Why is China so Attractive for FDI?  
The Role of Exchange Rates

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Abstract: This paper argues that China’s exchange policy played a critical role in its FDI boom. Yuan’s devaluation and the pegging yuan to the dollar policy not only offset the pressure of rising real wage due to sustained economic growth in the last two decades, but also improved China’s competitiveness in attracting global FDI. Examining the hypothesis in the context of Japanese FDI in China’s nine manufacturing sectors from 1981 to 2001, the paper finds a strong correlation between Japanese direct investment in China and the real bilateral exchange rate between yen and yuan. Empirical evidences strongly suggest that China’s exchange rate policy is one of critical factors driving FDI into China.

Key Words: FDI, Exchange Rate, Manufacturing
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1. Introduction

Relatively cheap labor in China is unanimously viewed by economists as one of prime factors attracting foreign investors. In the last two and half decades, Chinese economy grew about 9 percent annually. The cumulative economic growth should result in at least the same growth in the real wage of Chinese workers. Why is Chinese labor still cheap in the view of foreign investors? Conventional wisdom often ascribes the relative cheap labor to China’s abundant labor endowment. However, it is important to realize that the labor endowment is roughly constant overtime. The cumulative devaluation of yuan since 1980 might be the answer. The devaluation not only offset the rising wage pressure due to sustained economic growth, but also strengthened China’s competitiveness in attracting global FDI. For multinational enterprises (MNE), especially these engaging global outsourcing, the wealth and production cost effects induced by the devaluation are simply too large to be ignored. It is highly likely that the surge of foreign investments inflows was substantially fueled by yuan’s devaluation.

There are numerous studies on China’s FDI boom, for instance, Branstetter and Feenstra (2002) show that FDI inflows reflect political openness and state ownership in China; Cheng and Kwan (2000) find that large regional market, good infrastructure, and preferential policy are important determinants of FDI in China; Feenstra and Hanson (2004) examine the organization of export processing operations of foreign MNEs in China and test the property rights model. Lardy (1995), Henley et al (1999) and Zhang (2001) identify potential market size, low labor cost, preferential policies (e.g., tax credits), openness, geographic proximity, and political stability as primary factors attracting FDI inflows to China.