



Spatial polarization and dynamic pathways of Foreign Direct Investment in China 1990–2009

Simon Xiaobin Zhao^{a,b,*}, Roger C.K. Chan^c, Neo Ying Ming Chan^a

^aInternational Centre for China Development Studies, The University of Hong Kong, Hong Kong

^bDepartment of Geography, The University of Hong Kong, Hong Kong

^cDepartment of Urban Planning and Design, The University of Hong Kong, Hong Kong

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ABSTRACT

The spatial and sectoral distribution of Foreign Direct Investment (FDI) in China has changed dramatically in the past two decades. FDI was largely concentrated in the Pearl River Delta (PRD) and other Southern Coastal provinces in early stages and shifted to the Yangtze River Delta (YRD) and the Bohai Economic Rim (BER) sequentially in later stages. It created unique and dynamic paths of the spatial evolution of FDI in China. Although many provinces have received relatively more FDI since the late 2000s, Guangdong and Jiangsu are still the two major recipients of FDI in China, demonstrating and over-arching polarization process. Furthermore, most FDI in China has been in the manufacturing sector, making China well-known as the “World Factory of Manufacturing”. This paper analyses the most recent trends, characteristics and patterns of FDI in China. It portrays the factors that determined the investment location and the dynamic pathways of different kinds of FDI. This paper also foresees the possible changes in spatial and sectoral distribution of FDI in the near future and provides policy suggestions for both China and other developing countries in seeking new FDI inflows and transforming their industrial structures and economies in this particular phase of globalization.

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1. Introduction

Since adoption of the open-door policy in 1978, and particularly since the early 1990s, when China confirmed its intent to move on from socialism to marketization, the influx of inward foreign investment in China has increased rapidly. The country has in fact become the largest recipient of FDI among all developing countries, and the second largest in the world, next only to the United States of America. The trend has largely continued in the first decade of the 21st century as demonstrated by China's FDI inflow figures that reached USD 91 Billion in 2009 (UNCTAD, 2010). FDI has contributed significantly to China's economic development as it has not only provided capital and technology but also has helped China to integrate into the world economy.

This paper aims to analyze the evolving patterns and changing trends of FDI in China over the past two decades, with special focus on factors and reasons that have led to these changes. It attempts to illustrate the polarization of the spatial distribution of FDI in China over the past decades and identify various types and patterns of FDI in terms of its technology, capital and value-added

intensiveness embedded in different regions of China. The evolution of the spatial path and sectoral trajectories of FDI in China are also depicted, which shows unique Chinese experiences of the spatial evolution of FDI and their possible reference for other developing countries. The findings suggest the increasing occurrence of sectoral and spatial FDI polarization, although there is evidence of some kind of decentralization, particularly after the financial crisis and wage increases since 2008. Policy implications are provided for references for both China and other developing countries in seeking new FDI inflows and transforming their industrial structures and economies in a particular phase of globalization.

The data of this research is primarily from official statistics of the Chinese government, including the China Statistical Yearbook (1994–2009) compiled by the National Bureau of Statistics of China, and official websites of government units and international agencies such as the Ministry of Commerce of the People's Republic of China and the United Nations Conference on Trade and Development (UNCTAD). In-depth interviews were conducted for further validating the research findings. This article is organized as follows: Section 2 reviews the changing theories on global patterns and dynamics of FDI and factors determining locations of FDI worldwide and in China. Section 3 portrays the changing patterns of FDI in China over the past two decades. Section 4 discusses the spatial and sectoral characteristics of FDI and their underlying

* Corresponding author. Address: Rm 307, International Centre for China Development Studies, Hui Oi Chow Science Building, The University of Hong Kong, Pokfulam Road, Hong Kong.

E-mail address: sxzhao@hku.hk (S.X. Zhao).

reasons. Section 5 depicts the spatial paths of the dynamic evolution of FDI for the four kinds of FDI in China. The final section generates policy and theoretical as well as policy implications emerging from this study.

2. FDI worldwide and in China: a review of the literature

The United Nations Conference on Trade and Development (UNCTAD) defines Foreign Direct Investment (FDI) as a long-term relationship that entails lasting control of a resident entity in an economy other than the investors' host economy. FDI is normally of two types: horizontal (non-offshore) and vertical (offshore). The first type of FDI is driven by MNCs seeking entry into emerging and developing markets. In the mid-1990s, developing countries began embracing FDI as a passport to achieve economic prosperity. In a critical assessment of FDI in South American countries, *Porzecanski and Gallagher (2007)* found that Brazil, Mexico, Argentina, Chile and Venezuela received more than 80% of all FDI in Latin America that was designed to target domestic markets. *Agosin and Machado (2006)* claimed that although MNCs were increasingly emphasizing internationalization of production and global market orientation, the size of domestic markets still seemed to matter the most to foreign investors.

The second type of FDI is a form of dispersion of production processes and services across a range of locations for cost minimization, while each part of the process is located in countries most suitable for the specific process (*Aizenman and Marion, 2004*). *Chakraborty and Nunnenkamp (2008)* revealed a tremendous shift in FDI in India, from primary and manufacturing sectors to service sectors, since economic reforms began in 1991. In particular, they detected a unique phenomenon of FDI in India's service sectors. They argue further that while 'resource-seeking FDI' most likely appears in primary and manufacturing sectors, the bulk of FDI in services is motivated by 'market-seeking' reasons. Furthermore, resource-seeking FDI often takes place in economic enclaves such as export-processing zones. They found that foreign companies in India's software industry operate as "export enclaves." However, the role of India in the world's IT industry is limited to providing off-shore IT-enabled services at the lower end of the value chain, such as back-office services and software design. These activities are concentrated in technology parks in a few metropolitan centers and a large number of local economies in India have not earned any significant benefits from the increasing off-shoring of knowledge-based tasks and jobs (*Zhao, 2009*).

Huggins et al. (2007) observed that the global redistribution of knowledge is a result of the world's transformation into a 'global village', attributed to the rapid growth in civil aviation and telecommunications. Most of the developing countries are using this opportunity to improve their investment environment for attracting foreign investors to boost their national economic growth and competitiveness. According to UNCTAD, MNCs across all industry sectors are allocating an increasing proportion of their R&D budget to facilities abroad. *Hakanson (1990)*, *Zanatta and Queiroz (2006)* found that MNCs have already shifted focus to greater decentralization and cross-border knowledge interdependence. These new patterns of FDI in terms of locations of global nodes and networks of knowledge indicate that MNCs now attach greater importance to heterogeneity of locations (*Huggins et al., 2007*), which is different from the traditional practices characterized by one-way knowledge transfer. Under the new patterns of FDI, the process of generation of product concepts and technological knowledge can be disaggregated world-wide.

However, in terms of determining consideration for FDI going abroad, *Dunning (1980)* and *Agarwal and Ramaswami's (1992)* earlier studies are still the most convincing and influential. They highlight location, ownership and internalization advantages (i.e.

own production rather than producing through a partnership arrangement) as determinants of FDI, although as dependent variables only. These three advantages need to be viewed as a composite factor to identify and interpret trends of FDI activities initiated by Multinational Corporations (MNCs). *Dunning (1986)* identified three major criteria that are necessary antecedents of overseas investment. First, enterprises must possess net ownership advantages over competitors in the host country's local market. Second, investing firms must be able to maintain ownership advantages internally. Third, locational factors of host countries must be more beneficial (with firm-specific ownership advantages) than locational factors of investors' home countries. FDI is generally viewed as a medium of structuring international production in a more cost effective manner. *Dunning (1981)* combined an industrial organization approach, internalization theory and location theory to interpret determinants of FDI, namely, ownership, internalization and locational advantages.

Notwithstanding *Dunning's* notion that FDI is determined by the three advantages taken together, locational advantage is perhaps still the most crucial factor that has attracted FDI inflow in China. Implementation of the open-door policy has accelerated the growth of FDI in China since the end of the 1980s (*Chen, 1997*). According to extant theoretical and empirical studies on locational factors, the identified determinants of location are market size (*Cheng and Kwan, 2000; Zhou et al., 2002*), labor factors (*He, 2003*), transport infrastructure (*Head and Ries, 1996*), agglomeration economies (*Head et al., 1999; Guimaraes et al., 2000; Hong, 2007*), and preferential government policies towards FDI (*Wei et al., 1999; He, 2002*). *Chen (1997)* found in an empirical study that the FDI in 1980s and early 1990s was concentrated in provinces with intensive facilities for transportation to and from investors' home economies. *Sun (1998)* pointed out that during 1979–1996, geographical proximity and cultural and ethnic ties led to investment from Hong Kong to be concentrated in Guangdong, and Taiwanese investment in Fujian and Japanese investment in northeastern parts of China. American and European investments were located mainly in larger cities because they wanted to target local markets and strengthen industrial linkages. *Sun (1998)* claimed that governmental policy had heavily affected the sectoral composition of FDI in China. For example, from 1982 to 1985,¹ actually utilized FDI1, the FDI actually being put into use in the statistical years, was concentrated (38% of total) in oil exploration because of the Central government's 10-year plan to construct new oil and gas fields to meet the growing energy demand. *Miyashita and Russel (1994)* reported that Japanese investment was inclined to cluster its production facilities in China. They found that most Japanese manufacturing corporations had adopted their common practice of vertical integration of production processes in China, that is – the so-called "vertical keiretsu". When a large corporation locates its operations in a particular area, a large number of small companies (i.e. subcontractors) 'set up shop' in its vicinity (*Dobson, 1993*). In other words, the development of local industrial clusters affects the location of Japanese investment in China. The Japanese approach of "vertical keiretsu" has generated an agglomeration effect in regional economies and has contributed to cluster development in China.

Anselin (1988) argued that imbalanced economic development was the cause of inequality of FDI distribution in China. He found that different kinds of foreign investors seek different kinds of investment sites. Market-oriented MNCs normally look for leading growth regions in China since these regions tend to have considerable market demand while MNCs seeking local resources prefer resource rich regions even if they are lagging in growth. *Qiu (2005)*

¹ The "utilized" FDI refers to the FDI actually being put into use during a given set of years. It is contrasted with "contracted" FDI, which refers to FDI promised to be invested in the signed contracts but not being used yet in a given set of years

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