

FOREIGN DIRECT INVESTMENTS TO CHINA AND SOUTHEAST ASIA: HAS ASEAN BEEN LOSING OUT?

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INTRODUCTION

Conventional wisdom regarding the People's Republic of China (PRC) portrays an economic steamroller leaving its Asian competitors in the dust. A [New York Times](#) article sums it up this way:

“China is grabbing much of the new foreign investment in Asia, leaving its once-glistening neighbors – Thailand, South Korea, Singapore – with crumbs... Some Asian officials say they fear that Southeast Asia will be relegated to the role of supplier of food and raw materials to China in exchange for cheap manufactured goods...”¹

The purpose of this paper is to analyse China's inward Foreign Direct Investment (FDI) patterns and trends in order to shed light on the true extent of China's share of the Asia-bound FDI. The next section gives a brief history of FDI in China and ASEAN-5² and then examines if China has been receiving a disproportionately large share of global FDI. This is followed by a discussion on the “round-tripping” phenomenon of investments between China, Hong Kong and offshore tax havens. The paper will subsequently study if China has been taking FDI away from ASEAN and goes on to give the authors' views on FDI outlook for China and ASEAN. We end with some discussions of the policy implications of the findings in this paper.

The views expressed in this paper are solely those of the authors and do not necessarily reflect those of the Ministry of Trade and Industry, Government of Singapore.

¹ “Economic Juggernaut: China is passing US as Asian power”, [New York Times](#), 29 June 2002.

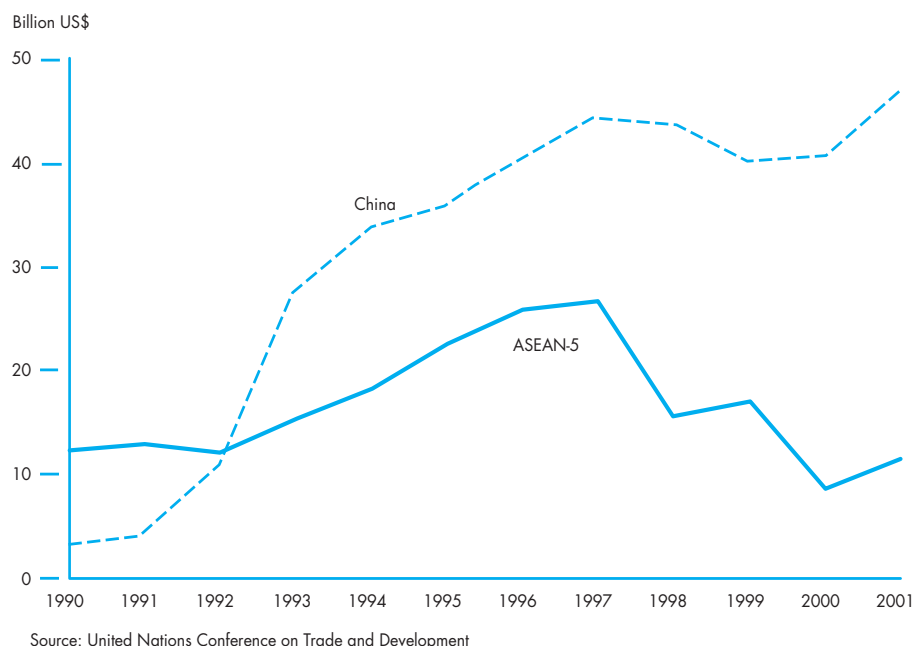
² Throughout this paper, ASEAN-5 refer to Indonesia, Malaysia, Singapore, Thailand and the Philippines.

A BRIEF HISTORY OF FDI IN CHINA AND ASEAN

The early 1990s was a period of strong FDI growth for ASEAN-5, but even more so for China. Foreign investments in China began in 1979 following the adoption of an “open door policy” in late 1978 and the Equity Joint Venture Law in 1979. Foreign participation in China, however, remained very limited until 1992, when the Chinese paramount leader Deng Xiaoping expressed a desire to attract more foreign investments and speed up liberalisation.

Beijing’s removal of several restrictions on foreign investments in 1992 gave a strong boost to FDI flows to China (*Exhibit 1*). China registered FDI growth of about 150 per cent in both 1992 and 1993. Total FDI flows to China surged from US\$4.4 billion in 1991 to US\$28 billion in 1993, culminating at US\$44 billion in 1997. China is now the largest recipient of FDI among all developing countries and, for many years, has been the second largest FDI recipient in the world³. Since 1993, China has been accounting for about half of total FDI flows to Asia, including intra-Asia FDI.

GLOBAL FDI FLOWS TO CHINA AND ASEAN-5 [Exhibit 1]



ASEAN-5's share of Asia-bound FDI had shrunk from 51 per cent in 1990 to only 11 per cent in 2001.

Singapore, Thailand and Malaysia also did well in attracting FDI. For several years prior to 1998, they received more FDI than larger economies like Taiwan, South Korea, and Japan. Since the Asian Financial Crisis in 1997, however, the pattern of FDI flows to Asia has changed significantly. While the level of China’s FDI inflows has hovered around US\$40 billion per annum, FDI to ASEAN-5 has plummeted precipitously and has yet to recover to the pre-crisis level. Specifically, ASEAN-5’s share of Asia-bound FDI had shrunk from 51 per cent in 1990 to only 11 per cent in 2001⁴.

³ From 1992 to 1997, China was the second largest recipient of FDI in the world, after the US. Since 1998, however, many European countries have overtaken China, largely a result of higher volumes of cross-border mergers and acquisitions. In 2001, the US, UK and France received the most FDI, absorbing a total of US\$231 billion among them; China, with US\$47 billion, was the world’s 6th largest recipient of FDI.

⁴ FDI to ASEAN-5 declined from US\$12.4 billion in 1990 to US\$11.4 billion in 2001. In contrast, total Asia-bound FDI had risen from US\$24.3 billion to US\$102 billion in the same stretch of time. FDI flows to China accounted for 46 per cent of Asia’s total inward FDI last year.

HAS CHINA BEEN RECEIVING DISPROPORTIONATELY HIGHER LEVELS OF FDI?

China may have been attracting more FDI than many other Asian countries, but it is also the second biggest economy in Asia. GDP measures the size of the domestic market and reflects the abundance of natural and human resources in a country. All things being equal, a country with a larger GDP should attract more FDI than another country with a smaller GDP. Needless to say, a small economy could still outperform a large economy if the former has a much more aggressive and attractive FDI regime (e.g. Singapore and Hong Kong).

The Inward FDI Performance Index was put forward in the United Nations Conference on Trade and Development's (UNCTAD) World Investment Report (WIR) 2002 as an instrument to compare the relative performance of countries in attracting FDI. The Index is the ratio of a country's share of global inward FDI to its share of global GDP. A country with an Index that is greater than unity is reckoned to have received more FDI than that implied by the size of its economy. It indicates that the country may have a comparative advantage in production or better growth prospects. On the other hand, a country that has an Index value of less than one may be more protectionistic and technologically backward, or may possess a political and social regime that is not conducive for investments.

Exhibit 2 shows the Inward FDI Performance Index for selected countries. As foreign investments are lumpy in nature, the ratios are computed using the averages for three years. In the WIR, the Index covers 140 countries in two periods: 1988–1990 and 1998–2000.

UNCTAD INWARD FDI PERFORMANCE INDEX [Exhibit 2]

Country	1988–1990		1998–2000	
	Value	Rank	Value	Rank
Singapore	13.8	1	2.2	18
Hong Kong	5.4	4	5.9	2
Malaysia	4.4	8	1.2	44
Thailand	2.6	25	1.3	41
Myanmar	1.9	36	0.6	82
Philippines	1.7	39	0.6	89
Vietnam	1.0	53	2.0	20
Taiwan	0.9	58	0.3	112
China	0.9	61	1.2	47
Indonesia	0.8	63	-0.6	138
South Korea	0.5	93	0.6	87
Japan	0.0	128	0.1	131
Asia	1.07	-	0.85	-

Source: World Investment Report 2002, UNCTAD

During 1988–1990, the country that stood out most was Singapore, whose Index topped the list. Singapore’s share of global FDI was a very impressive 13.8 times its share of global GDP, a big lead over Hong Kong. Other ASEAN countries also did well in 1988–1990. Malaysia was 8th and Thailand was 25th in the world. Myanmar, the Philippines, Vietnam and Indonesia were all in the top half of the table.

Having gone through the Asian Financial Crisis, ASEAN-5’s performance during 1998–2000 then became a shade of its former self. The rankings of ASEAN economies dropped markedly. Singapore fell 17 places from the top to the 18th position in ranking. Malaysia slid 36 places to the 44th position, while Thailand eased 16 places to the 41st position. Myanmar, the Philippines and Indonesia had slipped to the bottom half of the ranking. The only ASEAN country that bucked the downtrend was Vietnam, which shot up to the 20th position.

The drastic reversal in ASEAN countries’ propensity to attract FDI, however, was not because China had performed exceedingly well in attracting FDI. In fact, during the two periods, China remained just an above average performer in attracting FDI, holding the 61st and 47th positions in 1988–1990 and 1998–2000 respectively. China’s Index in 1998–2000 was 1.2, only a small improvement over 0.9 a decade earlier. In 1998–2000, even after the Asian Financial Crisis, China was still ranked lower than Singapore, Vietnam, Thailand and Malaysia.

From the Inward FDI Performance Index, it is clear that China’s share of global FDI flows is not out of proportion. Even though FDI flows to China saw dramatic increments in the 1990s, it had merely kept in pace with China’s strong GDP growth. Relative to the size of their economies, many Asian countries actually performed better than China in attracting FDI in the 1990s. Going forward, however, China’s entry to the WTO and the concomitant liberalisation of its foreign investment regime will no doubt raise the country’s ranking on the Inward FDI Performance Index⁵.

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⁵ An alternative interpretation for a low score on the Inward FDI Performance Index is that, rather than being unappealing to foreign investors, the latter could have under-invested in the country. Such under-investment could be due to institutional arrangements in the host country that do not encourage foreign participation, as could arguably be the explanation for sub-par inward FDI performances of East Asian manufacturing powerhouses of South Korea, Taiwan, and, in particular, Japan. On top of demonstrating that China’s performance in attracting FDI has been mediocre, the Index could therefore also suggest that China could get better, given that foreign investors had under-invested in China vis-à-vis other Southeast Asian economies. In fact, China’s ratio of inward FDI stock over GDP at end-2001 was only 0.34, which was still lower than that for Indonesia (0.39), Vietnam (0.52), and Malaysia (0.61). With this in mind, the strong growth in FDI flows to China in the 1990s was thus unsurprising, as both foreign investors and China were making up for lost time and opportunities.

THE “ROUND-TRIPPING” FDI PHENOMENON

China reported FDI inflows of US\$47 billion in 2001. However, there are indications that the “true” extent of FDI flows to China is likely to be smaller than what official statistics have reported. Current research outside China has widely acknowledged that China’s FDI inflows must be discounted for “round-tripping”. “Round-tripping” refers to the phenomenon where Chinese companies move funds out of China to other countries – mainly Hong Kong and the Caribbean tax havens⁶ — and bring them into China again in the form of FDI, mostly to take advantage of preferential tax treatment⁷.

The true magnitude of “round-tripping” cannot be precisely quantified. Since “round-tripping” is essentially clandestine, accurate data is impossible to obtain. Nevertheless, Peter Harrold and Rajiv Lall of the World Bank (1993) estimated that “round-tripping” probably accounted for 25 per cent of China’s 1992 inward FDI⁸. Similarly, Huang Yasheng of Harvard University (1998) estimated that “round-tripping” was responsible for at least 23 per cent of China’s 1992 inward FDI⁹.

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Some indirect evidence for “round-tripping” does exist at the macro-level. As reported by China’s Ministry of Foreign Trade and Economic Cooperation (MOFTEC), Hong Kong and the British Virgin Islands have been accounting for around half of China’s FDI inflows since 1998. On the other hand, the major developed countries – US, EU and Japan – accounted for only about 25 per cent. According to the Census and Statistics Department in Hong Kong, up to 80 per cent of Hong Kong’s inward FDI comes from China, the British Virgin Islands, and Bermuda. Similarly, as much as 80 to 90 per cent of Hong Kong’s outward investments goes to China and other tax havens. In 2000, for example, Hong Kong received 80 per cent (US\$50 billion) of its FDI flows from China and the tax havens, while 96 per cent (US\$55 billion) of its FDI outflows went back to these countries.

If the extent of “round-tripping” has increased, then we should see higher levels of unrecorded capital flows out of China, and stronger presence of Chinese, Hong Kong, and tax haven companies in each other’s economy. Four pieces of indirect evidence show that “round-tripping” is likely to have increased since 1992.

⁶ The major Caribbean tax havens are Bermuda, British Virgin Islands and Cayman Islands.

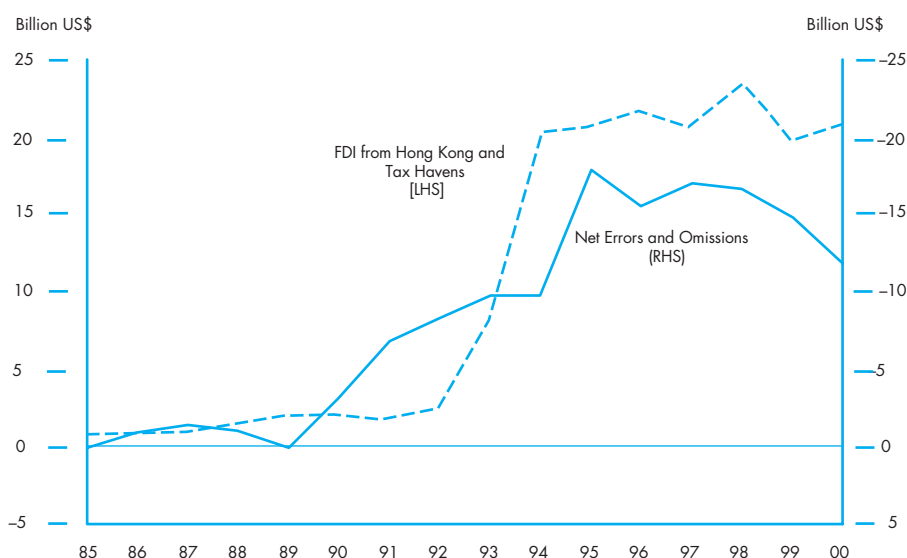
⁷ Foreign Invested Enterprises (FIEs) are free from paying taxes for two years starting from the first profitable year, and thereafter receive 50 per cent discount on taxes for the next three years. There are many other tax benefits.

⁸ Peter Harrold and Rajiv Lall (1993), *China Reform and Development in 1992-93*, World Bank Discussion Papers, World Bank. No methodology was given for their estimate.

⁹ Huang Yasheng (1998), *Foreign Direct Investment in China: An Asian Perspective*, Institute of Southeast Asian Studies, Singapore. His higher estimates are 36 per cent and 49 per cent. The estimates are, however, not robust.

- (a) The net errors and omissions item¹⁰ in China's balance of payments, a measure of unrecorded capital flows, had risen from a net positive inflow of US\$92 million in 1985 to a net negative outflow of US\$12 billion in 2000. This was in tandem with FDI inflows from Hong Kong and the tax havens, which had correspondingly grown from US\$960 million to US\$21 billion (Exhibit 3).

NET ERRORS AND OMISSIONS IN CHINA'S BOP STRONGLY CORRELATED WITH FDI INFLOWS FROM HONG KONG AND TAX HAVENS [Exhibit 3]



Source: Ministry of Foreign Trade and Economic Cooperation, China

- (b) The number of Chinese H-share firms¹¹ in Hong Kong had increased from 6 in 1993 to 50 in 2001. This is indicative of "round-tripping", because in order to carry out "round-tripping", Chinese firms need foreign affiliates or subsidiaries, and Hong Kong becomes the most convenient place to own one.
- (c) The combined market capitalisation of Chinese firms ("H shares" and "Red Chips") as a percentage of total market capitalisation in the Hong Kong Stock Exchange had also increased from 0.3 per cent (US\$332 million) in 1991 to 23 per cent (US\$115 billion) in 2000.
- (d) The number of companies in Hong Kong that are incorporated in Bermuda and the Cayman Islands jumped 5.2 times from 178 in 1990 to 924 in 2000. This is still a lower-bound estimate of the number of tax haven companies in Hong Kong because such data for the British Virgin Islands are unavailable.

¹⁰ "Net errors and omissions" are used to correct the measurement errors in a country's balance of payments and should hover around zero. China's large and persistently negative "errors and omissions" suggest consistent measurement gaps in official Chinese balance of payment statistics.

¹¹ H-shares companies are listed on the Hong Kong Stock Exchange, but are incorporated in China and approved for listing by the Chinese Securities Regulatory Commission (CSRC). These do not have large government holdings.

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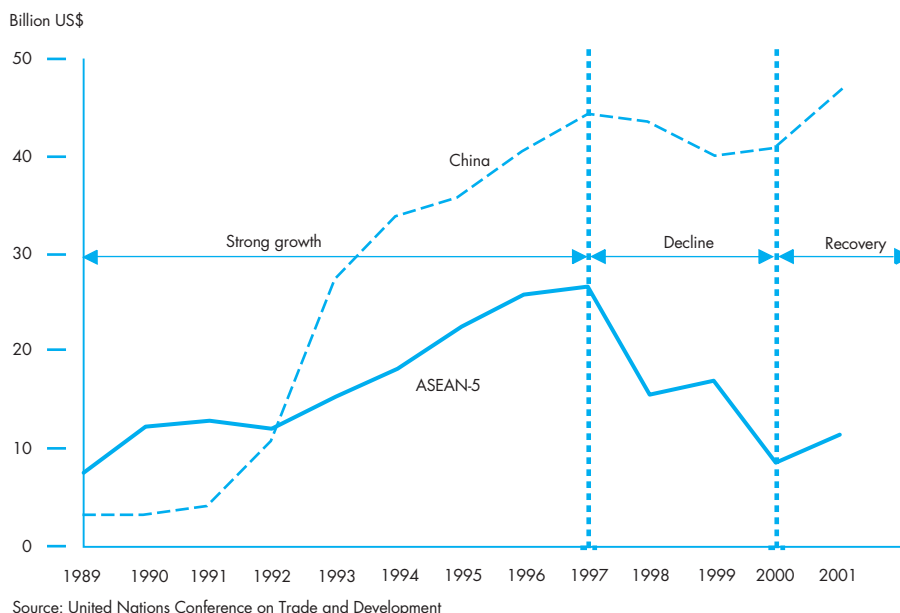
Based on the above indirect evidence, the level of “round-tripping” FDI flows to China today is likely to be much higher than the 25 per cent estimated by the World Bank in 1993. It is therefore not surprising that the Hong Kong-based Political and Economic Risk Consultancy (PERC) concluded in December 2001 that out of the US\$100 billion FDI to China and Hong Kong in 2000, probably only US\$36 billion were real FDI, with most of that going to China¹².

HAS CHINA REALLY BEEN TAKING FDI AWAY FROM ASEAN?

The popular perception that China is getting the lion’s share of FDI in Asia has been based on the assumption that FDI flows to Asia is a zero-sum game, i.e. an increase in FDI to one country must be at the expense of another country. If China has been taking FDI away from ASEAN-5, then whenever there is a large increase in FDI flows to China, we should see a corresponding decrease in FDI flows to ASEAN-5.

However, the zero-sum game assumption would be considered flawed if China and ASEAN-5 are both receiving higher inflows of FDI. In other words, if the pie is getting bigger, everyone can have a larger portion. In the case of China and ASEAN-5, both economies had experienced strong FDI growth throughout the 1990s before the onset of the Asian Financial Crisis in 1997–98 (*Exhibit 4*).

GLOBAL FDI FLOWS TO CHINA AND ASEAN-5 [Exhibit 4]



¹² PERC (2001), *How Foreign Direct Investors Are Treated in Asia*, No. 598, 12 December.

Over 1989–97, FDI flows to China shot up from US\$3.4 billion to US\$44 billion; FDI flows to ASEAN-5 burgeoned from US\$7.6 billion to US\$27 billion in the same period. For the eight years leading to 1997, FDI to China and ASEAN-5 had annualised growth rates of 38 per cent and 17 per cent respectively. This was hardly an indication of ASEAN-5 losing out to China, considering that FDI to ASEAN-5 grew at almost the same annual rate of 16 per cent between 1979–89. In other words, from 1989–97, the emergence of China had neither reduced the level of FDI to ASEAN-5, nor shaved off its growth rate.

On a similar note, between 1998–2000, when FDI to ASEAN-5 declined sharply, China also experienced a drop in FDI. Compared to 1997, FDI flows to ASEAN-5 and China in 2000 had declined by 67 per cent and 7.8 per cent respectively. In 2001, FDI to ASEAN-5 and China moved in tandem again, rising by 31 per cent and 15 per cent correspondingly. In a nutshell, the trends and patterns of global FDI flows to ASEAN-5 and China have not shown that the growth in FDI to China has been at the expense of ASEAN-5.

...the growth in FDI to China has not been at the expense of ASEAN-5.

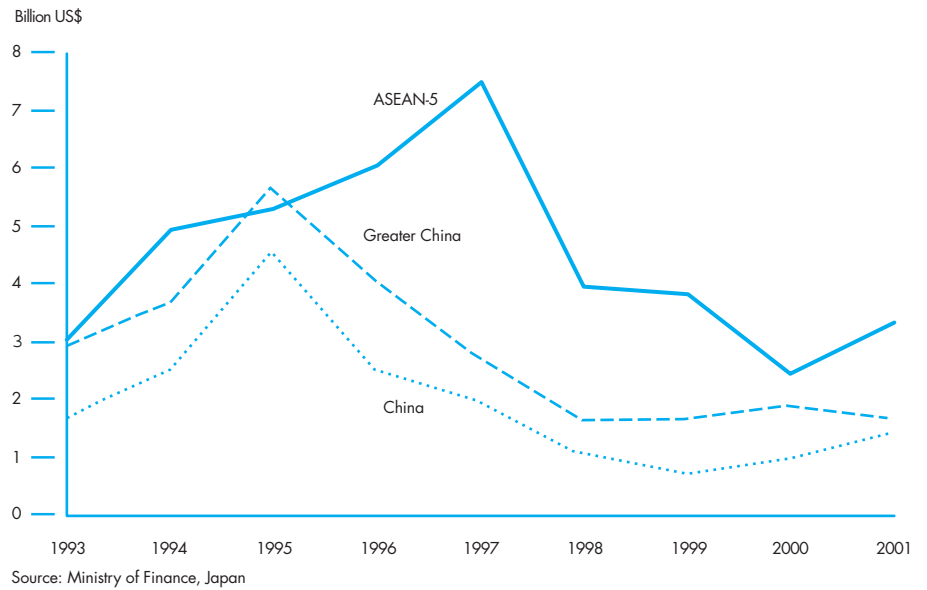
The next step in the exercise is to consider if the main investors in ASEAN have been diverting FDI to China. For the ease of cross-country comparability, source-country outward FDI data is preferred over host-country inward FDI data¹³ (see a technical discussion on “indirect FDI” and the use of source country data in *Appendix 1*). Using outward FDI data from Japan, the US and EU, which collectively accounted for more than half of ASEAN’s inward FDI from 1995 to 2000, we observe that developed countries have consistently invested more in ASEAN-5 than in China, while Hong Kong has hitherto remained the single largest contributor to China’s inward FDI. Since Hong Kong is a gateway for foreign investors to enter China (the same can be said of Singapore in relation to ASEAN), we include Greater China, i.e. China and Hong Kong, in our analysis as well¹⁴ (see a technical discussion on the definition of Greater China in *Appendix 2*).

Data from Japan’s Ministry of Finance show that Japanese firms have consistently invested more in ASEAN-5 than in China, even during and after the Asian Financial Crisis (*Exhibit 5*). From 1996–2001, the average annual outward FDI from Japan to ASEAN-5 was US\$4.5 billion, which was significantly more than the US\$1.5 billion to China and US\$2.3 billion to Greater China.

¹³ There could be huge differences in FDI definition and data collection among countries. The use of source country data can overcome these problems. However, source country data is still not free from “indirect FDI” and reporting errors.

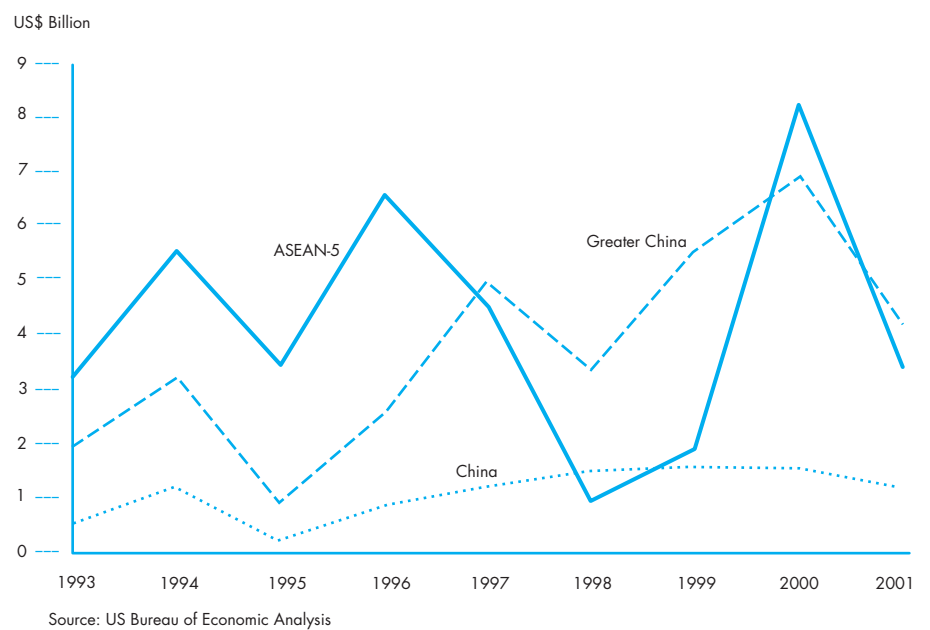
¹⁴ Taiwan is not included in “Greater China” because Taiwan receives relatively little global FDI.

FDI FLOWS FROM JAPAN TO GREATER CHINA AND ASEAN-5 [Exhibit 5]



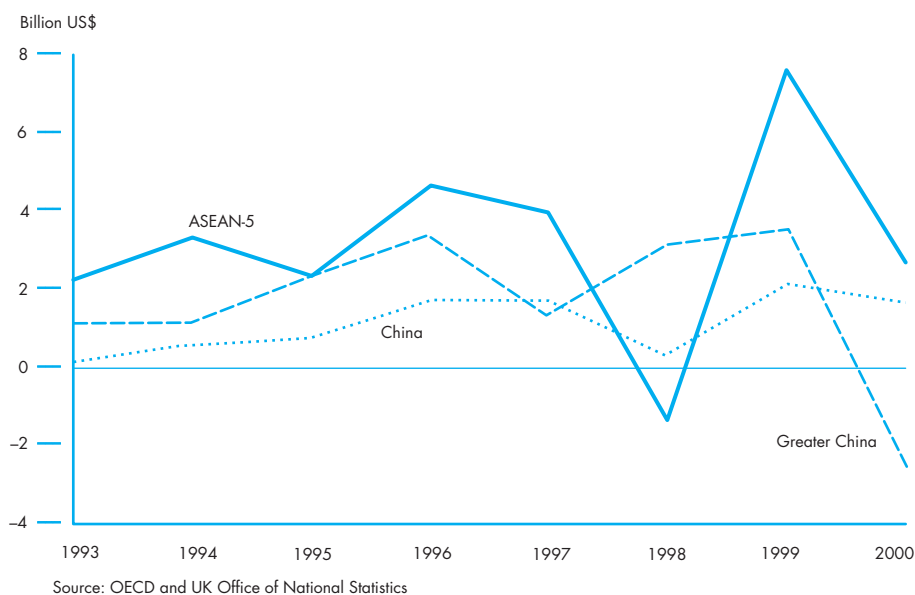
Figures from the US Bureau of Economic Analysis also indicate that ASEAN-5 have received more FDI from the US than China has, except during the financial crisis in 1998 (*Exhibit 6*). However the US has made substantial investments (mainly in financial services) in Hong Kong since 1997, and that has pushed Greater China’s importance to the US as a FDI destination to levels comparable to ASEAN-5. Between 1996-2001, the US had invested an average of US\$4.3 billion per annum in ASEAN-5, compared to US\$1.4 billion in China and US\$4.6 billion in Greater China annually.

FDI FLOWS FROM US TO GREATER CHINA AND ASEAN-5 [Exhibit 6]



Data from the EU paints a favourable picture for ASEAN-5 as well. Other than in 1998¹⁵, the main industrialised countries in Europe – the UK, Germany, France, and the Netherlands (EU-4) – have consistently invested more in ASEAN-5 than in China or Greater China (*Exhibit 7*). In 1996–2000, EU-4 had invested an average of US\$3.5 billion in ASEAN-5 annually but only US\$1.5 billion in China and US\$1.7 billion in Greater China¹⁶. Hence, source-country data show that, despite a booming FDI market in China, developed countries have so far not diverted investments away from ASEAN-5 to China.

FDI FLOWS FROM EU-4 TO GREATER CHINA AND ASEAN-5 [Exhibit 7]



... developed countries have so far not diverted investments away from ASEAN-5 to China...

However, even though our analysis has shown that China has not made gains in FDI from the major developed countries at the expense of ASEAN-5, and that both ASEAN-5 and China could concurrently see higher levels of FDI, we do not deny the existence of competition between them. Had China not opened up as much for foreign investments, a portion of the FDI that China had received could potentially have been channelled to ASEAN-5 instead. Unfortunately, it is impossible to determine how much more FDI that ASEAN-5 could have received had China remained closed to foreign investments, since it is an event that did not happen – we can only speculate.

¹⁵ Dis-investments from Singapore in 1998 resulted in negative FDI from EU-4 to ASEAN-5.

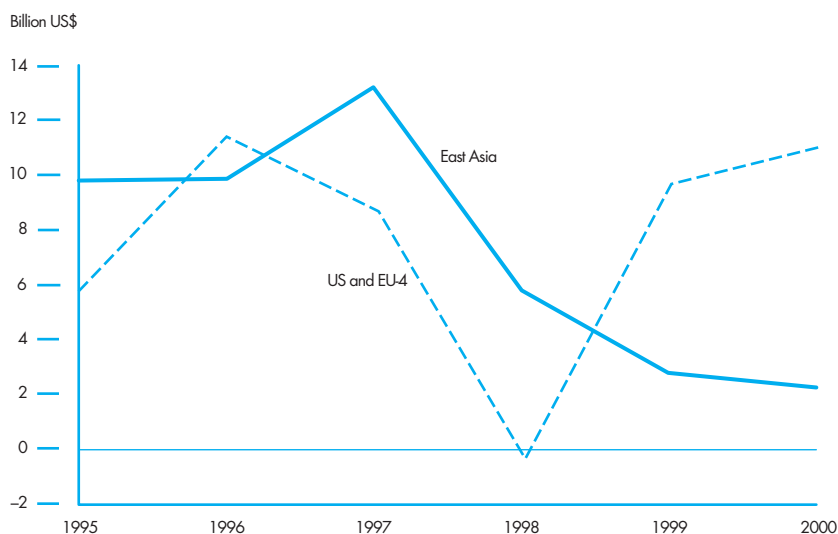
¹⁶ EU-4 FDI to Greater China was negative in 2000 because of large dis-investments from Hong Kong, to the sum of US\$4.3 billion.

WHY HAVE FDI FLOWS TO ASEAN-5 DECREASED?

The post-1997 sharp drop in FDI to ASEAN-5 can be largely attributed to the Asian Financial Crisis, which has severely dampened investors' confidence in the region. FDI to ASEAN-5 from main source countries plunged in 1998 (*Exhibit 8*)¹⁷. FDI from East Asia (including Japan)¹⁸ to ASEAN-5 shrank from US\$13.3 billion in 1997 to just US\$5.7 billion in 1998, while FDI from the US and EU-4 to ASEAN-5 plummeted from US\$8.5 billion to –US\$0.4 billion in the same period¹⁹.

The post-1997 sharp drop in FDI to ASEAN-5 can be largely attributed to the Asian Financial Crisis...

FDI FLOWS TO ASEAN-5 BY REGION [Exhibit 8]



Source: Various Official Sources

By 2000, however, FDI from EU-4 and the US to ASEAN-5 had recovered to the 1996 level of US\$11 billion, but FDI from East Asia itself remained depressed at only US\$2.3 billion, a far cry from the US\$13 billion in 1997. This is a much sharper decline than FDI from the US and EU-4. The drop was broad-based – almost all countries in East Asia lowered their investments in ASEAN-5. In particular, FDI flows from Japan to ASEAN-5 in 2000 was only half of that in 1997. Intra-ASEAN FDI among ASEAN-5 also fell from US\$5.1 billion in 1997 to merely US\$0.8 billion in 2000²⁰.

¹⁷ FDI from East Asia to ASEAN-5 in *Exhibit 8* is based on data from ASEAN Secretariat, which provides the most comprehensive data on FDI to ASEAN. In order to be consistent with *Exhibit 6* and *Exhibit 7*, however, FDI from the US and EU-4 to ASEAN-5 in *Exhibit 8* is based on figures from the US BEA, OECD and UK ONS. Being source country data, these figures are not strictly comparable to those provided by ASEAN Secretariat, which are host country data. FDI from the US and EU-4 to ASEAN-5, as reported by ASEAN Secretariat, show a smaller dip in 1998, as well as a weaker recovery in 1999-2000.

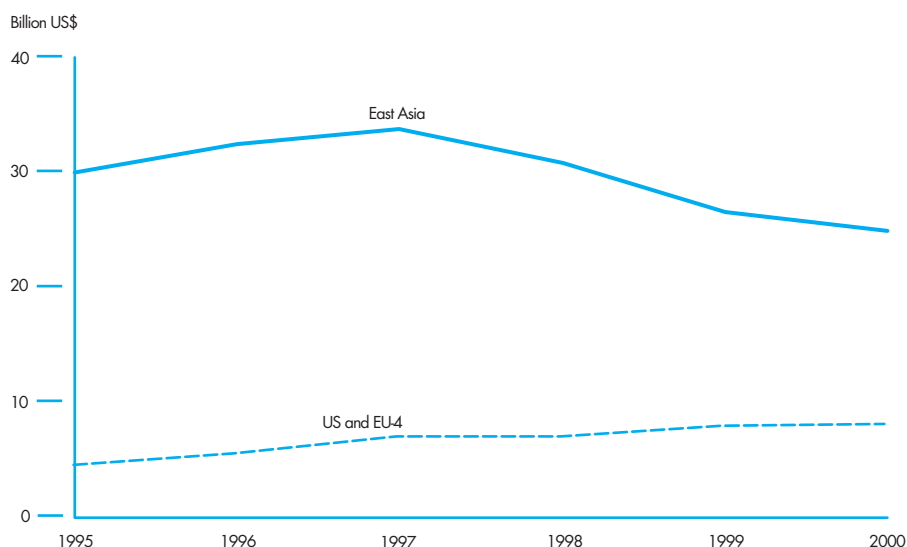
¹⁸ East Asia refer to ASEAN, Japan, China, Taiwan, Hong Kong and South Korea.

¹⁹ The dis-investments were primarily from Singapore. See footnote 15 as well.

²⁰ Intra-ASEAN investments increased by 10 per cent in 2001, ending three continuous years of decline. More detailed breakdown of FDI is not yet available from the ASEAN Secretariat when this paper is written. See "ASEAN sees investment recovery", *Business Times*, 12 September 2002.

This decline does not imply that East Asian investors have left ASEAN-5 for China. On the contrary, East Asian FDI to China also declined for three straight years starting from 1998 (*Exhibit 9*). From the apex of US\$34 billion in 1997, FDI from East Asia to China decreased to US\$25 billion in 2000. Furthermore, although US and EU-4 investors decreased their investments to ASEAN-5 en masse in 1998, they did not increase their commitment to the China market by a large degree. The US and EU-4 had only expanded their investments to China from US\$7 billion in 1997 to US\$8.2 billion in 2000.

FDI FLOWS TO CHINA BY REGION [Exhibit 9]



Source: Ministry of Foreign Trade and Economic Cooperation, China

...East Asian FDI to China also declined while the US and EU-4 had only expanded their investments to China marginally.

Arguably, if investors did not have an alternative investment location in China, the reduction in FDI to ASEAN-5 might not have been so drastic. To be sure, China has made great strides in shaping up its investment climate – infrastructure has improved, workers' skills have been upgraded and industrial clusters are developing. However, because the decline in FDI to ASEAN-5 has been an abrupt turnaround, it does not appear to be very closely related to China's increasing attractiveness as FDI destination, which has been more of a gradual process. Even in the unlikely future scenario that China's competitiveness should turn for the worse, unless ASEAN gets its own house in order, there can be no guarantee that investments would flow back to ASEAN as before.

FDI OUTLOOK FOR CHINA AND ASEAN-5

China's accession to the WTO will create more opportunities for foreign investments, especially to hitherto restricted industries such as commerce, telecommunications, finance, insurance and securities. It could also speed up acquisitions of Chinese companies by foreign firms.

Furthermore, China's strong GDP growth has not relented. China's National Bureau of Statistics announced that year-on-year GDP growth for the first nine months of 2002 was 7.9 per cent, and the momentum is likely to be sustained for the following year as well. The Economist Intelligence Unit (EIU) forecasts that China will grow by more than 7.5 per cent annually from 2003–2007²¹. Rapidly growing purchasing power in China, coupled with increasing quality of labour, would be welcoming for foreign investments.

...FDI outlook for China would be even brighter in the years ahead.

Therefore, unless being derailed by political and social instability, FDI outlook for China would be even brighter in the years ahead. According to MOFTEC, China absorbed US\$39.6 billion of utilised FDI in the first nine months of 2002, up 23 per cent year-on-year. The EIU predicts that China's inward FDI will reach US\$72 billion in 2006²², while the OECD expects it to increase to US\$100 billion in 2010²³. Foreign companies are also bullish about China's investment prospects. In the most recent (September 2002) A. T. Kearney's FDI Confidence Index rankings, China has taken over the world's top spot, overtaking the US for the first time²⁴.

Nevertheless, China's attractiveness as a FDI destination could be limited by the risk of depressed export prices due to over concentration in investment and over-production, a fear that has been expressed by some Japanese companies. The Nippon Keidanren is also concerned about market saturation and high transport costs in China²⁵. Furthermore, many foreign firms that have been lured to China by its large base of consumers have not been able to see good results on their balance sheets²⁶. Indeed, larger investment commitments in China may not guarantee higher rates of return than in other countries. According to the US Department of Commerce, US investments in China in 2001 had a rate of return of 12 per cent, which was lower than the rates of return in Indonesia (15 per cent) and Malaysia (17 per cent).

Despite the aforementioned problems in China's investment environment, the ASEAN-5 nations will still have a tougher road ahead. FDI to ASEAN-5 once peaked at US\$27 billion in 1997. EIU estimates that ASEAN-5's combined FDI flows will only reach US\$24 billion in 2006. This implies that there would be at least four more years before FDI flows to ASEAN-5 could fully recover from the Asian Financial Crisis.

²¹ The Economist Intelligence Unit (2002), *China Country Forecast*, October.

²² The Economist Intelligence Unit (2002), *World Investment Prospects: The Next FDI Boom*.

²³ OECD (2002), *China in the World Economy: The Domestic Policy Challenges*. This is conditioning on China opening up as accorded by the WTO.

²⁴ A. T. Kearney (2002), *FDI Confidence Index*, September.

²⁵ "Japanese firms unlikely to pull out of ASEAN. Officials warn of over-investment in China", *Business Times*, 5 August 2002.

²⁶ Several anecdotes of foreign companies that made losses in China can be found in Joe Studwell (2002) *The China Dream: The Elusive Quest for the Greatest Untapped Market in the World*, Profile Books Ltd.

CONCLUSIONS AND IMPLICATIONS

Since 1993, China has been the largest recipient of FDI in Asia. However, China's Asian neighbours need not be overwhelmed by the sheer amount of FDI that China is hosting. First, China's share of world FDI, relative to its share of world GDP, has not been excessive, and has only made small gains since 1988. In short, FDI flows to China are merely keeping up with China's high economic growth. In addition, FDI flows to China are not as large as official figures show because a significant percentage of it – 25 per cent or higher – consists of "round-tripping" of funds that originate from mainland Chinese commercial entities.

The growth in FDI flows to China has also not been at the expense of ASEAN. FDI flows to ASEAN-5 plunged as a result of the Asian Financial Crisis in 1997–98, and have remained subdued due to an unfavourable investment climate. Looking forward, FDI to China is expected to grow, driven by high GDP growth and accession to the WTO. FDI to ASEAN should also pick up pace as ASEAN gradually recovers from the financial crisis.

Unquestionably, ASEAN would have to contend with mounting competition from China for foreign investments. Most investors go to China either to tap the potentially enormous market or to take advantage of huge labour costs savings; others do so because everyone else is in China. However, popular media has been overstating the threat posed by China to ASEAN. Because FDI is not a zero-sum game, investments to ASEAN and China can grow concurrently, as was before the Asian Financial Crisis.

In addition, foreign firms have a strong incentive to stay in ASEAN because they have already made substantial investments in ASEAN in the past decades. China, with its vast population, is unmatched in market potential, but ASEAN can still compete with China in low-cost, productive labour²⁷. ASEAN already has a large domestic market, although it needs to improve the political environment in order to sustain its competitive advantage vis-à-vis China.

Recognising the need for member countries to work together, ASEAN has formed the ASEAN Investment Area (AIA) to make ASEAN a more competitive, conducive and liberal investment area. In a meeting on 11 September 2002, the AIA Ministerial Council announced a new two-year ASEAN Investment Initiative, which will see ASEAN engaging the private sector more actively and tapping on emerging exporting economies such as China, Australia and New Zealand.

The threat posed by
China to ASEAN
has been overstated...

²⁷ According to IMD (2002) *World Competitiveness Yearbook*, the hourly compensation for manufacturing workers in Indonesia is merely US\$0.14. Chinese manufacturing workers are paid US\$0.52 an hour, which is three times more than Indonesian workers, despite being less productive. Each Indonesian worker employed in industry contributes US\$3,853 to GDP, while the corresponding Chinese worker contributes just US\$3,693.

Rather than considering China as a threat, ASEAN could ride on China as an engine of growth. First, bilateral trade between China and ASEAN-5 is expanding. China Custom Statistics show that in 2001, Chinese imports from ASEAN-5 were US\$22.9 billion and exports were US\$16.4 billion, up from US\$6.3 billion and US\$5.5 billion respectively in 1993. Second, ASEAN can benefit from rising outward FDI from China²⁸. In 2000, out of China's US\$551 million outward FDI, nearly a fifth – US\$108 million – went to Southeast Asia.

...there is a need for ASEAN to reinforce trade linkages within ASEAN and with its trading partners.

As a final point, to make ASEAN more attractive as a FDI destination, there is a need for ASEAN to reinforce trade linkages both within ASEAN and with its trading partners. Progress is already underway. For senior member countries in ASEAN, namely Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand, the ASEAN Free Trade Area will be accelerated to 2010. From 1 January 2003, the six senior member countries will remove tariffs on 60 per cent of the goods that are traded between them.

In addition, ASEAN and China have signed a landmark deal to form the largest free trade zone in the world, which encompasses a total population of 1.7 billion people and a combined GDP of about US\$2 trillion. The ASEAN-China Free Trade Area (ACFTA) would involve the reduction and elimination of tariffs by 2010 for China and the six senior ASEAN member countries, and by 2015 for Cambodia, Laos, Myanmar and Vietnam. It is estimated that the ACFTA would bolster ASEAN's and China's GDP by 0.9 per cent and 0.3 per cent respectively. The ACFTA would also increase ASEAN's exports to China by 48 per cent and China's exports to ASEAN by 55 per cent²⁹. The ACFTA also provides for an "early harvest", in which the six senior ASEAN members and China would begin to lower tariffs in several product categories from 1 January 2004.

The ACFTA could also induce other countries, such as Japan and the US, to work towards FTAs with ASEAN, for fear of being left out in Southeast Asian trade. ASEAN and Japan have already signed a Joint Declaration on the ASEAN-Japan Comprehensive Economic Partnerships (AJCEP), which will include FTA elements within ten years. In the same vein, the US has proposed the "Enterprise for ASEAN Initiative", which would pave the way for bilateral FTAs with individual ASEAN members. Hot on the heels of China, Japan and the US, India and South Korea have also expressed strong interest in forming FTAs with ASEAN.

This paper has put China's FDI performance in proper perspective by examining the Inward FDI Performance Index and the degree of FDI "round-tripping" to China. Our analysis suggests that the Asian Financial Crisis, rather than China, has been primarily responsible for the decrease in ASEAN-5's inward FDI flows. Nonetheless, China still looms very large over Asia, and is a global economic force to be reckoned with. ASEAN will have to engage China both as a competitor and a partner – an intricate relationship that has to be managed prudently.

²⁸ For a comprehensive treatment on China's outward FDI to ASEAN, see "China's Rising Investment in Southeast Asia: How ASEAN and Singapore can benefit?", *Economic Survey of Singapore 2001*, February 2002.

²⁹ ASEAN-China Expert Group on Economic Cooperation (2001), *Forging Closer ASEAN-China Economic Relations in the Twenty-first Century*.

“INDIRECT FDI” AND THE USE OF SOURCE COUNTRY FDI DATA

APPENDIX 1

This appendix addresses the use of source country FDI data as a basis to evaluate the relative importance of FDI destinations.

“Indirect FDI”

Many Taiwanese firms have subsidiaries in Hong Kong and tax haven countries like Bermuda, Cayman Islands and the British Virgin Islands (BVI). Taiwanese firms may invest in China through these overseas subsidiaries. Such foreign investments, made by overseas affiliates of a parent company, are termed “indirect FDI”. Unfortunately, FDI data is usually recorded on a BOP basis and therefore cannot be traced back to the home country of the parent firm.

Taxation and embargoes can lead to “indirect FDI” – these are country-specific factors. For example, Mauritius became one of the largest FDI sources for India after it concluded a double-taxation treaty with India. Taiwanese companies have been investing in China via affiliates in Hong Kong, since there was no direct investment link between China and Taiwan until August 2002. There are also firm-specific factors. MNC operations can be such that the regional HQ undertakes the investment decision. This factor accounts for a large part of Singapore’s outward FDI to ASEAN.

UNCTAD, in World Investment Report (WIR) 1998, estimates that 30 per cent of outward FDI from Hong Kong are accounted by foreign affiliates. According to Singapore Department of Statistics, as at year-end 2000, foreign-controlled firms accounted for 41 per cent of total outward FDI stock from Singapore. It is safe to believe that most of the FDI from tax haven economies is undertaken by foreign affiliates. Hong Kong and BVI are major sources of FDI to China. Given the significant presence of foreign firms in these economies and their status as offshore financial centres, a significant amount of FDI from Hong Kong and BVI to China could be “indirect FDI”.

The Use of Source Country FDI Data

FDI data is notorious for being inconsistent among reporting sources. For example, figures of US FDI flows to China from China's Ministry of Foreign Trade and Economic Cooperation (MOFTEC) are consistently higher than the numbers from the US Bureau of Economic Analysis (BEA). MOFTEC numbers are about three times higher than numbers provided by BEA (Table 1). Even between OECD countries, FDI flows reported by host and home countries differ.

FDI FLOWS FROM US TO CHINA (US\$ BILLIONS) [Table 1]

Source	1998	1999	2000	Total (1998–2000)
MOFTEC	3.9	4.2	4.4	12.5
BEA	1.5	1.6	1.2	4.3

One reason for the discrepancies is the use of different thresholds in the definition of FDI. Countries may also treat short-term financial operations of foreign affiliates differently. There could also be diverging valuation principles, differences in data collection and reporting, and different treatment of real estate and construction. FDI data as reported in the most commonly-cited WIR, based on statistics provided by host countries, are not free of these difficulties.

Because it is collected by a single agency, source country FDI data permits cleaner cross-country comparison. Nevertheless, a few limitations would still apply. For one thing, source country data is subjected to reporting bias by firms. It is plausible that firms may have incentives to under-report their investments in certain countries, such as for strategic or political reasons. In addition, source country data usually does not account for "indirect FDI". Therefore, in our analysis, it is implicitly assumed that the problems of reporting bias and indirect FDI are not so severe that the implications and conclusions are made invalid.

Reporting bias is a common problem in statistics. It could be particularly serious in accounting for FDI from Taiwan to China, since for political reasons Taiwanese firms are not allowed to carry out business transactions directly with China. In the case of FDI from Japan, the US and EU-4 to China and ASEAN, however, there has been so far no strong evidence of reporting bias.

Indirect FDI is a trickier issue. Out of the FDI from Hong Kong and tax havens to China, it is not known how exactly much of it consists of indirect FDI, much less from which country. Nevertheless, it can be argued that, *vis-à-vis* other tax havens, Hong Kong is a much more important gateway for China-bound FDI, given Hong Kong's extremely strong economic linkages with China. In addition, Hong Kong is made even more attractive as a gateway for investments to China by its excellent financial, legal and physical infrastructure³⁰. Hence, by accounting for FDI to both China and Hong Kong, we should be able to capture most of the China-bound FDI.

³⁰ Like BVI and many other tax havens, Hong Kong does not tax foreign income, i.e. there will not be any tax applied to income repatriated from China to Hong Kong. This makes Hong Kong a very attractive hub for FDI to China.

GREATER CHINA OR JUST CHINA?

APPENDIX 2

Taiwan is not included in “Greater China” in the analysis in the main article because it has a minor role in inward FDI. In addition, Taiwan does not play the middleman role that Hong Kong does, and therefore is not likely to be channelling “indirect FDI” to China.

Taiwan receives just a small amount of world FDI compared to China and Hong Kong (*Table 2*). From 1995–2000, Taiwan’s average annual inward FDI flows was only about US\$2.3 billion, which compares poorly to US\$22 billion and US\$41 billion respectively for Hong Kong and China.

However, simply adding up the FDI figures in the *World Investment Report* (WIR) for China, Hong Kong and Taiwan would give a very misleading impression of how much FDI Greater China receives. First, a good part of the “round-tripping” FDI to China goes through Hong Kong. Second, a considerable percentage of FDI to Hong Kong is “indirect FDI” whose end destinations are China and tax havens. This is complicated by fund raising activities by Chinese companies in Hong Kong³¹. The use of source country data would get around some, but not all, of these problems.

According to source country data, Taiwan received little FDI from US, Japan, and EU-4. The US and Japan invest about two to five times more in China and Hong Kong than in Taiwan. Taiwan only received more FDI from EU-4 than Hong Kong during 1995-2000 because of huge EU-4 dis-investments from Hong Kong in 2000 (to the sum of US\$4.3 billion).

AVERAGE ANNUAL FDI FLOWS TO GREATER CHINA, 1995–2000 (US\$ BILLION) [Table 2]

	World	US	Japan	EU-4
China	41	1.1	2.0	1.4
Hong Kong	22	2.3	1.0	0.4
Taiwan	2.3	0.4	0.4	0.6

Source: UNCTAD

US Bureau of Economic Analysis

Ministry of Finance, Japan

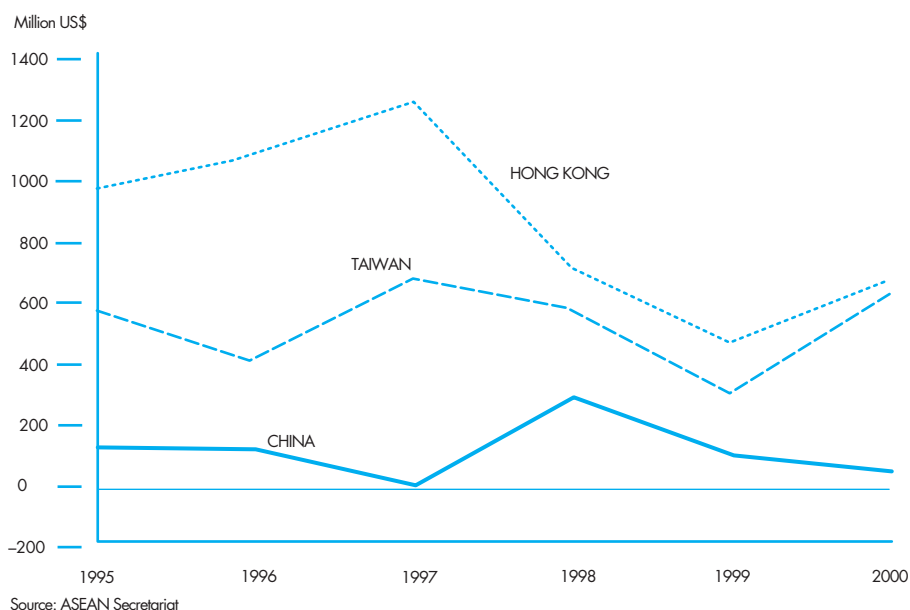
OECD

Office of National Statistics, UK

³¹ Hong Kong received US\$62 billion of global FDI in 2000, which made Hong Kong the biggest recipient of FDI in Asia that year. However, most of the US\$62 billion was likely to be “round-tripping” FDI and “indirect FDI”. It is thus not surprising that the huge amount of FDI that Hong Kong allegedly received did not have a large positive effect on its real economy. In 2001, FDI to Hong Kong declined sharply to US\$23 billion. However, most of it could still be merely FDI that would eventually end up in China and tax havens.

As for outward FDI, Hong Kong and Taiwan are the bigger investors in ASEAN. China's outward FDI to ASEAN is still a trickle (*Chart 1*). In 2000, Hong Kong and Taiwan invested US\$611 million and US\$802 million respectively in ASEAN, whereas China sank in merely US\$57 million. Together, China, Hong Kong and Taiwan contribute about 10 per cent of global FDI flows to ASEAN. If we were to use Greater China for our analysis, we might overstate the relatively small role of China.

FDI FLOWS FROM GREATER CHINA TO ASEAN [Exhibit 10]



Because of geographical proximity and a common heritage, there are very strong economic ties between China, Hong Kong and Taiwan. However, many differences still exist. The political and fiscal regimes in the three countries are different and they are far from converging. In addition, factors of production do not move all that easily across borders³². Greater China is not yet a Free Trade Area, and even further away from a monetary union such as transpired in Europe.

To conclude, with regard to FDI, Greater China masks the small roles of Taiwan in inflows and China in outflows. More generally, the concept of Greater China may only be useful for discussing broad strategies at this juncture. However, as economic linkages between China, Hong Kong and Taiwan deepen, and as present differences ease off, Greater China as a true blue economic entity may one day materialise.

³² Before August 2002, Taiwan companies could not invest in China directly, but had to channel investments through overseas subsidiaries. There is still no direct trade and travel links between China and Taiwan. Aircraft and sea vessels plying between Taiwan and China have to transit through a third party, most often Hong Kong.

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