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China's Inward Foreign Direct Investment Success: Southeast Asia in the Shadow of the Dragon

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ABSTRACT: This paper explores the impact of China's growing prominence in global and regional foreign direct investment (FDI) flows on the Southeast Asian countries as investment locations. Providing internal social and economic cohesion is maintained, China is likely to exert a greater pull on regional FDI after WTO accession. To benefit from China's success, the Southeast Asian countries will need to replace deteriorating individual locational advantages relative to China with a superior regional one. The ASEAN Free Trade Agreement or the Asian Investment Area or both are likely to be important policy solutions.

INTRODUCTION

A key aspect of the success of globalization is the emergence of the People's Republic of China as a major player in the world economy. This paper explores not only the success of China as a location for foreign direct investment (FDI) but also examines some negative externalities of this success for neighboring countries of Southeast Asia, in particular those of the Association of South East Asian Nations (ASEAN).[1] Much has been written on the character of inward FDI to China (Child and Lu, 1996; Wei and Liu, 2001) and,

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[1]ASEAN comprises Indonesia, Malaysia, Philippines, Singapore and Thailand (ASEAN-5), plus Brunei, Cambodia, Laos, Myanmar (Burma) and Vietnam (the latter four collectively being the 'newer ASEAN' countries). For longevity purposes, we refer to them collectively as the Southeast Asian countries.

particularly following its accession to the World Trade Organization (WTO) in December 2001, the determinants of FDI and its effect on the domestic economy, in terms of, for example, growth (Buckley, Clegg, Wang and Cross, 2002) and productivity (Liu, Parker, Vaidya and Wei, 2001). Other work assesses the implications of China's WTO accession for world merchandise trade flows (e.g., Lardy, 2002; Ianchovichina, Martin and Fukase, 2000; Ianchovichina and Martin, 2001). However, with the notable exception of a report by the ASEAN-China Expert Group on Economic Cooperation (ACEGEC, 2001), much less has been written on how multinational enterprises (MNEs) might adjust investment strategies in response to opportunities arising from China's deepening integration into the global economic system post-WTO and what the consequences of this might be for developing countries like those of Southeast Asia as FDI recipients.

China's growing prominence in the regional and global economy comes at a time when many Southeast Asian nations are themselves striving to augment stocks of FDI to help reinvigorate faltering economic growth in the wake of the Asian economic crisis of 1997. Since the inception of its 'Open Door' policy in 1978, China has been successful in capturing an increasing and substantial [illegible] Asian neighbors. China's [illegible] of

2003). When it entered the WTO, China was already host to the world's fifth largest FDI stock by country, a position which rises to second with the inclusion of Hong Kong Special Administrative Region (SAR). Over the same period, the performance of the Southeast Asian countries in this respect was steady; collectively they hosted around 4 percent of world FDI stock in 2001, a position not dissimilar to that of China (UNCTAD, 2001). However, since the Asian crisis, China has successfully out-stripped the Southeast Asian countries, individually and collectively, in terms of the share of annual global FDI flow attracted (see Table 1). The share of China and the Southeast Asian countries in global FDI flow all weakened in the final years of the 1990s, due in part to the effects of the Asian crisis. However, the decline in China's share was far less dramatic, dropping from 9.3 percent of annual world FDI flow in 1997 to 2.7 percent in 2000, compared with 6.4 to 0.7 percent for the ASEAN countries over the same period. Moreover, the decline in China's position in global investment flows is negated entirely when Hong Kong's rising status after the hand-over in 1997 is factored in (see Table 1). A resurgence of FDI flow to the region began in 2000, but, again, China's position improved more quickly than its Southeast

	1999	2000	2001
357	**1,088,263**	**1,491,934**	**735,146**
252	99,990	131,123	94,365
751	**40,319**	**40,772**	**46,846**
3%	3.7%	2.7%	6.4%
7%	40.3%	31.1%	49.6%
770	**24,596**	**61,938**	**22,834**
1%	2.3%	4.2%	3.1%
1%	24.6%	47.2%	24.2%
73	596	600	244
30	214	179	113
56	-2,745	-4,550	-3,277
45	52	34	24
14	3,895	3,788	554
14	253	255	123
52	578	1,241	1,792
89	11,803	5,407	8,609
43	3,561	2,813	3,759
00	1,484	1,289	1,300
04	**19,691**	**11,056**	**13,241**
7%	1.8%	0.7%	1.8%
3%	19.7%	8.4%	14.0%

(UNCTAD 2003).

For much of their recent histories, China and the Southeast Asian countries have followed a similar economic development model with regard to FDI. In general, they have all promoted high levels of foreign ownership in export-oriented, low-value added mass manufacturing, using combinations of relatively high tariff and non-tariff barriers to restrict imports and special trade regimes (typically liberal duty exemptions on inputs) to encourage exports (Lemoine, 2000). China and Southeast Asia may therefore be rival locations for certain types of FDI. In this paper, we review the literature on China's increasingly progressive policies towards FDI in recent times and against this map the concomitant effect on inward investment by source country, investment motive, sectoral trends, entry method and geographic distribution. Our aim is to assess whether or not China was a rival to the Southeast Asian economies as an investment location prior to WTO accession. We then consider how China's accession might impact its investment climate relative to the Southeast Asian economies. We do this under two generic scenarios; one, that China is willing and able to comply with the conditions of WTO accession and two, that compliance is partial. This review is used to draw some tentative conclusions on whether or not China will have a magnetic, neutral or benign effect on the future spatial distribution of MNE-owned production in East and Southeast Asia. Some policy recommendations for the Southeast Asian countries are presented in light of this analysis.

PATTERNS OF FDI IN CHINA

The degree to which China's WTO accession might impinge on patterns of Southeast Asian FDI depends largely on, firstly, whether or not China and Southeast Asia are substitute hosts for certain types of FDI and, secondly, how China's locational advantages might change after accession relative to Southeast Asia. To explore the first point, it is important to distinguish between two types of direct investment by motivation; namely labor-intensive, export-oriented (henceforth export platform) FDI and technology-intensive, market-seeking FDI. The former universally concerns manufacturing and is driven by cost pressures while the latter can be in both services and manufacturing and is driven by revenue-generation pressures. We disregard natural-resource seeking motives (insofar as the data allow) as the location-bound nature of many resource-based factor inputs makes it unlikely that Southeast Asia and China have been or will be substitute hosts for this type of activity.

The character of inward investment to China prior to WTO accession suggests strongly that China and Southeast Asia were not substitute investment hosts to this point. This is because the primary source of this investment was overseas Chinese capital. Table 2 presents four distinct phases in the evolution of China's

Table 2: FDI Policy in China and Some Resulting Inward Investment Trends (1979-1999).

PHASE AND POLICY MOTIVATION:	
Experimental Period (1979 to 1983)	
To attract greater inward FDI, especially from overseas Chinese, as one of the 'four modernisations', and to learn from the experiences of the opened areas.	**Main Policy Developments** ✓ A series of laws on joint ventures (JVs) permitted FDI, define equity JVs and set out the fiscal arrangements concerning foreign invested enterprises (FIEs). ✓ Creation of four Special Economic Zones (SEZs), with special investment incentives, at Shenzen, Zhuhai, Shantou and Xiamen in Guangdong and Fujian provinces, along with greater economic autonomy for these two provinces. ✓ Duty exemptions for imports of intermediate inputs used in the production of exports. ✓ Highly constrained access to domestic markets granted to foreign investors. ✓ Ministry of Foreign Economic Relations and Trade (MOFERT) created, responsible for FDI, trade and other foreign economic affairs. **Investment character and strategic motivation** ✓ Mostly speculative investment in real estate (hotels and apartment buildings). ✓ Some small-scale, export-oriented FDI in labour intensive industries manufacturing industries such as footwear, clothing, toys, and electrical appliances. ✓ Hong Kong and Taiwan ROC are main source countries.
Gradual Development Period (1984 to 1991)	
To build upon the success of the first SEZs and to divert FDI away from real-estate and into	**Main Policy Developments** ✓ Law for the Encouragement of Foreign Investment promulgated (1986) and implementing regulations announced (1987). ✓ Continued loosening of investment restrictions, mostly in sectors with few domestic firms (e.g. tourism and hotels) and where foreign capital and

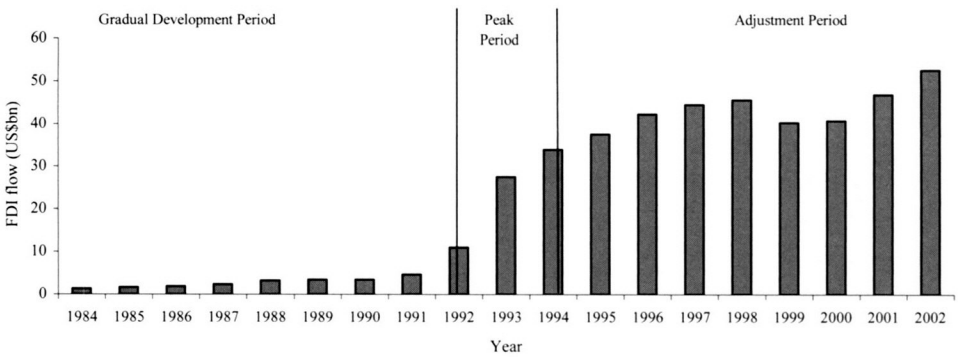
FDI policy direction and investment climate prior to WTO accession, against which we characterize the investment responses of foreign firms. (For more detail, especially on the early periods, see Cross and Tan, 2004; OECD, 2000; and Wei and Liu, 2001). Over much of the pre-WTO period, China's investment policy had two parallel strands. The first sought to boost domestic productivity and output by attracting export-oriented FDI to Special Export Zones (SEZs) and other opened areas, mostly in the

Table 2: continued

Peak Period (1992 to 1993)	
The imperative of Deng Xiaoping to accelerate economic reform and to develop new export industries.	**Main Policy Developments** ✓ Foreign firms allowed to sell more to China's domestic market. ✓ Some FDI approvals conditional on achievement of certain policy goals. Special investment incentives available in preferred sectors. ✓ New sectors opened up experimentally to foreign investment (e.g. domestic retail trade, finance, tourism, shipping, resource development). ✓ FDI remains tightly controlled by state policy, though approval of smaller projects now devolved to provincial and municipal government. Thousands of new SEZs spring up as a result. ✓ Market entry remains regulated through as performance requirements, local sourcing requirements, location restrictions, forced JV establishment. ✓ Further opening of 28 cities and 8 regions in the Yangtze River Delta area. **Investment character and strategic motivation** ✓ Around 60% of inward FDI flows into highly export-oriented and technology intensive industrial sectors, especially in the coastal provinces, but market-seeking motives beginning to grow in importance. ✓ Slowdown in FDI from the Triad regions. ✓ Equity JVs (49% of contracted value of FDI in 1993), Co-operative JVs (23%), WFOEs (27%).
Adjustment Period (1994 to 1999)	
To adjust the industrial structure of FDI and to provide national treatment for	**Main Policy Developments** ✓ The State Council decides to categorise sectors into those in which FDI was 'encouraged', 'restricted' or 'forbidden'. The former (typically export-oriented, technology intensive or import substituting investment) benefit from tariff exemptions and fiscal reductions. ✓ Duties re-imposed in 1995 on imp[illegible]

easternmost provinces, to generate foreign exchange, expand currency reserves and to finance imports of capital goods and production inputs. The second strand sought to shelter inefficient and vulnerable local firms (in which the State typically held a full or partial equity stake) by severely limiting domestic market access to foreign firms with devices like performance requirements, location restrictions and entry mode

Figure 1: Annual Inflows of Utilised FDI into China (1984 to 2002)



Note: data for 1984 are accumulated stock of FDI since 1979.
Source: China Statistical Yearbook (various issues).

constraints. Later, as the capacity of foreign invested enterprises (FIEs) to absorb foreign capital and technology became clear and because such firms were demonstrably more efficient than local incumbents, tight centralized control was slowly relaxed. Investment approval decisions and FIE-related matters were progressively devolved to the provinces and municipalities, investment (and particularly sectoral) restrictions were eased and larger geographic areas were opened, though still confined mostly to the coastal regions. Viewed in retrospect, each policy phase represents a cautious, pragmatic and staged opening of China's economy to foreign, and especially ethic Chinese, investors. As Thomsen (1999) comments, this is in stark contrast to the Southeast Asian countries, whose FDI policy has often been determined by events rather than shaping them.

Data on the aggregate value of realized cumulative FDI (Figure 1) reveals that each liberalization phase in China gave fresh impetus to FDI inflows.[2] Despite some volatility in global supply, FDI flows to China surged in the early 1990s, especially in manufacturing, in response to open political commitment to market-oriented reform, strong domestic growth, and the continued creation of SEZs and other investor benefits. The mid-1990s saw a deceleration in this inflow, however, as other developing countries in Latin America, Eastern Europe and Southeast Asia competed more effectively as FDI hosts and as internal policy served as a brake. In particular, the introduction of national

[2]We acknowledge fully the inherent inadequacies of the China Statistical Yearbook and other official Chinese data sources. It is widely accepted that much FDI in China is illusory and that actual total inflow is significantly lower than that reported. Over-valued foreign contributions and 'round tripping' of FDI via Hong-Kong and other intermediaries to avoid certain investment restrictions inflated the figures. Broadman and Sun (1997) estimate that such shortcomings inflated China's 1994 FDI inflow figures by as much as 37 percent.

treatment in 1995 brought with it import duties and other investment disincentives. A further deceleration in FDI inflow occurred between 1998 and 1999 (see Figure 1 and Table 1), which coincided with a slowdown in economic growth in China and the Asian crisis; China's share of global FDI flow dropped from 10.4 per cent in 1996 to 2.7 percent in 2000. Nevertheless, China's role in the investment strategy of MNEs seems unaffected over this period - a fourfold increase in inward FDI to Hong Kong (by value) between 1998 and 2000 is at least partly indicative of investment funds being 'parked on the doorstep' of mainland China by foreign firms in anticipation of emerging opportunities post-WTO (although Hong Kong's role as a tax haven and round-tripping hub will also have had a part to play).

Investment Motivation

Table 3 shows that in 1998 just under 60 percent of the contracted value of China's FDI stock and the bulk of individual investments was in manufacturing sectors (followed by real estate at around 24 percent) (China Statistical Yearbook, 1999). Of the former, an estimated 50 percent (by value) was in labor-intensive manufacturing, while technology-intensive manufacturing accounted for around 27 per cent and capital-intensive manufacturing, 23 per cent (OECD, 2000). Graham and Wada (2001) estimate that, overall, some 60 percent of FDI inflow in the mid-1990s was to highly export-intensive industrial sectors in China. Access to low cost labor was clearly

Table 3: Contracted FDI in China by sectors at the end of 1998.

Sector	Number of Projects	Share (%)	Contracted value (US$bn)	Share (%)
Manufacturing	249,352	73.0	365,547	59.6
Real estate	33,877	9.9	149,977	24.4
Distribution	21,279	6.2	36,929	6.0
• wholesale, retailing, catering	17,558	5.1	21,960	3.6
• transport, warehousing and telecommunications	3,721	1.1	14,969	2.4
Construction	8,826	2.6	11,860	3.1
Agriculture, forestry, animal husbandry and fishing	9,534	2.8	19,827	1.8
Scientific research and technical services	2,410	0.7	1,874	0.3
Education, broadcasting, film and TV	1,317	0.4	2,040	0.3
Healthcare, sports and social welfare	999	0.3	4,618	0.8
Other sectors	13,944	4.1	23,045	3.8
Total	341,538	100	613,717	100

a key investment motive at this time. However, Graham and Wada go on to report a distinct shift in the late 1990s towards market-oriented FDI, in sectors in which China had no revealed comparative advantage. This was driven by domestic market expansion and improved market access for foreigners (Lemoine, 2000). Similarly, UNCTAD (2001) note that inward Chinese FDI had become more capital and technology-intensive by this time, an observation confirmed by Li, Qian, Lam and Wang (2000) in a study of FDI in China's electronics industry. Of course, it is no coincidence that market-seeking investment increased in hand with more capital and technology-intensive investment. The local adaptation of products and processes to suit particular market needs and the establishment of miniature replica-type production plants in China equipped in much the same way as equivalent plants elsewhere are two explanations.

Investment Source

Indications are strong that the propensity to shift towards market-oriented investment in China differed by source country. Table 4 shows that Hong Kong and Taiwanese firms together accounted for the bulk (60.1 percent) of the accumulated FDI stock in China between 1983 and 1998 (OECD 2000). This is followed by firms from Japan (8.3 percent), the U.S.A. (8.1 percent), Western Europe (6.7 percent) and the ASEAN-5 (6.2 percent).[3] Moreover, the geographic distribution of ethnic Chinese-owned investors in China closely reflects the ancestral homeland of the migrant source country population. Hence, Fujian province has been generally favored by Taiwanese firms, and Guangdong province by firms from Hong Kong and Macao. Such firms enjoy transaction cost-related ownership advantages in these places relative to other investor nationalities because of geographic proximity, cultural convergence and familial ties. However, the combined share of Hong Kong and Taiwan in utilized FDI in China dropped to 43.7 percent in 2000, while the share of the U.S.A. and Western Europe (led by France and the U.K.) rose to 10.8 percent and 11.2 percent, respectively.[4] Japan's position weakened slightly to 7.2 percent, and ASEAN-5 recorded a small increase, to 7.0 percent (two thirds of which was from Singapore). Overall, these changes suggest that firms from the Triad countries had raised their level of equity participation appreciably in China in the two years prior to WTO accession. Moreover, while Hong

[3] Firms from Macao and Taiwan are also major investors. However, as Taiwanese investment was prohibited in China before 1990 an unquantifiable proportion was routed through intermediary countries, notably Hong Kong, thus boosting its contribution to FDI flows by source.

[4] The Cayman Islands and the British Virgin Islands are significant sources, but as they are not the ultimate home country of FDI, they are disregarded in this discussion.

Kong and Taiwanese firms invested mostly in export-processing activities in China, it was Western European and Japanese companies that were now making more capital-intensive investment, mainly to supply goods and services to China's domestic market; U.S. firms are thought to fall somewhere in between (Graham and Wada, 2001; UNCTAD, 2001; Lemoine, 2000).

Investment Form

Until 1993, the equity joint venture was the preferred entry mode for China, accounting for just under half of all contracted amounts of FDI (OECD, 2000). However, after the mid-1990s, wholly-foreign owned enterprises were increasingly favored; in 1999 just over half (51 per cent) of the contracted value of FDI took this form, mostly as greenfield operations (OECD, 2000). Graham and Wada (2001) note that the average size of individual investments also began to rise in 1999, which they attribute to a growing preponderance of larger-scale Japanese, U.S. and E.U. investments compared to smaller individual investments from Hong Kong, Taiwan and other Newly Industrializing Countries.

Geographic Distribution

In general, FDI has been concentrated in just four coastal provinces of China: (in descending order of FDI value) Guangdong, Jiangsu, Fujian and Shanghai (Lemoine, 2000). For the period 1983 to 1998, the eastern provinces together absorbed 87.8 percent of total FDI inflows, with 8.9 percent going to the central provinces, and less than 4 percent to the western provinces. But since the mid-1990s, FDI has become more evenly distributed between the eastern provinces. For example, the share of Guangdong

Table 4: Accumulated FDI stock in China, by home country and region (1995 constant prices and %)

	1979-91	1983-90	1991-95	1996-98	1983-98
Total FDI stock (US$m)		24,528	118,086	126,119	268,733
Source country and region (% share)					
Hong Kong	62.0	58.5	58.8	45.2	52.4
Taiwan	n/a	1.1	9.8	7.3	7.9
ASEAN 5	n/a	1.5	5.1	8.1	6.2
Japan	14.0	13.7	6.9	8.6	8.3
USA	10.0	12.1	7.4	8.0	8.1
Western Europe	n/a	6.6	4.5	8.7	6.7

Sources: OECD (2000) Lamoine (2000).
Note: ASEAN 5 = Singapore, Thailand, Philippines, Malaysia and Indonesia.

province in total FDI inflows dropped from 46 percent in the 1980s to 28 percent in the 1990s, while other coastal provinces and the central provinces recorded an upward share. One interpretation is that more recent investors to China are less drawn to Guangdong and Fujian provinces than earlier ones (probably because they benefit less from transaction cost-related ownership advantages), and that a more even distribution of FDI in China is now underway.

To summarize, then, we see a general transformation in the character of inward FDI in China in the few years immediately prior to WTO accession. In very broad terms, a greater proportion of investment by developed country firms (notably from the Triad countries) which is of a larger scale, is more capital-intensive and is more market-oriented, has made steady inroads on the substantial stock of smaller scale, labor-intensive and export-oriented investments of Hong Kong and Taiwanese firms since the 1980s. This distinct shift in the character of inward FDI to China began in the Adjustment Period (1994-1999, see Table 2) when a significant number of large investments by Western MNEs joined the much larger number of small investments originated from overseas Chinese sources. Furthermore, wholly-owned foreign operations supplanted equity joint ventures as the preferred means of entry, and FDI progressively, albeit slowly, began to penetrate regions beyond the coastal provinces. For the first time since the Second World War, the general pattern and character of FDI in China has begun to converge with that of the developed countries (Buckley and Clegg, 1998).

RIVALRY BETWEEN CHINA AND SOUTHEAST ASIA FOR FDI PRIOR TO WTO ACCESSION

This description suggests strongly that, before the mid 1990s, China and Southeast Asia were unlikely to have been rivals as hosts for export-platform FDI. As we see, in China this type of FDI is characterized by certain ownership advantages derived from transaction cost benefits peculiar mainly to Hong Kong and Taiwanese investors in particular geographic contexts. Although ethnic Chinese firms from these source countries also invest in Southeast Asia, they are much less prominent (Thomsen, 1999), as their ownership-specific advantages are much reduced in contexts outside of mainland China. Up until the late 1990s, therefore, the opening of China probably *increased* the global supply of export-platform FDI; that is, opening had an FDI *creating* effect. This included significant amounts of "round-tripping", whereby domestic investment was transformed into FDI by being routed through Hong Kong and Macao back to China to benefit from positive discrimination afforded to foreigners. WTO accession, with its provision for national treatment, should remove this artificial incentive. Moreover, several authors (such as Tan, 1999; Cheong, 2000; and Palanca, 2001) hold that the emergence of China

as an FDI host has not crowded out regional FDI *in general*, and that WTO accession offers little threat of this in the future. Data on the share of China and Southeast Asia in total investment flow underscores this view (see Table 1). As China's annual share of global FDI rose from around 8 percent in the early 1990s to just over 10 percent by 1996, so too did that of Southeast Asia, if only slightly. The magnitude of the growth in China's share, and that of Southeast Asia, was matched by a drop in FDI share for the industrialized countries and a positive change in world FDI flows, from which both China and Southeast Asia benefited, perhaps in a noncompetitive way. Closer examination of the data, however, reveals some evidence of crowding out in the late 1990s. As we have already noted, after 1997, and despite rising total values, China and Southeast Asia's annual share

haven position of Hong Kong it seems likely that investment allocated at the *regional level* by MNEs (and perhaps at the global level) was indeed being preferentially diverted towards China and Hong Kong in the few years prior to WTO accession. The correlation between the rise in market-seeking FDI by developed country firms in China from 1997 onwards, and the decrease in overall FDI in Southeast Asia, is suggestive that a proportion of China's FDI growth was at the expense of market-seeking manufacturing FDI in Southeast Asia. Moreover, this trend may not be confined to the Triad countries as an FDI source. In 1997, China overtook Malaysia to become Singapore's principal FDI destination, and by 2000 Singapore held the fifth largest stock of cumulative FDI in China (around 5 percent of the total) notably in labor intensive manufacturing (Hong, 2001). Some intra-Southeast

of global FDI flow both decreased, reflecting worsening investment climates in the region compared to elsewhere. However, the rate

Asian FDI flows may also have been diverted to China at this time.

RIVALRY BETWEEN CHINA

put, China is obligated to open and further liberalize many of its markets, providing foreign firms with greater access to domestic markets and levelling the playing field for foreign and domestic business, either immediately or through a phased implementation, to be completed by 2005.

As with past periods of policy reform, China's membership of the WTO is likely to provide fresh impetus to FDI inflows. In particular, the elimination of severe controls on distribution in China should enhance market access and increase substantially the incentive to make new and sequential market-oriented investments across many sectors. Also, new investment opportunities are likely to arise in sectors previously closed or highly restricted to foreign firms, especially in telecommunications services, wholesaling and retailing, logistics, financial services, travel and tourism, and audiovisual-related activity. But the interactions are complex, and the outcome - for China as well as for the Southeast Asian countries - is far from clear.

First, given China's already prominent position in global investment flow, it is unlikely that accession to the WTO will bring about any dramatic change to China's *external* economic relations in this regard (Cross and Tan, 2004). Instead, the major and most immediate changes are likely to be *internal*. These could concern not only its economy, but its social fabric and political order as well. If China's authorities do decide to comply fully with its accession commitments, then China will almost certainly experience several simultaneous 'shocks'. Nolan (2001, p. 925) characterizes these shocks as arising from:

- normal restructuring, as a consequence of rapidly intensifying competition, especially from overseas;
- having to compete on a global level playing field with a highly concentrated global business system;
- the IT revolution and modern production systems on employment;
- the drastic impact of the global media revolution upon Chinese culture;
- for its people's self-esteem, should China fail to establish a collection of powerful indigenous corporations;
- dealing with the dominance of foreign-owned corporations, especially those from the USA.

Painful short-term restructuring of previously sheltered state-owned enterprises brought about by sharply heightened competitive pressure from abroad could adjust employment away from the state-owned sector in a manner that nascent foreign and domestic owned private sectors could find difficult to absorb. At the same time, the ability of China's institutions to provide and abide by a framework of international law and to make the fundamental and wide-ranging systemic adjustments necessitated may well prove limited.

Table 5: China's WTO Accession Obligations and Commitments.

- The average bound tariff level for all industrial goods will be reduced to 9.4% by 2005 from the current 24.6%, with a wide range of detailed commitments to lower tariffs on other products. Some tariff reductions will be immediate, and others phased. All will be complete by 2005.
- The average tariff level for ASEAN products will be reduced by 34% to 47% by 2005, faster than the average reduction.
- Rules on Trade-Related Investment Measures (TRIMs) will be observed immediately on entry. Almost all administrative examination and approval procedures for the import of goods (such as quotas, licenses and other non-tariff quantitative restrictions) will be abolished. Many quotas were eliminated on accession; most of the remainder to be eliminated by 2003 and entirely phased out by 2005. The following devices were eliminated immediately on entry:
    - local content requirements,
    - technology transfer requirements and offsets as a condition for investment,
    - export performance and trade balancing requirements.
- Intellectual Property Rights - China agreed to implement TRIPS immediately on entry. Requirements that Chinese partners to a JV gain ownership of trade secrets after a certain number of years are removed.
- Trading Rights (the right to import and establish distribution networks) for foreign companies will be eliminated by 2003. Coverage is comprehensive, and includes commission agents' services, wholesaling, retailing, franchising

Chang (2001) and others are doubtful that the ability or will exists in China to balance rapid market liberalization after accession against equally rapid social cost hikes and societal tensions. Given these challenges, instead of reduced government intervention in foreign trade and investment, the enhancement of intellectual property rights, and the modernization of China's administrative and legal systems and practices, all agreed under WTO (that is, full compliance), what might occur instead is a heightening of bureaucratic and technical barriers to investment (cf. Japan in the 1970s), patchy implementation of WTO obligations, and on-going arbitrariness amongst local government agencies and the judiciary (that is, partial compliance). Partial compliance would provide new and established foreign investors with their own 'shock' - that investment barriers remain high and that accession fails to make Chinese investments any more profitable.

THE IMPLICATIONS OF CHINA'S WTO ACCESSION FOR SOUTHEAST ASIA

Three possible generic outcomes concerning FDI patterns in East and Southeast Asia can be envisaged following China's accession to the WTO. The first is the *magnetic effect* argument. This asserts that accession will strengthen China's locational advantages for FDI relative to the Southeast Asian countries. Firms would respond by (i) switching 'footloose' foreign owned operations in the region to China; (ii) diverting investment funds intended for existing operations in Southeast Asia to China; and (iii), direct new investments to the region towards China. The second is the *neutral effect* argument. This asserts that, once the euphoria surrounding China's entry has waned, regional investment flows will readjust to produce a distribution of FDI across the region equivalent to that of the mid 1990s, before the Asian crisis. The third is the *benign effect* argument. This asserts that, should China attract greater shares of regional and global FDI flows, the Southeast Asian countries will be able to 'ride on the back' of this success, through greater trade and investment, so neutralizing any detrimental effects to their own economic development that might otherwise occur. The outcome observed depends greatly upon China's willingness and ability to comply with its accession commitments and, if it does, whether or not it can make the profound structural and institutional adjustments necessitated. The growth of the Chinese economy brought on by greater integration with the regional and global economy could provide a huge stimulus to income effects which have the potential to benefit the whole of East Asia (including Southeast Asia and Japan) while the relative attractiveness of China as an investment location creates a potential substitution effect which threatens to reduce FDI in the East Asian region. Nevertheless, the extent to which China will rival Southeast Asia as a host for export platform and market-seeking FDI activity after

joining the WTO remains an open question. Let us now explore some of the issues.

With regard to the export platform FDI, China's full compliance with its WTO obligations will bring about a reduction in tariffs and other non-tariff barriers to trade. This will help foreign firms to serve China's market by exporting from other nearby production locations rather than from production bases *within* China (Nolan 2001). Accession and compliance may therefore have the effect of *strengthening* the position of neighboring countries, including Southeast Asian countries, as hosts for export-platform manufacturing FDI oriented towards serving the China market. Naturally, this effect would be accentuated if China's investment climate worsens after accession, because of growing political or social instability or rising factor input costs, for example. However, if China is unable to fully comply with its accession conditions, and if barriers to trade do rise (especially non-tariff barriers) in order to protect Chinese industry or for other economic or political imperatives, then the incentive for MNEs to continue with import-substituting strategies in China will be strong. With regard to market-seeking FDI, full compliance should create many new business opportunities for foreign firms, especially in those services sectors where market access is being granted for the first time. Given the inseparability of production and consumption for many services, the propensity for service MNEs to undertake FDI is likely to rise as they achieve market access. However, investment in new manufacturing capacity (i.e., greenfield projects) may not grow as fast as in services. There is much over-capacity in many goods markets in China where structural weaknesses have stifled demand. However, full compliance could see many of these weaknesses diminish as greater competitive pressures raise efficiencies, as export-led economic growth accelerates, and as inward investors themselves provide a spur to domestic demand.

This account points to the fact that accession and the extent of compliance could reconfigure China's investment climate relative to those of Southeast Asia which, in turn, may lead to further adjustment in regional FDI flow patterns. The degree to which intra- and extra-Southeast Asian FDI inflows might be displaced to China depends greatly on factors such as relative market growth projections, cost structures of location-bound factor inputs for production, and overall location attractiveness of China and individual Southeast Asian countries after China's WTO accession. We now consider each of these in turn.

Market Growth Projections

Ianchovichina and Martin (2001), working for the World Bank, use a conservative static model to predict that the removal of barriers to Chinese imports following WTO membership will bring about a 2.2 percent rise in China's income as exports grow (by at least 6.8 percent

under one scenario), especially in textiles and clothing. This figure may even be understated as dynamic considerations like the positive effect of accession on wages, economic efficiency and investment in China are discounted. On the other hand, the authors predict a gloomier outlook for the Southeast Asian countries. Although Singapore, Thailand, Malaysia and Indonesia in particular benefited in the 1990s by exporting to China and that this may accelerate (by 3 to 14 percent depending on the economy) as aggregate demand in China rises, it is predicted that such increases will be insufficient to compensate for export sales lost to China in third markets, especially in textiles, apparel and electronics. Consequently, a modest 0.1 percent decline in income for the Southeast Asian countries is forecast, with the exception of Singapore, which shows a small rise of 0.9 percent. Providing the reform process is not derailed, accession should accelerate economic growth in China. This in turn should stimulate both new market-seeking investments and sequential investments by foreign incumbents already active in the China market. Concomitantly, and with some exceptions, the relative market attractiveness of the Southeast Asian countries will probably decline in general terms. This may have the effect of reducing the propensity for foreign firms to undertake market-seeking FDI in these countries relative to China.

Location Attractiveness

Recent surveys allow us to comment on the relative attractiveness of China, Hong Kong and the ASEAN-5 countries as inward investment hosts. Table 6 presents data from the IMD (2001) Annual Executive Opinion Survey of current and expected competitiveness conditions for forty-seven host countries. China is ranked 29th overall as an investment location in the period 1998-99, a position bettered only by Singapore and Malaysia among the ASEAN-5 (the other five Southeast Asian countries being excluded from the survey). As a production location, China has many advantages relative to Southeast Asia. Perhaps most obvious is its abundant pool of low cost labor. Despite certain shortages, especially in middle management, there are in general sufficient numbers of workers skilled at most stages of the value chain to satisfy the current needs of the majority of investors, even in more capital-intensive and knowledge-intensive sectors. China has also developed stocks of technological capability in several sectors, notably in electronics, due in part to its economic isolation in recent decades and to the spill-over effects of FDI. This stock is now being augmented by China's rapidly modernizing educational system, overseas educated returnees and FIE training and development programs. China's technical and transport infrastructures have also been upgraded considerably in recent years, especially in the eastern provinces. New foreign investment

in services, distribution and logistics sectors following accession could help to further drive down manufacturing costs. The unevenness of China's development means that the underdeveloped northern and western provinces will continue to offer many equivalent benefits to foreign investors, certainly in respect of labor, should manufacturing costs rise in the coastal provinces after accession. By contrast, several Southeast Asian countries are reported to have labor shortages and rising labor and land costs (Yean, 1998).

The IMD survey also presents data on the FDI regimes and transactions costs of doing business in the region (see Tables 7 and 8). In terms of its FDI regime, China scores lower than each of the ASEAN-5 countries except Indonesia, faring particularly badly on the availability of local capital and foreign ownership of domestic firms. However, full compliance to the WTO should bring about considerable improvement in these areas, and in others such as equal treatment and national protectionism. In terms of transaction costs, China's overall assessment compares favorably with the ASEAN-5 countries, bettered only by Singapore and Malaysia. While China scores poorly on bureaucracy and levels of corruption, its business environment in general seems to be no worse than that of the ASEAN-5 countries (with the obvious exception of Singapore), and is in some respects better. Importantly, unlike the smaller Southeast Asian economies, many foreign firms will view China's large market potential as sufficiently adequate compensation for the comparatively high transaction costs

Table 6: Location Attractiveness Rankings for China, Hong Kong and the ASEAN-5.

	Manufacturing	R&D	Service and Management	Overall ranking
China (PRC)	39	40	45	33
Hong Kong	6	16	10	6
Singapore	1	3	3	2
Thailand	42	42	40	38
Malaysia	28	35	32	29
Indonesia	48	49	48	49
Philippines	36	37	35	40

Note: data not available for Brunei, Cambodia, Laos, Myanmar and Vietnam.

Source: IMD (2001).

ment ction	Image of country	Overall assessment
	G	H
3	7.4	5.49
0	7.3	8.21
7	8.4	7.99
1	5.6	5.99
9	6.2	5.59
8	2.0	5.19
4	2.6	6.37

for each item.

r
g imported
countries

and the ASEAN-5 Countries.

aucracy	Corruption	Protection of IP	Distribution systems	Infra-structure	Labour regulations	Overall assessment
E	F	G	H	I	J	K
2.9	2.6	5.0	5.4	5.3	4.3	5.11
5.2	7.0	6.4	8.8	8.1	8.1	7.22
7.5	8.8	7.8	9.3	9.0	8.4	8.47
3.5	2.8	4.9	6.9	6.0	6.4	4.89
4.6	4.5	6.2	8.0	7.2	6.7	5.96
2.8	1.0	2.5	3.6	2.3	4.0	3.34
2.0	1.5	3.7	3.2	2.8	3.6	4.47

for FDI) to 10 (most favourable for FDI) for each items.
Myanmar and Vietnam.
(10)
nted (10)
country's competitiveness
/ intentions clearly (10)
opment
ic sphere (10)
n your country
erally inefficient (0) / efficient (10)
adequately planned and financed (10)
ugh (10)

experienced there.

A measure recently invoked by UNCTAD (2002) reinforces the view that China has a generally more favorable investment climate compared to Southeast Asian countries (see Table 9). UNCTAD (2002) calculate the Inward FDI Performance Index as an approximate measure of a nation's relative performance in attracting FDI, allowing for economic size. For China, this index rose from 0.9 to 1.2 between the periods 1988-90 and 1998-2000; an improvement in its 'revealed competitive advantage' for FDI, and an indication perhaps of the country's resilience to the Asian crisis and its causes. However, the index declines for each Southeast Asian country except Vietnam over the same period, indicating a reduction in the attractiveness of the Southeast Asian countries relative to China, especially in market-related aspects. This may be due to the consequences of the Asian crisis, or an indication perhaps of more serious structural economic deficiencies.

Other surveys of MNEs also reveal optimism among the international business community that China's relative position as an investment location will be sustained. UNCTAD (2001) cites a recent survey of 3,000 regional headquarters and representative offices of MNEs situated in Hong Kong. Some 45 percent of respondents reported that they planned to increase their investment in mainland China, and 93 percent predicted that the investment climate there would be 'favorable' or 'very favorable' through to 2005. Bartels and Freeman (2000) report similar findings in their 1999 survey of 31 retail-oriented MNEs with regional headquarters in Singapore, 71 percent of whom indicate that 'greater China' was given 'high' or 'highest' priority by the parent firm as a business location. More recently, UNCTAD (2002) highlight two studies by the Japan Bank for International Cooperation (JBIC) and JETRO that hint at the growing importance of China in Japanese investment strategy. Of 469 respondent Japanese manufacturing firms surveyed by JBIC in 2002, over half (57 percent) find China more attractive than the ASEAN-5 as an investment location. The JETRO survey revealed that 21 percent of the 645 respondent Japanese MNEs were planning to relocate production to China following WTO accession, mostly from Japan itself (92 firms), but also from Hong Kong (13 firms) and the ASEAN-5 (11 firms).

Two final and interrelated observations also bear upon China's position as a future rival to the Southeast Asian countries as an investment location. First, there is ample absorptive capacity in China for FDI. FDI stock on a per capita basis remains comparatively low in China (U.S. $ 348 in 2002), well below that of Hong Kong and Singapore (U.S. $59,296 and U.S. $27,866 respectively), but also below that of Malaysia (U.S. $2,493) and Thailand (U.S. $454). The uneven sectoral and geographic distribution of FDI in China means that much geographic and economic space is

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and Potential Indexes for China and SE Asian countries

	rmance Index		FDI Potential Index			
	Rank		Score (0-1)		Rank	
	1988-1990	1998-2000	1988-1990	1998-2000	1988-1990	1998-2000
	61	47	0.234	0.251	59	84
	4	2	0.441	0.589	21	13
	125	128	0.315	0.424	35	33
	n/a	n/a	n/a	n/a	n/a	n/a
	63	138	0.203	0.189	73	110
	n/a	n/a	n/a	n/a	n/a	n/a
	8	44	0.252	0.368	52	40
	36	82	0.067	0.083	138	139
	39	89	0.139	0.265	111	78
	1	18	0.470	0.641	16	3
	25	41	0.235	0.298	57	61
	53	20	0.134	0.277	115	71

of a country's share in global FDI flows to its share in global GDP
ed average of the normalised values of GDP growth rate; per
lephone lines per 1000 inhabitants; commercial energy use per
ss national income; share of tertiary students in population; and

untouched by it, particularly in the northern and western provinces where many SOEs are located. Second, strategic-asset FDI in China (that is, mergers and acquisitions involving Chinese SOEs and foreign firms) has been highly restricted by the regulatory regime and underdeveloped stock markets. However, regulatory changes following WTO membership, embodied in the State Council's 10th five-year plan, should lead to the removal of many of these obstacles. Providing political opposition is also quelled, this should generate significant inflows of FDI in the medium term as performing SOEs are partially or totally sold-off. This could see strategic asset-seeking FDI surge to the northern and western regions of China, despite the relatively under-developed physical and technical infrastructures there.

CHINA'S ROLE AS A REGIONAL DRIVER

China currently enjoys the powerful combination of a large, low cost and educated labor pool, strong demand potential and at least a favorable investment climate relative to the Southeast Asian countries. As long as social and political cohesion is preserved (by no means a guarantee), China's full compliance to its accession terms should lead to a rise in domestic demand, better market access for foreign firms and an improvement in its investment climate relative to the Southeast Asian countries. WTO accession could therefore further strengthen China's position as a rival host for global and regional FDI flows in the future. While a good proportion of future FDI flow to China will be 'new' (that is, China's further opening could continue to have an FDI-creating effect), it is important for policy-makers in the region to recognize that an indeterminate yet potentially significant amount could be displaced from intra-Southeast Asian FDI, or from initial and sequential FDI made by the Triad countries in Southeast Asia. The greatest competitive effect is likely to be on higher value-added market-oriented FDI, which is already accelerating following accession, especially from the Triad countries. Certain structural impediments currently prevent this from happening in many, if not most, of the Southeast Asian countries. The most immediate surge in China's inward FDI is expected in those services-related sectors being opened for the first time. However, as domestic demand in China expands, more manufacturing-based FDI should also be attracted, particularly from developed country firms undertaking increasingly more capital and technology-intensive production. Some foreign and domestically owned production in Southeast Asia may also migrate to China, as its investment climate improves relative to current production locations. Both Singapore - already a major investor in China - and Malaysia have recently registered increased outward FDI flows in labor-intensive manufacturing as production costs rise at home, and a growing proportion of this may soon be directed to

China. Likely candidates would be those more 'footloose' export-oriented manufacturing operations with relatively few backward and forward linkages to local suppliers and other parties. These are presently commonplace in Southeast Asia, especially in textiles and garment production and some in types of electronics manufacturing. The coastal provinces of China are likely to exert the more immediate pull effects on export-platform FDI in Southeast Asia. However, as wage and non-wage related production costs here rise, then greater pressure should be felt from China's central and western provinces, as transport and technical infrastructures are further improved and as economic development is boosted by the acquisition of SOEs by foreign investors. The provinces of Sichuan, Hunan and Henan are strong candidates for the next wave of inward FDI to China, for cost-oriented as well as market-seeking motives. Nevertheless, coastal locations such as Beijing, Shanghai, Zhejiang and Hebei will retain their appeal for many foreign investors, for obvious reasons.

Should China have a magnetic effect on patterns of regional FDI, this could have significant implications for each of the Southeast Asian countries, though to varying degrees and for different reasons. Of course, a certain level of market-seeking FDI will always be maintained in the Southeast Asian region, irrespective of developments in China. For example, MNEs will continue to support and establish subsidiaries in individual Southeast Asian countries, to complement their import function with sales, marketing, and distribution activities. But this is relatively low-value added activity, and generates few spill-overs and other benefits for the host economy compared to more capital intensive investment. Moreover, for some Southeast Asian countries, such as Brunei, Myanmar and Indonesia, FDI is mostly natural resource-oriented, notably in the oil and gas extraction and support industries. It is unlikely that China is, or will be, a magnet for FDI in these sectors. In this regard, China's influence on regional FDI flows will be least felt by more resource-oriented economies. However, if China does prove able to attract a greater proportion of regionally allocated market seeking FDI in services and manufacturing, this will impact most those Southeast Asian countries which themselves have relatively small markets in terms of, for example, population (such as Brunei, Laos and Singapore) or purchasing power (such as Myanmar and Vietnam). Larger Southeast Asian countries like Malaysia, Thailand and the Philippines should continue to attract market-seeking FDI, but whether this is in capital and technology-intensive sectors may be open to question. Currently, the FDI stock of these countries exhibits a strong source country affiliation, with a preponderance of European, and especially British-owned, FDI in Malaysia and American investment in the Philippines and Thailand. Should these source countries continue to

direct their investment in China to levels typically found in developed host countries, then this may be at the expense of at least some sequential FDI in Southeast Asia. What is more, some of these Southeast Asian countries may experience divestment, as 'footloose' foreign and domestically-owned production relocates to China.

Of course, several Southeast Asian countries should benefit directly from market opening in China. An obvious candidate is Singapore, whose firms have expertise in a variety of service-related sectors such as education, construction, engineering consultancy, business services, transport and logistics. Certain language and cultural similarities should enhance the competitive advantage of Southeast Asian firms in China compared to their U.S. and European counterparts. Nevertheless, although intra-Southeast Asian FDI is not significant in terms of world flows, it is important to some ASEAN economies. For example, the newer ASEAN members - Cambodia, Laos, Myanmar and Vietnam - only attract relatively small amounts of FDI in absolute terms (although often large as a proportion of GDP), but their principal source tends to be fellow Southeast Asian countries, particularly Singapore. If China's opening does displace intra-Southeast Asian FDI, and especially Singapore-sourced FDI, these countries could suffer economically. Indonesia and Malaysia, which also host large amounts of Singaporean FDI, could be similarly affected.

ALTERNATIVE POLICY RESPONSES FOR SOUTHEAST ASIA

MNEs are incentivized to withstand global competition by strengthening their ownership advantages across all markets in which they operate. It is important therefore that each Southeast Asian country provides competitive immobile assets to complement the mobile assets of MNEs if they are to counter any rivalry effects from China as an investment location after WTO. On a unilateral level, this means continued proactive national policies to enhance the quality of the workforce, infrastructure, supply networks, institutions and so forth. Deficiencies in the respective investment climates also need to be tackled. As we have seen, transaction costs in Southeast Asia are often on a par with those in China, while several nations lack an economic base of comparable size that would enable investing MNEs to offset transaction costs against revenue streams. Investment promotion measures targeted at particular industries (in which the host country has an actual or potential competitive advantage) or source countries (with existing trade or historic connections) will also continue to be important policy instruments. Southeast Asian countries could also compete individually with China as a production site by depreciating their currencies and cutting production costs. However this is an untenable solution given the high social costs and lower living standards that would

follow. The countries could also realign their economies to become more resource-oriented, supplying agriculture and minerals, not only to a growing China, but also the wider region. However, economic rigidities and under-investment in several of the Southeast Asian economies will be a constraint to this, at least in the short term. Nevertheless, those countries with a common border to China - Laos, Myanmar and Vietnam - should improve their transport and communications infrastructure with both China and the rest of Southeast Asia in order to benefit as conduits for the rise in China-Southeast Asian trade flows that should follow accession.

Although such unilateral initiatives may go some way to offsetting China's improving situation as a host economy, the real gains to Southeast Asia will come by replacing deteriorating *individual* locational advantages relative to China with a superior *regional* one. Consequently, the ASEAN Free Trade Agreement (AFTA) or the Asian Investment Area (AIA), or both, should form at least part of the policy solution. For two reasons, more concerted effort is needed to coordinate and harmonize investment regulations and regimes across Southeast Asia. First, this would help to negate unilateral 'beggar thy neighbor' policies, in which individual Southeast Asian countries 'race to the bottom' by attempting to out-compete each other with improved investment conditions under WTO rules. Second, coordination could facilitate an improved division of labor across Southeast Asia. This would permit Southeast Asian and outsider firms to allocate resources regionally according to the comparative advantage of member states, in much the same way that MNEs are beginning to do now in China. Both Southeast Asian and non-Southeast Asian MNEs would be better able to rationalize existing production across the region, and to generate greater economies of scale and other efficiencies as a result. Opportunities for intra-industry specialization would provide a boost to the investment climate of Southeast Asia as a whole, especially for efficiency-seeking FDI. Thus labor-intensive manufacturing may be encouraged in low cost countries like Myanmar and Vietnam, while high-end, capital-intensive manufacturing could continue to be sited in Singapore, for example. At the same time, a workable AFTA would also create a single market of sufficient size to begin to counter that of China for market-seeking FDI. It could also help to stimulate outward investment in Southeast Asia by Chinese enterprises, which themselves will soon be under growing competitive pressure to develop foreign markets following accession. Indeed, this process is already underway, with the Philippines, Malaysia and Thailand beginning to attract Chinese FDI in resource-based sectors such as agriculture, chemicals, paper and rubber (ACEGEC, 2001). Southeast Asia is a net investor in China, however, which means that investment cooperation both within Southeast Asia, and between Southeast

Asia and China, may be directed more to protecting Southeast Asian investors in China and improving the conditions for Southeast Asian firms there than *vice versa*. If so, any further deepening of economic integration within Southeast Asia could be impeded. However, if implemented, greater regional integration in the form of AFTA and the AIA should provide fresh stimulus to both intra- and extra-Southeast Asian FDI, and could go some way towards offsetting China's growing economic weight in the region.

CONCLUSION

This paper shows that the impact of global FDI goes beyond host and source countries. The rise of China as a major location for world FDI can be counted as a success for the globalization of the world economy. However, even such spectacular successes can have negative consequences in the interdependent global economy. The success of China poses particular policy challenges for Southeast Asia. In order to counter the growing economic weight of China in East and Southeast Asia, and as individual member states will be limited by what they can accomplish alone, the Southeast Asian countries should act in concert to enhance the attractiveness of the region as an investment location relative to China. Greater regional integration (in the form of AFTA or the AIA) will be an important, if not crucial, element of the policy solution. Whilst the income effect of China's growth should stimulate the economies of Southeast Asia, there is also likely to be a substitution effect such that China attracts FDI and other economic activities away from the Southeast Asian region. The balance of these effects needs further detailed investigation.

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