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What will an appreciation of China's currency do to inward and outward FDI?

by
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What will an appreciation of the Chinese yuan do to China's inward and outward direct investment? The discussion so far has been almost exclusively about the impact on China's trade balance. But it is at least as important to see what effect it may have on the country's inward foreign direct investment (IFDI), which plays such a crucial role in China's economic development, and its outward FDI (OFDI), which is receiving increased attention worldwide.[1]

China has been the developing world's largest recipient of IFDI since the mid-1990s, attracting US$95 billion in 2009.[2] A revaluation of the yuan will make it more expensive for foreign firms to establish themselves (or expand) in China (the world's most dynamic market), giving an advantage to foreign firms already established there over new entrants. At the same time, exports of foreign affiliates, which account for 54% of total exports,[3] will become less competitive internationally, although the increased costs will be partly offset by lower costs of imported inputs. Foreign affiliates can also expect to repatriate higher profits from sales in China in terms of their own currencies.

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[1] For a most recent overview of China's IFDI and OFDI, see Ken Davies, "Inward FDI in China and its policy context", *Columbia FDI Profiles*, October 18, 2010, and Ken Davies, "Outward FDI from China and its policy context", *Columbia FDI Profiles*, October 18, 2010.

[2] UNCTAD FDI statistical database http://stats.unctad.org/

[3] Figure for the first eight months of 2010 from MOFCOM website: http://www.fdi.gov.cn/

However, the most notable development of recent years has been the take-off of the country's OFDI since the government in 2000 adopted the "go global" policy encouraging Chinese firms to invest overseas.[4] China's OFDI doubled from US$12 billion in 2005[5] to US$27 billion in 2007, and then doubled again the following year, to reach US$56 billion.[6] Outflows continued to rise to $57 billion in 2009, even as world FDI flows collapsed by 50%. In 2009, China was the world's fifth largest outward investor.

The increasing international competitiveness of Chinese firms and an encouraging government policy have been the main drivers of this surge. The 20% revaluation of China's currency against the US dollar in 2005-2008 undoubtedly provided a favorable condition facilitating this in the case of host countries whose currencies did not also appreciate against the US dollar. There is ample evidence in the academic literature that a weaker exchange rate induces increased IFDI.[7]

China's OFDI is poised to grow sharply again in 2010, judging by the first half of the year, when it was rising at an annual rate of 44%.[8] Revaluation would accelerate this trend. This is precisely what happened with Japan after the yen was revalued by over 50% against the US dollar between 1985 and 1987, following the 2005 Plaza Accord.[9] Japan's OFDI tippled from US$6.5 billion in 1984 to US$19.5 billion in 1986, peaking at US$48 billion in 1990.[10]

A renewed yuan appreciation would boost China's OFDI growth even further by lowering the cost of overseas assets for Chinese firms, which have strong cash reserves from both retained earnings and large-scale state credit allocations that put them in a position to invest internationally. Like competitors elsewhere, they need to invest abroad to acquire a portfolio of locational assets to protect and increase their international competitiveness through better access to skills, technology, natural resources, and markets.

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[4] See Qiuzhi Xue and Bingjie Han, "The role of government policies in promoting outward foreign direct investment from emerging markets: China's experience", in Karl P. Sauvant and Geraldine McAllister, with Wolfgang A. Maschek, eds., *Foreign Direct Investment from Emerging Markets: The Challenges Ahead* (New York: Palgrave, 2010), pp. 305-324.
[5] Not including financial FDI.
[6] Ministry of Commerce, *2009 Statistical Bulletin of China's Outward Foreign Direct Investment* (2010).
[7] See e.g. Kenneth A. Froot and Jeremy C. Stein, "Exchange rates and foreign direct investment: an imperfect capital markets approach", *The Quarterly Journal of Economics*, vol. 106, No. 4 (1991), pp. 1191-1217; and Kathry L. Dewenter, "Do exchange rate changes drive foreign direct investment?", *The Journal of Business*, vol. 68, No.3 (1995), pp. 405-433.
[8] Invest in China website: http://www.fdi.gov.cn
[9] Announcement of the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom, and the United States (Plaza Accord) September 22, 1985. University of Toronto G8 Information Centre: http://www.g8.utoronto.ca/ .The yen went from 238 to the dollar in 1985 to 168 in 1986, 145 in 1987 and 128 in 1988. See Zhang Zongbin and Yu Hongbo [张宗斌/于洪波], "Comparative research into China's and Japan's OFDI" [中日两国对外直接投资比较研究], *World Economy and Politics* [世界经济与政治] 2006.
[10] JETRO, Japanese Trade and Investment Statistics, JETRO website: http://www.jetro.go.jp/

Revaluation would combine with already rising wage pressures inside China. Labor-intensive firms in China's coastal provinces are under pressure to seek lower labor cost by either investing in China's interior of abroad. Already more than 700 Chinese affiliates have been established in Vietnam.[11] Revaluation would push even more in that direction.

Suspicions of non-commercial motivations behind China's OFDI are widespread because most of the country's OFDI is by state-owned enterprises (SOEs). However, there is no systematic evidence that China's SOEs, like their counterparts elsewhere, are driven by more than normal commercial considerations. At the same time, private or semi-private entities have been investing abroad. As their operations are less visible, it is likely that their OFDI, and therefore China's total OFDI, is understated.

Fears of Chinese OFDI, as of Japanese and Korean investment in earlier decades, are misplaced. It is good for China and for host countries: Chinese FDI, like all FDI, can bring to host countries a bundle of tangible and intangible assets needed for economic growth and development. While a good part of China's OFDI initially takes the form of trade-supporting FDI, it can be expected to lead relatively quickly to a shift of some production out of China, including to the US and Europe, thereby reducing exports from China. Moreover, OFDI is a key mechanism for integrating China into the world economy and making it a responsible stakeholder in it.

However, Chinese firms will have to learn from the past mistakes of other emerging multinationals about how to operate in the highly sophisticated developed-country markets and in developing countries. They need not only to overcome the "liability of foreignness" that any multinational faces when establishing itself in a foreign market, but they also need to overcome the "liability of the home country". In particular, they need to establish a good social brand name so that they are seen as making not only a positive economic contribution to their host countries, but are also seen as good corporate citizens. The Chinese government can play a crucial role by adopting a code of conduct for all Chinese enterprises investing abroad, in line with internationally accepted norms and taking into account the increasing importance of sustainable FDI. For their part, host countries need to accept the "new kids on the block" and not discriminate against Chinese investment, nor establish protectionist barriers against it.

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[11] *China Daily*, August 31, 2010, p. 14.

The Vale Columbia Center on Sustainable International Investment (VCC), led by Dr. Karl P. Sauvant, is a joint center of Columbia Law School and The Earth Institute at Columbia University. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. VCC focuses on the analysis and teaching of the implications of FDI for public policy and international investment law.

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