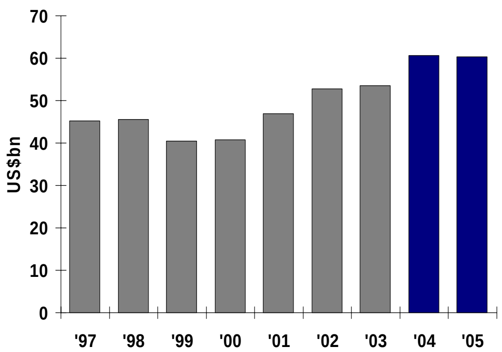
The Insight Bureau

Is China's lustre dimming? From a first glance at recent FDI statistics it might appear so, but upon closer inspection …

From a first glance at recent foreign direct investment statistics, it might appear so. Closer inspection shows, however, that while the attraction for manufacturers may have lost some of its brightness, the gleam for investors in the financial sector (banking, securities, insurance) is bright — and due to brighten further in the next 12-24 months.

Last year, foreign investors — certainly those in manufacturing — paused for breath. In 2005, actual foreign direct investment reached US$60.3 billion — thrilling by any country's standards but down slightly from 2004's US$60.6 billion. What this amounts to is a plateau in China's intake of foreign capital. And it's not the first one. In the last nine years, China's FDI intake has experienced three other such plateaus (1997-1998, 1999-2000, 2003-2004; see graph).

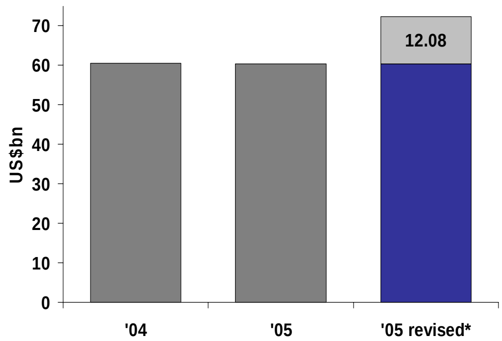
FDI, annual, actual, US$bn



This year, 2006, should show us whether China has been experiencing just one more plateau—or that many foreign investors have decided not to enter or expand, at least for the time being. The amounts absorbed thus far this year should be a good indicator. The first seven months have produced sluggish investment totals: the January-July period is lagging the similar 2005 period by 1.2%, with a value of US$32.7 billion.

In early January 2006, the official FDI total for 2005 was released. For the next five months, the Chinese government let the US$60.3 billion figure stand. Then, without much fanfare in early June, came an announcement of a revision. According to Ma Xiuhong, Vice Minister of Commerce (MofCom), actual FDI last year in fact was US$72.4 billion.

FDI, 2004, 2005 and revised 2005*, US$bn



Where did the extra dollars come from? The difference, she said, was the US$11.8 billion that was injected into the banking, insurance and securities sectors in 2005. (Here too there appears to be a discrepancy: the statistics issued by her ministry that month showed US$12.08 billion more than the originally stated US$60.3 billion.) Observers can be forgiven for wondering why financial sector investment was suddenly revealed, investment that had not been previously published—and has not been published since. The vice minister said that the financial sector had in the past attracted less than US$2 billion a year.

New data underline what the old had suggested: investor interest in manufacturing, retailing and other non-financial services had indeed cooled

The new data underline what the old had suggested: investor interest in manufacturing, retailing and other non-financial services had indeed cooled. As with other recent periods of leveling off in foreign capital intake, companies already invested in the country might have needed time in 2005 to reassess the progress and profitability of their investments, before taking the expansion plunge. Several other factors also account for 2005's lack of growth in manufacturing and other non-financial sectors. Among them:

- **Exchange rates**: the unsettled exchange rate kept investors guessing. For the first half of 2005, the discussion over the future value of the renminbi was hot. Then, in July, Beijing carried out a slim 2.1% upward revaluation and de-pegged the currency from the US dollar. Investors watched to see how the dust would settle and what the impact would be on their investment dollars. Investors continue to carefully monitor fluctuations in the currency's value now, 15 months since the beginning of the managed float.
- **Energy**: energy shortages and rising energy costs slowed some companies
- **Excess capacity**: China's excess capacity in a wide range of sectors trouble foreign firms already in those sectors in China — or contemplating coming in. One of the country's hottest manufacturing sectors — automotive — is believed, even by those already in it, to be suffering from severe overcapacity that is likely to worsen before a future consolidation improves the situation.
- **Operational concerns**: coastal sites — most popular with investors — are costly and crowded while inland cities present operating problems that many investors are not yet ready to tackle.
- **Investment options**: competition at the headquarters about where to put investment dollars overseas is diverting some cash from China. India is definitely rising in international companies' perceptions.

Investors' interest in China seems far less affected by protectionist sentiments in their home countries than by nationalist sentiments in China. Concern among international companies is rising about recent central government moves to regulate foreign purchases of property; ban (temporarily) foreign acquisitions of brokerages (in September, after the statement by MofCom that the nearly US$12 billion of foreign investment in the financial sector reflected the increasing openness of that sector!); regulate foreign firms' M&A activity in China; and prevent foreign providers of information from selling it directly to PRC clients. These actions suggest that Beijing, for the moment, is acknowledging the opposition in some circles in the country to what they see as growing, even dominant foreign participation in sectors of the Chinese economy.

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But foreign investors remain essential contributors to China's economic growth — and Chinese officials know it. In June, while announcing the revised foreign investment totals, the vice minister noted that foreign-funded companies are only 3% of China's total companies but accounted in 2005 for 57.3% of the country's exports, 87.9% of its high-tech exports, and 20.5% of the country's tax revenue. Other officials speak openly of benefits to the Chinese economy of such investor inputs as technology, creation of jobs, assistance in upgrading products to exportable standards and tutoring in management skills.

Inevitably, foreign investment in the financial sector will burgeon, spurred further by China's fulfilling by end-2006 its WTO-entry promise to open the market more fully to foreign banks.

So, *has* China's lustre dimmed? A bit if you're in manufacturing but the country shines ever so brightly for the world's financial investors.

About Lois Dougan Tretiak

Mrs. Tretiak is a highly respected China Analyst and facilitator of dialogue about the country's business and investment environment. She has over 30 years' experience advising foreign companies on entry and operating strategies in China. She is Advisor to The Economist Group in China and past Chairperson for the Economist Intelligence Unit's *Corporate Network* executive programmes in Beijing, Shanghai and Hong Kong. ldtnbj@gmail.com

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