Research Bulletin 12/4

The Impact of Foreign Direct Investment to China on Foreign Direct Investment to Other Countries

Laura Resmini and Iulia Siedschlag

The Impact of Foreign Direct Investment to China on Foreign Direct Investment to Other Countries

Laura Resmini and Iulia Siedschlag*

China has recently become a leading destination for foreign direct investment (FDI). The surge of FDI to China has followed its opening to the world economy and selective easing of capital controls. While the main motivation driving the increased inflows of foreign investment to China has been the availability of a large pool of low-cost labour, in recent years there has been a shift of inward FDI in China towards high-tech industries and services.

The success of China in attracting FDI has raised concerns that it may have come about at the expense of FDI to other countries and regions.

In a recently published paper[1], we provide empirical evidence to answer these concerns. This paper addressed the following key research questions: To what extent and how have FDI inflows to China affected FDI inflows to other countries, particularly the EU countries? Have these effects changed over time? Do these effects differ for market-seeking and efficiency-seeking FDI? Do these effects differ across existing host countries?

Using a theory-based gravity model and data over the period 1990-2004, the analysis indicates that, on average, over the analysed period, other things equal, FDI inflows to China have been complementary to FDI flows to other countries. However, this FDI creation effect has varied across country groups, being less strong in European countries than in the other host countries. Within the European Union, Central and Eastern Europe (CEE) countries have benefited less from this complementary effect. This result suggests that the geographic proximity of the CEE countries to the sources of FDI in Western Europe has not been sufficient to offset the attractiveness of China as a FDI destination. In addition, this research found that this complementary effect of FDI to China to FDI to other countries has decreased over time.

Furthermore, this research uncovered that increased FDI to China has encouraged both market-seeking and efficiency-seeking FDI to other countries.

* Laura.Resmini@unimib.it; Iulia.Siedschlag@esri.ie

Again, these effects have varied across country groups. It appears that in the case of more advanced EU economies, in comparison with non-EU countries, the FDI creation effect has been less strong in the case of market-seeking FDI and stronger in the case of efficiency-seeking FDI.

A more in-depth analysis of country specific effects found that, on average, the FDI creation effect prevailed. However, there were a number of cases in which FDI to China diverted FDI from other host countries. For example, while, over the analysed period, FDI to China has complemented FDI to Italy, Spain and Sweden, it has substituted bilateral FDI flows between Austria, Germany, Belgium, France, the Netherlands, the United Kingdom and between Greece and Portugal. Furthermore, it appears that FDI to China has substituted bilateral FDI flows between the Baltic countries (Estonia, Latvia, Lithuania), and between Poland, Hungary and the Slovak Republic.

In the case of Ireland, this analysis showed that, on average, over the analysed period, the FDI to China has fostered FDI to Ireland. It appears that the FDI to China has led to less FDI to Ireland from Belgium and France. However, this substitution effect has been weak.

This empirical evidence suggests that while the FDI to China has fostered FDI to other countries located all over the world, FDI to China has substituted FDI among similar countries located in the same geographic area.

Taken together, this research suggests that future effects of FDI to China on FDI to other countries are likely to foster as well as substitute FDI to other countries. To the extent that China's high growth rates will persist, China is likely to attract more market-seeking FDI and less efficiency-seeking FDI. While the effects of FDI to China on FDI to other countries are likely to persist over time, country specific effects will change depending on the evolution of international production networks.

[1] Laura Resmini and Iulia Siedschlag, "Is Foreign Direct Investment to China Crowding Out Foreign Direct Investment to Other Countries?", *China Economic Review*, Published online on 20 December 2012, http://dx.doi.org/10.1016/j.chieco.2012.12.003.