

# Foreign direct investment inflows and economic growth of China

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## Abstract

This study examines the causality between FDI inflows and economic growth in case of China using a small sample cointegration test. The empirical results show that since economic reform FDI inflows have not caused economic growth, but the latter has caused the former.

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## 1. Introduction

It has often been argued that FDI inflow is one of the driving forces of economic growth in developing countries. Historical evidences are mixed. Of the so-called four east Asian tigers, Hong Kong and Singapore succeeded in attracting huge amount of FDI; however, South Korea and Taiwan did not attract it so much.

Since economic reform in 1979, China has recorded remarkable economic growth rates; for instance, the annual average real GDP growth rate was as high as 8.3 percent during 1979–2001. In the meantime, China has actively tried to attract FDI inflows. FDI flows into China increased from US\$ 0.9 billion in 1983 to US\$ 46.9 billion in 2001 (Table 1). Chen, Chang, and Zhang (1995) evaluated that FDI had contributed to China's post-1978 economic growth by augmenting resources available for capital formation and export earnings. Meanwhile, the issue on the causality

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Table 1  
FDI inflows and economic growth.

Years	FDI Inflows (US\$ million)	Annual average real economic growth rate <sup>a</sup> (%)
1983–1985	4,291	12.4
1986–1989	11,145	8.0
1990–1993	11,376	11.3
1994–1997	158,271	10.4
1998–2001	173,375	7.1

<sup>a</sup> Real GNP growth rate until 1990 and real GDP growth rate since 1991.

between FDI inflows and economic growth in case of China has seldom been analyzed rigorously. Although [Qin, Cagas, Quising, and He \(2006\)](#) revealed that economic growth caused investment in China, the latter was not restricted to FDI. Using a simulation, [Dees \(2001\)](#) showed that FDI has a long-run effect on output. The current study tests whether or not increase in FDI caused increase in economic growth of China with a cointegration test procedure allowing for different orders of integration and the Granger causality test using stationary data.

## 2. Factual background

The investment atmosphere in China had not been friendly to foreign investors until 1978. A new policy towards foreign investment allowing foreign firms to operate in China was proclaimed in 1979, which granted foreign investment a legal status in China ([Chen et al., 1995: 692](#)). The Special Economic Zones (SEZs) were established in the coastal areas, which granted the investors administrative support and tax benefits like profit tax reduction ([Park, 2002: 21](#)). The decision to open up China to the world economy was formally included in the 1982 state constitution. In 1984, the concept of SEZs was extended to another fourteen coastal cities and Hainan Island. In 1985, development triangles were established for the encouragement of foreign investment. Several investment incentives were provided to the SEZs ([Chen et al., 1995](#)). Despite such measures, the amount of FDI inflows was not substantial.

Since Deng Xiaoping's Southern Trip in 1992, China began to strengthen the market economy. Preferential taxation schemes were provided to foreign investors as well ([Park, 2002: 23](#)). Consequently, FDI flows into China began to increase substantially in 1992. In late 1997, China introduced various measures to attract FDI, including import tariff reductions and began to provide preferential tax measure to the finance sector in 1999 ([Park, 2002: 26–30](#)). Although China attracted huge amount of FDI inflows, the cumulative FDI amount per capita was only US\$ 200 in 1998, for instance, which was lower than those of most other transition economies.

## 3. Empirical evidence on the causality between FDI and economic growth

[Alguacil, Cuadros, and Orts \(2002\)](#) examined the Granger causality from exports and FDI to output in Mexico. Their empirical evidence supported not only the export-led growth hypothesis but also the existence of an FDI-led growth relationship. [Basu, Chakraborty, and Reagle \(2003\)](#) found the bi-directional causality between FDI and GDP for open economies, while, for closed economies, although causality was bi-directional in the short run, it ran mainly from growth to FDI in the long run. [Cuadros, Orts, and Alguacil \(2004\)](#) examined both the export-led growth hypothesis and the FDI-growth nexus in Mexico, Brazil and Argentina. Their results based on the

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