Available online at www.sciencedirect.com
SCIENCE DIRECT®
China Economic Review 17 (2006) 198–209
China Economic Review

Why is China so attractive for FDI? The role of exchange rates

Yuqing XING *

International Development Program, International University of Japan, 777 Kokusai-cho, Minami Uonuma Shi, Niigata-ken, 949-7277, Japan

Received 31 August 2004; accepted 4 October 2005

Abstract

This paper argues that China's exchange rate policy played a critical role in its FDI boom. Devaluation of the Yuan (Renminbi) and the policy of pegging the Yuan to the Dollar both improved China's competitiveness in attracting Foreign Direct Investment. Examining the hypothesis in the context of Japanese FDI for nine Chinese manufacturing sectors from 1981 to 2002, the empirical results show that the real exchange rate between the Yuan and Yen is one of the significant variables determining Japanese direct investment in China. The devaluation of the Yuan substantially enhanced inflows of direct investment from Japan, and the response of FDI to the change of the real exchange rate is elastic.

JEL classification: F23; F31; O53
Keywords: FDI; Exchange rate; Manufacturing

1. Introduction

China's unprecedented success in attracting foreign direct investment (FDI) has drawn much attention of both academic scholars and policy makers. One of the prime topics among scholars researching on the Chinese economy is how to explain the country's FDI boom; as a consequence, a plethora of literature has emerged. For instance, Branstetter and Feenstra (2002) show that FDI inflows reflect political openness in China, while Cheng and Kwan (2000) find that large regional market and good infrastructure are important determinants of FDI in China.

* Tel.: +81 25 779 1424; fax: +81 25 779 1187.
E-mail address: xing@iuj.ac.jp.

1043-951X/$ - see front matter © 2005 Elsevier Inc. All rights reserved.
doi:10.1016/j.chieco.2005.10.001

Lardy (1995), Henley, Kirkpatrick, and Wilde (1999), and Zhang (2001) identify potential market size, low labor cost, preferential policies (e.g., tax credits), openness, geographic proximity, and political stability as primary factors attracting FDI. Moreover, Chen (1996) analyzes the regional distribution of FDI and emphasizes the role of special economic zones in attracting FDI.

Unambiguously, those studies substantially enrich our understanding on the issue. However, the role of China's exchange rate policy in determining FDI is largely ignored in the literature. Since the beginning of the economic reform, the Chinese Yuan had been on a devaluation track until 1994. During that same period, FDI into China surged significantly. An open question is whether the devaluation of the Yuan stimulated the inflows of FDI. The Yuan's devaluation reduced the cost of Chinese labor and other productive inputs relative to foreign production costs, and thereby reinforced China's comparative advantage in labor-intensive industries and strengthened its competitiveness in attracting FDI. Moreover, the devaluation decreased prices of domestic assets such as land, and encouraged foreign firms to acquire them. For a multinational enterprise (MNE), especially one engaged in global outsourcing, the wealth and production cost effects induced by the devaluation are simply too large to be ignored. Therefore, it is highly likely that the surge of direct foreign investment in China was partially fueled by the Yuan's devaluation.

Furthermore, FDI in China has been export-oriented. In 2003, foreign invested firms in China exported \$240.3 billion, which accounted for approximately 55% of China's total exports of \$438 billion (China National Bureau of Statistics, 2004). Theoretically speaking, domestic market oriented foreign direct investment may not benefit from the devaluation of the host country's currency, because a decrease in production cost resulted by the devaluation is offset by a corresponding decrease in sales revenues (if both are measured in foreign currency). On the other hand, this is not the case for export-oriented FDI. The segmentation between production location and product market confines the impact of the devaluation only to local production cost rather than sales prices in global market. Therefore, export-oriented FDI could benefit substantially from the currency devaluation of the host country. The magnitude of the benefit depends on the share of the production cost that must be covered by foreign currency, such as importing intermediates and paying royalties to parent firms. Generally, export-oriented FDI firms with relatively higher production costs calculated in foreign currency benefit less from the devaluation of a local currency as the cost also rises proportionally.

Empirical investigation into the exchange rate–FDI nexus is very important for the formulation of both FDI and exchange rate policies. China has been pressured by its major trading partner, the United States, to introduce a flexible exchange rate regime. On July 21st, 2005, the People's Bank of China raised the value of the Yuan to the Dollar by 2% and introduced a currency basket system. Examining the effect of the exchange rate policy on FDI, which has performed a critical role in facilitating China's export growth, could partially reveal the potential consequences of the exchange rate policy reform. This paper attempts to offset the gap in the literature and investigate to what extent China's deliberate devaluation and changing exchange rate regime contributed to its FDI boom. Specifically, this paper focuses on Japanese direct investment in China's manufacturing sectors, and examines how FDI inflows from Japan were affected by the real exchange rate between the Japanese Yen and the Chinese Yuan. The analysis is based on Japanese FDI in nine Chinese manufacturing sectors from 1981 to 2002. This is the first research that analyzes FDI in China with sectoral data rather than aggregated data, and sectoral data can provide more detailed information on the characteristics of FDI.