2. Foreign Investment Leverages China's Growth

AMONG THE FEW PROPOSITIONS on which all China experts—those in China as well as outside—agree is that foreign direct investment (FDI) has been one of the two or three most important contributors to China's rapid economic growth during the past fifteen years. Initial calculations suggest that each $10 billion of FDI is associated with between 0.9 percent and 1.6 percent of annual economic growth in China. If annual FDI fell by $30 billion, China's annual growth might decline by nearly half its current rate.

FDI is defined as the creation and/or acquisition, by foreign capital owners, of tangible assets situated in the recipient country.

There is less agreement concerning the explanation for FDI's impact. According to one view, the effect of FDI lies in its packaging of technology, management, and marketing (especially export marketing), together with capital, with each component enhancing the effectiveness of the others.

A second explanation contends that FDI's effectiveness results

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from the preferential treatment it is accorded, enabling FDI to take advantage of opportunities within China inaccessible to domestic capital due to barriers to capital mobility that exist among China's thirty-one provinces.

In any event, China is the second-largest recipient of FDI in the world economy (the largest is the United States). The $43 billion of FDI in China in 2001 is larger than the corresponding amounts received by all other Asian economies, excluding Hong Kong, which functions as an entrepôt for FDI in China as well as other Asian countries. FDI in China has risen to this level from a figure of $2 billion in 1986, increasing at a compound annual rate of more than 18 percent, and steadily rising from 1986 through 1997, with a slight decline since 1997 in constant 1995 US dollars.

The consensus among China experts is that FDI will continue to rise in the coming decade. According to a survey I conducted a few months ago, 88 percent of the respondents expressed this view. But experts are typically more reliable in interpreting and explaining the past—for example, in their consensus that FDI has been crucial in contributing to China's economic growth during the past fifteen years—than in forecasting the future. In forecasting what *will* happen, rather than explaining what *has* happened, their testimony has frequently been wrong. Consider, for example, the failure to forecast Japan's stagnation in the 1990s against its background of remarkable growth in the 1970s and 1980s; the failure to predict the plunge in the economies of Korea, Indonesia, and Thailand in 1997–1998; or the protracted slow growth of Germany in the 1990s.

So, although FDI may remain at high levels or increase in the coming decade, it may also fall substantially, with serious consequences for China's economic growth. This uncertainty is due to the many factors—both within China and outside—that can affect FDI in an upward or downward direction.

Internal factors prominently include such political developments as the harmony or friction that accompanies the impending transition from China's third-generation to its fourth-generation leadership and the prevalence of political and social stability in China or, conversely, the spread of civil unrest from rural areas to urban areas.

Numerous other factors will make China's economic environment either congenial or adverse for FDI in the coming decade. These include, for example, whether China moves toward or away from a rule of law in which property rights are respected and predictable, equities markets are expanded, corporate governance becomes more responsive and transparent, and corruption recedes rather than advances. The outlook for FDI in China will also be materially affected by the pace and fidelity with which China complies with its WTO commitments, whether the Chinese yuan remains stable while moving toward full convertibility, and whether and how the huge volume of nonperforming loans on the balance sheets of China's four state banks continues to grow without triggering a financial crisis.

With increasing integration and competitiveness in global capital markets, FDI in China will depend not only on these internal factors but on how the environment for FDI evolves in other parts of the world in both capital-exporting countries (such as the United States and the European Union), as well as capital-importing emerging markets including Korea, Russia, Eastern Europe, Southeast Asia, Taiwan, South Asia, and Latin America. Hence, China's ability to attract FDI will depend on other countries' political stability; their development and protection of property rights, corporate governance, the rule of law; and their possible resource discoveries, in particular. It will also depend on China's ability to maintain reasonably harmonious relations with its neighbors, including the United States, Japan, the European Union, Taiwan, and Southeast Asia.

In the past, FDI in China has been sparked by the lure of its potentially huge market. In most instances, promise has exceeded performance. Thus far, few FDI undertakings have resulted in significant profits for foreign investors. As a consequence, some of the previous optimism has been replaced by increasingly hard-headed calculations of costs and prospective returns.

In sum, future FDI in China will depend to a much greater extent than in the past on China's risk-adjusted, after-tax return on investment, relative to opportunities elsewhere in a world of globally integrated capital markets.

The ensuing stakes for China are immense. If the combination of internal and external factors influencing FDI in China moves in an unfavorable direction, China's forgone economic growth would be seriously eroded. This prospect will and should, as Samuel Johnson observed, "concentrate the minds" of China's policymakers.

POSTAUDIT

The importance ascribed to FDI was right on; the prognosis was way off! FDI in China has continued to grow but at a decreasing rate.