DETERMINANTS OF FDI IN CHINA

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ABSTRACT

Why and how firms take advantage of foreign opportunities, especially via foreign direct investment (FDI) has been much documented. China, as a major emerging market, has attracted significant flows of FDI, to become the second largest receipt. This paper briefly examines the literature on FDI and focuses on likely determinants of FDI in China. It then analyses responses from 22 firms operating in China on what they see as the important motivations for them to undertake FDI. Results show that market size is a major factor for FDI especially for US firms. For local, export-orientated, Asian firms, low labor costs are the main factor. The paper concludes with managerial implications for businesses wish to exploit opportunities in China.

INTRODUCTION

The past few years has seen a tremendous growth of foreign direct investment (FDI) that has exceeded both world output and world trade. China is by far the largest recipient, and in 2004 surpassed the USA as host destination. It has consequently attracted an increasing attention from multinational businesses. Since China adopted the reform and opening-up policy in the late 1970s, foreign investment has played an increasingly important role in its economic growth. According to the World Investment Report for 2004 by the United Nations Conference on Trade and Development, China absorbed a total of US$53.5 billion worth of foreign direct investment (FDI) in 2003. The Xinhua News Agency, quoting The National Development Reform Commission, China's top economic planning agency, reported that foreign investment in 2004 rose to US$60 billion, a 13 per cent increase over 2003. Contracted investment was US$153.5 billion in all of 2004, up one-third year-on-year. Other statistics also point to the importance of foreign capital in China's economic growth.

At present, further economic development of China depends to a large extent on continuous FDI and policy-making that will facilitate inward investment. Moreover, China's entry to the World Trade Organization (WTO) suggests that trade will play an important role in the country's economic development. So under this new international environment, do multinational enterprises go to China to exploit some conventional advantages such as low labor costs, or do they have other motives to meet challenges of the new international competition?

Foreign enterprises account for 28 per cent of China's industrial added value and one-fifth of taxation. They export about 57 per cent of the country's total goods and services and account for 11 per cent of local employment. China's preferential foreign investment policies, inexpensive labor, increasing purchasing power and improving investment environment, especially after entry into the World Trade Organization (WTO) in 2001, have made the country a favorite destination for global investment (Yunshi and Jing, 2005).

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The aim of this paper is to investigate the determinants of FDI in China from the perspective of country characteristics, identifying what are the most significant factors in China that influence foreign investors' decision to invest in the country. Several location advantages as determinants of FDI in China, drawn from previous studies, will be tested by primary research. Will there be evidence to indicate that China's huge market size, liberalized FDI policy, and the regional distribution of FDI within China is influenced largely by FDI incentives and historical cultural links with foreign investors, or will other factors emerge. The result of this research will hopefully make further contributions in the study of FDI in China.

DETERMINANT OF FDI IN CHINA

Growth of FDI in China

FDI in China has gone through various phases. The peak period was the 1990s, in contrast with the moderate growth in the 1980s (the growth development period). Although a lot of interest among foreign investors in China emerged after 1979, large FDI inflows did not occur in the initial period because of the poor infrastructure (OECD, 2000). The period of 1983 -1991 saw a steady growth and relatively large inflows, as the special economic zones expanded from four to fourteen cities, and FDI incentives introduced in 1986. This increasing tendency reached its peak at approximately US$110.852 billion in 1993; China became the largest host country for FDI among the developing countries and the second largest host country in the world (UNCTAD, 1995). From 1994, the inflows of FDI entered an adjustment period, but the contracted amount of FDI still climbed steadily, so that in 2001, the inflow of foreign capital to China increased by 15 per cent, which went against the global contracted trend. Since that year, China has become the only country that has seen its FDI increase continually. China's FDI growth seems not a part of the global expansion of multinationals as China's FDI as share of both developing countries and the world experienced a significant rise over time. This fact suggested location factors play a critical role in China's FDI growth process, and China has unique advantages over other potential countries in attracting FDI (Zhang, 2001a).

FDI by Source country

In terms of the source of inward FDI in China, it is well acknowledged that the lions share of investment has been from Asian countries, especially the round tripping of investment through Hong Kong, Macao, Taiwan. With over 90 percent of global FDI originating from industrial countries (UNCTAD, 2000), China has a very unbalanced origin of FDI, with Hong Kong, Macao and other Asian countries being the dominant source. With the exception of Japan and the U.S., other industrialized countries played a minor role. Hence, it is interesting that although China is the largest recipient country of FDI among the developing countries it has failed to attract substantial amounts of foreign investment from the major industrial countries. One possible reason may be that investment from the major industrial countries in China is mainly motivated by the access to the Chinese market, and that from Hong Kong/Macao had been export-oriented (Zhang, 2000a and 2001a). Another reason is that the ambiguous Sino-US relationship and political uncertainty in China also resulted in less investment from the US to China (Chen *et al*., 2000). However, the Asian countries share in total FDI has decreased while that of EU has increased in recent years.

Major types of FDI in China

The main types of FDI in China are Equity Joint Ventures (EJVs), Contractual Joint Ventures (CJVs) and the establishment of Wholly Foreign Owned Enterprises (WFOEs). Contractual joint ventures were initially the most important type since the late 1970s. Since the late 1980s, equity joint ventures and wholly foreign owned enterprises became predominant and recent years have seen a proliferation of wholly foreign owned enterprises. Equity joint ventures have been a popular entry mode for two reasons. First, the Chinese

government believes that equity joint ventures best serve the Chinese objective of foreign capital, technology, and management experiences. Second, foreign investors hope through engaging in joint ventures to get local partner's assistance in the domestic markets (Zhang, 2002). Deng (2001) notes that many foreign investors have chosen wholly foreign owned enterprises as the preferred entry mode in recent years so as to avoid problems associated with equity joint ventures.

Multinationals that used to form join ventures with domestic investors are seeking to establish wholly owned enterprise to strengthen corporate control, improve efficiency and better co-ordinate corporate resources. According to Yunshi and Jing, (2005), from 1984 to 2002 the number of WFOE foreign firms has been on the rise. In the 1997-2001 period, foreign investors wholly funded more than 50 per cent of newly registered firms. The proportion of investment by joint ventures decreased from more than 50 per cent before 1994 to 31.5 per cent in 2000. (Yunshi and Jing, 2005). Even at those joint ventures, foreign shareholders have tended to increase their investments to wield greater corporate control. This is in line with the development strategies of multinationals that have boldly entered the Chinese market to strengthen their control. By forming a corporate network, they reduce overall costs of their operations and optimize their local presence.

Industry sector distribution of FDI in China

In terms of sectoral distribution, foreign investment in China has concentrated on secondary industries, but tertiary industries have become the latest destination for China-bound FDI. As China fulfills its WTO commitments, it will further open up the financial, insurance, telecommunications, energy, water, commercial, accounting, auditing and legal sectors, which are expected to absorb more foreign investment.

Early investors saw China as a place to digest out-dated technologies. In the 1980s, multinationals saw the world's new markets, such as China, India and Brazil, as a venue for selling their out-dated products. But as market competition intensifies in China, many foreign firms have increasingly adopted new technologies to maintain their market shares. The number of patents registered by multinationals in China has been rising rapidly since the early 1990s, up by 30 per cent on average annually. It is clear those companies see China as a new focus of their global strategy and have put more emphasis on localization of their research and development (R&D) capacities.

Multinationals have built more R&D centers in China. According to UNCTAD (2001), by the end of 2000, they had established more than 100 such centers in China. Most of them are located in Beijing, Shanghai and Guangzhou. Intensifying market competition has driven the localization of the R&D capacities of multinationals. It can speed up the launch of new products on the domestic market, which is crucial for grabbing market share. It can also help improve relations between multinationals and the host country, which often hopes multinationals can transfer more state-of-the-art technologies (Yunshi and Jing, 2005).

Regional FDI distribution in China

The geographical distribution of FDI in China has been very uneven but new trends are emerging. Until recently, the FDI has been highly concentrated in the prosperous eastern coastal provinces and major metropolitan cities, which account for about 90 percent of total FDI in China's eastern and south regions. The uneven regional distribution of FDI in China is a result of a variety of factors, including FDI policies and regional disparities in investment environments. First, the government restricted FDI to four economic zones, then widened it to 14 coastal cities, which offered advanced infrastructure and cost-cutting information networks. Broadman and Sun (1997) also argue that this uneven distribution of FDI is also explained by inland China being undeveloped, with poor infrastructure. Second, the destinations of the investments from Asian developing economies reflect the Chinese diaspora factor. Most overseas Chinese originally came from coastal areas that have received a huge share of total Asian FDI (Zhang, 2001a). Third, Western investors concern themselves primarily with market access, therefore, metropolitan cities such as Beijing, Shanghai and Shenzheng and coastal areas would inevitably be the heavily favored cities relative to inland regions.

A new trend is foreign capital inflows moving gradually from the Pearl River Delta to the Yangtze River Delta. This is because the Pearl River Delta region, the first on the mainland to accommodate foreign investment, has lost its advantages in terms of labor cost and preferential policies while Shanghai has caught up thanks to its high quality of labor, its leading role in the national economy and its new investment policies that are often more favorable than those of Guangdong (Yunshi and Jing, 2005).

Assessment of FDI Determinants in China

The previous characteristics of FDI in China can all be grouped as location advantages in its broadest sense, signified by factors such as unbalanced source country, uneven regional distribution of FDI and distribution of realized of FDI caused by the determinants of market size, low labor costs, government policies, Chinese connections, geographical distance etc. As Zhang described, export-oriented FDI is motivated by foreign cheap labor, while market-oriented FDI is motivated by foreign market access, i.e. locating manufacturing in multiple countries to serve local markets (Zhang, 2000b). The export-oriented FDI is more likely to be attracted to host countries with low wages relative to source countries (Zhang and Markusen, 1999). Hence, this type of FDI is usually attracted to countries that offer favorable incentives conditions. Otherwise, the host market size is expected to play a key role in attracting market-oriented FDI because the larger market size offers greater opportunities to realize effectively economies of scale (Zhang, 2000b).

Determinants of FDI in China

China has many country specific advantages that are believed to be particularly significant as being the determinants of FDI. Swain and Wang (1995), Liu et al (1997), Zhang (2000), Wei and Liu (2001), Zhang (2002) and others have argued the determinants of FDI inflows into China identified by FDI theories can be classified into three categories, Micro-, Macro, and strategic determinants. Micro factors concern firm ownership specific advantages such as product differentiation and the size of the firm. Macro-determinants of FDI emphasize the market size and the growth of the host country, which is measured by the gross domestic product (GDP), GDP per capita, GNP, or GNP per capita, as rapid economic growth may create large domestic markets and businesses. Other macro factors include taxes, political risk, exchange rates, and so on. Strategic determinants refer to those long-term factors such as to defend existing foreign markets, to diversify firms' activities, to gain or maintain a foothold in the host country, and to complement another type of investment.

China's GDP has grown between 8-9% per year since 1980. Studies have shown that market size, measured by GDP, GDP per capita, GNP, or GNP per capita, has a significant effect on inward FDI. Rapid economic growth creates large domestic markets and business opportunities for foreign firms to invest in China. Swain and Zhang (1997) analyzing data of FDI in China in the period of 1978-92, used GDP and real GDP growth rate; Liu et al (1997) using GDP, GDP growth, wages, concluded that market size is the fourth most important economic factors for the pledged FDI in China. Their empirical results indicated that the real GDP rate was significantly related to inward FDI in China. The positive relationship between market size and inward FDI is also confirmed by Zhang (2000) and Wei and Liu (2001) who found that both US and Hong Kong FDI are attracted by China's large market size. This reflects the market-seeking motive of US firms and Hong Kong firms to shift from mainly export-oriented investments towards the Chinese markets. Hence, most empirical results are consistent with each other that market size is the most important factor why foreign firms invest in China. The larger the market size of province, the more FDI is likely to be received (Zhang, 2002).

Costs factors are one of the determinants of FDI, among which labor cost has been extensively investigated in the study of FDI. Although it is logical to say that foreign firms can take advantage of low labor cost by investing in developing countries, there is another argument that the cost of transportation and low productivity often exceeds the cost of labor in developing countries (Miller, 1993). Swain and Wang (1995) found that there was a positive relationship between the relatively cheap labor in China and inward FDI. Liu et al (1997) also agreed that the low wage rates were one of the most important economic factors for FDI. Both Zhang and Yuk (2000) found that China's relative cheap labor costs greatly encourage HK Multinationals

to invest in Mainland China. On the other hand, Zhang (2000) concluded that the labor cost factor hardly had any influence on US MNE decisions to invest in China. Even recently, low labor cost is still proving to be key location factor for foreign investors in China (Wei and Liu, 2001), especially in manufacturing industries such as automobile assembly and telecommunication equipment. Lieberthal and Liberthal (2003) found that electronic apparatus and telecommunication manufacturers in Hong Kong and Taiwan have proven particularly adept at leveraging inexpensive mainland Chinese workers for international competitive advantage. However, the low-labor-cost advantage of China may not be sustainable as China now faces competition from its neighboring countries such as Vietnam, Laos, and India, which are also endowed with cheap labor factors and have adopted various policies to attract FDI.

Although it has been argued that political instability in the host country could discourage the inflow of FDI, and most of the empirical studies support this argument, some empirical evidence suggested that political factors played an insignificant role in firms' decision to invest abroad (Swain & Wang, 1997 Zhang, 2002, Andreosso – O'Callaghan & Wei, 2003).

Geographic proximity of the host to the home country of investors reduces informational and managerial uncertainty, lowers monitoring and transportation costs and reduces the exposure of multinationals to risk, theoretically the more the geographic distance between the home and the host country, the less the FDI (Grosse & Trevino, 1996; Wei and Liu, 2001). However, Liu et al. (1997) found that geographic distance was found to have little influence as a determinant of FDI in China, arguing that the reason for this result might be that the rapid developments in communication technology mitigates distance factors. However, from another perspective, Yuk and Zhong (1997) found that the location of FDI projects in China, funded by capital from Hong Kong, was hugely influenced by geographic distance. In China it seems that geographic location within the country rather than distance is a factor for nearby investors, however, there is no evidence demonstrating whether the location of FDI projects from western countries is related to geographic distance. One of the reasons might be that given the long distance between China and most western countries, the geographic distances within China are seen as unimportant.

The view that the geographic distribution of FDI in China is influenced by geographic location rather than distance is supported by the phenomenon that FDI projects funded by capital from Taiwan were mainly located in Fujian Province (eastern China) while Hong Kong investors choose a location in Guangdong Province (southern of China). Culture proximity between FDI sources and hosts would encourage FDI flows into China (Liu, *et al*, 1997, Zhang, 2001). This is especially true for both of Hong Kong-Guangdong province and Taiwan-Fujian province (eastern China) because these two pairs are not only are geographically adjacent to each other, but also speak the same dialect. There is not enough evidence to support the view that the cultural issues were a significant determinant of western FDI in China (*Liu et al*, 1997).

METHODOLOGY

As discussed earlier, the literature shows that the most identified factors to attract FDI in China include market size and growth, labor cost, host government policies, cost of capital, geographic distance and cultural differences. This suggests that the location characteristics of China are indicative of the determinants of FDI. Liu et al. (1997), Wei and Liu (2001), Zhang (2002) use GDP, GDP per capita, GNP, GNP per capita and other economic indicators to explain why China attracts MNEs. These studies utilized secondary data, however we chose to undertake primary data collection direct from foreign investors to identify what location characteristics of China are leading to the determinants of FDI. Primary data was preferred over secondary data because secondary data information lacks currency (in terms of timeliness, accuracy and access) in the Chinese context.

We sent self-administered, structured questionnaires via e-mail to pre-selected recipients who had agreed to take part in this research. The responses were also returned via e-mail. Company details are shown in Appendix 1. Apart from the background information, the questionnaire was split into 2 parts. Part A sought to ascertain what factors had influenced foreign investors originally to invest in China. Part B sought to investigate what factors encouraged investors to re-investment. A 5-point Likert-type scale was used. The

variables and scaling details are shown on the results table. The questionnaires were received via e-mail with telephone contact assistance. By the deadline given we received 25 responses, of 22 were useable. Results were coded and analyzed using Microsoft Excel.

FINDINGS AND DISCUSSION

Employment figure varies among the 22 companies. The largest company had almost 40,000 employees, the smallest only 120 employees. Of the twenty-two companies who replied, 4 were American, 4 from Hong Kong, 3 each from Germany, and Taiwan; 2 each from Japan and Netherlands and 1 each from France, Switzerland, Korea and Poland. The industrial sector composition spanned across many sectors, from automotive manufacturing, electronic apparatus manufacturing, telecommunication equipment manufacturing, computer manufacturing, chemical & energy, food processing, banking, insurance, shipping, retailer & property development, wall coverings manufacturing, and management. It is significant that manufacturing forms the largest sector. There are two forms of investment among the respondents, which also represents the major types of FDI in China. They are wholly owned equity joint ventures, and wholly owned enterprises. Equity joint ventures have been the main form of FDI since 1989, though many foreign investors have chosen wholly foreign owned enterprises as an entry mode in recent years (Deng 2001). In our sample 86.4% of the investments were joint ventures and 13.6% wholly owned companies.

Results

The questionnaire had 11 statements regarding the determinants of foreign direct investment in China and consisted of two parts. The first part of the questionnaire (Part A), focused on the importance of various factors to foreign investors in choosing to invest in China. Part B attempts to identify what factors motivate foreign companies to undertake further investment. There were three investors that have not undertaken any re-investment in China, so the number of respondents for Part B was 19. The results are shown in Table 1.

From Table 1, the mean scores for each part clearly shows the significance of each statement for influencing the determinant. China's large market size and growth received significant support. From part A, 5 out of 22 companies rated it as the most important factor for them to invest in China, while another 8 rated it as a very important factor for them while 7 companies rated it important. From part B, out of the 19 companies that had reinvested, 17 were of the view that China's large market size and growth is an important factor to encourage their further investment. In conclusion, from both of these two parts, large market size and growth of China is a key point that influences multinational enterprise's investment decisions.

Similar result are also found in the responses toward statement 2 (labor costs), 5 (government incentives) and 7 (part of their globalization strategy); with significant indications that lower labor costs, and the Chinese government's incentive policies favor China as host country for investment and that China is an important part of their globalization strategy.

High investment return (statement 4) is an important factor influencing investors, but for 8 companies it was not important. Items 3 (exchange rates), 6 (political stability), 8 (export platform), 9 (Chinese connections), and 11 (weak industrial infrastructure) all had means around 2.5 indicating a mixed picture. We suspect there are some industry sectors issues here that need to be explored further via perhaps follow-up interviews. Chinese connections are important to Taiwan and Hong Kong companies, but not to Western firms.

Obstacles/problems

According to the twenty-two companies who responded, three of them did not have any plans to undertake further investment in China. The remainder, who had reinvested or had plans to invest further, cited

a number of problems and obstacles that impacted the investment climate negatively. These are summarized in Table 2.

Location advantages

FDI in China has been motivated by several factors. According to our research, China's large potential market size and growth is considered as the most important factor influencing multinational enterprises to invest in China. In fact, one major motivation for FDI is to seek new markets. The larger the market size of a particular province is, the more FDI the province should attract (Shapiro, 1998). Host countries with larger market size, faster economic growth and higher degree of economic development will attract more market-oriented FDI.

Table 1 Actual responses to variables and mean scores

		No of responses Part A					Mean Score	**No of responses Part B**					Mean Score
	FDI Determinants	**1**	**2**	**3**	**4**	**5**		**1**	**2**	**3**	**4**	**5**	
1	Market size and growth	0	2	7	8	5	3.73	0	2	6	6	5	3.23
2	Cheap labor cost	2	3	7	6	4	3.32	2	2	7	6	2	2.77
3	Exchange rate	6	7	5	3	1	2.36	6	7	4	1	1	1.86
4	High investment return	2	6	5	5	4	3.14	2	4	6	5	2	2.64
5	Government incentive policies	1	3	7	5	6	3.55	1	2	7	5	4	3.0
6	Political stability	5	7	5	3	2	2.55	5	6	5	2	1	2.05
7	Part of company's globalization strategy	2	3	5	7	5	3.45	2	3	6	5	3	2.77
8	Serving as an export platform	5	7	4	3	3	2.64	4	6	4	3	2	2.27
9	Chinese connections	6	7	4	2	3	2.5	6	7	3	2	1	1.91
10	China's advanced technology	9	11	1	1	0	1.73	9	10	0	0	0	1.32
11	China's weak Indus. infrastructure	5	7	6	3	1	2.45	5	6	4	3	1	2.09

5= most important, 4=very important, 3= important, 2=not important, 1=not important at all

Table 2 Obstacles and problems in Chinese investment environment

The obstacles/problems:	Frequency
Political stability	8
Unsatisfactory foreign trade policy	6
Regulations not strictly implemented	9
Unsatisfactory banking system	7
Foreign capital limit	5
Too complicated application process	4
Incomplete legal system	9
The development of business related industry	5
Low productivity	4

From Table 2, it appears that most of the obstacles relate to the political and legal environment of China. Even for non-market-oriented FDI, the market size of host countries is important because larger economies can provide larger economies of scale and spillover effects (OECD, 2000). This has also been supported by the response to statement 8, whereby for EU multinational enterprises, using China as an export platform is not seen as important because EU FDI tends to be market-oriented, and thus more committed to the

Chinese domestic market than to foreign markets through exports in contrast to Asian FDI (Andresosso-O'callagham & Wei, 2003). This is why EU multinational enterprise rated China's large market size and growth as important, and US respondents have similar feedback as well.

Labor cost is also considered an important factor, though not the primary one. Foreign investors generally aim to take advantage of cheaper labor were production is labor intensive (Andresosso-O'callagham & Wei 2003). With the world's largest population, China has rich resources of labor and China has paid great attention to the education of its people, therefore, Chinese laborers are of relatively high quality and there are comparatively numerous technical personnel with average salaries at a low level (Andresosso-O'callagham & Wei, 2003). The result of statement 2 also shows that more than eighty percent respondents think the low labor cost is important for them, particularly for Taiwanese, Hong Kong, Korean, and Japanese investors. According to the responses, Hong Kong, Taiwan, and other Asian investors significantly depend on china's low labor cost for international competition. Whilst Zhang (2000) concluded that the labor cost factor hardly had any influence on US MNE decision to invest in China (presumably because it is market-orientated), in our research, some US and EU firms with manufacturing linked FDI believed cheap labor cost is important. Only banks and insurance respondents agreed that cheap and unskilled labor is diminished.

Incentive policies are an important factor to consider, especially in developing countries (Sun et al, 2002). China is most likely to maintain its economic growth policy and investment promotion (OECD, 2000). It has provided foreign investors with special favorable policies in taxation, land use, and foreign currency exchange in coastal regions, particularly 4 special economic zones and 14 opened cities. Preferential FDI policies might be one important factor to bring the overwhelming performance of attracting FDI so far (Zhang, 2002). This also links with the high ranking of statement 5 in the questionnaire. Respondents from manufacturing sectors such as automotive, electronics and telecommunications strongly agree that incentive policies encouraged their investment. As China's WTO obligations become due, more and more industry sectors are opening up to FDI such as banking, financial services sector etc. This is likely to lead a new wave of FDI in China. High investment return is also ranked as important. However, Zhang describes companies in the US, EU, and Japan, viewing their investment in China as part of a global strategy, which is designed to secure sales in China over the long term, but not necessarily resulting in short-term profits (Zhang, 2002).

Political stability has a mixed result in this questionnaire since half of the respondents regard it as important and half ranked it not important. Swain & Wang, Liu et al (1997) argued that political instability was negatively related to inward FDI in China. However, two companies consider political stability one of their biggest concerns to investment in China and other two think it is very important for them. So while ambiguous, the result support Lankes and Venables'(1996) findings that host country political stability influences FDI inflow in a transition economy. Although in the case of China, the fact that the Communist Party is in firm political control could be seen as a sign of stability.

Liu et al, (1997) Zhang (2001), and Wei & Liu (2001) suggested that FDI projects funded by capital from Taiwan were mainly located in Fujian Province, while Hong Kong investors choice to locate in Guangdong Province is influenced by Chinese connections. The literature shows that cultural issues were not a significant determinant of western FDI in China (*Liu et al*, 1997). Our results show only two Hong Kong, three Taiwan companies and four others ranking Chinese connection as an important factor. Finally, if proof were needed to support China's drive to secure technology transfer and upgrade its industrial infrastructure by the FDI route, most of the respondents themselves thought it was an important investment motive, signifying deficiencies in these areas.

The other findings in this research are that global integration is ranked high. Although global integration is not a key location factor, it is chosen for this study to particularly address the question of whether the phenomenon of globalization influences FDI in China. As argued by Dunning (2000), globalization has had limited effect on the determinants of FDI from developed country to developing country in terms of push factors. But some explanations of the pattern of international trade, developed by such economists as Paul Krugman (1981) and Kelvin Lancaster (1980), examine the impact on trade flows of global strategic competition between MNEs. According to this view, firms struggle to develop some sustainable competitive advantage, which they can then exploit to dominate the global marketplace. MNEs competition internationally affects international investment. The findings in this research suggest that global integration seems one of the

key factors for foreign investors undertaking investment in China. This suggests that foreign firms do not simply come to China to exploit some location advantages, but regard investing in China as a part of firm's strategic capability development. It also supports Zhang's (2002) suggestion that in particular companies in the US, Europe, and Japan such as Boeing, General Motors, Motorola, Volkswagen, and Toyota view their investment in China as part of a global strategy, which is designed to secure their sales in China over the long term. The research also shows that the major obstacles in foreign firms decisions to invest in China include the political and legal system. According to our respondents, major obstacles include political stability, unsatisfactory foreign trade policy, regulations not strictly implemented, foreign capital limit, and incomplete legal system etc.

Since it has been shown that investment policy is the single most important variable in attracting FDI (Broadman & Sun 1997, Chen 1997, and Andreosso-O'Callaghan and Cassidy 2003), clearly the Chinese government needs to address the above issues. Liberalization of China's FDI policy has gone through five main improvements, the latest 'comprehensive liberalization' began in 1992 and as a direct result of this comprehensive open door policy, total FDI increased rapidly. However, the responses to obstacles/problems shows the FDI political environment still needs to improve. Fortunately, the Chinese government also notices that a good political environment is an important factor in attracting FDI, by promising that measures will be taken to remove local protectionism, strength laws, establish an open, unified and fair market environment, further protect the legal rights of foreign companies according to law (Ministry of commerce of the People's Republic of China, 2004).

CONCLUSIONS

Identifying determinants of FDI in China is a broad and complex issue. In this paper, the authors only attempted to understand the location advantages in the investment process. Our research has found that China's huge potential market size is the most significant factor for FDI inflow in China, which is in line with both theory and previous studies. China's large population, fast growing economy, coupled with membership of the World Trade Organization, are an unbeatable combination for foreign firms it seems. Government incentive policies are another important reason; other key factors include labor costs, and high investment return. One of the new findings from the research is that global integration is one of the key factors for some foreign firms investing in China. This indicates that China is a very important market and investing in China is part of firms' global strategy. In conclusion, foreign firms do not simply come to China to take the advantage of any single location factor, but are more importantly driven by a whole myriad of often conflicting and competing reasons.

IMPLICATIONS FOR THE CHINESE GOVERMENT

Without a doubt, FDI has proved to be the driving force for economic growth for China. Foreign capital has had two positive effects; it has improved the liquidity of the Chinese economy, and thus facilitated other investments (e.g. more business opportunities for local entrepreneurs as well as support businesses such as legal work, accountancy, construction, transportation, hospitality etc). Secondly, it has created employment, earnings and thus taxation revenue for the central and regional governments. Such revenues have been fed back into the economy to boost the living standards of all Chinese people, further boosting the economy, facilitating a virtuous-cycle of prosperity for over two decades.

The main sustainable benefit of FDI lies in its ability to bring in technical know-how for a developing country. In the absence of this, FDI may serve only to exploit the cheap labor or natural resources of another country. The Chinese government has played a nimble game to attract FDI into China, and the country being the largest host country for FDI among the developing countries supports success of its policies. However, further reforms are needed.

Reform of investment laws is long overdue. For example, under current Chinese laws, foreign investors are prohibited from owning more than 25 percent of a commercial bank, and no single foreign investor can own more than 20 percent. Such limits on foreign ownership of its banks need to be removed. Also, foreign financial institutions that want to buy Chinese securities need to be freed from having to have at least $10 billion in assets and to have been in business at least five years. Foreign-affiliated banks, brokerage firms and insurers need to be freed from restrictions on setting up multiple branches at one time.

It is well understood that the issue for the government is how to manage the relationship between FDI and other political, social and cultural factors. However, it is our opinion that the crucial importance of FDI for China may not be the FDI itself, but the degree of openness the government commits to in order to lure foreign capital. With a free market, free low of international trade and capital, deregulation of businesses, the country will become the preeminent economic powers it aspires to be.

Thus China should continue its program of economic reforms, as a sustained healthy economic growth is the biggest attraction for foreign capital. However, any political reforms need to ensure that instability does not ensue. Market access barriers should be removed and it should encourage market-oriented FDI as this is preferable to export-orientated FDI since it leads to technology transfer and spillover effects. Such a path will help Chinese firms to climb up the technology ladder. Furthermore, China should speed up the privatization of state-owned companies, including banks; to develop a futures market for currency trading and to establish an independent credit-rating agency.

Lastly, the government should create specific location advantages in Western areas of China such as skilled employees and improving the infrastructure in order to attract more foreign capital to the region. This will help reduce the huge gap of development between the Eastern, Southern areas and the Western region.

MANAGERIAL IMPLICATIONS

For businesses and their executives, we suggest they follow the example of long-term players in the Chinese market and re-organize their presence in China and seek majority control of their investments. The reorganized operations need to streamline material procurement and distribution costs, and to further reduce costs they need to encourage their component suppliers to move to China to form a complete supply chain, which makes products more price-competitive. Some, such as Honda are doing this already. By May 2004, their more than 50 core component providers had opened or planned to open branches in Guangzhou, where Honda has its key-manufacturing base in China.

In terms of sectors of investment, we suggest that retailing (food, clothing and luxury goods) is promising a sector, as are broad financial services. Opportunities for manufacturing are currently bleak. Any significant privatization of state industries is not on the horizon, therefore few opportunities are likely in the short to medium term.

LIMITATIONS AND FUTURE RESEARCH

Like all research, our findings need to be interpreted cautiously given the relatively small sample size and nature and size of firms that we used. Given the geographic and sector disparity of our sample, not to mentioned origin of the companies, it is suggested that a large, well-funded project be undertaken with a sample of several hundred firms. A separation of service and manufacturing firms is likely to yield distinct patterns, not only of ownership preferences but market-entry motives and expectations. Such delineation is also likely to be evident between small and large firms and indeed between countries of origin. Such findings are likely to enrich our understanding of this fascinating area.

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