Round-Tripping Foreign Direct Investment in the People’s Republic of China

Xiao Geng

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Introduction

There is no doubt that part of foreign direct investment (FDI) inflows to the People’s Republic of China (PRC) FDI belongs to the return of Chinese capital that has gone abroad. The World Bank and others have estimated that the scale of this round tripping could be as high as a quarter of the total FDI inflows into the PRC. The prevailing view in much of East and South East Asia is that the PRC has attracted too much of global FDI at the cost of other developing economies. The estimations here indicate that the round-tripping FDI in the PRC is likely to be in the range of 30% to 50% of officially recorded flows, which implies that such concerns are greatly exaggerated.

A large part of the capital originally created in PRC has gone abroad and has stayed abroad waiting for opportunities to return to the PRC. The pattern of capital creation and movement suggests that competition for FDI flows is not a zero-sum game. FDI inflows are not simply a fixed sum to be competed away among different countries. Instead, the PRC’s experience shows that FDI inflows are endogenously determined by the capacity of the host countries to create new capital.

When a developing economy like the PRC is creating new capital, a significant part of the new capital is likely to find its way abroad through mis-invoicing in international trade, smuggling, and other channels of capital flight since the people who are creating the new capital have strong incentives to diversify domestic risks and to seek better protection of property rights. The accumulated capital flight then forms the base for sustained round-tripping FDI when the opportunities to make profits and create new capital at home continue to exist.

In the case of the PRC, Hong Kong, China plays an important role in each of the three stages of capital’s journey: (1) the original creation of new capital in the PRC, (2) the capital flight out of the PRC and (3) the round tripping of FDI back to the PRC. In the past two decades, about 40% to 60% of the PRC’s FDI inflows were from Hong Kong, China. However about half of Hong Kong, China’s FDI to the PRC, as reported by the PRC, cannot be verified or confirmed from the related statistics collected in Hong Kong, China. Clearly Hong Kong, China is crucial in understanding the PRC’s round-tripping capital flows.
But Hong Kong, China is not alone in facilitating capital creation, capital flight, and the return of flight capital through round-tripping FDI. The offshore financial centres, such as the British Virgin Islands, Bermuda, and Cayman Islands, have been playing an increasingly important role, particularly in facilitating round-tripping capital flows for the purpose of listing PRC companies in Hong Kong, China and overseas stock markets.

**FDI to PRC in the Global Context**

Global FDI to developing economies has been driven by profit opportunities, as well as by the reduction of physical and institutional barriers to cross-border capital mobility. The improvement in transport and communications has reduced physical barriers while reforms in developing countries such as the PRC have led to new profit opportunities.

Since the early 1980s, the PRC emerged as a major global development frontier. The barriers to foreign trade and investment in the PRC have declined steadily since then, leading to the PRC’s accession to the World Trade Organization in late 2001. By the end of 2002, only a year after joining the WTO, the PRC overtook the U.S. in FDI inflows, becoming the most attractive FDI destination in the world, and receiving $52.7 billion in FDI.

FDI into the PRC has exceeded $40 billion since 1996 and has been growing steadily every year since 1990. This puts pressures on other developing countries, especially its Asian neighbors. The Asia-7—covering India, Indonesia, Malaysia, Philippines, Korea, Singapore, and Thailand, and with more total population than the PRC—only had $33 billion FDI inflows at their peak year of 1997. After the Asian financial crisis in 1997-1998, the Asia-7’s FDI inflows declined dramatically to only $18 billion by 2001.

In 2001, per capita FDI inflows were $120 for the world, $420 for the developed economies, $42 for the developing economies excluding the PRC, $37 for the PRC, and only $12 for the Asia-7. Apparently, based on these statistics the PRC is winning the competition for FDI inflows over its neighbors. However, adjustment for round-tripping FDI in the PRC, narrows this gap. This gap in FDI inflow is driven primarily by the capacity of the host countries in creating new capital. If there is any competition, it is more
in competition in domestic reform, which can increase profit-making opportunities and less in competition for a fixed amount of global FDI.

Among the PRC’s top 15 suppliers of FDI in 2002, Hong Kong, China ranked the first with $20.5 billion utilized investment, followed by the U.S ($4 billion), Japan ($3.6 billion), Taipei, China ($3.3 billion), British Virgin Islands ($2.4 billion) and Singapore ($2.1 billion). FDI per project has little correlation with the size or importance of the source economy. It turns out that the Cayman Islands has the largest average size of FDI per project at $556,000. Eight out of the fifteen countries/regions on which there is separate data have an average size of FDI per project below $110,000, including the U.S and Hong Kong, China. The average FDI per project from Canada and Taipei, China was below $60,000, the smallest among the group.

If small projects are more likely to be associated with round-tripping FDI, then both developed economies such the U.S. and Canada and the Asia Pacific economies such as Singapore and the Republic of Korea are equally likely to have significant round-tripping FDI in the PRC.

Incentives for Round-Tripping

*Tax advantages and fiscal incentives*

The PRC provides many preferential policies to attract true foreign direct investment, including low tax rates, favourable land use rights, administrative support, and even favourable financial services from domestic and foreign financial institutions. In other words, it pays to be a foreign invested enterprise (FIE) even if you are really just a domestic private enterprise. However to become an FIE there has to be foreign investment and if firms cannot find foreign investors who are willing to invest in their enterprise they have to take the capital abroad and bring it back as FDI.

*Property rights protection*

The legal system in PRC is still weak in the enforcement of property rights and contracts. This weakness directly affects the robustness and efficiency of the Chinese economy and is one of the key factors behind the
sustained capital flight and round-tripping FDI. Many private enterprises operate in an environment of very restrictive regulation with loose and ad hoc enforcement.

As the government tends to give better protection of property rights to foreign investors domestic enterprises have an incentive to move their profits out of the PRC first and then to move them back in the form of FDI when they see profit opportunities.

*Expectations on exchange controls and exchange rates*

In recent years the PRC has relaxed its controls on the capital account and the international pressure to revalue the RMB has intensified, increasing speculative flows. Activities associated with speculation on exchange rates are not easy to identify directly, but change in the errors and omissions term in the balance of payments account (a rough estimate of capital flight) partly reflects the trend in speculative cross-border capital flows, some of which may return as round-tripping FDI.

*Competitiveness of Hong Kong, China and overseas financial services*

Hong Kong, China is an important international financial centre that serves PRC related business. An important motive for round-tripping is to register domestic enterprises in Hong Kong, to take advantage of the financial services available in Hong Kong. This is “round tripping for value added services” and FDI in the form of cross-border mergers and acquisitions is driven by the same motives.

**Estimates of Round-Tripping FDI**

Whenever there is round-tripping FDI, inflow statistics as reported by the PRC will be higher than the FDI outflow statistics as reported by the source country, since there will be no incentive for foreign investors to report their false investment in the PRC in their home countries. Hence by comparing FDI inflow statistics as reported by the PRC and FDI outflow statistics as reported by capital exporting country we can obtain an indication of round-tripping.
A proportion of the discrepancy between the two sources will be due to normal statistical reporting error, due to inconsistencies of definition between countries, and the remainder we treat as round-tripping FDI. To isolate the former source of discrepancy we use the conservative assumption that is it one half of the standard deviation of the unverifiable element of FDI flows.

Using this approach and a number of simplifying assumptions, estimates are obtained that range from a low of 30% of official FDI flows to a high of 50% of official FDI flows, with a most likely estimate at 40%. This shows that the scale of round-tripping FDI in the PRC is very large.

In comparison with recent estimates of capital flight from PRC based on the data during the period 1994-2001, about 20% to 30% of flight capital appears to have returned in the form of round-tripping FDI.

This estimate is much higher than previous estimates in the literature. The high level of round-tripping FDI in the PRC means that FDI inflows to PRC are considerably exaggerated and total capital flight appears much larger than FDI inflows.

FDI inflows to the PRC are largely a result of its capacity to create new capital and new profits and should not be regarded as a threat to other developing economies. At the same time the weak institutions for protecting property rights have led to sustained and large capital flight and also to round-tripping FDI.

As the PRC continues to liberalize its economy, we are likely to see more and more cross-border capital flows in various forms, including capital flight and round-tripping FDI. Our results suggest that the control on the PRC’s cross-border capital flows is looser than most people believe and suggest the existence of a large amount of overseas Chinese capital.