approximately 29 per cent of their working capital from bank loans, less than in Indonesia, Malaysia, the Philippines, Thailand or Korea.

Firms with fewer than 100 employees obtained only 12 per cent of their working capital from bank loans, compared with, for instance, Malaysia's 21 per cent and the Philippines' 28 per cent. In other words, many Chinese firms face credit constraints entirely unrelated to the probability of their eventual success.

Understandably, any company hamstrung by such crippling restrictions might find it hard to take advantage of the new knowledge FDI makes available. Chinese firms may be able to finance their new requirements through internally generated funds, alternative financing resources such as trade credit, the efficient management of working capital or the forming of industrial clusters; but the greater the technological gap between extant and new practices, the greater the need for external finance.

Funds are inevitably required to invest in, adopt and even imitate foreign technologies. Implementing organisational changes, purchasing equipment, hiring new managers and skilled labour – all are difficult, if not impossible, if resources are scarce or simply unavailable.

Such a situation raises genuine concerns as to whether the status quo in China, with all its acknowledged inflexibility, truly allows domestic firms to take full advantage of FDI. According to new research by the Globalisation and Economic Policy Centre (GEP), based in the UK at the University of Nottingham's School of Economics, it does not.

The study set out to investigate the role financial frictions play in influencing productivity spillovers from foreign to domestic firms, focusing on annual accounting reports covering more than 20,000 Chinese manufacturing companies for the period 2001-05. Analysing standard information including input costs, employment, ownership, location, fixed assets, affiliation and export sales, the research factored in the amount of FDI in a sector and province to investigate if outputs were higher or lower than they would have been without the presence of FDI.

It was discovered that credit-constrained Chinese manufacturing firms receive lower or even negative FDI spillovers. Furthermore, the reduction in spillovers is systematically greater in sectors with higher levels of dependence on external finance.

So, for instance, firms producing non-electric or wood products benefit less than firms that produce clothes or iron goods. Significantly, companies in the former sector finance approximately 30 per cent of their investment through external funds, while those in the latter rely almost entirely on funds generated internally.

Industrial characteristics also play a part. Domestic firms in sectors that are capital-intensive, highly tangible and manufacture durable and highly tradable goods enjoy greater FDI spillover benefits than their counterparts in sectors that are labour-intensive, less tangible and manufacture non-durable and less tradable goods.

Failure to maximise benefits

In addition, in spite of the preferential treatment they receive from state-owned banks and the resultant easier access to external financing, SOEs fail to maximise the potential benefits of FDI. This is because of widespread inefficiencies in management and asset allocation.

These findings are merely the latest to question the long-term wisdom of China's existing structural rigidity, which represents the biggest challenge to the successful realisation of the gains associated with FDI. The ongoing provision of special incentives to foreign enterprises is rooted in FDI's perceived "growth-development" spin-offs, but in many ways it is domestic conditions that demand attention.

Between 1984 and 2004 the total stock of FDI in China amounted to $562.1bn. During the same period, according to the UN Conference on Trade and Development, annual FDI inflow increased from $2.7bn to $60.6bn.

As Mr Zhuqing's soundbite so unequivocally underscored, businesses will surely continue to turn to China to bolster sales as rising unemployment and government indebtedness damp confidence in developed nations. Europe's debt crisis and the US's budget troubles have served only to strengthen the dragon's position.

Yet China will one day, possibly quite soon, need to move on to policies that are conspicuously more balanced.

Financial market reform, by allowing further expansion of the private sector through credit availability, may well be the next engine of sustained growth. The current divisions and inequalities cannot endure indefinitely, and the culture of haves and have-nots, however gradually or discreetly, will ultimately have to make way for a system that is more encompassing and equitable.

The broader implication is that policymakers should weigh the merits of policies aimed at attracting FDI against the merits 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 supposed bounty.

As the banners that lined Dalian's streets proclaimed: "Cooperation, harmony and win for all." The syntax might be lacking, but the sentiment is well worth pursuing.

Natasha Agarwal is a co-author of the Globalisation and Economic Policy Centre study 'Credit Constraints and FDI Spillovers in China'