

Impact of Foreign Direct Investment on the Development of an Emerging Economy: The Case of China

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Abstract

This paper describes the impact of Foreign Direct Investment (FDI) inflows on the development of the economy of emerging markets. The focus will be on the performance of Chinese locally owned firms.

Some of the topics covered in this paper include theories of the firm, globalization and economic development theories. This paper will examine many aspects of China's economy, including economic and market reform policies, labor standards, capital market integration, foreign capital participation, productivity, risks and their correlated effects, and the role they play in shaping the level of economic development, and market acceptance among investors.

Key words: Foreign Direct Investment, Emerging Economies, China.

INTRODUCTION

Over the past several years, China has emerged as one of the largest and fastest growing economies in the world and has become a major destination for foreign direct investment (FDI) (Bilston, 2004). Its population of 1.3 billion represents a huge market with endless potential and entry to the World Trade Organization (WTO) has guaranteed a place in the global financial world. As a result, the Chinese economy is undergoing a major transformation. By addressing many of the historical challenges of entry with deregulation, privatization and economic liberalization, China is turning challenges into opportunities for foreign investment.

As leaders see the value of globalization, China has been actively seeking to attract foreign direct investment (FDI) and technology to promote its modernization efforts and accelerate its export trade capabilities since it opened its doors to foreign countries in 1978 (Xiamen, 2000). The total amount of incoming FDI increased from almost zero in that year to a high of about \$110 billion in 1993 and \$320 billion in 1999. As a result, China has

become the world's third largest recipient of FDI, and the largest recipient among emerging countries.

Membership of the WTO has been key in opening up the Chinese market (Bilston, 2004). It has proven to be a good thing for private entities and unifying government regulations, despite concerns that the WTO membership would have a negative impact for foreign companies since it removes tax incentives. Early forecasts hinted that foreign investment into China would decrease due to China's tax rate unification reform granting equal treatment to domestic and foreign enterprises. However, these negative predictions have not affected foreign investment and China's foreign direct investment inflow continues to grow steadily, passing the US\$50 billion mark in 2003. "This is a market that is actively seeking to break down barriers to entry," said Mr Rohan Geddes, Partner of International Assignment Solutions at PricewaterhouseCoopers.

There are a number of key sectors that hold strong potential for FDI, including manufacturing, construction and resources (Bilston, 2004). Accounting for 44 percent of GDP and 62 percent of foreign invested capital,

manufacturing represents one of the largest sectors for FDI. "Sourcing and manufacturing product continue to be key areas of opportunity for companies," according to Mr Lyndon James, PricewaterhouseCoopers Transfer Pricing partner. "Reports suggest savings of 20 to 40 per cent off initial manufacturing costs due to the low cost of labor and production in China."

As China's various industries become prime targets for FDI, many questions are raised. Recent studies show both advantages and disadvantages to the large amount of FDI in this emerging country, particularly for domestic firms. The most obvious distinctive features that attract foreign investors to the Chinese economy are spending power, low labor costs and labor productivity that characterize it (Angresano and Zhang, 2000). Rapid GDP growth comes with high levels of government investment in infrastructure, such as modern airports and reliable highway and railway systems. High technology zones have been developed to draw major international companies. In Beijing the Zhanguangcun Science and Technology Park already features research and development centers, regional headquarters, manufacturing bases or joint ventures for multinational giants such as IBM, Nokia, Motorola, Microsoft, Intel, GE, Kodak, Siemens and Samsung (Liu, 2002).

In addition, other favorable features that aim to bring in foreign investors include a stable political structure, a very stable currency, a well-educated population, an energetic labor force with wage rates much less than those of the USA, and close proximity to other Asian countries, which keeps shipping costs for exports low, and a preferable tax rate (Angresano and Zhang, 2000). In addition, because many of the products manufactured in China are in the early- or mid-growth stage of the product life cycle, many investors believe China offers great potential for them to find new business opportunities (Zhou, 2002).

One of the most unique features has been the contribution to FDI from overseas Chinese (Angresano and Zhang, 2000). Starting in the early 19th century until 1949, there was considerable migration, primarily from coastal provinces to neighboring countries. Many of these "overseas Chinese" became successful entrepreneurs. The leasing of Hong Kong province to the British and the province of Taiwan's declaration of independence (and subsequent prosperity in both provinces) created still more wealthy Chinese entrepreneurs living outside the main areas. By 2002 the estimated wealth of overseas

Chinese has been estimated to be equal to that of the entire state of Taiwan (AFROC, 1998).

Another distinguishing feature of FDI is the variety in the cultural characteristics of overseas Chinese investors, who usually adopt useful aspects of the local business culture (Angresano and Zhang, 2000). Overseas Chinese investors are often well educated and trained in enterprise management. They are much more familiar than their Mainland Chinese counterparts with market principles, modern management techniques, and business cultures and practices in countries outside China. Many of them were educated in the USA or Europe, and understand both Chinese and the international language of business, English, as well as their knowledge of business cultures and practices around the world.

The investment criteria used by overseas Chinese during the early (i.e., pre mid 1990s) period also is a distinguishing feature of China's FDI (Angresano and Zhang, 2000). In addition to rational economic calculations, their desire for prestige was significant (Zhang, 2002). When an overseas Chinese family became wealthy and gained prestige in their country of residence they often tried to demonstrate that wealth within their Mainland village, city or province. This desire influenced them to make investments that would enhance their prestige in China despite a low expected rate of return. Such investments included, for example, the establishment of a new private business in their name, or building a primary school with their name.

Since the mid 1990s, however, a new generation of overseas Chinese investors has emerged (Angresano and Zhang, 2000). These people are wealthy, younger, well educated, and practical in terms of international business. These investors have been heavily influenced by the Western business culture and thus tend to make their investment decisions based upon rational calculations, focusing mainly on profitable rates of return. Many are attracted to China not only by the large market and low labor costs, but also by the opportunity to develop a new business in a rapidly growing economy featuring a wide range of emerging investment opportunities. They are more likely than earlier overseas Chinese investors to invest anywhere in China, rather than sticking to their hometowns.

Generally speaking, the contribution to China's economic development made by overseas Chinese investors may be the most distinguishing feature of the country's FDI (Angresano and Zhang, 2000).

While it is difficult to provide an accurate estimate of the total dollar value of FDI from overseas Chinese, it is undeniable that these investors helped transform an economy characterized mainly by inflexible state-owned enterprises into a dynamic economy with prominent high technology enterprises. In the process these investors provided a great deal of managerial expertise in the areas of factory design and human resources. With their knowledge of multiple business cultures, they taught local Chinese people about the working rules of a market-oriented economy. One analyst argues that since 1990 China has experienced a more favorable development than that of Russia over the same period because Russia has no counterpart to overseas Chinese.

In a country whose culture has dominated for centuries, both investment behavior and the business practice of locals likely will remain part of China's business culture (Angresano and Zhang, 2000). However, global capital and product markets are becoming increasingly integrated, open and competitive. Such integration implies that the investment climate for non-Chinese investors will continue changing. The future of FDI in China will depend upon the potential investor's perceptions of the benefits and costs within China's investment climate relative to those in the rest of the world.

Statement of the Problem

FDI in China can be expected to increase or decrease as expected profitability and associated risks of planned FDI ventures fall or rise relative to other countries (Angresano and Zhang, 2000). One analysis done by The Economist Intelligence Unit (EIU) concludes there will be "an avalanche of new funds" (i.e., a 10 percent annual growth of FDI) over the next few years due to China's WTO membership (Economist Intelligence Unit, 2002b). If the current investment climate in China is not too adversely affected by the upcoming political succession, and if job creation is sufficient to absorb the growing number of laid-off workers, the existing positive factors could very well serve to make this forecast accurate.

Despite the positive outlook shared by many, it is a wide concern that the development potential of FDI is limited but beneficial for emerging countries, particularly in regards to locally owned firms (Jacobs, 2001). This paper hypothesizes that FDI is most beneficial when

the government exercises strict rules and regulations regarding foreign investment. Therefore, developing countries must be careful to avoid an approach that solely aims at increasing FDI. The purpose of this paper is to provide a solid background on the advantages of FDI and possible pitfalls for developing countries, with an emphasis on China. It will specifically examine the effects of FDI on domestic businesses.

HYPOTHESIS

The general benefits of FDI for emerging economies are well documented. Given the appropriate host-country policies and a basic level of development, various studies show that FDI results in technology spillovers, enables human capital formation, improves international trade integration, helps create a more competitive business environment and improves enterprise development. All of these result in higher economic growth, which is a crucial tool for alleviating poverty in developing countries. In addition, beyond the economic benefits, FDI may help improve environmental and social conditions in the host country by, for example, transferring - cleaner - technologies and resulting in more socially responsible corporate policies.

This paper hypothesizes that while FDI in general is greatly beneficial to the development process, certain drawbacks are involved. These drawbacks may reflect shortcomings in the domestic policies of developing countries, such as China, but important challenges may nevertheless arise when these shortcomings cannot easily be resolved. Potential drawbacks include the effects on locally owned businesses.

LITERATURE REVIEW

BATTLE FOR MARKET SHARE

In 1979, when Deng Xiaoping offered foreign businessmen a chance at 1.2 billion consumers in China, there was a great deal of interest (Crane, 2000). Many financial experts and corporate leaders were convinced that one day China would be the biggest, the best, the most lucrative market in the world. However, for most that ventured into China hoping that this dream would be realized, that potential never materialized. Rather, the easy conquest of China's vast market became the financial equivalent of trench warfare.

According to Crane (2000), “Burdened with incompetent partners, stonewalled by Chinese bureaucracy, and up against surprisingly stiff local competition, many corporations lost millions. For some companies, injury was compounded by insult - they were forced to manufacture goods under Chinese brand names. By 1998, the generals back at head office had pretty well had enough. Factories were closed and joint ventures were dissolved. In 1999, for the first time since Deng’s promise of market reform, foreign direct investment dropped 12.1 percent.”

“There’s no denying that, in relation to MNCs, local companies [now] dominate the Chinese market,” said Merlin Poljak, the Beijing-based CFO for Swedish appliance manufacturer Electrolux (Crane, 2000). However, while the multinationals lost a few battles, China’s entry into the World Trade Organization is making major changes. Foreign companies are finally able to import and export directly, as well as handle their own distribution and after-sales service. For MNCs, that means that the battle for market turf will be on equal terms for the first time in history. In the past, the influence that domestic companies had with government authorities was sometimes too high. However, now local companies must meet foreign companies on stricter and fairer terms.

This means a battle against state-owned giants like Qingdao-based Haier Group, which has captured a 40 percent market share, and aggressive independents like Guangdong Kelon with 20 percent (Crane, 2000). In 1998, foreign players, including Electrolux, held just 7 percent of China’s US\$9.7 billion white goods sector, including home appliances. Still, Poljak believes that his own company’s edge in technology, along with its expertise in distribution, production and financial systems will gain it more territory in the China market. The fact that the company can afford large investment helps, as well. “Foreign companies can suffer losses for a few years,” said Poljak, “and still have a strong future here. But increased competition for many medium and smaller Chinese companies will mean their closure or sale.”

Whether MNCs or locally-owned, firm that survive will have a key role in defining the world’s largest consumer market for the next decade (Crane, 2000). In industries ranging from telecommunications to insurance to automobiles, corporate leaders will be on the front-line. Electrolux, for example, with worldwide sales of

US\$14 billion in 1998, generated less than 1 percent or US\$131 million of those sales in China. However, in the next few years, due to China’s incremental concessions on foreign trade, Electrolux and other MNCs expect their global sales breakdowns to be a lot more even and their presence a lot stronger. “In the case of both international and local players,” says one analyst, “the big will get bigger and the small will shrink away.”

One of the biggest industries that highlight the battle between locally owned firms and MNCs is China’s overcrowded white goods sector (Crane, 2000). According to analysts, the number of Chinese white goods giants will drop from about 50 in 1999 to less than ten by 2007. Larger local players, like Haier and Guangdong Kelon, are expected to remain dominant in the industry. Despite the global resources of MNCs like Electrolux and US-based Whirlpool, few are betting they will succeed in the long run. Local companies in sectors like banking and telecommunications may diminish in the face of increased foreign competition, but some analysts claim that foreign brands have a lower chance of success in white goods.

Unlike the United States, where the service and technology sectors dominate, China’s manufacturers are still dominant (Crane, 2000). As a result, in terms of talent, the white goods and brown goods (televisions, VCRs, camcorders, etc.) sectors attract the best executives - the leaders of Haier and Kelon are the Bill Gates and Jack Welch of China. This is why the competition is so tough. However, the ability of MNCs to adapt cannot be underestimated. According to Michael Deng, the financial controller at Whirlpool’s washing machine joint venture with Shanghai Narcissus Electrical Appliance Corporation: “In the long run, MNCs have the resources, the experience and the culture of best practices. What we won’t have is the problem of political struggles which inevitably will affect state-owned companies.”

An increasingly powerful contender is the locally-owned Chinese independent that operates free of political interference (Crane, 2000). For example, Guangdong Kelon was launched in 1984 as a township and village enterprise with just US\$11,000 in local government funds and no government hand-outs. The company has since won of 140 state, provincial and international quality and management awards, including a place in the top 20 of the world’s best small companies from Forbes magazine.

“With no debts to the government, we can say that our responsibility is to our shareholders - and the authorities have to listen,” said CFO Don Lee (Crane, 2000). One important element of the company’s success, according to Lee, was the company’s early acceptance of international reporting and accounting standards. Further, the group located its CFO and finance department in Hong Kong in order to attract the best possible managerial talent.

Until a major restructuring of the sector takes place, Kelon stands to boost profitability and crush the competition by offering products that its competitors do not have (Crane, 2000). For example, Kelon was first to the market with a two-door refrigerator instead of the typical one-door model.

Historically, according to Charles Leung, vice-president of Asia Pacific equity research for Salomon Smith Barney in Hong Kong, Kelon innovated and gained market share by shamelessly copying Western and Japanese products (Crane, 2000). In many cases, its copies hit the market before the foreign products they were copying. This was because MNCs often found the necessary government consents for their products elusive. Today, with the battlefield beginning to look more level, Kelon and many other Chinese companies are forced to develop their own technology. In addition, government approvals are expected to be handed down more fairly. According to Electrolux’s Poljak: “In the past, it was often easier for Chinese companies to get government approval for their products. But after WTO, it may be a little harder for [the authorities] to push [local] companies.”

ROLE OF FDI IN CHINA’S RAPID TRANSFORMATION

Foreign Direct Investment (FDI) in China over the past few decades has increased at an unprecedented rate (Angresano and Zhang, 2000). The net impact upon the Chinese economy seems to be highly favorable. A major portion of that FDI has been made by overseas Chinese, with assistance from a Mainland Chinese ministry level agency known as the All-China Federation of Returned Overseas Chinese. Despite some problems faced by foreign investors seeking to enter China’s market, experts predict that foreign direct investment will continue expanding in the future.

INTRODUCTION

Since 1978 China has seen a major transformation from a relatively underdeveloped economy to one of the world’s largest economies (Angresano and Zhang, 2000). It is considered the fastest growing economy in the world. During this period, over 200 million Chinese are estimated to “have been lifted out of absolute poverty”—an accomplishment that some analysts argue is “certainly the swiftest, most extensive rise out of poverty any nation has seen” (The Economist, 2001a).

In the process the percentage of the population subject to malnutrition has decreased from about 50 percent to less than 5 percent (The Economist, 2001a). Since 1990 over 12,000 kilometers of new highways connecting the provinces have been built, and the number of passenger flights has increased threefold (Angresano and Zhang, 2000). Internet usage within China is more than doubling each year (The Economist, 2001a). The primary factors credited for this huge transformation include rapid GDP growth, high savings and domestic investment rates, rapid expansion of exports, and a dramatic increase in foreign direct investment (FDI). Since 1993 China has been the world’s second largest recipient of FDI. A recent FDI confidence index lists the United States with the highest FDI confidence rating (most attractive destination for FDI), with China ranking second (The Economist, 2001b).

Before the mid 1990s most FDI was targeted for labor-intensive industries that produced toys, shoes, garments, textiles, and consumer electronics (Angresano and Zhang, 2000). Since this time, an increasing share has been devoted to property development (commercial and residential) and infrastructure (ports, power plants, highways). In the process, China has become a “manufacturing superpower . . . [as] the world economy is becoming more reliant on Chinese factories. . . . In the past few months, Intel announced a US \$100 million investment in Shanghai to assemble Pentium 4 microprocessors. Dell Computer [has] shifted its giant PC-making facility to Xiamen, Toshiba is making TVs and Sony is manufacturing Play Stations in China” (Hua, 2002).

Foreign distributors have started to invest heavily, as well (Angresano and Zhang, 2000). Recently, a leading office product firm, Office 1 Superstore, established a headquarters in China. The firm believes that “the

Chinese market for stationary alone will reach over 60 billion Yuan (US\$2.7 billion) each year. Such a prosperous market will allow our group to open at least 500 stores in china in the next three years” (Zou, 2002).

Additional evidence of industrial development within China comes from the growing power of a few large locally owned companies (Angresano and Zhang, 2000). Some have become multinational by shifting their production capabilities to neighboring countries, as their Western multinational counterparts have done. One example is Haier, a Chinese owned home appliance manufacturer, which has established production plants in South Carolina and Pakistan (Economist Intelligence Unit, 2002c).

This paper will examine aspects of FDI in China that are relevant to Chinese policy makers, how changes in FDI have impacted the Chinese population, and some important issues for foreign investors.

POST-1978 FDI IN CHINA

Before the 1949 revolution, approximately 40 percent of China’s industrial assets and transportation network were foreign owned, and there was major foreign ownership and control of the county’s natural resources and financial institutions (Angresano and Zhang, 2000). China had so little control over its own trade policy that it could not impose infant industry tariffs. In 1949 the new ruling authorities made a conscious tradeoff. Seeking to transform China from a semi-colonial and semi-feudal level of development, the country’s leaders sought to regain Chinese control over its political, economic and cultural, although at the price of economic efficiency. As a result, the extent of foreign influence throughout the economy was dramatically reduced for the next three decades.

The thirty-year period before 1978 included a mixed performance of the Chinese economy. The nation achieved its goal to re-establish its national identity and reduce the domination of foreign powers over the economy (Angresano and Zhang, 2000). However, the radical political, cultural and social transformations were not accompanied by positive economic transformation.

According to Angresano and Zhang (2000): “By the late 1970s China was a dual society with an urban versus rural income differential of about 3 to 1 (when urban rental subsidies were included), relatively poor living conditions on communes, widespread underemployment,

low agricultural output per worker, and considerable manufacturing inefficiencies. Authorities realized that in economic terms China was lagging far behind its Asian neighbors. The 1978 change in ruling authorities coincided with a shift away from “Maoist” ideology and idealism towards economic and political pragmatism. Gradually, pragmatism came to mean “the willingness to adopt whatever works with little ideological constraint,” so that authorities felt free to open the economy to foreign investment as had their more economically successful neighbors (e.g., Japan, South Korea, Thailand, and the Chinese territories of Honk Kong and Taiwan).”

Policy makers, however, had not intention of transforming China’s economy to resemble its neighbors (Angresano and Zhang, 2000). Instead, they decided to open the economy slowly. Unwilling to risk the type of recession, and corresponding social unrest, experienced by other emerging countries that decided to transform their economies too rapidly, Chinese policy makers continued subsidizing state enterprises while promoting private sector growth. This shift in policy opened the door for FDI.

In 1978 the Joint Ventures Act enabled foreign investors to invest within China’s borders by entering into joint ventures with existing Chinese firms (Angresano and Zhang, 2000). Within a few years, new rules further facilitated FDI in fourteen coastal cities. After the 1989 political incidents the flow of FDI slowed for a brief period. However, changes in tax rules and Deng Xiaoping’s endorsement of the special economic zones (SEZs) reassured foreign investors that their property was safe and that Chinese entrepreneurs were given sufficient freedom to expand private enterprise activity.

Table 1: Annual Foreign Direct Investment in China, 1979 - 2002

Year	FDI, utilized* (US \$billion)	Number of Projects
1979-82	1.77	920
1983	.92	638
1984	1.42	2166
1985	1.96	3073
1986	2.24	1498
1987	2.31	2233
1988	3.19	5945

Year	FDI, utilized* (US \$billion)	Number of Projects
1989	3.39	5779
1990	3.49	7273
1991	4.37	12978
1992	11.01	48764
1993	27.52	83437
1994	33.77	47549
1995	37.52	37011
1996	41.73	24556
1997	45.26	21001
1998	45.46	19799
1999	40.32	16918
2000	40.72	22347
2001	46.84	
Total	\$395.3	363,885

*Amount of FDI actually realized rather than contracted for (approved). Note that forms of FDI include joint venture, contractual joint venture, wholly foreign owned enterprise, FDI share-holding system, and joint exploration.

**This represents a 12.4 percent increase on a year-on-year basis. Meanwhile, contracted FDI of over \$55 billion represents growth of almost 33 percent on a year-on-year basis during the first 7 months of 2002.

Sources: *The Economist Intelligence Unit, China Hand, February, April 2002; China Statistics Yearbook, 2001; Almanac of China's Foreign; Almanac of China's Foreign Economic Relations and Trade, 2001; (www.chinagate.com.cn, 8/14/02).*

ECONOMIC THEORIES AND OLI PARADIGM

Any analysis of the development of FDI inflows over time and their regional distribution must take into account reasons why an enterprise should engage in investment projects outside its home region (Yang, 2003). The theory of the multinational corporations (MNC) as developed by Hymer, Kindleberger, Heckscher, Ohlin, Casson, Vernon and others, and integrated in Dunning's eclectic OLI paradigm identifies four fundamental motives for FDI, a mixture of which usually determines the investment behaviors of MNCs: resource seeking FDI; efficiency seeking FDI; market seeking FDI; and strategic asset / capability seeking FDI (Yang, 2003):

1. Resource seeking FDI is motivated by the desire to exploit interregional factor price differentials for the MNCs production process. This type of FDI usually amounts to a vertical split of the MNCs production process between skill and/or capital intensive processes at the headquarter, and labor intensive manufacturing

abroad. As the various factor proportions found in the host economy often go hand in hand with low local purchasing power, the FIE are usually export oriented.

2. Efficiency seeking FDI has a similar pattern. It is driven by the desire to realize economies of scale and scope, to diversify the MNCs' risk exposure, and to take advantage of the different comparative cost advantages of various economies for the MNCs' production process.

In the past, the most important causation of the overseas firms investing in China was to make use of Chinese very cheap labor and natural resource.

Prior to economic reform China was a very poor country, and even today employees earn low wages except in Beijing (China's Capital) and Shanghai (China's largest city). Even in these two world-class great cities, the average wages are still much lower than North America, Western Europe and Japan, Korea etc. According to: "In 2001, Chinese employees' average salary is RMB 10,870 per year (the present exchange rate of the RMB to Krone is 1 : 0.7814). While in Shanghai and Beijing City this number is RMB 30,085 and 21,852 respectively. However, the gap between wealthy and poor is very remarkable. For example, in Shanghai city it is popular for a section manager to acquire more than RMB 10,000 per month and a senior consultant in McKinsey Company could earn RMB 20,000 per month. The salary of Accountancy Manager of Shanghai Maersk could attain to RMB 30,000."

It is important to point out that great numbers of young strong farmers have headed to almost all of the big cities to look for all kinds of labor, improving China's labor market. Many dream of becoming wealthy and taking their money back home. Currently, in Shanghai city, these skilled workers can only earn RMB 1000 or so per month and do not complain about their low wages, for the most part. In the other cities, this number is even lower.

With the development of the economy, Chinese education is also improved. At the same time, more and more Chinese students have acquired opportunities of leaving the country to further their education, which was not a possibility, their parents. Currently, MNCs have gradually built many research and development centers, engineering centers and research labs to exploit the Chinese market even more.

In addition, MNCs are providing more and more white-collar positions. For example, in Microsoft's headquarters there are 350 researchers; in the village of

Silica and Cambridge there are 21 and 80 respectively. While in Beijing's research and development center, this number is 180. In addition, a total investment of 40 million US dollars over the next few years will be used to expand the company's Asian Regional Engineering Center in Shanghai. The scale of the center will double, from the current 300 engineers to 600 engineers. According to the CEO of Microsoft Asia Research Center Zhang Yaqing, this will help company accomplish research items more quickly that build research and development centers all over the world.

Besides the labor resource, China also possesses advantageous physical conditions with great natural wealth. Cheap and sufficient natural resource is also one of the very key factors attracting FDI especially for the industry enterprises. In China, the well-known reserves of tungsten, antimony, vanadium, titanium, zinc, lithium, stannum, rare earth, magnesite, fluorite, barite, graphite, and plaster are the best in the world.

3. According to Yang (2003): "Market seeking FDI is motivated by the intention to supply a market that until then had been supplied with exports (if at all) with locally produced goods. It is not the differences in factor prices that lead to this move, but rather the appraisal of proximity to the foreign market versus the advantages of concentration of the production process at one location. Whenever the advantages of proximity outweigh those of concentration, FDI will appear to be a rational choice. This type of FDI may be classified as "horizontal" as the production process is not split, but rather duplicated at the foreign location. Specific reasons motivating market seeking FDI may include the potential of the foreign market, the need for complex product adaptations to local tastes and demand structures, the wish to follow important customers into the foreign market, etc. Given the existence of a reasonable market size, the willingness for market seeking FDI operations may also be prompted by the need to circumvent barriers to trade erected by the host economy."

4. Strategic asset / capability seeking FDI is based on strategic considerations with the intention of consolidating and strengthening the long-term competitiveness of the corporation. Such FDI operations may be driven by a company's motivation to occupy market shares and achieve learning effects in an early stage of market development, to block or inhibit business

activities of competitors, or to counter the move of a competitor already positioned in the foreign market.

Over the past several years, there has been a sharp rise in the living standards of the Chinese people. The annual growth of consumption per capita has been about 15 percent, and annual average growth in the saving deposit balance of residents have been over 50 percent since 1978. As a result of higher incomes, dramatic changes in the Chinese life style are taking place. Chinese consumers now demand convenience, variety, and natural materials. If ranking according the lever of purchasing power, China is already the second biggest economy region. In addition, China is rapidly developing a potentially enormous market, which could decide who would become the leader of the tomorrow's business world.

"China is the most populous country in the world, and it's becoming an ever more important location for information technology," said Michael Rawding, Microsoft's Greater China Regional Director; "China is the biggest and most important market for Ericsson in the world. China, a central supplier for Ericsson's global chain, provides product and service for Ericsson's worldwide customers," said Ericsson China president Jan Malm; "We have long realized the importance of China in our strategy for growth and have made significant investment in Asia-Pacific as a whole in recent years," explained Arthur van der Poel, Philips Semiconductors president and CEO; Christopher Galvin, chairman and chief executive officer of Motorola, said that the directorate of Motorola has full confidence in the Chinese market and will promote closer cooperation with information industry players of the country; manufacturing giant Toshiba said the Chinese market will be the mainstay of its global operation by 2008 as the company plans to increase its investment in China by stages in the next five years. Obviously when they are investing today, they are considering the future.

5. Tax Reduction, exemption and refund

The Chinese government has implemented various policies to attract overseas firms invest in China. The most attractive policy is that it levies low tax on enterprises with foreign investment, and preferential tax policies are offered to the sectors and regions where investment is encouraged by the state.

BENEFITS OF FDI TO CHINA'S ECONOMY

Aside from the profits received by foreign investors, China has reaped many benefits from FDI (Angresano and Zhang, 2000). From the perspective of political authorities the technology transfer and increase to labor productivity from FDI has contributed to China's ability to transform its economy gradually while enjoying a high rate of growth and development and opening its economy to outside investors.

Rapid development of the SEZs, powered by FDI, enabled China to speed up its rate of transformation towards a more market-oriented type of economy that integrated China's market with the global market while developing the economy at a pace that alleviated the types of adverse effects encountered throughout Central and Eastern Europe when the economy suddenly experienced foreign competition (Angresano and Zhang, 2000). During the transformation wealthy Chinese have gotten richer, but there is little evidence that the poor have become poorer in general (Johnson, 2002).

China has realized benefits from the rapid increase in total exports from about \$10 billion in 1978 to over \$125 billion in 2001 (Angresano and Zhang, 2000). The value of China's exports is now ranked at 10th in the world. Much goes to the "foreign-owned" manufacturing enterprises for this export growth (Economist Intelligence Unit, 2002b). A major portion of FDI is for developing manufacturing facilities to produce goods for export. Exports from Nokia's eight joint ventures made up about \$2.3 billion in 2001, making it the largest foreign-investment exporter in the country's communication sector (Li, 2002).

Job creation has been a major benefit of FDI. For example, Nokia has invested heavily in China, and one new manufacturing facility located in the Beijing area has brought about 15,000 jobs (Li, 2002). Foreign-owned, export-oriented enterprises have sharply increased income and benefit levels since foreign firms usually pay more and offer more comprehensive benefit packages than local Chinese-owned firms (Angresano and Zhang, 2000). Another benefit from rapid export growth has resulted from its contributing to China's very positive balance of trade. The IMF projects the overall balance of payments will mark a surplus of at least \$15 billion in 2002. In the process foreign exchange reserves have increased consistently to over \$210 billion by the end of 2001, more than twice the 1995 level (IMF, 2001).

As a result, China has sustained the Yuan's value relative to the dollar at very close to a \$1 = Yuan 8.28 for the past five years. This stability has enabled the country to maintain high foreign investor confidence, thus promoting FDI in China.

Another benefit FDI has given China has been the dynamic style of leadership, openness to change, new technology, and managerial expertise introduced by foreign firms (Angresano and Zhang, 2000). These firms bring new attitudes and develop skills in Chinese workers which not only help the foreign owned firms, but which will be transferred if these workers switch employment to locally owned firms (Angresano and Zhang, 2000). The new attitudes include efficiency, competition, merit-based rewards systems, and quality control. There is evidence that domestic firms have begun to copy the training practices and attitudes of foreign firms. Some foreign firms also have contributed to furthering the Chinese understanding of environmental issues, including germs in water, immunization, plant breeding, and improved environmental quality through forestation.

The case of Unilever demonstrates some of these benefits (Angresano and Zhang, 2000). Unilever originally invested in China during the 1920s, left during the 1950s along with many foreign firms, and returned in 1986 with its "Home and Personal Care Products," which at the time were luxury goods for most Chinese people. By 2000 Unilever had invested over \$800 million in China. Today, the company has 17 brand names under which over 2000 products are produced and sold throughout the country. It employs more than 4000 Chinese workers.

According to Unilever administrators, the company has given each employee the opportunity "to grow like a tree" - with the Unilever learning tree based upon basic knowledge as the roots, function and skills as the trunk, and branches and leaves for specific senior-level training (Unilever, 2001) (Angresano and Zhang, 2000). Unilever also teaches the concept of a brand throughout China (a country with many locally produced products but few domestic products which are national "brands"), emphasizing that brands are intended to protect the consumer. Civic projects funded by Unilever include a program under which performers from rural areas receive travel and expense funds to perform throughout China, and a national environmental project that will plant 1.25 million trees.

It is important to note that there are also many costs borne by China from FDI (Angresano and Zhang, 2000). These include the adverse impact of the demonstration effect, which fast food, especially that of McDonald's and Kentucky Fried Chicken, is having on Chinese eating habits, particularly in regards to children. There has been a significant increase in obesity rates in cities where such fast food restaurants have been introduced. Foreign vehicle producers, by encouraging sales of their vehicles throughout China, are aggravating an already poor air quality. Some local producers are also being displaced by FDI, with a corresponding loss in traditional values, goods and services. Additionally, with the increasing FDI, it is inevitable that foreign cultures are spreading as quickly and challenging traditional Chinese culture.

SOURCES AND PURPOSES OF CHINA'S FDI

Since 1985 over 85 percent of FDI into China has been invested in SEZs located in eleven provinces and provincial-level cities along the eastern coast, particularly in Southern China's Hainan and Guangdong provinces, as well as to the greater Shanghai and Beijing areas (Economist Intelligence Unit, 2002b). The Shanghai area has received over \$3 billion in FDI annually since 1997, with about 30 percent going to the Pudong SEZ (Angresano and Zhang, 2000). This SEZ has attracted almost \$40 billion in FDI since 1990. Firms established from FDI are so important to Shanghai that they now account for about 30 percent of its GDP, 50 percent of its fiscal revenue, and over 75 percent of its high-technology output (China Daily, 2002a). Only about 15 percent of all FDI has gone into China's central and western provinces where the relatively poor infrastructure, modest-sized and scattered markets, and a less advanced business culture have turned off investors.

Before the early 1990s most FDI came from overseas Chinese: between 1978 and 1983 about 80 percent originated in Hong Kong or Macao, and for the 1979 to 1996 period the percentage from Hong Kong was about 57 percent (Economist Intelligence Unit, 2002b).

Recent estimates of the origination for China's FDI place about 40 percent from Hong Kong and Macao, followed by the USA (11 percent), EMU, with Britain being Europe's top investor, 11 percent, Japan (8 percent), ASEAN 8 percent, Taiwan (6 percent), and 16 percent from the rest of the world (Wolf, 2002).

Recently, Taiwanese manufacturing industries have invested over \$60 billion in China (The Economist, 2002). Some of these Taiwanese firm, and other foreign companies handle their China investments through subsidiaries located in Hong Kong, The Cayman Islands or Virgin Islands (Angresano and Zhang, 2000). This practice and the peculiarities of tax and foreign investment laws and rules for firms establishing "offshore" companies in China, Hong Kong (prior to 1997), Taiwan, the Virgin Islands, Bermuda, and The Cayman Islands make accurate identification of the "foreign" investors' place of origin.

According to Angresano and Zhang (2000): "Some of the subsidiaries established to facilitate preferential tax treatment have no operating assets. This is done to take advantage of tax rules or to avoid politically motivated policies since some offshore jurisdictions do not levy taxes on firms registered there on any external business those firms conduct. Further, there are reasons to believe that the data concerning FDI from Taiwan are understated. In order to avoid restrictions imposed by the Taiwanese government on investing in Mainland China some Taiwanese investors establish "shell companies" in Hong Kong as a "front for their [mainland China] operations."

In response to limitations imposed by their government on infrastructure project investment, Taiwanese investors are now investing in medium and small manufacturing facilities" (Economist Intelligence Unit, 2002b). Even some mainland Chinese companies look for these tax havens, which explains the relatively large inflow of FDI from Hong Kong, the Virgin Islands, Bermuda and The Cayman Islands.

CASE FOR GLOBALIZATION

According to Farrell (2004), few topics are more intensely debated or generate more controversy than the pros and cons of globalization, especially foreign direct investment (FDI) by multinational companies (MNCs) in emerging markets, such as China.

The McKinsey Global Institute recently studied the impact of FDI on local industries in China, India, Brazil, and Mexico, including manufacturing and service sectors (Farrell, 2004): automotive, consumer electronics, banking, food retailing, and information technology and business process outsourcing. In each

of fourteen industry studies, the institute analyzed the change in industry dynamics, sector productivity, output, employment, and prices before and after foreign players entered time market, and conducted extensive interviews with foreign and local executives.

The research revealed that FDI is indeed good for the economic health of developing countries, regardless of the policy regime, industry, or time period studied (Farell, 2004). In thirteen out of fourteen case studies, FDI increased productivity and output in the sector, increasing national income while lowering prices and improving quality and selection for consumers. Despite criticisms of the impact of FDI on emerging countries' economies, this research showed that foreign companies paid higher wages and were more likely to comply with local labor laws than domestic companies.

The McKinsey Global Institute revealed that FDI impact on host countries significantly differed depending on what investors were seeking—lower costs or new markets. Investment by companies seeking lower costs—known as “efficiency-seeking” investment—resulted in improved sector productivity, output, employment, and standards of living in the host countries, with few negative consequences (Farell, 2004). This type of export-oriented FDI posed little threat to locally owned businesses, who instead often benefit as foreign companies look for local distributors and suppliers. They can also benefit by copying and building on what the foreign players are doing, as demonstrated by the domestic Chinese consumer electronics and high tech industries.

Companies seeking new markets in the host countries also had a positive economic impact. In these “market-seeking” cases, however, the impact on employment was mixed and the benefits were often at a cost to incumbent, less productive companies (Farell, 2004).

The impact on domestic living standards is one positive result of FDI (Farell, 2004). In most of the emerging countries studied, the institute saw lower prices and better selection after foreign companies arrived, mainly because they have a tendency to improve the efficiency and productivity of the sector by bringing new capital, technology, and management skills and forcing less efficient domestic companies to either improve their operations or leave. While incumbent companies stand to lose, consumers benefit. Often, lower prices then led to an increase in demand and industry growth.

In market-seeking FDI scenarios, prices to consumers declined in seven out of ten cases, and product selection increased in all but the retail banking cases (Farell, 2004). The impact on prices was major in some cases: for example, Chinese consumers saw passenger car prices decrease by more than 30 percent between 1995 and 2001, although consumer prices more broadly grew by 10 percent during the same period.

Efficiency-seeking FDI cases tended to have a more limited impact on host country consumers as most production is for export and benefits global consumers (Farell, 2004). However, even in these cases, the presence of foreign players benefited domestic consumers—either in the form of broader selection enabled by local production. Indirectly, national income grew through improved productivity and output in many sectors and their suppliers.

According to Farell (2004): “These results suggest that many of the criticisms directed at foreign companies today are not broadly warranted. Rather than being beneficial in only select circumstances, it appears that foreign investment nearly always generates positive spillovers to the rest of the economy.”

To reap the most benefits from FDI, developing nations, such as China, should focus on stabilizing their economies and promoting competitive markets (Farell, 2004). Macroeconomic instability discourages long-term investment because it makes demand, prices, and interest rates hard to forecast.

Competition is crucial for diffusing the positive impact of foreign investments (Farell, 2004). If a country lacks competitive markets, the entry of foreign players is not likely to have much effect on inefficient domestic incumbents and productivity. FDI had the most dramatic impact in countries where domestic incumbents were not shielded from foreign players, such as the consumer electronics industry in China. To promote competitive markets, developing nations must reduce restrictions on FDI, lower import tariffs, and streamline requirements for starting new businesses and conducting mergers and acquisitions.

Another way for developing countries to promote fair competition is to crack down on companies in the informal economy, or “gray” market, who do not pay taxes or comply with regulatory requirements (Farell, 2004). This allows them an unearned cost advantage, enabling them to stay in business, despite their small scale and inefficient operations.

Finally, developing countries should make every effort to build a strong infrastructure, including roads, power supply, and ports, especially if they are seeking to attract export-oriented foreign investment (Farell, 2004).

As criticism increase about globalization, many observers question whether it has broadly alleviated poverty and increased standards of living (Farell, 2004). The evidence from this paper clearly shows that it can. Rather than rejecting foreign direct investment, developing nations would do better by embracing it and implementing sound policies to get the most from it.

Foreign capital is once again playing an increasingly important role in developing countries.

Gross value of foreign capital stock in developing countries.

Year	Percent of developing world GDP	Total stock in current prices billions of dollars
1870	8.6	\$4.1
1914	32.4	\$19.2
1950	4.4	\$11.9
1973	10.9	\$172.0
1998	21.7	\$3,590.2

Source: *The World Economy: A Millennium*

ARGUMENTS AGAINST FDI IN EMERGING ECONOMIES

The idea that foreign investment is always good for development, and that a liberal policy towards foreign investment and MNCs is sufficient to achieve positive effects is frequently challenged, as demonstrated in a recent study by two Latin American economists (Raghavan, 2000).

The study revealed that there is “crowding in” effect of FDI on domestic investments only where the governments of emerging nations maintain restrictive regimes and subject FDI applications to screening and grant of different incentives to different firms (Raghavan, 2000). However, in countries that maintained or moved to ‘open’ regimes for MNCs and their investments, there is frequently a “crowding out” effect on domestic investment, according to the study.

The term ‘crowding in’ (CI) is used when the presence of the foreign direct investment by an MNC stimulates new downstream and upstream investments that would not have taken place in their absence (Raghavan, 2000).

A ‘crowding out’ (CO) effect frequently occurs when the MNCs and their foreign investment displace locally owned firms or pre-empt their investment opportunities. A neutral effect occurs when a dollar of FDI results in a very small investment in the economy.

According to Raghavan (2000): “This is an important issue in development economics and literature: if investment is a key variable in determining economic growth, does the presence of MNCs in an economy and the FDI flows associated with them result in increased total investment in an economy or reduces total investment in the economy.”

The study by two Latin American economists, Manuel Agosin and Ricardo Mayer, in showing either a crowding out effect or at best a neutral effect, challenges the idea of the push for liberalization of FDI and policies towards MNCs by developing countries, and creating multilateral or regional rules and disciplines (on emerging countries) (Raghavan, 2000).

The policies of FDI liberalization by developing countries have been promoted since the early 1980s by economists and by the industrialized countries at the World Trade Organization (WTO) (Raghavan, 2000). Following the collapse of the moves at the OECD for a Multilateral Agreement on Investment (MAI), to provide greater rights for foreign investors (including the right of entry and exit in any economy, and disciplines on the governments of emerging countries), the European Union (EU) and Japan have been trying to achieve similar results by bringing on the agenda of the WTO the so-called “Trade and Investment” issues as well as funding related projects in UNCTAD.

However, the study, ‘Foreign Investments in Developing Countries: Does it Crowd in Domestic Investment’, challenges one of the central ideas of the neo-liberal economics, mainly that FDI and MNC presence in an economy, and liberalization policies to bring this about, has a beneficial effect on the host (Raghavan, 2000).

The study, which looks at 32 countries in Africa, Asia and Latin American and Caribbean, contradicts one of the conclusions of UNCTAD’s World Investment Report 1999, which discussed the same issue (pp 171-174) and cited an annexed model (189-191) (Raghavan, 2000). The WIR does not indicate the authors of the econometric exercise cited in support but the econometric model and exercise in the annex appears to be similar, if not the

same, as in the discussion paper of Agosin and Mayer, which uses a theoretical model of investment with FDI as one of the independent variables.

According to Raghavan (2000): "The somewhat different conclusion was reached by the WIR by including, in an ad hoc and unexplained way, seven more countries. The seven included are Cyprus Turkey (shown here as in Europe), Poland (a transition economy) and Oman, Saudi Arabia, Jordan and Egypt -- with all of them shown as in West Asia. In main annex tables though the WIR classifies, Cyprus and Turkey as part of West Asia, while Egypt is classified as North Africa. For the box, and the annex, Cyprus and Turkey are described by WIR-99, as 'developing countries' from Europe and Oman, Saudi Arabia, Jordan as from West Asia, but with Egypt thrown in this group. But elsewhere in the main annexed tables of the WIR (for e.g. Annex B at p 491), Cyprus and Turkey, with Saudi Arabia, Oman and Jordan are classified as part of West Asia, while Egypt is shown in North Africa. This enables the WIR (in the annex of econometric analysis) to suggest in the table that in West Asia there is both crowding in and neutral effect."

The WIR reaches this conclusion by dividing the effects over two periods, that Africa showed strong CI effect in the first period (1976-1985) and a weak CI effect in the second (Raghavan, 2000). In addition, the WIR reaches a different view (than Agosin and Mayer) by "what may at best be described counter-factual based on assumptions such as 'gains in efficiency, if crowded out (domestic enterprises) are inefficient."

According to Agosin and Mayer, FDI is prized by developing countries for the package of assets that MNCs deploy with their investments (Raghavan, 2000). Many MNC 'assets' are intangible in nature -- technology, management skills, channels for marketing products internationally, product design, quality characteristics, brand names, and more. In addition, they are usually scarce in emerging economies.

However, when evaluating the impact of FDI on development, an important question is whether MNCs crowd in domestic investments or they have the opposite effect of displacing domestic producers or pre-empting their investment opportunities (Raghavan, 2000). Agosin and Mayer believe that this is a rather important issue, as theoretical and empirical works identify investment as a key variable of determining economic growth.

"Thus, if FDI crowds out domestic investment or fails to contribute to capital formation, there would be good

reasons to question its benefits for recipient developing countries (Raghavan, 2000)."

Taking into account the scarcity of domestic entrepreneurship and need to nurture existing entrepreneurial talent, a finding that TNCs displace domestic firms, say Agosin and Mayer, "would also cast doubts on the favourable development effects of FDI."

These are all crucial questions, when one considers FDI is far from being a marginal magnitude, but as a share of total gross fixed capital formation is and important and growing magnitude in the developing world, and is a much larger proportion of investment in developing than in developed countries.

FDI is a financial balance-of-payments concept, while investment is a real national accounts variable. "Much FDI," the two authors say (Raghavan, 2000), "never becomes investment in the real sense: mergers and acquisitions (M&As) are mere transfers of ownership of existing assets from domestic to foreign firms."

The assessment of effects of FDI on domestic investment is an important subject, but little could be said on an a priori basis and may vary across countries "depending on domestic policy, the kinds of FDI that a country receives and the strength of domestic enterprises (Raghavan, 2000)."

However, it is entirely possible to specify conditions favorable to a CI, according to the authors (Raghavan, 2000). In an emerging economic setting, foreign investments that introduce goods and services new to the domestic economy, be they for export or domestic markets, are more likely to have positive effects on capital formation than foreign investments in areas where there are already local producers.

FDI could contribute to development if it introduces new goods to the economy - and with it technology and human capital - that do not have the expertise to human resources to produce them (Raghavan, 2000). However, if FDI enters the economy in sectors where there are competing domestic firms, or firms already producing for export markets, the act of foreign investment may take away investment opportunities open to domestic entrepreneurs before FDI entered the picture.

Such FDI is likely to cut back local investments that would have been undertaken by local firms. The contribution of such FDI to total capital formation is likely to be less than FDI itself.

According to Raghavan (2000): "Thus, the relationship between FDI and domestic investment is likely to be

complimentary when investment is in an undeveloped sector of the economy (owing to technological factors or lack of knowledge of foreign markets). But the FDI is more likely to substitute for domestic investment when it takes place in sectors where there are plenty of domestic firms or when domestic firms already have access to technology that the MNCs bring into the country. Even where FDI does not displace domestic investment, foreign investments may not stimulate new downstream or upstream production and therefore might fail to exert CI effects on domestic investment.”

“Thus the existence of backward or forward linkages from the establishment of foreign investors is a key consideration for determining the total impact of FDI on capital formation,” according to the two authors (Raghavan, 2000).

The linkages are important but not a sufficient factor for CI and, in cases where local firms simply displace existing ones, the existence of linkages cannot prevent CO (Raghavan, 2000). Thus, the impact of FDI on investment is greater when it is greenfield investments rather than when it is M&As.

Initial studies of M&A in Argentina and Chile (in early 1990s), involving privatization of telecommunications and public utilities, revealed that there was post-purchase investments in modernization and rationalization of operations (Raghavan, 2000). However, in the case of several other acquisitions in Latin America, the acquisition of locally owned firms were similar to portfolio investment, with the MNCs doing nothing to improve the operation of the local company.

“Very recently,” the authors argue (Raghavan, 2000), “there have been a large number of cases of FDI (involving acquisitions), all with doubtful impacts on capital formation. Many of the acquired companies are not in need of modernizing, since they operate with state-of-the-art technology. Nor is it likely that their purchase by a foreign company will be followed by sequential investment that the acquired firms would not have made themselves. In such cases, the act of FDI is not investment in the national account sense, and does not lead to investments later on.”

Major M&As, like large portfolio inflows, might have negative macro-economic externalities (Raghavan, 2000). When of a size no longer considered marginal, they tend to appreciate the exchange rate and discourage investment for export markets, and for the production of importables as well.

The Agosin-Mayer paper points out that some of the most successful newly industrializing economies restrict foreign ownership: in Taiwan province of China foreign equity ownership in domestic enterprises are restricted, with no single person or entity able to own more than 15 percent of a domestic company and foreigners as a whole not allowed to own more than 30 percent of a domestic company (Raghavan, 2000).

According to Raghavan (2000): “In their econometric exercise, Agosin-Mayer show that over the period 1970-1996, FDI had a CI effect in three countries of Africa (Cote d’Ivoire, Ghana and Senegal), a neutral effect on 5 African countries (Gabon, Kenya, Morocco, Niger and Tunisia) and a crowding out (CO) effect on four others (Central African Republic, Nigeria, Sierra Leone and Zimbabwe). In Asia, there was a CI effect in three cases (Korea, Pakistan and Thailand), and a neutral effect on five others (China, Indonesia, Malaysia, the Philippines and Sri Lanka). There was no country in Asia that experienced a CO. In Latin America, there was a neutral effect on seven countries - Argentina, Brazil, Colombia, Costa Rica, Ecuador, Mexico and Peru. There was a CO effect on five others - Bolivia, Chile, the Dominican Republic, Guatemala and Jamaica. There was no case of CI effect in the region.”

The econometric exercises, Agosin and Mayer say, suggest that over a long period of time (1970-1996), CI has been strong in Asia, and CO is dominant in Latin America (Raghavan, 2000). In Africa, FDI increased overall investment one-to-one. If the exercise is done for two sub-periods separately (1976-1985 and 1986-1996), the results are different only for Africa, which then appears as having CI rather than neutral-effects. According to: “The main conclusion that emerges from this analysis is that the positive impacts of FDI on domestic investment are not assured.”

In many cases, total investment may increase much less than FDI or may even fail to rise when a country sees an increase in FDI (Raghavan, 2000). “Therefore the assumption that underpins policy towards FDI in most developing countries -- that FDI is always good for a country’s development and that a liberal policy towards TNCs is sufficient to ensure a positive effect -- fails to be upheld by the data.”

The study notes that some countries had been successful in screening policies to make sure that FDI does not displace domestic firms or that MNCs contribute new technologies or introduce new products to the

country's export basket (Raghavan, 2000). However, most emerging countries lack the administrative capabilities to implement effective screening policies and their attempts to do so often wind up scaring off foreign companies altogether. An alternative is to adopt a fairly liberal regime, and then go after specific companies that fit in well with the process of progressing up the quality ladder.

The authors suggest that CI in Asia may also be associated with high overall investment rates (Raghavan, 2000). Where investment is strong, investment by MNCs might bring out positive investment responses in the domestic economy through backward or forward linkages. CI may also take place in countries with low domestic investment rates, such as those in Africa, where MNCs invest in sectors that domestic investors are unable to enter due to technological or capital requirements that domestic firms cannot meet. This point of view leads to the conclusion that even in Africa, countries should not bind themselves by agreeing to investment rules for all time, and for all sectors, but rather keep the options open for the future.

"Latin America," Agosin and Mayer conclude (Raghavan, 2000), "is the great disappointment. One reason for the CO in that region is that overall investment has been much weaker in Latin America than in Asia. It could also be that Latin American countries have been much less choosy about FDI than Asian countries, either in the sense of prior screening or attempting to attract desirable firms."

FUTURE OF CHINA

China's gross domestic product (GDP) is predicted to grow by more than 8 percent in 2005 compared with an estimated 9 percent this year, according to recent National Bureau of Statistics of China statistics (Beijing Portal, 2004). The majority of the 50 leading Chinese economic experts that participated in the bureau survey suggested that China's economy may slow down in 2005 as a result of the government's macro-control measures implemented since 2003.

While China has enjoyed massive success over the past several years, it is unclear whether it is catching up to the U.S. in terms of economic power. According to Foy and Maddison (1999):

"It has become popular, if unrealistic, to speak of levels of growth of around 10 percent. This is understandable,

in a sense; Chinese official figures, upon which most other estimates are based, do show such rates of growth. However, the Chinese national accounting system is based upon old Soviet methods, essentially relying on output reports from enterprises and production units in the countryside. This method is crude and unsound, and can be used to provide only part of the calculation. When standard OECD accounting procedures are employed to evaluate China's GDP growth in purchasing power parity terms, however, it can be shown to have been lower, though still strong, at 7.5 percent per year since 1978."

If China were to reach an overall level GDP equal to the United States, the largest economy in the world, an annual rate of growth of approximately 5.5 percent would be required up until about 2015 (Foy and Maddison, 1999). Based on past performance, this seems to be possible, especially if China's leadership continues to promote economic adaptation to the requirements of international competition. This means continued improvements in the efficiency of human and physical capital allocation; further embracing foreign technology and adapting it to China's special needs; and allowing identification and implementation of comparative advantages.

The Chinese economy is still handicapped by an excessive number of loss-making state enterprises that will either need to be reformed or closed (Foy and Maddison, 1999). In the former Soviet Union and in other economies being transitioned from command to market economy, this process has resulted in hardship and political instability. China must handle certain problems strategically, particularly that of unemployment, as state-sector employment currently offers social benefits such as health care and housing that workers depend on given the absence of state-wide systems. Suppression of jobs would lead to serious social consequences.

Key to the problem of inefficiency in state enterprises is the need to reform China's banking and financial system (Foy and Maddison, 1999). During the initial stages of opening up the economy, the Chinese monetary authorities could not control the financial system's development. This caused inflationary pressures and inefficient allocation of savings. While the banking system, which is supporting inefficient state enterprises through the bad loans it has made to them, remains under state control, a parallel system of non-banking financial intermediaries (NBFIs) has emerged which provides financing for the non-state sector by using a proportion of private savings. These NBFIs – trust and investment

companies, urban credit co-operatives – have helped to satisfy enterprise-wide needs for investment loans and have benefited from transfers from the state banks which use them for their specialized knowledge. This has resulted in excessive credit creation. Reforms in 1994 partially remedied the situation, but this mix must still be reconciled and the non-bank financial intermediaries must become real competitors of the banks through a wide-ranging rationalization and renewal of the whole financial system.

Finally, the weak fiscal position of central government needs to be strengthened. Current relations between the central and regional governments for tax-raising purposes must be clarified and the tax base increased to replace the current use of extra-budgetary income.

In general, as we enter the 21st century, China remains a poor nation (Foy and Maddison, 1999). This makes high growth rates easier to achieve but it also means that per capita incomes have a long way to go to reach those of the U.S. and other major OECD countries. Per capita GDP increased by an average annual rate of 6 percent from 1978 to 1995; it can be expected to grow by a more modest (but still honorable) 4.5 percent between now and 2015. That increase will bring China up to the world average, but still well below the OECD average and to only one-fifth of the U.S.

According to Foy and Maddison (1999):

“With 5.5% overall GDP growth in the same period, China would account for 17% of world GDP, giving the country a much greater weight in the global economy. This implies growth in Chinese exports, but also corresponding increases in imports which would stimulate the world economy generally. Despite the current difficulties in Asia’s normally dynamic economies, the region as a whole can be expected to recover and assume growing importance in the world economy over the medium term. Provided it continues to open up to the world economy, China will have a key role to play in determining the pace and form of that recovery.”

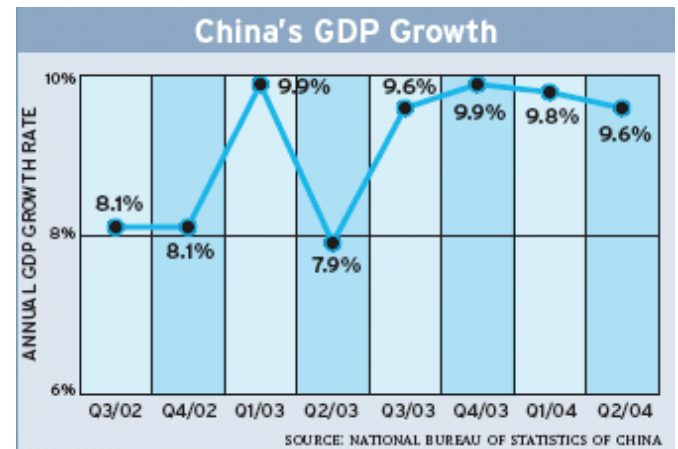
The Western business press frequently underplays the global significance of economic development in China (Hansen, 2004). Shanghai makes New York City look like a provincial town, and Beijing does the same to Los Angeles. According to Goldman Sachs projections, China is likely surpass France in GDP by the end of 2004; it is expected to surpass the United Kingdom in 2005. In

12 years China’s GDP will be larger than Japan’s, and China is slated to become the world’s dominant economy within the next four decades.

A middle class of more than 100 million consumers is the main force of the expansion (Hansen, 2004). Shanghai store are full of rich, young Chinese consumers. BMW plans to produce 50,000 cars a year in its new Shenyang factory by 2005. Motor vehicle sales increased by 43.7 percent in the first half of this year, and sales of telecommunications equipment increased by 52.3 percent.

Foreign direct investment jumped 12 percent in the first half of 2004 to \$33.9 billion (Hansen, 2004). American companies are pouring money into China, but their spending falls well behind investments from European and East Asian companies. And it does not begin to compete with the country’s huge market growth.

Volkswagen currently dominates Chinese car sales, with a 30 percent market share (Hansen, 2004). General Motors announced in June that it will invest \$3 billion in China over the next three years, but it currently holds only 11.7 percent of the market. Potential market share for U.S. businesses will drop if they invest too cautiously.



SOURCE: Hansen, Fay. (October, 2004). Economic & Business Focus: The China Imperative. Business Finance Magazine, pp. 34-38.

The bureau reported that 81 percent of the experts considered that the GDP growth may surpass 8 percent, about half of them put it at 8.5 percent to 9 percent, and nearly 25 percent gave a forecast of higher than 9 percent (Beijing Portal, 2004). The average growth rate currently stands at 8.4 percent. Approximately 70 percent of the experts believed that the GDP would increase by 9 percent in 2003.

The experts predicted that the growth rate of capital asset investment would reach 27 percent by the end of 2004, less than the first half year and 15 percent less than the first quarter of 2004 (Beijing Portal, 2004). They estimated 2005's growth rate at 24 percent.

Stephen Roach, Morgan Stanley's chief economist released an analytical report in 2003, suggesting that as the world listed towards stagnation and deflation, China, which was making great economic progress, may be singled out as a source of global deflation (China Daily News, 2003). However, he noted, because Chinese imports account for less than 2 per cent of Japanese gross domestic product (GDP), it is unreasonable to accuse China of fueling Japan's deflation. He argues that Chinese exporters won their way into the global market by being more cost effective than their competitors, and that China should not be criticized for being a cost-effective producer.

The National Bureau of Statistics of China survey revealed that about 45 percent of the experts were optimistic about the increase in consumer demand in 2004, while 50 percent of them said consumer demand would stay the same (Beijing Portal, 2004). Real estate would remain as an important drive for increased consumer consumption in 2005. Half of the experts said the price of real estate would rise in 2005, 29 percent of them believed prices would remain the same as this year, and the remaining predicted a decline. The experts also pointed out significant problems, such as the supply of coal, electric power and oil, the shortage of capital in some enterprises and deep-rooted structural problems.

Even if the growth rate drops, most experts agree that according to China Daily, China will sustain an annual economic growth rate of above 7 per cent by 2020 (China Daily, 2004). Vice-Premier Zeng Peiyan announced this prediction at the ongoing China Business Summit 2004. His announcement echoed forecasts by the world's business leaders, who believe that the global economy will be gradually dominated by the United States and China, rather than just the U.S.

While maintaining its growth momentum, which has achieved an average growth of 9.4 percent over the past 25 years, it is expected that China's total volume of gross domestic product (GDP) will reach US\$4 trillion and per capita GDP, which surpassed US\$1,000 last year, will increase to US\$3,000 in 2020, Zeng announced (China Daily, 2004). The present US-centered world economy will thus become dominated by two countries in the next

decade, said Jeffrey E. Garten, dean of the Yale School of Management of Yale University.

In achieving this goal, China will be challenged by global competition for capital and resources and its ability to engage in international organizations such as the G7 (China Daily, 2004). Garten also warned that China should concentrate more on the protection of its culture and education while integrating with the global economy.

Many Chinese scholars agree with Garten's stance. "China's big challenge over the next 20 years will be a shortage of resources, especially an energy shortage," said Zhang Jianyu, head of the Beijing Office of the US-based non-governmental environmental organization Environmental Defense (China Daily, 2004). However, he pointed out that the Chinese Government is facing up to this challenge and is working to develop the economy in a sustainable way.

METHODOLOGY

With the increasing interest in emerging economies, researchers have begun to realize that conventional approaches often are unsuitable and have begun seeking new approaches specifically designed for the emerging economy institutional context. This section will briefly review two popular theories of the firm and their strengths and weaknesses in an emerging economy context (Young, 2003). Next, building on Foss's (1999a) theory of the firm framework, this section will explore the findings to address these questions (Young, 2003):

1. Why do firms exist in emerging economies?
2. How might the boundaries of firms differ in emerging economies?
3. How might the (formal or informal) organizational structure differ for firms in emerging economies?
4. What are sources of competitive advantage for locally owned firms in emerging economies?

STATISTICAL ANALYSIS

China's trade and foreign direct investment have some distinctive characteristics (Fung, 2004). Some of these characteristics have business and policy implications for the United States. By allowing foreign firms to substantially participate in its external sector, China is

often seen to be more open than many economies at similar stages of economic development.

Unlike many developing and transition economies, China attracts many foreign multinationals because of both its large and booming domestic market as well as its cheap but high-quality labor (Fung, 2004). However, to many foreign firms in the high-technology sector, China is not only a cheap export platform, but it is also an important link in the global supply chain.

It is crucial to put the presence of foreign firms in China in perspectives (Fung, 2004). In 2002, less than one percent of the stock of U.S. direct investment in the world was in China. In 2001, less than 4 percent of the employment of the non-bank majority-owned American affiliates abroad was located in China. It will take a long time before China can come close to have the amount of American direct investment and associated employment in countries like the United Kingdom or Canada.

In the 1960s and the 1970s, when European countries embarked on the initial stages of European economic integration, many were concerned that in some countries, whole industries or sectors would be eliminated (Fung, 2004). In later years, this was proven to be inaccurate. Part of an industry may move from Germany to Italy, but countries would specialize in niches of the same industry and trade with one another. For instance, Italian shoes are exported to Germany, while German shoes are exported to Italy. Most researchers now believe that due to this type of horizontal two-way trade, economic adjustments took place within industries and were not as large as anticipated.

In the case of China, a similar situation is likely (Fung, 2004). The economic integration of China into the global market system will increase global efficiency, but it will also cause dislocations and in some situations, major dislocations. However, countries in the Asia-Pacific will adapt to specialize in various stages of the global production process and increase their trade of differentiated components and parts with each other. For instance, Korean liquid crystal displays may be exchanged with Chinese motherboards. The increased vertical two-way trade of intermediate goods between China and its neighbors will reduce their costs of economic adjustments. Similarly, China's rapidly growing market represents concrete benefits to China's Asian neighbors, as well as to the United States.

Table 1: Determinants of Direct Investment in Different Provinces of China

	U.S. Direct Investment	Japanese Direct Investment	Hong Kong Direct Investment	Taiwanese Direct Investment
1% increase in Gross Domestic Product	Increase by 0.76%	Increase by 0.71%	Increase by 0.40%	Increase by 0.58%
1% increase in the Wage Rate	Decrease by 1.79%	Decrease by 1.57%	Decrease by 2.66%	Decrease by 2.64%
1% improvement in Labor Quality	Increase by 0.97%	Increase by 1.29%	Increase by 0.43%	Insignificant

Source: Fung, Iizaka and Parker (2002).

Table 2. Destinations of Sales of Japanese Affiliates in 2001 (%)

	Locally	Exported to Japan	The Third Country
China and Hong Kong	47.2	31.5	21.3
ASEAN4	38.8	28.1	33.0
NIE3	59.1	17.7	23.2
Asia	48.8	24.7	26.5
World	70.0	10.9	19.1

Source: METI (2002)

NIE3 includes Taiwan, Singapore and Republic of Korea

ASEAN4 includes Thailand, Indonesia, Malaysia and the Philippines

Figures may not add to 100% due to rounding.

Table 3. Motives behind Japanese Direct Investment, 1999

Motive	China and Hong Kong	ASEAN4	NIE3	World
Reasons related to lower costs	40.1%	37.6%	31.0%	30.0%
To expand their market shares in the country	20.9%	19.4%	24.1%	24.3%
To re-export to Japan	8.9%	6.7%	5.7%	5.8%
For research and development	0.7%	0.1%	1.0%	1.8%

Source: Fung, Iizaka and Siu (2003), METI (2001)

NIE3 includes Taiwan, Singapore and Republic of Korea

ASEAN4 includes Thailand, Indonesia, Malaysia and the Philippines

The answers are percentage of firms that pick that reason as their motives

Table 4. Characteristics of U.S. Multinationals in China

	Rate of Return in 2002	Share of U.S. Direct Investment Position in the World in 2002, by Industry	Share of U.S. Employment of Non-Bank Majority-Owned Affiliates in the World in 2001, by Industry
All Industries	14.1%	0.7%	3.3%
Manufacturing Industries	16.9%	1.6%	4.8%
Computer and Electronic Products	21.2%	2.8%	10.2%
Electrical Equipment, appliances and components	17.7%	6.0%	18.6%

Source: Survey of Current Business, September 2003, Mataloni, 2003.

The rates of returns and the shares of U.S. direct investment position in the world are for 2002. U.S. direct investment positions are measured by historical costs. The shares of employment by U.S. non-bank majority-owned affiliates are for 2001.

Table 5. The Effects of Foreign Direct Investment in China on Other Asian-Pacific Economies

Levels of Foreign Direct Investment in China's Neighbors	Foreign Direct Investment in China's Neighbors as Shares of Total Foreign Direct Investment in Asia	Foreign Direct Investment in China's Neighbors as Shares of Total Foreign Direct Investment in all Developing Countries
An increase of 1% of foreign direct investment from the world to China	Increase by 0.55%	Decrease by 0.23%
		Decrease by 0.19%

Source: Busakorn Chantasawat, K.C. Fung, Hitomi Iizaka and Alan Siu (2003a, 2003b).

The studies examine the effects of China's foreign direct investment on foreign direct investment inflows into Hong Kong, Taiwan, Republic of Korea, Singapore, Thailand, Malaysia, the Philippines and Indonesia.

Table 6. China's Two-Way Trade of Electric Equipment with its Neighbors, 2003

	Exports of Electrical Equipment to China (US\$1,000)	Rank in Exports to China	Imports of Electrical Equipment from China (US\$1,000)	Rank in Imports from China
Taiwan	17,075,435	1	2,470,679	1
Republic of Korea	13,224,831	1	4,122,382	1
Singapore	3,432,677	1	2,869,225	1
Thailand	1,984,551	2	888,914	2
Malaysia	7,179,539	1	1,587,136	2
Philippines	4,251,766	1	890,895	1
Indonesia	346,577	7	632,660	3

Source: China's Custom Statistics Monthly, 2003, December.

Table 7. Domestic Value Added Induced US\$1 of Chinese Exports, 1995, (US\$)

	Manufacture of Electric Machinery and Instrument	Manufacture of Electronic and Communication Equipment	Weighted Average of All Sectors
Direct Domestic Value-Added of Processed Exports	0.128	0.128	0.153
Total Domestic Value-Added of Processed Exports	0.144	0.138	0.176
Direct Domestic Value-Added of Aggregate Exports	0.148	0.155	0.240
Total Domestic Value-Added of Aggregate Exports	0.257	0.243	0.545

Source: Chen, Cheng, Fung and Lau (2001).

SUBJECT POPULATION

The subjects for this study were developing nations—especially China. For the purpose of focusing on China, relationships between various industries in China and their relationship with FDI were examined.

DATA COLLECTION

This report has presented a number of examples of how researchers view the impact of FDI on China's locally owned businesses. These examples are meant to inspire developing countries to adopt better FDI policies or to remind China that FDI controls are necessary.

The data for this study was collected from a wide variety of sources, including empirical studies, newspapers, magazines, university studies, census data, and more.

CONCLUSION

RESULTS

China has clearly set the goal of establishing a successful society in the next two decades and quadrupling its gross domestic product between 2000 and 2020. In order to achieve this ambitious goal, the emerging country will comprehensively improve the level of opening-up, further enhance economic and trade cooperation with countries and regions around the world. China was the first and biggest emerging market in the last decade. China is predicted be the first and largest existing market in the decades to come.

Foreign Direct Investment (FDI) is one type of private finance available for development.

It consists for about one fourth of "greenfield investment" (foreign companies financing the physical equipment of their subsidiaries), and for about three quarters of mergers and acquisitions (M&As) (foreign companies acquiring stakes in excess of 10 percent in domestic firms, including privatized ones) (Jacobs, 2001). Other types of private finance are bank loans and portfolio investments (purchasing bonds and equities).

Economic theories hold that FDI has the potential to be an important component of an emerging nation's development strategy.

FDI contributes to development in three major ways (Jacobs, 2001). First of all, capital inflows such as FDI enable countries to import more than they export, which enables them to invest more than they save and thus accumulate capital faster, boosting labor productivity and wages. FDI translates one-to-one into increased investment, in comparison to other types of private finance that are usually only partially used for consumption (World Bank, 2001; Bosworth & Collins,

1999). It also tends to be less volatile than other capital flows (Cobham, 2001), particularly during financial crises as foreign companies are less likely to sell their subsidiaries quickly compared to banks cutting their short-term lending or portfolio managers selling their assets (Lipsey, 2001). However, financial crises may interrupt new FDI inflows, so central banks should cautiously build foreign exchange reserves when FDI is high in order to even out predictable reversals. Another advantage of FDI in comparison to other types of capital flows is that foreigners assume the investment risk, as no interests are due on failing projects. However, profit repatriation can represent an unsustainable drain on a country's foreign exchange if the foreign companies' production primarily serves the local market instead of being exported.

Secondly, FDI has the potential to absorb some of the surplus literate labor in the rural and urban informal sectors (Jacobs, 2001). Employment creation in industries with good productivity growth prospects is an important aspect of poverty alleviation strategies, which is good for local entrepreneurs (Watkins, 1998).

Thirdly, FDI can transfer technology and expertise, stimulating the productivity of locally owned firms (Jacobs, 2001). This can occur through training, competition and emulation within industries where foreign firms are present, and through "forward and backward linkages" with other industries (for example, foreign firms providing domestic enterprises with both inputs and output markets under more favorable terms than imports and exports).

Still, recent research shows that the spillover advantages of FDI are weak at best (Hanson, 2001) (Jacobs, 2001). MNCs often harm competing locally owned firms rather than stimulating them, which can result in the reduction of total industry size or employment (Cobham, 2001). Still, it is important to note that this may be beneficial in cases where domestic industries are very inefficient and deprive other sectors of scarce resources. The impact of FDI on productivity thus depends on the existence and competitiveness of domestic firms in the industries where FDI is invested and in those that trade with them upstream or downstream.

The general relationship between FDI and economic growth, after examining the advantages and disadvantages, is itself subject to arguments (Jacobs, 2001). Some studies using aggregate data find no real relationship (Durham, 2000a&b) and others show that

FDI urges growth only above a certain threshold of average schooling (Borenstein & al., 1998). Numerous industry and country-specific studies confirm the importance of pre-existing human capital and infrastructure in determining the development impact of FDI (World Bank, 2001).

This study suggests that the development potential of FDI is limited but beneficial for emerging countries (Jacobs, 2001). The literature suggests that FDI is most beneficial when the government exercises strict rules and regulations regarding foreign investment. Emerging countries may want to attract as much FDI as possible in order to achieve full use of available resources. However, government should make every effort to micro-manage FDI, favoring it in some industries with targeted subsidies while forestalling it in other industries through legislation. Hanson (2001) provides a framework to guide these types of decisions, which is grounded in economic theories and aims to make the best use of a country's resources. The economic success of China must be attributed to pro-active industrial policy rather than across-the-board liberalization (Watkins, 1997).

Transferring industrial policy to regional intergovernmental organizations is a good recommendation for many reasons (Jacobs, 2001). First, the majority of national markets are too small to take advantage of the economies of scales permeating manufacturing industries. In addition, regional cooperation would increase policy analysis and administrative capabilities. Finally, it would limit tax competition and increase negotiating power in comparison with MNCs. On the other hand, governments should resist global trade agreements that limit their ability to pursue pro-active industrial policies.

In the 1960s, Hymer (1976) and Kindleberger (1969) developed the Structural Market Imperfection Theory, which argues that the development of MNCs shows the imperfection of the market (Zhang, 1998). The market is imperfect, according to this theory, because MNCs can use their organizational efficiency to compete with the domestic firms.

Vernon (1966) developed a International Product Life Cycle Theory, which held that a product's position in its life cycle determines its geographical production location (Zhang, 1998). FDI is the result of this transaction of production location. Buckley (1976) came up with the Natural Market Imperfection Theory and Internalization of Market Theory, demonstrating that

MNCs use effective administrative structure to replace the imperfect market structure. MNCs internalize the imperfect market structure.

Dunning (1974, 1985, 1988) analyzed Structural Market Imperfection Theory and Natural Market Imperfection Theory, creating a more general theory of MNCs (Zhang, 1998). He described economic structure as the way in which resources are distributed among alternative uses. Dunning's theory answers the question "what goods or service should a nation produce". Optimum allocative efficiency is defined as achieved when the distribution of resource between competing uses cannot be improved by transferring one unit of any one resource from one activity to another. There are two types of efficiency (Zhang, 1998):

1. technical and scale efficiency, the way in which resources are used within a given sector;
2. allocative efficiency, the way in which resources are distributed between sectors.

According to Zhang (1998): "The extent and pattern of multinational operations, as generally accepted, are determined by three factors: ownership-specific advantages (the extent to which firms of one nationality possess advantages relative to those of another nationality in sourcing a market), internalization-specific advantages (the extent to which enterprises find it profitable to use these advantages themselves rather than lease them to firms in foreign countries), and location-specific advantages (the extent to which it is profitable to combine the use of internalized ownership-specific advantages with immobile resources in a foreign country rather than in the home country)."

These OLI advantages are not evenly distributed between countries and the MNCs will affect the allocation of resources in both the home and FDI recipient countries. MNCs may affect economic structure in three ways (Zhang, 1998):

1. transferring assets across national boundaries,
2. internalizing these assets, and
3. affecting the disposition of resources by assigning a common ownership to separate but interrelated activities.

The benefits a country gains from FDI and MNEs are dependent on its general economic climate and investment environment (Zhang, 1998). Because of its

improving economic environment, China is in a good position to make maximum use of the potentials of MNCs by applying some specific FDI policy designed to channel MNE efforts in the desired direction.

DISCUSSION

Research on strategic management in emerging economies has moved past the question of ‘does strategy differ in emerging economies?’ with the answer being a firm “yes” (Doktor & von Glinow, 1991; Hoskisson, Eden, Lau & Wright, 2000; Nelson, 1990). The new generation of theoretical research in emerging economies has moved towards modifying existing theories or developing new theories that are more relevant to the institutional context that exists in emerging economies like China (Young, Peng, Ahlstrom & Bruton, 2002). This search for new theories is increasing as it is becoming less clear when, if ever, emerging economies will “catch up” with developed economies. Many experts believe they will likely display unique ‘emerging economy characteristics’ for the foreseeable future (Choi, Raman, Usoltseva & Lee, 1999; Guillen, 2000a; Samuals, 1995; Young, Ahlstrom & Bruton, 2004).

To this end, when examining the impact of FDI on China’s firms, it is important to address the theory of the firm or, to paraphrase Coase (1937) by asking “What is the nature of the firm in emerging economies?” Theories of the firm are a basic foundation of organizational research that provide perspectives for considering organizational objectives and frameworks for analyzing important research problems (Grant, 1996; Seth & Thomas, 1994) or as Conner and Prahalad (1996: 480) put it: “a theory of performance difference between firms necessarily implies and incorporates a theory of the firm itself.” Theories of the firm are involved in just about every strategic management proposition or hypothesis and thus in a sense are the foundations upon which strategy theories are developed.

Emerging economies are “low-income, rapid-growth countries using economic liberalization as their primary engine of growth” and usually include countries in transition from either traditional agricultural based economies or previously centrally planned economies (Hoskisson et al. 2000: 249) (Young, 2003). While little is known about strategy in emerging economies, it is widely accepted that strategic management is “different”

in an emerging economy context (Hoskisson et al. 2000; Nelson, 1990; Shenkar & von Glinnow, 1994). In terms of the firm, the boundaries and initiatives of firm strategy are usually different for a firm depending on whether it exists in a developed economy or an emerging economy.

According to Hoskisson and colleagues (2000), one of the most important theories used to examine the differences in emerging economy strategy is institutional theory (Young, 2003). Institutional theory has been developed with both an economic orientation (Coase, 1992; North, 1990; 1994; Williamson, 1985) and a sociological orientation (DiMaggio & Powell, 1983; Scott, 2001).

From an institutional economic perspective, institutions are the “rules of the game” that build economic interaction (North, 1990). Institutions include a country’s formal rules (laws, regulations) and informal constraints (customs, norms, cultures), and therefore provide the rules of the economic environment. The role of institutions in an economy is to eliminate uncertainty and develop a stable (and hopefully efficient) structure that promotes interactions (North, 1990). In general, the institutional structure of emerging economies is different in two major ways (Young, 2003):

1. it is less stable (Nelson, 1990; Scott, 2001) and
2. it is possibly less conducive to mutually beneficial economic exchange between economic actors (North, 1994).

The neoclassical theory of the firm was first developed as part of a broader theory of value and was used to show how prices distribute resources throughout the economy (Penrose, 1959). In this light, the neoclassical firm is represented as a simple production function that combines inputs in the most efficient manner to maximize profits (Young, 2003). Early developers of industrial organization economics, such as Mason (1949) and Bain (1954), developed the structure-conduct-performance (S-C-P) paradigm. Basically, the S-C-P paradigm stated that industry structure determines firm conduct, which, in turn, leads to performance outcomes (Scherer & Ross, 1990).

Based on the neoclassical view, the Mason-Bain View of the firm simplified reality to view the firm primarily as a profit maximizer (Conner, 1991). A unique characteristic of the Mason-Bain View of the firm is that firms seek “monopoly profits” by attempting to ban competitors from competing in their markets and

restricting output (Young, 2003). Despite its simplicity and elegance, the neoclassical theory of the firm has long been criticized for its failure to account for realities—in the case of China, its accession to the WTO.

One problem with basing strategy on the neoclassical approach in emerging economies is the heavy dependence on the institutional structures (Young, 2003). Industrial organization economics is a sub-discipline of neoclassical economics that was designed to increase consumer welfare, with the litmus test of consumer welfare being determined by perfect competition (Scherer & Ross, 1990). The institutional structure of emerging economies is less advantageous to mutually beneficial cooperative exchange (North, 1994). The institutional structure in emerging economies is more likely to promote activities that promote corruption, rent seeking, or other types of value destroying behavior (Ahlstrom, Young & Nair, 2002; Baumol, 1990; Mudambi et. al., 2002; Murphy, et. al., 1993; North, 1990).

For example, if a firm uses the industry forces approach to conclude that it would be beneficial to erect barriers to entry to limit the threat of new entrants (Young, 2003). In a mature market economy, the options might include increased differentiation through advertising as advised by Porter (1985). However, in the institutional environment of emerging economies, corruption is likely to be more accepted given the formal and informal institutional structure (Ahlstrom et. al., 2002). Thus, a firm in an emerging economy may be able to, for example, use bribery to gain exclusive access to a market and eliminate the threat of new entrants (Acemoglu & Verdier, 2000; Nelson, 1990).

While this type of action may, in a sense, be “entrepreneurial” and bring profits to the firm, it will not likely encourage the firm to use scarce resources in the most efficient manner, nor is such activity beneficial from society’s viewpoint (Dougan, 1991; Murphy, et. al., 1993). Also, it must be considered that firms are simply trying to win the game, if the institutional structure permits market-restricting behaviors to do so, then this will be a likely outcome (North, 1990, 1994). In a nutshell, encouraging firms to pursue strategies based on frameworks derived from neoclassical economics without first reconfiguring the institutional structure, may lead to what Baumol (1990) refers to as unproductive or even destructive entrepreneurial activities (Young, 2003).

THE RESOURCE-BASED VIEW OF THE FIRM

The resource-based view of the firm (Conner 1991; Wernerfelt 1984) is based on the work of Penrose (1959) and classical economist David Ricardo (c.f., Peteraf, 1993) (Young, 2003). This theory views the firm as a collection of a variety of technological, financial, and organizational resources. As time goes on, certain resources are developed into capabilities that allow the firm to gain competitive advantage (Barney 1991, 1997). While the neoclassical view of the firm concentrates on factors external to the firm, such as industry structure, the resource-based view concentrates on internal factors, like acquisition, and deployment of resources and capabilities that are value-adding, unique, and hard to imitate by competitors (Barney 1991).

The resource based view is based on the theory that a firm can earn above average returns if and only if it has superior resources and those resources are protected by some sort of isolating mechanism preventing their diffusion in the industry (Knott, Bryce & Posen, 2003) (Young, 2003). Additionally, acquiring such resources is path dependent and must be done over a period of time by nurturing relationships among organizational stakeholders that create socially complex and difficult to imitate organizational capital (Dierickx & Cool, 1989).

Firm-specific human capital is key to this process, According to Galunic and Anderson (2000: p. 1): “The resource-based literature has stressed that only firm-specific human capital is likely to generate organizational rents, since those assets are more likely to be inimitable, rare, and therefore a better basis for sustained competitive advantage (Young, 2003).”

However, it is crucial for an individual stakeholder to at least have what Barney and Hansen (1994: p. 182) refer to as “semi-strong form trust” in other members of the organization to encourage him or her to invest in firm-specific capital (Young, 2003). If the institutional structure is changing and there is little protection for property rights of organizations, then the actors have less incentive to invest in the higher productivity firm-specific assets and more incentive to invest in general assets, which can be redeployed in other areas (Fukayama, 1995). Basically, the institutional environment of emerging economies provides less incentive for organizational stakeholders to invest in firm-specific intangible assets (North, 1990; 1994; Skaperdas, 1992), which presents a problem for

locally owned firms in emerging economies hoping to base strategy on an RBV perspective because intangible, firm-specific investment is a crucial ingredient in RBV theory of the firm (Galunic & Anderson, 2000; Knott, et. al., 2003).

A second point is that the “valuable resources” that firms nurture and create may be very different in emerging economies (c.f., Guillen, 2000b) (Young, 2003). For example, political connections or corruption or deceptive practices may come to be a key source of a firms’ competitive advantage in emerging economies (Ahlstrom et. al., 2002; Nelson, 1990). While these types of intangible resources, such as political connections, vary from what is normally considered as “core competence” from a resource based perspective, it is obvious that such resources are valuable, rare, inimitable and without substitutes and can therefore serve as an important source of above average returns in emerging economies (Fisman, 2001).

THE CHARACTERISTICS OF THE FIRM IN EMERGING ECONOMIES

The following table summarizes the two theories of the firm along with the outcomes resulting from application to the emerging economy context (Young, 2003).

TABLE 1: Theories of the Firm in Emerging Economies

Theory of the Firm	Basis for Strategy	Major Consequences in Emerging Economy Context
Neoclassical Theory of the Firm	Views firm as production function, with competitive advantage coming from the external and particularly, industry structure. Managers will erect various barriers for other firms and reduce output to extract rents. Managers may also maneuver within industry structure to achieve favorable position via suppliers, buyers and rivals.	(1) Institutional structure is less stable in emerging economies making it difficult to analyze. (2) The institutional structure may provide more socially unproductive means for firms to restrict output or gain advantage via bargaining power of buyers and suppliers.
Resource-Based View of the Firm	Views firm as a bundle of resources, with emphasis on acquiring resources that are valuable, rare, costly to imitate and without substitutes. Strategies based on RBV would nurture specific resources to obtain a core competence.	The institutional environment of emerging economies offers less incentive for organizational stakeholders to invest in firm-specific organizational capital required for core competencies.

When addressing the question of what impact FDI has on emerging economies, it is important to examine how competitive advantage can be explained in the emerging economy firm (Young, 2003). Because emerging economy firms are more likely to rely on general assets that are less distinguishable between firms, it is likely that they will be forced to rely more heavily on factors such as political connections to block new entrants (Ahlstrom et. al., 2002). In this case, competitive advantage is better explained from a neoclassical view of the firm, which assumes that firm assets are strategically similar from firm to firm (Seth & Thomas, 1994) and that firms must rely heavily on industry structural characteristics, including barriers to entry, to obtain better than average returns (Porter, 1985). However, depending on how resources are defined, the distinction between the RBV and neoclassical view may be unclear in emerging economies if a value is placed on the “resource” of political connections that make the barriers to entry possible (Fisman, 2001).

Because of the institutional environment of China’s emerging economy, it may be suggested that entrepreneurial skill are even more important in emerging economies (Young, 2003). Entrepreneurs must be careful not to become complacent in relying on political connections as the source of advantage as the political winds frequently shift without notice in emerging economies (Nelson, 1990), in which case, regime watching and political astuteness may be considered a highly valuable entrepreneurial skill or asset (Fisman, 2001).

Globalization, and the foreign investment that is associated with it, has presented emerging economies with both opportunities and challenges (Young, 2003). Locally owned firms are attempting to compete on a global market, but the institutional context in which their organizations and routines, and thus their potential competitive advantage, are embedded at the local level (Porter, 1990). This poses a challenge that is not easily overcome, as Nolan (2001) demonstrates in his writings of China’s effort to develop indigenous “national champions.”

It appears that bridging the gap between global markets and locally owned firms is perhaps the biggest challenge that globalization poses to emerging economy firms and country leaders (Young et. al., 2004). However, unless indigenous emerging economy firms

are content to maintain their “comparative advantage” in undifferentiated, low wage labor indefinitely, it is crucial that they overcome this challenge.

Fung, K. (February 12, 2004). Hearing on China as an Emerging Regional and Technological Power: Implications for U.S. Economic and Security Interests. U.S.-China Economic and Security Review Commission.

FDI CHARACTERISTICS

China’s open door policy has encouraged foreign direct investment and has been an economic as well as a political success (Shirk 1994). Today in China, a substantial amount of China’s trade is conducted by foreign-invested enterprises (Fung, 2004). In 2003, foreign firms conducted 56.2 percent of China’s imports and 54.8 percent of China’s exports. In many ways, China’s trade is dependent on enterprises from other economies (Naughton, 1996, Fung 1998). Due to the involvement of foreign-invested enterprises in China’s exports, this implies that foreign firms, directly benefit from the massive growth of China’s trade with the rest of the world. In 2002, the rate of return for American multinationals in computer and electronic products is estimated at 21.2 percent.

China’s trade and foreign direct investments are geographically concentrated (Fung, 2004). In 2003, Guangdong’s imports made up 31.7 percent of China’s total imports, while Guangdong’s exports made up 34.9 percent of China’s total exports. The majority of China’s foreign direct investments still flow to the east and coastal areas. In 2002, the east and southeast coastal areas (Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, Hainan, Beijing, Tianjin, Hebei, Liaoning and Guangxi) received 89.5 percent of all realized foreign direct investments.

The majority of recent foreign direct investments in China are not joint ventures (Fung, 2004). Rather, they take the form of wholly foreign-owned enterprises. In 2002, 69.2 percent of contracted foreign direct investments were entirely foreign-owned. In 2002, with the exception of the Virgin Islands, the United States is the second largest direct investor in China. There is no particular reason to expect that U.S. investments in China to have different modes of ownership that differ significantly from the general pattern. This implies that American multinationals will increasingly have greater controls of their operations in China.

As a rapidly expanding market, China plays the role of a locomotive in the Asia-Pacific region. This role is demand-enhancing and investment augmenting (Fung, 2004). To American multinationals, the Chinese market represents a profitable opportunity (see Table 4). Unlike the Japanese growth experience, China’s development strategy thus far is one of relative inclusiveness. By opening its doors to foreign firms, it allows foreign companies to participate and to benefit from its rapid growth.

As a site for low-cost manufacturing, China is a major source of opportunity for U.S. multinationals to cut their costs of productions (Fung, 2004). By reducing costs, foreign firms stand to increase their global profits. However, if foreign multinational corporations view China mainly as a low-wage export platform, then they may consider investing in China rather than in other locations. This may reduce direct investments in other countries and reduce the economic welfare of China’s neighbors.

The theory that direct investment levels in China are complementary to direct investment levels in its neighbors is consistent with the view that China is not only viewed by multinationals as a low-wage export platform, but also as an important link in the global supply chain (Fung, 2004). In business models, the value chain is sliced thinner and thinner and each stage of production is parceled out to a different specialized site to minimize global costs of production (Table 6).

In the immediate geographic vicinity of China, this network of production sharing is obvious among the three members of the China Circle (China, Hong Kong and Taiwan) and in specific industries such as technology goods and components (Naughton 1997, 2004, Roach 2003). Being a key site for global production-sharing, China will both import and export goods that belong to the same industry such as electrical equipment (Fung, 2004).

In 2003, China imported and exported significant amount of items in the category of electrical equipment to its neighbors (Fung, 2004). With the exception of Indonesia, exports and imports of goods, components and parts in the electrical equipment industry rank either as first or second in the trade of these economies with China. The two-way trade of many goods, including those within electrical equipment raises the issue of how much domestic value added China derives from such trade.

Existing studies seem to suggest that the domestic value-added generated by such types of Chinese exports is not particularly high, particularly for processed exports (Table 7) (Fung, 2004). In the case of processed exports of electric machinery and instrument, the total domestic value-added generated amounted to an estimated 14.4 percent, while for processed exports of the manufacture of electronic and communication equipment, the corresponding estimated total domestic value-added is 13.8 percent. In general, for processed and non-processed exports combined (aggregate exports), the domestic value-added generated is usually greater.

RECOMMENDATIONS

Since the early 1990s, FDI in China has undergone some dramatic changes. MNCs have played a key role in the recent wave of foreign investment “invasion” into the Chinese market (Zhang, 1998). One of the direct effects of this new trend is that many formerly successful Chinese domestic companies have been forced to alter their business practices or shut down. This MNC invasion has been a major concern for Chinese society and Chinese government.

At the core of this issue is the fear experienced by locally owned businesses of losing control over the markets and industries to the expanding MNCs (Zhang, 1998). To answer the question how national firms can survive and compete with MNCs, the government must revisit their policies concerning FDI and MNCs.

Many studies have examined this issue. However, most of them have used aggregated data or been presented as case studies of a single industry or a firm (Zhang, 1998). Most have neglected the quantitative analysis of the effects of multinational enterprises on economic efficiency. This study attempted to answer the question of the positive and negative contributions of MNCs on China’s economic efficiency and economic structure.

The main results of the research include the following findings (Zhang, 1998):

- MNCs have impacts on Chinese economic structure different from that of locally owned firms and other foreign invested firm (such as Hong Kong, Taiwan and Macao firms), the MNCs focus more on capital and knowledge intensive sectors.
- The OLI advantages of MNCs have assisted the economic restructuring towards higher allocative and technical efficiency.

- The disadvantages of MNC activities include (a) losing some structural autonomy at the part of Chinese government; (b) making Chinese economy more vulnerable to the global market, and (c) changing the income distribution between and within industries in China.

The main data source of this research is the Third National Industrial Census of the People’s Republic of China (Zhang, 1998). The census includes all industrial enterprises (7341517 enterprises) in 30 provinces in China, with the exception of Taiwan, Hong Kong and Macao, including 59311 foreign invested enterprises. The data is compared with the National Industrial Census in 1985.

The structural characteristics of multinational enterprises in 1995 are reviewed, in comparison with locally owned firms (Zhang, 1998). The statistical relationship between these structural variables and the sectoral distribution of two types of production are established and statistically tested.

The study presents an effective picture of a quantitative calculation of the positive and negative effects of MNEs on the allocation of resources within and between sectors and on the distribution of income, and recommendations on how to deal with the recent increase in FDI.

Recommendations for the future include the following (Zhang, 1998):

1. continue to keep China’s open door policy to FDI and MNCs in the long run;
2. MNCs should receive similar treatment to locally owned businesses and special treatment should be restricted in the long run;
3. using the positive effects of FDI to adjust the economic structure; and
4. using FDI as a weapon to promote domestic reform and aid locally owned businesses.

In conclusion, due to the positive effects of FDI investment on Chinese economy, Chinese government should continue to keep its open door policy to FDI and MNCs in the future. However, feasible measures should be taken to limit the disadvantages on domestic businesses. The foreign investment policy should be considered as a supplemental part of the domestic development policy. The opening to FDI and

MNC investment should be carried out simultaneously. Special treatment should not be given to MNCs. Rather,

the local firms should be given the same treatment and the administrative constraints on the domestic state-owned-enterprises should be gradually eliminated.

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