

Le Défi Chinois

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NEW YORK – So far, discussions about whether or not China should revalue its currency, the renminbi, have focused almost exclusively on the impact of the currency's exchange rate on China's trade balance. But what would an appreciation of the renminbi do to China's inward and outward foreign direct investment (FDI)?

In evaluating China's currency policy, the effects of any change on the trade balance are no more important than the potential consequences for inward FDI, which plays such a crucial role in China's economic development, and China's outward FDI, which is receiving increased attention worldwide.

China has been the developing world's largest recipient of FDI since the mid-1990s. Revaluation of the renminbi would make it more expensive for foreign firms to establish themselves (or expand) in China – the world's most dynamic market – and would render exports of foreign affiliates, which account for 54% of total exports, less competitive internationally. On the other hand, the increased cost would be offset to some extent by lower-cost imported inputs, and foreign affiliates could expect to repatriate higher profits from sales in China in terms of their own currencies.



But the most notable development of recent years has been the surge in China's outward FDI since the government adopted its "go global" policy in 2000, encouraging Chinese firms to invest overseas. China's outward FDI more than doubled in 2005-2007, from \$12 billion to \$27 billion, and then more than doubled again in 2008, to \$56 billion. Outflows continued to rise to \$57 billion in 2009, a time when global FDI flows had collapsed by 50%, making China the world's fifth largest outward investor.

The increasing international competitiveness of Chinese firms, together with government policy, has been the main driver of China's skyrocketing outward FDI. The 20% revaluation of the renminbi against the US dollar in 2005-2008 undoubtedly facilitated this in the case of recipient countries whose currencies did not also appreciate against the dollar.

China's outward FDI is poised to increase sharply again in 2010, judging by the first half of the year, when it was rising at an annual rate of 44%. Revaluation would accelerate this trend.

This is precisely what happened in Japan after the yen was revalued by over 50% against the dollar between 1985 and 1987, following the Plaza Accord. Japan's outward FDI rocketed from \$7 billion in 1984 to \$20 billion in 1986, peaking at \$48 billion in 1990.

A renewed renminbi appreciation would boost China's outward FDI growth even further by lowering the cost of overseas assets for Chinese firms, which operate in a fairly competitive market and have strong cash reserves from both retained earnings and large-scale state credit allocations. Like competitors elsewhere, they need to invest abroad to acquire a portfolio of local assets that give them better access to the markets, skills, technology, and natural resources that they need to protect and strengthen their international competitiveness.

The revaluation effect would be reinforced by rising wage pressures inside China, which are already leading some labor-intensive Chinese firms to invest abroad (there are more than 700 Chinese affiliates in Vietnam alone). Some of these firms have been weighing whether to move production abroad or to inland provinces of China; revaluation could push them in the former direction.

Because most of China's outward FDI is from state-owned enterprises (SOEs), suspicions of non-commercial motivations are widespread. But there is no systematic evidence that China's SOEs are driven by more than normal commercial considerations. At the same time, various private or semi-private entities have been investing abroad. As their operations are less visible, it is likely that their outward FDI, and therefore China's total, is understated.

Fears of Chinese overseas investment, as of Japanese and South Korean investment in the 1980s and 1990s – and, before that, of the great post-war U.S. multinationals, which the French writer Jean-Jacques Servan-Schreiber dubbed "le défi américain" in the 1960s – are misplaced. These investments were eventually accepted as making a contribution to their host countries. Similarly, the surge in China's outward FDI is good for China and for host countries.

Chinese FDI, like all FDI, can provide host countries with a bundle of tangible and intangible assets needed for economic growth and development. While a significant part of China's outward FDI initially takes the form of trade-supporting FDI, it can be expected to lead relatively quickly to some production being shifted out of China, including to the US and Europe, thereby possibly reducing exports from China. Moreover, FDI, like trade, is a key means to integrate China into the world economy and make it a responsible stakeholder.

Like their Japanese and South Korean counterparts, however, Chinese firms will have to learn how to operate in highly sophisticated developed-country markets, as well as in developing countries, where their investments in natural resources are expanding rapidly. They will also have to learn from the past mistakes of other multinationals. In particular, they need to establish a strong reputation as good corporate citizens, in addition to making a positive economic contribution to their host countries.

The Chinese government can play a crucial role by adopting a code of conduct for all Chinese enterprises investing abroad, in line with internationally accepted norms and taking into account the increasing importance of sustainable FDI. For their part, recipient countries should accept, rather than shun or discriminate against, China's "new kids on the block."

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