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# The Composition of Foreign Investment in China and the Governance Environment

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# THE COMPOSITION OF FOREIGN INVESTMENT IN CHINA AND THE GOVERNANCE ENVIRONMENT

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## Abstract

The paper explores, in the specific context of China, the influence of the financial dimension of the "governance environment" on the composition of foreign investment. The hypothesis that the preferred form or mode of foreign investment is influenced by the state of financial development of the host country suggests that foreign investment in China should consist predominantly of FDI during the initial phase of China's transformation, followed by an increasing share of FPI as financial development deepens and governance arrangements become increasingly transparent and reliable. A corollary of this conjecture is that the secular evolution of the composition of foreign investment may shed some indirect, but important, light on the progress of financial development in China and on the perceived "quality" of her governance regime.

These conjectures are loosely supported by our findings. The progress of reforms in China has been effective in buttressing confidence of international investors sufficiently to maintain a substantial flow of foreign investment into China, the Asian Crisis notwithstanding. However, the continuing dominance of FDI and the absence of significant FPI growth against the backdrop of financial sector reforms suggest that international investors regard those reforms as inadequate. Financial reforms have failed to improve the governance environment sufficiently to establish investor confidence in the efficacy of domestic markets, specifically in the financial sector.

**Key words:** Foreign investment, FDI, financial reform, information asymmetry, China
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# THE COMPOSITION OF FOREIGN INVESTMENT IN CHINA AND THE GOVERNANCE ENVIRONMENT*

Dietrich K Fausten and James Lake

Cross-border investment flows improve the global allocation of resources by facilitating their deployment according to their expected profitability. To the extent that they augment the capital resources in locations where the expected return from investment is relatively high they constitute a potentially powerful engine of economic growth. Such locations typically include the relatively capital-scarce less developed countries and transition economies. Hence, foreign investment constitutes an important element in the attempt of such countries to lift economic performance and to improve material well-being.

Cross-border investment flows can take a variety of forms that offer different risk-return combinations at any given point in time. These alternative modes range from relatively illiquid resource-focused direct investments to highly liquid finance-focused portfolio flows. Circumstances specific to both the host country and the source

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country influence their relative suitability. These "circumstances" encompass at one extreme micro-considerations at the firm and industry level such as managerial practices, the possession of unique (and often intangible) assets, and market position. At the other extreme they include macro characteristics such as aspects of aggregate economic performance, the state of financial sector development, the regulatory regime, and the institutional environment that governs the conduct of commercial transactions. Foreign investors choose among the alternative forms of cross-border capital movement according to a set of optimizing criteria that are conventionally expressed in some form of expected risk-adjusted return.

The purpose of the present paper is to explore, in the specific context of China, the influence of one particular dimension of the "governance environment" on the composition of foreign investment. That dimension embraces the financial sector institutions and the regulatory framework in which they are embedded. The rationale for this focus derives from the fact that the financial sector mediates powerful incentives that affect the conduct of business. It does so through the terms on which finance is provided and through a variety of monitoring mechanisms. Regulatory institutions and provisions influence the efficacy of these mechanisms. They also control directly foreign access to host country markets as well as the organization and conduct of commercial activity.

In the following section we introduce the hypothesis that the preferred form or mode of foreign investment is influenced by the state of financial development of the host country. Sections two and three provide the empirical and institutional context. Section two examines the recorded pattern of foreign investment in China during the first two decades (approximately) of transformation. Section three traces some salient facets of financial reforms in China and their potential association with changes in the pattern of foreign investment. Section four relates the empirical record to some recent theoretical work on the composition of foreign investment, and section five concludes.

## I HYPOTHESIS OF THE DEVELOPMENT OF MARKET INSTITUTIONS AND THE MODE OF FOREIGN INVESTMENT

Cross-border investment flows may involve active engagement by the investor in the conduct of foreign projects (foreign direct investment – FDI) or they may involve the provision of finance to permit such engagement by third parties (foreign portfolio investment – FPI). Interest in the relative behaviour of FDI and FPI is informed by the presumption that the comparative advantage of these alternative modes changes with the secular evolution of the host economy. As the market system gains depth and appropriate institutional arrangements are put in place, entrepreneurs and financiers can rely increasingly on the incentive and monitoring functions of market forces - the "invisible hand" - in their pursuit of profit opportunities.

Recent economic history of China provides an instructive setting to examine that process. China's economy and institutions have experienced dramatic change as the country embarked upon a determined process of transformation towards a predominantly market-oriented system. Core elements of this process are the progressive privatization of enterprise and the attempt to establish a financial system capable of performing effectively the intermediation function that channels national savings to their most productive use. Concomitant with this specifically economic transformation numerous changes have been instituted in the institutional and regulatory infrastructure that governs economic activity in China.

Cross-border investment decisions are subject, *inter alia*, to a host of informational problems that affect their profitability and eventual realisability. Foreign investors suffer an absolute knowledge disadvantage compared to potential domestic investors in salient aspects of the host country environment such as language, customs, and cultural practices (e.g., Portes, Rey and Oh, 2001). Attempts to correct for that disadvantage through the retention of specialist agents impose additional costs on the foreign investor that may provide some rough indication of the economic significance of that disadvantage. Difficulties in assessing the quality of investment projects, and scope for opportunistic behavior influence the expected profitability of a given project and the choice of preferred investment mode. Conversely, foreign investors may possess scarce assets and skills that enable them to extract rents from foreign investment ventures (Moody, Razin & Sadka, 2003). Incomplete monitoring of FDI and possession of intangible managerial capital create opportunities for "cream skimming" by foreign firms. Such opportunities increase with the lack of corporate transparency in the host country and the degree of specialisation of the source country in the given industry. Transparent governance mechanisms and a resilient financial infrastructure restrain the private interest exploitation of such informational asymmetries

Accordingly, the present investigation adopts the working hypothesis that the resource-focused direct form of FDI is particularly suitable when financial markets are thin and governance arrangements are relatively opaque, inscrutable or capricious. Under such circumstances, the use of real resources as the investment vehicle, and the direct involvement in their management and deployment in the host country, confer a powerful advantage to FDI over alternative modes of cross-border investment. That advantage derives from the retention of control which such ownership confers on the investor as well as from the direct access to undistorted inside information about the operation and performance of the particular venture. Naturally, these advantages come at a cost that is attributable to indivisibilities and the relative illiquidity of the foreign asset, and the large financing burden of the typical FDI commitment. The alternative form of foreign portfolio investment (FPI) alleviates these costs provided an institutional environment exists for the efficient conduct of financial intermediation. Salient elements of such an environment are transparency of governance arrangements, respect for contractual commitments, and their effective enforcement.

This working hypothesis suggests that foreign investment in China should consist predominantly of FDI during the initial phase of China's transformation. FPI is expected to gain progressively in importance as financial development in China deepens and governance arrangements become increasingly transparent and reliable. A corollary of this conjecture is that the secular evolution of the composition of foreign investment in China may shed some indirect, but important, light on the progress of her financial development and on the perceived "quality" of her governance regime. In particular, the absence of significant FPI growth against the backdrop of financial sector reforms may suggest that international investors regard those reforms as inadequate relative to their expectations.

These conjectures are loosely supported by our findings. The progress of reforms in China has been effective in buttressing confidence of international investors sufficiently to maintain a substantial flow of foreign investment into China, the Asian Crisis notwithstanding. However, these reforms have failed to improve the governance environment sufficiently to establish investor confidence in the efficacy of domestic markets, specifically in the financial sector. As a result, FPI in China has remained fairly stagnant and foreign investment into China continues to be dominated by FDI.

## II TWO DECADES OF FOREIGN INVESTMENT IN CHINA, 1982-2002

### II.1 Direct Investment

The outstanding characteristic of China's recent foreign investment experience is the unequivocal dominance of inward FDI during the second half of the observation period (Fig 1.a). A clear breakpoint occurs in 1992, the year of Deng's visit to the southern provinces that launched the dramatic expansion of foreign investment in China. Average annual FDI increased almost seventeen-fold, from approximately $US2,200m during the first decade to approximately $US37,000m. No other cross-border investment component exhibits any remotely comparable shift in behavior. Portfolio and Other Investments were of similar orders of magnitude to FDI during the first decade, albeit exhibiting somewhat greater variability than FDI. But they show only a modest drift throughout the 1990s associated, however, with a notable increase in variance.

**Fig 1a: Investment Inflows**

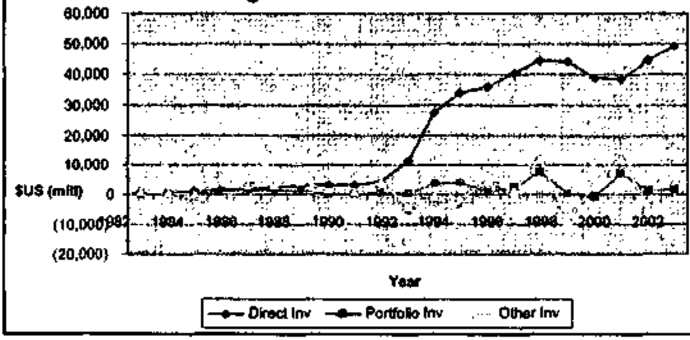
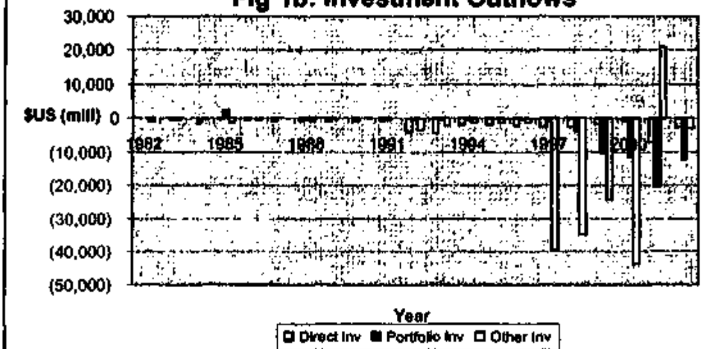



**Fig 1b: Investment Outflows**




A rather different picture is presented by investment outflows from China (Fig.1b). Compared to the other main components, outward FDI ("Direct Investment Abroad") displays relative stability throughout the entire observation period. There is a discernable shift in average annual outflows around 1992, but the extent of that shift is "only" of the order of approximately five-hundred per cent, from $US540m to

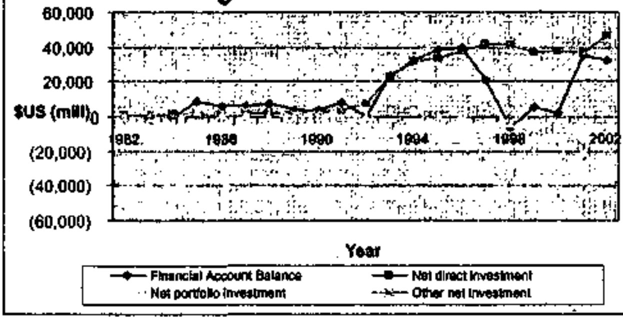
$US2,900m. Significant increases occur in 1992 and 1993, and almost a decade later, in 2001. But these bursts in direct investment outflows are strictly transitory.

The considerable increase in net FDI[1] since 1992 is the driving force behind the evolution of the Financial Account Balance (FAB) (Fig.2). That balance exhibits a clear breakpoint in 1992 and follows the path of FDI, varying between $US21,000m and $US40,000m during the period 1993-2002. This pattern is disturbed by the three post-crisis years which are dominated by the reversal in portfolio and other investment flows.[2]

[1] FDI outflows increased from $US100m-900m over the 1982-91 period to $US2,000-7,000m over the 1992-2002 period, while FDI inflows increased from $US1,000m–4,000m to $US 28,000m-$50,000m over the corresponding periods.

[2] China's balance of payments also report significant Net Errors and Omissions (E&O). Over the twenty-year period 1982-2002 they amount to a cumulative deficit of $US142,127m, or 46% of the recorded increase in China's international reserve holdings. The negative E&O entries could reflect underrecorded reserve gains. Conversely, they could indicate that the reported capital inflows or net exports overstate their true magnitudes. Either way, the cross-border transaction records have to be treated with circumspection. At the same time it should be noted that the absolute magnitude of negative E&O entries has been decreasing, and that a positive entry has been recorded for 2002.

**Figure 2: Financial Account**




The increase of FDI in China coincides with the official encouragement and rapid expansion of private sector activity.[3] The historical dominance of FDI as the preferred investment vehicle since the late 1980's and especially since 1992 is also evident relative to China's economic growth (Fig. 3). Yet while 1992 was definitely a break point, there appears to be a flattening out after 1998 of annual FDI at around 3.5-4 per cent of GDP, which is below the annual flow of 4.5-6.25 per cent of GDP over the 1993-1998 period. However, this flattening merely indicates that FDI growth has decelerated relative to domestic economic growth. In absolute terms, FDI has increased by 63 per cent over the 1993-2001 period.

[3] Private and foreign enterprises account for 11.7% of industrial output in 2002 compared with 4.5% in 1999 while the share of SOE's and State-Holding Enterprises in 2002 accounted for 40.6% compared with 80% in the late 1970's (EIU, 2004(a), p.51).

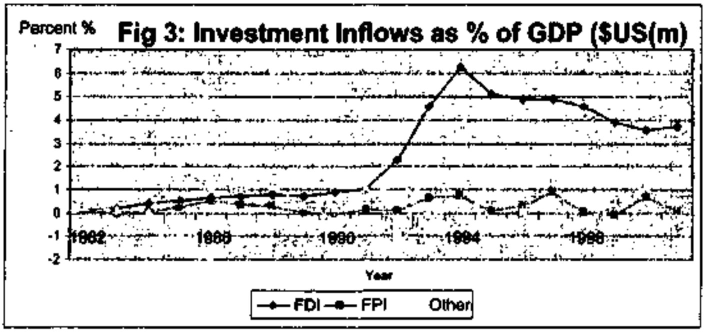
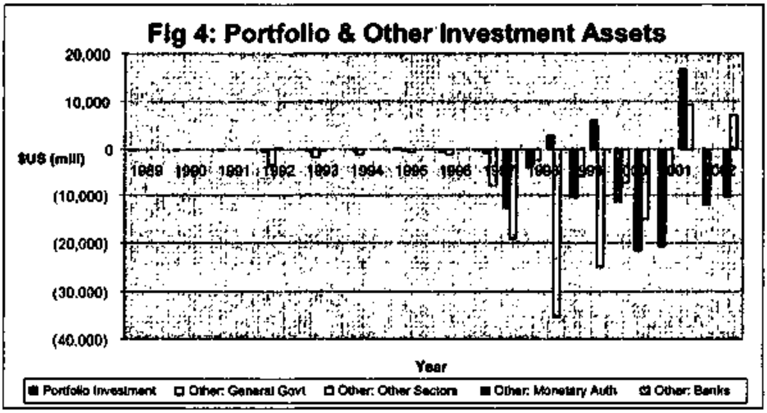



Fig 3: Investment Inflows as % of GDP ($US(m)

## II.2 Portfolio and Other Investment

Capital outflows from China are dominated by the substantial increase of Other Investment (OI) outflows during the Asian financial crisis and their partial reversal in 2001 (Fig. 1b, above). Portfolio outflows also increased in the wake of the Asian financial crisis, but proportionately less so, and with a noticeable lag, and then declined sharply (by almost fifty percent) in 2002.

There appear to be two reasons for the immense increase in OI activity during the late 1990s. One has to do with the Asian financial crisis, and the other with regulatory reform. First, the large volume and mild volatility of OI outflows in conjunction with relatively stable gross and net FDI flows conform to the stylized features of regional financial crises[4] identified by Lipsey (2001). China's acquisition of OI assets jumped forty-fold in 1997. In 1998 the capital outflow was augmented by a *repatriation (liquidation)* of $US8,600m of Other Investment Liabilities compared to an *acquisition (issue)* of such liabilities of $US12,000m in 1997. This buildup of China's net foreign asset position continued throughout the immediate post-crisis triennium, particularly on the part of China's banks. But a massive turn-around occurred in 2001 with the liquidation of approximately $67,000m in OI assets held abroad.




Secondly, while the Chinese Banks and Monetary Authority (B&MA) accumulated nearly $US140,000m of OI assets over the 1997-2000 period, they had not acquired *any* OI Assets abroad during the

[4] In particular, the Latin American financial crises of the early 1980's and the Mexican financial crisis of 1994 exhibited similar capital flow patterns.

preceding decade and a half (Fig. 4). This dramatic shift suggests that such crossborder investments had either been illegal prior to 1997 or that they had not been reported, or reported incorrectly in other OI categories or in E&O. Such possible misreporting is unlikely to constitute a valid explanation. Neither of the OI categories recorded any significant entries before the sudden shift, nor are there commensurate negative E&O entries. Instead, the relaxation of regulatory constraints is a more likely factor that permitted core financial institutions to enter the international financial market.

OI-activity was dominated by transactions of China's B&MA, abstracting from the $20,000m swing in 1997 that was largely attributable to withdrawals by overseas investors. The sudden explosion of their foreign asset acquisitions may well represent evidence of financial market deepening in the Chinese economy. Their significant initial engagement in foreign investment is entirely consistent with the uncertain economic environment and volatility associated with the Asian financial crisis. However, the subsequent unwinding of these positions is a strong signal that these prominent domestic agents had finally regained confidence in the robustness of the domestic economy and institutions. While it must be emphasized that this vote of confidence was issued by domestic agents, it should be recognized that the domestic monetary authority and banks are unlikely to enact a strategy diametrically opposed to the collective judgment of the international investment community.

## II.3 External Debt

The aggressive strategy of foreign asset acquisition by China's B&MA led to a sharp deceleration in the growth of her external debt after 1997[5] (Figure 5a). At the same time, the average maturity of the debt, while volatile, shortened significantly.[6] While the World Bank figures distinguish only between short-term and long-term maturities the new Joint BIS-OECD-IMF-World Bank figures are far more disaggregated. This disaggregation reveals that the maturity shortening of the external debt is accompanied by a compositional change in favor of market instruments[7].

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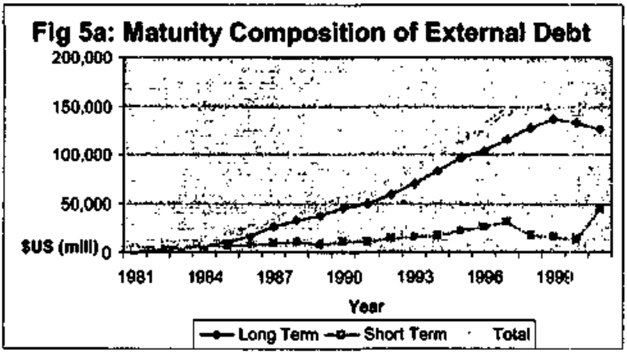
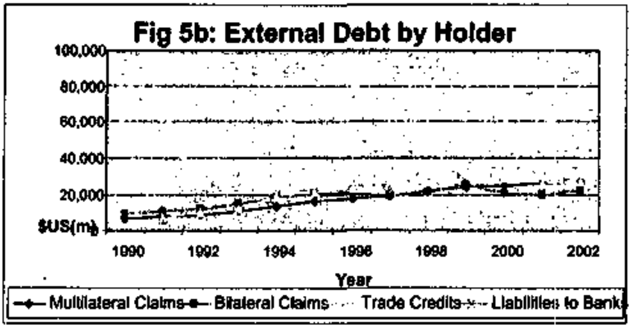
[5] Based on World Bank figures

[6] A comparison between the five years immediately preceding the Crisis (i.e., the period bounded by Deng's visit to the Southern Provinces and the Crisis) and the immediate post-crisis years is instructive. Total and long-term debt approximately doubled during the 1992-97 period while short-term debt grew by nearly 130 per cent. During the four post-crisis years, total and long-term debt increased by slightly less than 16 and 10 per cent, respectively, while short-term debt expanded by approximately 40 per cent.

[7] There are notable inconsistencies between different international sources in the calculation of external debt figures. Since the Joint BIS-OECD-IMF-World Bank External Debt figures do not provide a total figure we define total External Debt as the sum of Multilateral Claims *plus* Official Bilateral Claims *plus* Total Liabilities to




Note: based on World Bank figures




Note: based on Joint BIS-OECD-IMF-World Bank figures

Liabilities to Banks have traditionally dominated China's external debt (Figure 5b). These liabilities include bank loans and bank holdings of debt securities which have been issued in international markets by private and public sector borrowers. After reaching a peak in 1997,

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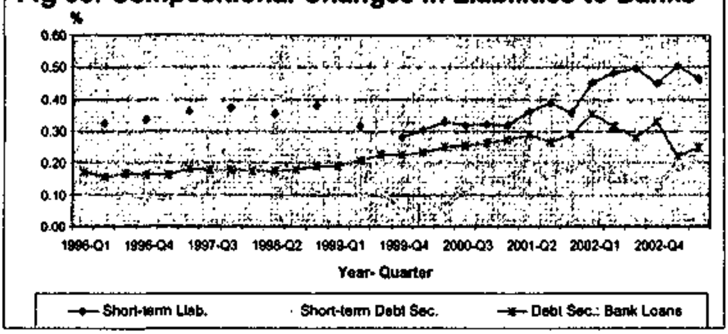
Banks (locational) *plus* Total Trade Credits. On this basis, China's external debt nearly doubled over the 1991-2002 period from $US62,000m to $US120,000m, while World Bank figures suggest that it almost tripled from $US60,000m to $US170,000m over that period.

liabilities to banks have been decreasing sharply, and almost symmetrically, to return to their approximate 1992 level in 2002.

**Fig 5c: Compositional Changes in Liabilities to Banks**




Note: based on Joint BIS-OECD-IMF-World Bank figures

Since Liabilities to Banks are the predominant element of China's external debt, it is instructive to examine their composition (Figure 5c). The rise in the ratio of short-term debt securities to bank loans provides some circumstantial support for a gradual "deepening" of China's financial markets. Simultaneously, the share of short-term liabilities to banks has been increasing, particularly after 2000, from around 30 per cent to the 45-50 per cent range of total liabilities to banks. Moreover, there has also been an increase in the percentage of short-term debt securities as a proportion of total debt securities issued abroad, from 5-15 per cent (1994-2000) to 15-20 per cent

(2000-2003). To the extent that shorter maturities are desired to provide greater liquidity and flexibility when perceived risk is higher, a shortening average maturity indicates the perception of increased risk on the part of international investors. Thus these two shifts, firstly towards debt securities and away from bank loans and, secondly, towards shorter maturities produce conflicting signals about international perceptions of the success of Chinese financial reform. Conversely, the fact of conflicting signals precludes an overwhelming 'international investor consensus' and suggests instead that international perceptions about the investment climate in China are likely to be quite fragile.

## III RECENT FINANCIAL REFORMS IN CHINA

China's banking sector has been a main target for reform in recognition of its core role in enhancing allocative efficiency and, ultimately, economic performance. As the overwhelmingly largest component of China's financial market the banking sector is representative of the financial market in general.

### III.1 Banking sector reform

The sector comprises the Peoples Bank of China (PBC) which acts as a central bank and regulator of the industry, and the "Big Four" state-owned banks[8] which account for 60 per cent of total banking assets. The Big Four would be obvious initial targets for substantial FPI. Despite the pursuit of financial reforms important problems persist in the banking sector including low foreign competition and restricted interaction with foreign markets, a high percentage of non-performing loans, low profitability, lack of managerial expertise and inadequate corporate governance strategies. The upshot is that private firms remain unable to get appropriate levels of credit because of the persistence of inefficient lending practices.

***Foreign Competition and Interaction with international markets***

Crossborder interaction is gradually increasing and should continue to increase. This should not only promote the deepening of the Chinese equity market but also improve the investment environment more generally. At present, foreign banks are allowed to compete in the domestic banking sector subject to geographical and locational

[8] Bank of China, China Construction Bank, Agricultural Bank of China and the Industrial and Commercial Bank of China.

restrictions. Since April 2002 they have been allowed to transact in foreign exchange with local businesses and residents, and from 2007 onwards they may transact in local currency (EIU, 2004(a), 54). They are subject to licensing requirements that generate significant costs and disincentives. The resulting distortions provide extensive scope for further reform.

While the Chinese authorities have been actively encouraging cross-border M&A activities since late 2003 in both directions[9], foreign banks are not permitted to gain direct control of domestic banks. Foreign banks are only permitted to apply to purchase non-tradable shares in the Big Four banks. Like many national governments, the Chinese authorities seem to regard the domestic banking sector of strategic importance for the national interest. Hence, they attempt to shield it from dominant influence and control by foreign interests.

[9] For instance, Eastman Kodak purchased a 20 per cent stake in China's biggest traditional photographical film producer in October 2003 for $US100m. One month later China's largest electronics firm, TCL, acquired a 67 per cent controlling interest in a joint-venture agreement with a French firm (EIU, 2003, p.35).

***Non Performing Loans (NPL's)***

High levels of NPL's are one of the legacies of state ownership of the Big Four banks. Historically, these banks have been obliged to lend a large share of their funds to State-Owned Enterprises (SOE's). Pervasive inefficiencies of SOE's and failure to respect hard budget constraints caused a significant portion of these forced loans to be Non-Performing. Official Chinese figures put NPL's at 26.2 per cent of total banking assets at the beginning of 2003, while independent international sources put that figure twice as high, at 50 per cent (EUI, 2004(a), p.54). Both sources agree that the proportion of NPLs is falling, although their relative estimates grow even further apart. At September 2003, the ratios are 21.4 and 44.45 per cent, respectively (EIU, 2003, p.41). The improvement of the NPL profile is associated with the appointment, in 1999, of Asset Management Companies for each of the Big Four banks. These companies purchased approximately 25 per cent of the NPLs held by the Big Four and converted outstanding SOE debt to equity (EIU, 2004(a), p.38).

***Profitability***

Profitability of the Big Four banks is constrained by the high levels of NPL's as well as by the traditional state controls over their portfolio management. In particular, these controls have severely restricted their ability to lend to the private sector. This sectoral imbalance is reinforced by the banks' inability to price loans based on their risk assessment, by the absence of state guarantee on funds lent to the private sector, and by pervasive government regulations and interventions. Recently, the scope for the banking sector to pursue profitability has started to improve in response to the transfer of the burden of the NPLs to the asset management companies, and their growing involvement in international financial markets. Another important change is the officially sanctioned increase of the maximum commercial interest rate that can be charged (announced in December 2003; EIU, 2004(b), p.1).

As the banks are increasingly able to adopt market principles and commercial criteria in determining the direction of lending and the pricing of loans, they are able to improve the allocative efficiency in the uses to which their loanable funds are put. Expansion of private sector activity and improving economic performance should help sustain bank profitability, as well as the policy of liberalisation. At the same time, it is important that financial liberalization not be pursued as an end in itself and pushed to excess lest it undermine the confidence of the international investment community.

***Managerial experience and corporate governance***

The Chinese authorities are encouraging the Big Four banks to build up managerial expertise through the employment of foreign managers and senior executives in top positions. There also appears to be a strong commitment to improve corporate governance strategies. In the first place, banks with NPL's less than 15 per cent will be able to list on stock exchanges (EIU, 2004(a), p.42). The China Construction Bank has already listed and the Bank of China plans to do so by 2005. Compliance with listing requirements will improve transparency of operations and the amount of publicly available information. Secondly, the third recapitalisation of the banking sector, valued at $US45bn, will be based on improvements in the corporate governance environment within the Big Four banks. Wu Xiaoling, the vice-governor of the PBC has been quoted as saying the main problem is "not about the recapitalisation of the banks, but about institutional reform. If there is no institutional reform then the money would be wasted" (EIU, 2004(a), p.25).

## III.2 The Markets for Equities and Financial Intermediaries

The domestic markets for financial instruments are still relatively closed and underdeveloped. The Chinese equity market is based on the stock exchanges of Shanghai and Shenzen, and it is regulated by the Chinese Securities and Regulatory Commission (CSRC).

***Equities Market***

Significant restructuring has occurred in the equities market since 1993, particularly since 1997 as documented by Zhang (2000). In particular, the proportion of nontradable state-held shares has been brought down to approximately 60 per cent after having remained at very high levels throughout the 1990's. Principal methods of reducing state ownership of shares include negotiated transfers of equities to private entities and asset exchanges. Since the latter typically involve an exchange of high-quality assets for low-quality assets they tend to be effected at non-market values and supported by government inducements such as tax breaks, favourable land prices, awards of major construction projects or special business permits. This restructuring of share ownership yields three major types of potential benefit. First, the transfer of ownership and separation of functions between the state and market creates incentives for improving the corporate governance environment and adopting best practice management procedures. Secondly, by encouraging the active engagement of shareholders, corporate governance reforms together with the growth of shareholder wealth, strengthen efficiency incentives. Thirdly, market pressure for efficiency may accelerate the adjustment of industrial structure by promoting the adoption and absorption of technology.

Realization of the potential benefits from extending the distribution of share ownership may be seriously inhibited by the methods and processes of restructuring. For instance, in negotiated transfers share prices are determined by the two controlling shareholders who need not involve the state. The rights and returns of small shareholders may well be infringed by such transactions if, for example, they are unable to influence the price or to sell at market value when the negotiated selling price is substantially less than market value. To the extent that a large base of diverse small shareholders is important for developing a strong and sound equities market, these restructuring methods are counterproductive and undesirable. Asset exchanges at non-market value effectively use a highly "visible hand" and thus seriously inhibit the allocative efficiency of the equities market. Government inducements to encourage such transactions open opportunities for rent seeking that may dissipate the potential benefits from restructuring. For instance, parties may enter into asset exchanges to win control of a company and then proceed to use that company to misappropriate funds. Further, government retains a prominent 60 per cent of total shares. This fact itself inhibits the ability of market forces to achieve allocative efficiency and promote incentives for corporate governance improvements,

There are also a host of legal and governance issues that plague the Chinese equities market. "Self dealing", that is, entering into transactions with associated companies, is a common practice. Since such transactions often occur at non market value they provide opportunities for the transfer of profits in order to meet share allotment criteria. A more fundamental problem is that self dealing can be used to distort the performance of individual companies and to compromise transparency. Transfers of debt and non-productive assets between companies are often not announced at shareholder meetings. Hence some companies in the group can effectively be used as a "guard" against payment of debts to creditors. By encouraging large debt default and the erosion of small shareholder rights these malpractices reduce the expected return to financiers, and may critically debilitate the securities market.

Other legal and corporate governance issues include disputes over proxies, restructuring of financial statements, insider trading, and the infringement of creditors' rights in the course of self dealing as noted above. Proxies are increasingly becoming important as a means to protect the rights of small shareholders. A wide shareholder constituency is essential to impart depth and resilience to the equities market. Restructuring of financial statements refers to the manipulation of financial accounts, or window dressing, in order to qualify for share allotments. Such behaviour is easily identified by the widespread incidence of sharp deterioration in reported financial performance after the allotment has been granted. Again this inhibits the (already constrained) allocative efficiency of the equities market. Insider trading is also a large problem in China, and the substantial profit potential it affords may constitute the sole reason for restructuring. Controlling shareholders may utilize inside information to undertake obviously profitable transactions during the restructuring process.

Widespread reliance on these practices indicates that there is a vital need to develop commercial and company law to protect the rights of small shareholders and creditors, and to promote transparency by providing appropriate and correct information to potential investors. Without such a development the depth of the equities market and the financial sector in general will be critically restricted.

***Financial Intermediaries Markets***

The markets in financial intermediaries are very small. Corporate debt issues are rare as the government strongly encourages purchase of Treasury Bonds. Nevertheless, markets in Treasury Bonds are by all accounts also in their early infancy because relatively little paper is offered to the private sector. The Treasury Bond market consists of an inter-bank over-the-counter market and a market on the Shanghai stock exchange. The majority of holders of Treasury Bonds (60 per cent) purchase the bonds over the counter from banks, while trading volume on the Shanghai stock exchange is quiet (EIU, 2004a, p.55). The insurance market is also quite small, consisting of fourteen domestic firms and twenty-one joint ventures with foreign firms. Despite rapid growth it services only one million people (EIU, 2004a, p.55).

## III.3 Financial Sector Reform, the Asian Financial Crisis, and the Pattern of Foreign Investment

It is important to place the financial sector developments noted in the preceding section in the context of the financial upheavals wrought in the economies of Eastern Asia by the 1997 currency crisis. Unlike most countries of the region, and particularly unlike the recent "star performer" Thailand and the erstwhile "tiger" South Korea, China has remained relatively unscathed by the crisis.

### *Foreign portfolio investment*

As would be expected in the absence of well-functioning market arrangements, the behavior of net FPI was nonsystematic before 1997. There have been consistent, albeit small, net portfolio outflows since 1998.[10] Net inflows of portfolio investment rose slightly for three consecutive years after Deng's celebrated visit, experienced a transitory setback in 1995 to resume the path of expansion in 1996. In the lead-up to the crisis they amounted to $US7,000m. The crisis was associated with an $US11,000m turnaround in 1998 and a further deterioration of $US19,000m in 2001. The subdued rate of inflows

[10] Chinese annual acquisition of portfolio assets abroad has ranged between $US10,000m and $US20,000. Foreign portfolio inflows since 1998 have remained below $US2,000m except for 2000 when they reached $US7,000m.

during the post-crisis period is somewhat surprising against the *backdrop of an average annual inflow of $US3,500m and an incipient* upward trend during the period 1992-97. However, the volatility of FPI is consistent with the uncertainty engendered by financial crises. Lipsey (2001) documents major swings in the 1982 and 1994 financial crises in Latin America and Mexico, respectively.[11] Developing Asia (excluding Hong Kong and Taiwan) display a similar pattern with FPI inflows climbing before the crisis to reach $US23,000m in 1996 and plummeting to outflows of $US19,000m in 1998. It is worth noting that Chinese net portfolio investment flows are basically entirley in the form of debt. The small pre-crisis equity inflows ($US2,000m in 1997, representing 36.2 per cent of total FPI) have been virtually entirely repatriated even though the strict distinction between "A class shares", which only domestic residents could purchase, and "B class shares" has been lifted.

Overall, the pattern of FPI investments appears to provide no compelling evidence of confidence on the part of foreign investors in

[11] In 1982 Latin American net PFI had reached $US4,300m inflow. However this dramatically decreased over the 1983-86 period, reaching a low of $US3,000m outflow in 1986. In 1993 Mexican net portfolio investment flows were $US28,000m inflow, turning into a $US10,000m outflow in the immediate aftermath of the crisis in 1995, reverting to quite low inflow levels for 1996-1998.

China's equity and financial markets. Presumably, the easing of restrictions on foreign participation in the equity markets together with other institutional reforms of the financial sector have not been sufficient to overcome perceived structural weaknesses and imperfections that increase the risk of FPI. That is, it seems that institutional reform has not satisfied the expectations of international investors, and thus FPI flows remain stagnant and negligible.

***Foreign direct investment***

As compared to the large volatility of net OI and PFI, FDI in China was remarkably stable over the late 1990's. FDI increased approximately fourteen-fold between 1990 and 1998, then fell 12.2 per cent in 2000, but by 2002 the rate of inflow exceeded its 1998 peak by 13 per cent. This performance is in general consistent with the region as a whole, although somewhat more spectacular. Lipsey (2001, pp.9-10) shows that FDI into developing Asia increased slightly more than four-fold between 1990 and 1997, fell by 8.1 per cent in 1998, and was by 1999 4 per cent above its 1997 peak.

More significantly, Lipsey (2001, pp.11-14) demonstrates that international investors perceived the Chinese environment much more positively compared to the rest of developing Asia. During the height of the crisis US manufacturing affiliates pursued vigorous expansion in China. They increased employment, exports, local and total sales by 23.8, 32.3, 33.8 and 32.4 per cent, respectively. This stands in sharp contrast to the experience of developing Asia excluding China where US manufacturing affiliates decreased employment, local and total sales by 6.5, 3.5 and 23.6 per cent, respectively per cent while exports increased by 10.4per cent. The favourable perception of China as the preferred location for offshore operations in Asia is corroborated by the investment behaviour of US manufacturing affiliates. They increased R&D expenditure by 26.9 per cent and capital expenditure by 51.2 per cent whereas such firms operating in developing Asia excluding China decreased those expenditures by 6.1 and 21.1 per cent, respectively. *These concrete actions provide strong signals of* future intentions and hence beliefs about the economic environment.

This interpretation may seem to contradict the apparent dissatisfaction of international investors with the financial institutional reforms noted earlier. This apparent paradox may be resolved by recognizing the different spheres within which FDI and FPI operate. Consistent with the hypothesis developed in Section I, an assessment of the overall economic environment (i.e., economic performance and expectations regarding future economic performance) in the host country together with considerations specific to the target industry drive FDI. FPI, on the other hand, is prominently influenced by perceptions specific to financial sector institutions and performance. While these two spheres of economic activity are necessarily interdependent, they do not evolve in a rigid lockstep fashion. Thus, it is entirely consistent to hold favourable expectations about productivity and growth and simultaneously apprehensions about the efficacy of financial sector reforms. The former may sustain a strong and stable pattern of FDI, while the latter may inhibit substantial FPI activity. While it is plausible to expect lackluster FPI engagement in the immediate aftermath of a financial crisis, such an interpretation is difficult to sustain five years after the event. Hence, the explanation must be sought in the financial sector of the host country rather than in the fallout from the international currency crisis.

## IV ASSESSMENT

The record of foreign investment in China reveals little systematic relation between the different types of capital flows. Large net inflows of direct investment have beenassociated with large net outflows of portfolio and other investment. In the immediate aftermath of the crises, the two aggregate flows virtually balanced between 1998 and 2000 keeping net foreign investment flows and the financial account balance at trivial levels. This post-crisis scenario is consistent with the pre-1995 situation depicted by Bosworth & Collins (1999, p.151) when "China, the largest developing country recipient of FDI in the 1990's, obtained very little portfolio capital or lending, while Brazil, the largest recipient of portfolio capital among developing countries ... maintained a very restrictive policy toward FDI."

Recent theoretical research has emphasised the role of information, or lack of thereof, of levels of corporate transparency, imperfect contract enforcement and inalienability as factors that may bias the pattern of cross-border capital flows towards FDI. The absence of correlation between the different categories of capital flows is consistent with the Moody et al. (2003) argument that the two types of flows enjoy different "comparative advantages". The comp advantage of FDI derives from the lack of info etc and is rewarded by cream skimming. The Chinese situation offers plenty opportunity to exploit that particular comparative advantage. Even though institutional reform has been occurring, the overall level of corporate transparency is still quite low relative to the expectations of international investors. Until those expectations are met, FDI is likely to continue to be the preferred investment vehicle. Further, the Moody et al. hypothesis is consistent with the behaviour of US affiliated manufacturing firms who expanded their involvement in China throughout the 1990s. High levels of specialisation and "intangible capital" provide those firms with sufficient market power, control, and knowledge to realize the required returns. At the same time, informational advantage enables them to interpret fundamental productivity and profitability signals more astutely than domestic investors. Thus, they were able to pursue direct investment objectives in China in an informed way, undeterred by the financial upheaval of the Asian financial crisis.

A complementary theoretical explanation of the bias in favour of FDI is provided by Albuquerque (2003). The fact that developing countries are financially constrained, as reflected in international credit ratings, and subject to high expropriation risk, discourages all types of foreign investment. Secondly, Albuquerque notes that the relative inalienability of FDI compared to other types of foreign investment leads to a preference for FDI. Thus, we should expect, a priori, that developing and transition economies exhibit foreign investment patterns characterized by

- large levels of FDI and minimal levels of FPI because of the risk-sharing advantage possessed by FDI;
- relatively stable FDI flows compared with FPI flows because FDI possesses a fundamentally lower level of risk compared to FPI; and, hence,
- more volatile reactions of FPI, compared to FDI, to an increase in the general level of risk.

The smaller and much more volatile levels of FPI relative to FDI observed in China before and after the Asian financial crisis are consistent with Albuquerque's conjectures.

The main policy implication of this interpretation of the evidence is that a more balanced (or less biased) pattern of direct and portfolio investments requires greater corporate transparency and effectiveness of contract enforceability mechanisms. More generally, it requires wide-ranging and incisive institutional reform of China's financial market and regulatory system. For instance, Levine (2002) recommends as core elements of financial reform the establishment of legal rights of investors, both domestic and foreign, and increasing the effectiveness of the legal system in enforcing such rights. Such reforms are an essential means to promote the effectiveness of contract, financial depth, and ultimately the efficiency of resource allocation and economic welfare. Accordingly, they would rectify the specific institutional deficiencies in China's equity markets noted above.

A related issue is the question whether foreign investment in general, and FDI in particular, are indispensable for "kick-starting" economic growth in developing and transition economies. Durham (2004) cautions that foreign investment is not invariably good for growth. The potential benefits from FDI may be dissipated in rent seeking unless threshold levels of various institutional dimensions such as regulations, corruption and property rights are met. Even though China was not included in Durham's data set, his findings that only a proportion of countries investigated passed the relevant threshold criteria for growth-effective FDI are instructive.[12] In a similar vein, Durham found that FPI affects growth positively only after stock

[12] Measures used by Durham regarding FDI include a business regulation index which 4 out of 32 developing countries passed, a measure of property rights which 11 out of 32 developing countries passed, and a corruption index which 25 out of 32 developing countries passed. With respect to the business regulation index, 15 further developing countries were very close to the threshold as were 19 developing countries for the measure of property rights.

market capitalisation reaches a threshold value of 41.2 per cent of GDP. This implies a critical need for concerted reform of the investment environment to encourage progressive expansion of portfolio inflows. One explanation of the Durham skepticism towards foreign investment is that capital inflows do not necessarily expand the resource constraint for domestic capital formation. The foreign funds may be used instead for unprofitable government or consumption expenditure, or to build up international reserves. [13] The likelihood of such unproductive (in terms of growth promotion) use varies with the institutional and governance environment captured by the type of indexes used by Durham.

## V CONCLUSIONS

Direct observation as well as indirect evidence derived from the composition of foreign investment in China suggest that China's financial sector remains in a rudimentary state. Substantial institutional

[13] While increased consumption and current account deficits are not very relevant concerns in the case of China, the accumulation of large stocks of international reserves is. Virtually the entire cumulative surplus on financial account recorded over the period 1992-2002 has been converted into international reserves. The cumulative sum of FAB surpluses between 1992 and 2002 is $US220,000 while the increase in the stock of international reserves is $US270,000m over the same period. Given that the return on international reserves is relatively low, China is not utilising many of the potential benefits that can be derived from foreign investment inflows

reforms are required to satisfy international investors' expectations before they will undertake debt and equity investments on a substantial scale. Current financial market developments are focused on banking reform, increased financial interaction with international markets and firms, development of domestic equity markets - especially reduction of state owned nontradable shares and the resulting efficiency incentives, acknowledgement of corporate governance issues and a general political pro-economic reform agenda. The entry of China into the WTO may promote the progressive replacement of *ad hoc* arrangements by a rules based system. This may further complement and to encourage reform.

These changes may promote some gradual increase of FPI in the near future, but they are unlikely to change the composition of foreign investment in China dramatically. Significant reform of the equities market addressing the rights of small shareholders and creditors, self dealing, insider trading, and the excessive proportion of state owned shares, is still required. Continuing restrictions on the operational scope of banks (both domestic and, especially, foreign), mergers and acquisitions in the financial sector, and discriminatory practices in favour of foreign investors lead to inefficient lending practices, inefficient organizational structures, less than optimal competition, and they compromise corporate governance.

From the Moody et al. perspective, these features signal to the foreign investor that corporate governance remains at low levels. From the perspective of Albuquerque, they indicate the persistence of significant financial constraints. Both interpretations imply the persistence of a strong bias in favour of direct and against portfolio flows in the composition of foreign investment in China. The immediate effect of current and future institutional reforms is likely to attenuate this bias without, however, eliminating it. A countervailing influence could be the emergence of overcapacity in the Chinese economy noted by the Economist Intelligence Unit (20003, p.31). Such a development could potentially lead to productivity declines and a resultant bias against FDI. However, there is no robust evidence at present for such a prognosis. The number and value of investment contracts that are signed, including US manufacturing affiliates, show no sign of abating. Accordingly, strong productivity and growth together with limited financial sector reform are likely to sustain the strong overall perception of the Chinese economy and the strong, stable pattern of FDI.

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