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FDI and market entry/exit: Evidence from China

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ABSTRACT

This paper considers the impact of FDI and FDI-related spillovers on the entry and exit rates of domestic firms in mainland China's manufacturing sector. Since we suspect that aggregate results obscure differing effects based on the source of the FDI, we disaggregate FDI into that originating from Hong Kong, Macau and Taiwan (HMT) area and the rest of the world. The empirical analysis, based on 4-digit industry level panel data over the period 2003–2007, reveals that FDI originating from the rest of the world has made a significant contribution to the entry rate of domestic firms in China and the spillover effect arising from backward linkages is also positive and significant. However, FDI originating from HMT area has not encouraged domestic entry, whilst it has contributed to an increase in the exit rate of domestic firms.

1. Introduction

Globalisation has resulted in a significant increase in foreign direct investment (FDI) around the globe. An important driver of globalisation is technological progress. Technological progress has contributed to a significant reduction in the cost of coordination of production activities at various locations. As a result, firms are increasingly involved in breaking up the production process into a few stages. This has allowed firms, especially those that were originally located in developed countries, to take advantage of, for example, cheaper labour in China and Vietnam. A number of existing studies have considered the impact of FDI and FDI-linked spillovers on host countries.[2] These studies have suggested that FDI affects the economic performance of host countries through direct as well as indirect channels (also known as spillover effects). FDI-linked spillover effects arise from a number of sources including the linkages that are formed between the domestic and foreign firms and, through increased competition in the domestic market that leads to better allocation of resources. The linkages between domestic and foreign firms can also facilitate technology and knowledge transfer. Blomström and Kokko

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[2] For example, see Blomström (1986), Blomström and Kokko (2001), Liu and Wang (2003), Görg and Hijzen (2004), Wei and Liu (2006), Duanmu and Fai (2007), Beugelsdijk, Smeets, and Zwinkles (2008), Girma, Görg, and Pisu (2008), Liu (2008), Suyanto, Salim, and Bloch (2009), Barbosa and Eiriz (2009), Blalock and Simon (2009), Santangelo (2009), Abraham, Koninga, and Slootmaekers (2010) and Du, Harrison and Jefferson (2012). These studies have, amongst other things, considered the impact of FDI and FDI-linked spillovers on productivity and technology transfer.

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(2003), Görg and Greenaway (2004), Kneller and Pisu (2007), Wagner (2007) and Sun (2009, 2010), amongst others, have suggested that linkages between domestic and foreign firms can also affect the export performance of domestic firms which provides yet another explanation for increased competition for FDI amongst host country governments.

Based on these existing studies, it can be argued that the presence of foreign firms in a country does not always benefit domestic firms in developing countries (see Ayyagari & Kosová, 2010 and references therein). For example, owing to increased competition, entry of foreign firms can reduce the output of domestic firms. Entry of foreign firms can also adversely affect the export performance of domestic firms (for example, see Alvarez & López, 2008; Wagner, 2007 and the references therein). The existing literature suggests that the impact of FDI in any given host country varies from industry to industry and hence results presented for one country cannot be applied to another. The empirical evidence is mixed, which is not surprising since the impact of FDI related industrial linkages on export performance depends on the characteristics of domestic firms, industries and indeed the host country.[3] Some of these characteristics are categorised as the absorptive capacity, which includes variables such as the size of a country's stock of human capital, the level of its financial market development and the technology gap between domestic and foreign firms. The role of absorptive capacity has been highlighted by Harris and Li (2009), who argue that absorptive capacity can affect the size of FDI related spillovers in host countries.[4]

Whilst most existing studies deal with the impact of FDI related spillover effects on productivity and export behaviour, relatively few studies have considered other aspects of FDI. For example, in a cross-country study involving 100 countries in 1999 and 2004, Alfaro and Charlton (2007) examined the impact of financial liberalisation on entrepreneurship.[5] They argued that foreign investment enhances domestic financial intermediation which contributes to an increase in the availability of capital in domestic markets. They also found that entrepreneurial activities are higher in industries that have a relatively large share of foreign firms.

FDI can also affect both the entry and exit rates of domestic firms in host countries. Foreign presence can foster domestic entry and entrepreneurship through (a) movement of workers from foreign to domestic firms, (b) management related knowledge spillover which can arise from the demonstration effect and (c) vertical backwards as well as vertical forward linkages that are established over time between foreign and domestic firms (Ayyagari & Kosová, 2010). In other words, the presence of foreign firms can create new business opportunities in host countries, which can be described as the demand creation effect. However, the presence of foreign firms can also increase the exit rate of domestic firms. FDI increases market competition in host countries, which can reduce the profit of relatively inefficient domestic firms. As indicated by, amongst others, De Backer and Sleuwaegen (2003) and Ayyagari and Kosová (2010), increase in market competition arising from foreign presence can lead to a situation where demand for goods produced by domestic firms shrinks and some existing firms end-up leaving the industry. The presence of large sunk entry cost and foreign firms' superior technology and management skills can be viewed as entry barriers faced by domestic firms especially in less developed countries. In other words, it can be argued that FDI can affect both the entry and exit rates of domestic firms in host countries.

De Backer and Sleuwaegen (2003) examined the impact of import competition and foreign investment on firm entry and exit in Belgium's manufacturing sector. Their empirical work suggests that import competition decreases domestic entry. They also found the impact of foreign investment on domestic entry to be negative. They argue that foreign investment in industries that are dominated by domestic firms can have a negative effect on domestic entrepreneurship in the shortrun. However, depending on other factors, the longrun effect can be positive. In a recent study Ayyagari and Kosová (2010) considered the impact of foreign presence on the entry rate and domestic firm size in the Czech Republic. Whilst De Backer and Sleuwaegen consider the impact of FDI on both entry and exit rates of domestic firms in Belgium's manufacturing sector, Ayyagari and Kosová's work is restricted to the Czech Republic and they did not consider the link between foreign presence and the exit rate of domestic firms.

This paper focuses on China, a country that has attracted significant FDI since the late 1980s. This can be attributed to, amongst other things, tax incentives offered to foreign firms and China's accession to the WTO in December 2001. Up until January 2008, tax incentives were not available to domestic firms. A uniform corporate tax rate of 25% is now applied in China. The incentives offered in China underline the strong belief on the part of the Chinese government that FDI enhances economic growth through direct as well as indirect channels.[6]

FDI inflows have played an important role in the rapid economic growth experienced by China. A number of studies have investigated the effect of FDI on China's economy. This includes studies that have considered the impact of FDI on productivity, economic growth and exports. However, none of the available studies has considered the impact of FDI on the

[3] For example, see Blomström (1986), Blomström and Kokko (2001), Liu and Wang (2003), Görg and Hijzen (2004), Wei and Liu (2006), Duanmu and Fai (2007), Beugelsdijk et al. (2008), Girma et al. (2008), Liu (2008), Suyanto et al. (2009), Barbosa and Eiriz (2009), Blalock and Simon (2009), Santangelo (2009), Abraham et al. (2010) and Du et al. (2012). These studies have, amongst other things, considered the impact of FDI and FDI-linked spillovers on productivity and technology transfer.

[4] Anwar and Nguyen (2011) have recently considered the impact of absorptive capacity on the export performance of Vietnam's manufacturing firms. They found that absorptive capacity has played an important role in export performance of domestic firms in Vietnam.

[5] Other aspects of entrepreneurship have been considered by, amongst others, Kannianen and Vesala (2005) and Schäfer, Talavera, and Weir (2011).

[6] During the 1980s, FDI in China was largely confined to joint ventures with state-owned enterprises. In 2010, FDI in China reached a record US$105.74 billion which represents an increase of 17.4% from 2009. In order to encourage FDI in advanced technology, joint ventures are encouraged (Whalley and Xin, 2010).