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Volume Title: China's Growing Role in World Trade

Volume Author/Editor: Robert C. Feenstra and Shang-Jin Wei, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-23971-3

Volume URL: http://www.nber.org/books/feen07-1

Conference Date: August 3-4, 2007

Publication Date: March 2010

Chapter Title: Comment on "China's Outward Foreign Direct Investment"

Chapter Author: Nicholas Lardy

Chapter URL: http://www.nber.org/chapters/c10476

Chapter pages in book: (578 - 580)

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Comment Nicholas Lardy

The analysis of Leonard K. Cheng and Zihui Ma is an important addition to our understanding of the nature of China's outbound foreign direct investment (FDI). While outbound FDI from China has grown substantially in recent years, it remains far smaller than inward investment flows, and most of the existing literature focuses on the latter.

One strength of the analysis of Cheng and Ma is that it relies on FDI data that are compiled in accordance with Organization for Economic Cooperation and Development (OECD) definitions and International Monetary Fund (IMF) balance of payments guidelines. This is a much more realistic approach than the all too prevalent practice of relying on a compilation of press reports. Press accounts fail to differentiate between proposed projects and actual flows, fail to recognize that flows for those projects that are undertaken frequently occur over a period of years, and fail to differentiate between projects financed with Chinese direct investment from those financed with loans from Chinese financial institutions.

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Cheng and Ma use a gravity model to estimate the determinants of China's FDI outflows, finding that they are significantly related to the host economies' gross domestic product (GDP) and negatively related to distance from China. They report results also for a large universe of countries with outbound FDI, finding that in addition to GDP and per capita GDP in the host country, that the level of reserves, openness (measured by the ratio of trade or inward FDI flow to GDP), and currency appreciation in the investing country all are also significant in explaining outward FDI flows. In a closer examination of outbound FDI from Japan and South Korea, they find discontinuous upward jumps in FDI outflows as these economies achieved critical thresholds of per capita GDP.

The authors are wisely cautious in trying to extrapolate the implications of these findings for the future levels of FDI outflows from China. China's outflows could easily exceed those of their East Asian neighbors for at least two reasons. First, the level of China's foreign exchange reserves is much larger, and these large reserves have been achieved at a much earlier stage of economic development than was the case, for example, in Japan. Thus, there is at least the potential for much larger outbound FDI in the case of China.

Second, compared to its East Asian neighbors, China has been much more open in terms of foreign investment. To date, the most successful outbound investors in China are firms that have first competed successfully with foreign firms in China's domestic market and then later invested or made acquisitions abroad. Legend (now called Lenovo) may be the best example. Legend, which was founded in the mid-1980s, initially was a distributor of foreign brands of personal computers (PCs). It began producing PCs in 1990 when the market leaders in China were all foreign firms. Compaq, IBM, HP, and Digital Equipment were ranked one to four, respectively. But in less than a decade, in 1997, Legend had become the market leader, and by 2000 it controlled 31 percent of domestic market. In contrast, the combined market share of all foreign brands had fallen to only 15 percent. Only a few years later, Legend purchased the PC business of IBM. At the time, that transaction was one of the largest Chinese cases of outbound FDI.

The story is similar for the Chinese firm Huawei. Initially, it competed in the telephone switching equipment market against both imports and the output of Chinese joint ventures involving Siemens (Beijing International Switching Systems Corporation) and Alcatel (Shanghai Bell) and pure foreign suppliers, such as Lucent. Joint ventures and imports had 95 percent market share in 1995. But Huawei became successful competitor, and its market share rose to 18 percent and 35 percent in 1998 and 2000, respectively. Huawei then began to sell its products abroad and, shortly later, started to invest abroad.

Perhaps more Chinese brands will emerge as successful global players at an earlier stage of economic development than was the case in Korea and

Japan because China's massively larger amounts of inward foreign investment have made the domestic environment more competitive than was the case in Korea and Japan. Joint venture production in China now accounts for more than 25 percent of manufactured goods output, many times the level in Japan and South Korea in the 1960s and 1980s, respectively.