



An Interview with K. C. Fung, coauthor of *U.S. Direct Investment in China*

Q: *How large is U.S. investment in China?*

A: According to U.S. government data, the average annual rate of direct investment in China is \$1.4 billion a year—foreign direct investment, or FDI as it is known, is the investment of foreign assets into domestic structures, equipment, and organizations. It does not include foreign investment into the stock markets. The \$1.4 billion represents barely 1 percent of the total average annual U.S. direct investment of approximately \$127 billion, but is still ample enough to make the United States the second largest direct investor in China, behind Hong Kong.

Chinese government data reports a higher average annual inflow of U.S. direct investment: approximately \$3.69 billion a year, or nearly 9 percent of the average total annual inflow of FDI of approximately \$41.2 billion.

The Chinese and U.S. figures differ primarily because of differences in the definitions used. The U.S. figure principally measures the amount of equity committed by the U.S. investor. The Chinese figure refers to the total value of the investment project in China. For example, if the U.S. investor puts in an equity investment of \$1.5 million but borrows an additional \$2 million from commercial banks to invest in the project, then the U.S. Department of Commerce figure will be \$1.5 million while the Chinese figure will be \$3.5 million. There are many other possible variations, but the important distinction is that the U.S. figure more closely reflects the net outflow from the United States and the Chinese figure represents the total gross inflow into China.

Q: *In the short term, is it profitable for U.S. firms to invest directly in China?*

A: Yes, it is—and it is becoming more profitable over time. From 2002 data collected by the Bureau of Economic Analysis of the U.S.

Department of Commerce, the estimated rate of return of U.S. direct investment in China was 14 percent, compared with 8 percent for U.S. direct investment in all countries. That does not even include the \$723 million in net payments of royalties and fees from Chinese firms to U.S. firms for technology transfers. In fact, investing in China is becoming more profitable for U.S. firms, since the average annual rate of return between 1994 and 2002 was an estimated 10 percent. Nevertheless, these are just averages; as in all investment activities, not every investor will find it profitable.

Q: *Does this profit come at the expense of American workers?*

A: No. In general, U.S. direct investment in China does not compete with U.S. domestic producers and does not cause job losses in the United States. On a net basis, in the United States, it is likely to be job enhancing, not job displacing.

More than 90 percent of U.S. firms with foreign investments produce goods abroad that are not directly competitive with those produced by their parent companies; two-thirds of the U.S. firms with investments in China produce products either totally different from, or of lower grade than, the products produced by their parent companies.

Most light industrial products that China does export to the United States—such as garments, shoes, and toys—generate low-wage, low-skilled jobs, which the United States lost three or even four decades ago, first to Japan, then to Hong Kong, then to Taiwan, and then to Southeast Asian countries such as Indonesia, Malaysia, the Philippines, and Thailand. The jobs that the Chinese workers have today are most likely to have been lost by workers in

Hong Kong and Taiwan. China has gradually climbed up the technology ladder and has begun to produce high-tech items such as notebook computers, hard disc drives, and computer chips. Nonetheless, China is still manufacturing items from the low-technology spectrum of the electronics industry. It may be competing directly with Southeast Asian countries such as Malaysia, but not with the United States.

Q: *If cheap labor is not the draw for U.S. firms investing in China, what is?*

A: Cheap labor is not the primary draw for U.S. firms investing in China. U.S. firms invest in China primarily to establish a beachhead to penetrate the large and rapidly growing Chinese domestic market. The concentration of most U.S. direct investment is in regions where per-capita incomes, retail sales, and wage rates are relatively high by Chinese standards. This suggests that the focus of U.S. direct investment is the potential size of the local markets rather than the level of the local wage rates. Other reasons cited for investment include the abundant labor supply, preferential tax and tariff treatment given to foreign direct investors, avoidance of transport costs and tariff and nontariff barriers to trade, exploitation of China's natural resources, and establishment of a low-cost production base to supply Asian and other markets.

Q: *What modes of direct investment do U.S. firms select?*

A: Excluding joint development (discussed separately below), the three most important modes of U.S. direct investment in China are the equity joint venture, the contractual joint venture, and the wholly foreign-owned enterprise. In an equity joint venture, both the United States and the Chinese partners contribute capital to the venture, with profits distributed accordingly. In a contractual joint venture, the arrangements are flexible, with specific agreements on capital contributions (including contributions in kind) and profit distribution embodied in each contract. A wholly foreign-owned enterprise is owned and controlled solely by the U.S. direct investor; there is no Chinese partner.

A joint development venture is typically set up between a Chinese corporation or a ministry and a foreign partner to develop and explore natural resources such as coal, oil, and natural gas. In general this mode of foreign direct investment is not typical in China, although it is fairly significant in some U.S. direct investment in China—in the petroleum industry, for example.

However, U.S. direct investment in China increasingly takes the form of wholly foreign-owned

enterprise, which gives the parent much better control over finances and pricing and also better protection of the intellectual property rights. This is especially the case if the products are expected to be exported.

Q: *In what sectors do U.S. firms invest?*

A: Based on U.S. government statistics, approximately two-thirds of U.S. direct investment in China occurs in the manufacturing sector. Almost one-quarter of investment in manufacturing industries is in electronic and other electrical equipment. U.S. firms also invest heavily in mining and utilities. Among the service industries, wholesale trade claimed the highest share of investment, with about 5 percent in 2002.

Q: *How does U.S. direct investment affect trade between the two countries?*

A: U.S. direct investment in China increases the demand for U.S. capital goods, intermediate goods, services, and technology. In particular, it increases intrafirm trade between different units of the same U.S. multinational corporations. U.S. direct investment also increases trade in services between the two countries. The United States has consistently run a surplus vis-à-vis China in trade in services.

Moreover, U.S.- and other foreign-invested firms in China are responsible for a large fraction of exports from China. In 2002, foreign-, including U.S.-, invested firms in China produced 52.2 percent of all Chinese exports. Likewise, foreign-invested firms in China produced a similar percentage of Chinese exports to the United States. Exports generated by foreign-invested firms have different economic welfare properties: the profits from such exports accrue in part to the foreign owners of those firms, not to the host country.

A large fraction of Chinese exports are related to processing and assembly activities. Since 1996 more than half of Chinese exports have been generated either by foreign-invested firms or through processing and assembly activities. Such exports from China are in part responsible for consumer goods in the industrialized economies, including the United States, remaining inexpensive; if the imported Chinese goods were supplied by their traditional domestic producers, prices would have been much higher.

However, by most indications, the value-added content in China associated with processing and assembly activities for exports is relatively low, approximately one-third of the gross value. For exports to the U.S., the value-added content may be estimated at 20 percent.

Q: *Does U.S. direct investment affect economic growth in China?*

A: The U.S. government has estimated that outputs of U.S.-invested firms in China collectively accounted for 0.5 percent of the Chinese GDP in 2000. The effect is small but not insignificant, especially considering that U.S. direct investment is only a very small fraction—approximately 1 percent—of the total annual gross domestic investment (the sum of the total capital formation and increases in inventory in a country during a given period) in China. Qualitatively, however, U.S. direct investment should have a large long-term impact on the Chinese economy. Technologically the United States is the most advanced country in the world.

To modernize, China needs to import advanced technology from the United States. Direct investment is the appropriate vehicle for the transfer of technology, with U.S.-invested firms maintaining control of and directly benefiting from their proprietary technologies and know-how. U.S. and other foreign direct investors are more advanced in management techniques, corporate governance, and market institutions. Their presence in China will accelerate the transformation of Chinese enterprises, as well as the process of the Chinese transition to a market economy. In the long run, the presence of U.S. and other foreign direct investment will significantly enhance the efficiency and the productivity of the Chinese economy.