



Understanding the Slowdown in Foreign Investment in China

By

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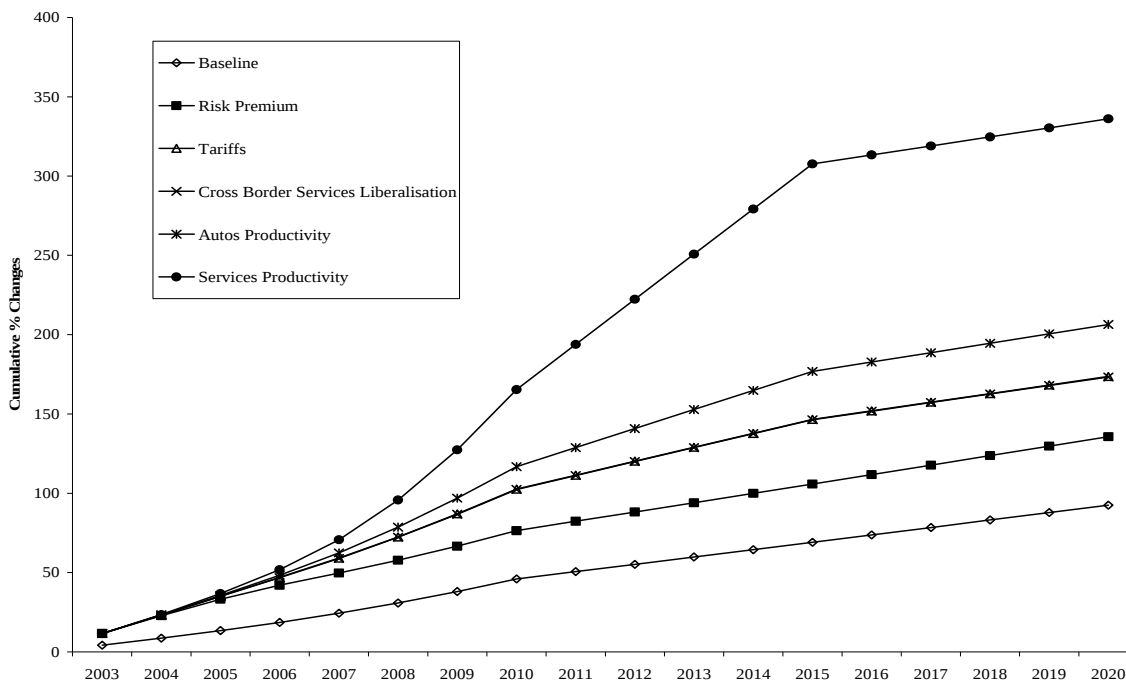
No one thought China's high growth rates would persist forever, or that multinational firms would always keep pouring into the Chinese market, eager to establish operations regardless of local conditions. Economic convergence ensures that there will be a cooling off as wages rise and expected rates of return to investments fall. The difficult question has never been whether China will lose its luster, but when this would happen and how the adjustment will occur.

As of late, there have been signs that change is in the air. While China's growth continues to be strong, it is no longer in the double digit range, typical during the 2000s. Furthermore, the global financial and economic crisis exposed the limits of China's export-led growth model and provided impetus for policies that will boost domestic consumption and reduce reliance on exports.

Still, to many it might be surprising that China's market has started losing its appeal with multinational companies. China's qingjinlai or 'welcome in' policy has been encouraging foreign direct investments (FDI) for the past 3 decades. Importantly, China continues to have the fastest growing market in the world, having contributed more than any other country to the world's consumption growth in 2011-13. Yet, Revlon, L'Oréal, Best Buy, Media Markt, and Yahoo have all either left China or downsized their operations there, and many other multinationals find it difficult to stay profitable in the Chinese market, according to a recent lead article in the Economist (2014). It cites several reasons why foreign firms are leaving or finding it increasingly difficult to carry out profitable operations in China. These include rising costs, restrictions in some sectors that make it difficult to operate in China, and more intense competition as local firms are catching up to global standards.

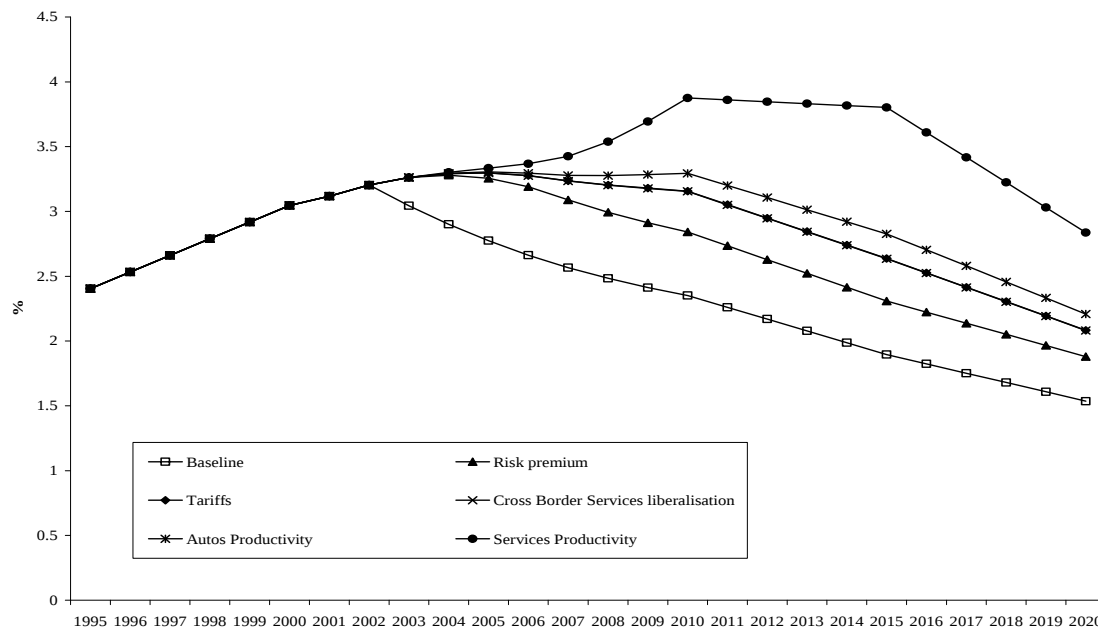
Nevertheless, the difficulties facing multinationals in China today have long been anticipated. A paper by Walmsley, Hertel, and Ianchovichina (2006) assessed the impact of China's WTO accession on investment and projected accurately that accession would boost foreign ownership of assets located in China (see Figure 1), with the share of foreign ownership in Chinese assets peaking around 2010 and declining after 2014 (see Figure 2). They also predicted a gradual increase in the share of Chinese wealth located abroad.

Figure 1. Gross Foreign Ownership of Chinese Assets



Source: Walmsley, Hertel, and Ianchovichina (2006), based on simulations with GDyn, documented in Ianchovichina and Walmsley (2012)

Figure 2. Share of Foreign Ownership of Chinese Assets



Source: Walmsley, Hertel, and Ianchovichina (2006), based on simulations with GDyn, documented in Ianchovichina and Walmsley (2012)

The success of Walmsley et al. (2006) may be traced back to the careful economic modeling underpinning their analysis of foreign ownership in China. They used GDyn: a dynamic recursive CGE model for the global economy (Ianchovichina and Walmsley, 2012), which allowed them to track changes in firm profitability and foreign ownership. Walmsley et al. (2006) also implemented into the model China's existing trade policy environment, notably the presence of duty exemptions on imported inputs (Ianchovichina, 2004), and carefully reflected the various aspects of reforms as part of China's accession to the WTO. Importantly, Walmsley et al. (2006) benefited from detailed studies on the impact of sectoral reforms, especially the ones that constrained foreign investments in the service sectors.

Using the model as a lens through which to view this downturn in foreign investment in China, we find that several factors have been particularly important as shown in Figures 1 and 2. First, Walmsley et al. (2006) noticed that foreign ownership in China had been increasing at rates which were significantly higher than justified by growth in expected rates of return during the pre-accession period. This was a sign of excessive optimism on the part of investors. According to foreign investment data, the growth rate of domestic ownership in 2001, when China was about to join the WTO, was 9% less than the GDyn model would have projected in the absence of reforms associated with accession. Over the years, the increase in the share of foreign ownership in China had been driven by tax incentives for FDI, removal of restrictions on FDI in some industries, and a decline in risk premia which occurred as China gradually opened up its economy and accession to the WTO became increasingly assured. Duty exemptions were particularly important as they enabled multinationals to access low cost labor in China, while obtaining materials and other intermediate inputs at world prices, thereupon linking to global production networks (Ianchovichina and Martin, 2001).

Despite creating incentives for FDI in the 1990s, on the eve of accession China was still relatively closed to foreign investments and joint ventures remained the best way for multinationals to invest there. Importantly, sectors such as services were closed to foreign investments until the early 2000s. These sectors were opening up to foreign investors on a schedule, specified in the negotiated accession documents. Walmsley et al. (2006) believed that the opening up to FDI would persist only if China's accession succeeded. They assumed that under such a scenario risk premiums would continue to fall at a diminishing pace and by 2007 any affinity by foreign investors to increase foreign ownership in China, caused by China's opening up to foreign investment, would most likely have been eliminated (Figure 1).

Second, in order to avoid overstating the impact of reductions in these policy instruments on firms' costs and therefore on foreign ownership, Walmsley et al. (2006) took a lot of care to

implement realistically the prevailing tariffs and quotas on the eve of China's WTO accession. The tariff reductions agreed to by China as part of the accession offer were obtained from Martin et al. (2000) and were based on China's offer as of August, 1999. However, because many of the reductions had already been implemented as part of China's preparation for WTO accession, Walmsley et al. (2006) compared the offer to China's 1997 applied tariffs and took the offer as a change in policy only when the binding was lower than the applied tariff. The tariff cuts were assumed to be evenly distributed over the entire simulation period and to affect only imported intermediate goods for production of commodities for domestic consumption and final consumption goods. Duties on imported intermediates used for the production of exports were already zero. Finally, they assumed that quotas on China's textiles and clothing exports to North America and European Union would be removed in a back-loaded way by the beginning of 2007, with the bulk of the impact not felt until the final two years.

Third, Walmsley et al. (2006) expected that the opening of China's heavily protected motor vehicle industry would lead to substantial restructuring and rationalization in the industry and an estimated 20% boost in the industry's total factor productivity in assembly operations (Francois and Spinanger, 2004). These gains were assumed to occur slowly, peak in the last year of accession (2006), and then fall back to the baseline rates by 2010.

Fourth, China's commitments in the services sector, viewed by Mattoo (2003) as the most radical reform program negotiated in the WTO, were expected to result in significant cost savings and therefore the strongest increase in foreign ownership. The impact on the economy and investment in other sectors was also expected to be significant due to the use of services as intermediate inputs. Thus, omitting the services commitments from the evaluation of China's WTO accession would have seriously underestimated the gains from trade reform, leading to a decline in foreign ownership in China soon after 2007 and not in 2014, as presented in Walmsley et al. (2006).

The commitments on delivery of services across national borders and commercial presence of foreign companies in the services sector of China were the most important and especially those related to commercial presence had the strongest implications for FDI. Walmsley et al. (2006) used the tariff equivalents of non-tariff barriers on cross-border supply of services from Francois and Spinanger (2004) and assumed that the impact of cuts in tariff equivalents on direct trade in services would occur gradually over the accession period (2002-2007). Importantly, changes on the rules for foreign commercial presence in telecommunications, transport, logistics, and financial services were expected to draw in foreign companies and lead to significant boost to profits,

starting in 2007, when productivity growth was assumed to be 1%/year relative to the baseline rate of growth and diminish gradually to zero by 2010.

A modeling framework and detailed analysis of the impact of reforms by sector allowed Walmsley et al. (2006) to represent accurately the Chinese economy, time the reforms, and track changes in foreign ownership. The model used in their study captures other factors that have contributed to rising costs of operation in China such as labor shortage associated with demographic factors. Looking into the future is not an easy task. Although the lure of China has waned, companies who manage to compete successfully in China are bound to reap rich rewards. However, they have to work even harder than before in order to cut costs and innovate.

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