CHINA'S FOREIGN DIRECT INVESTMENT (FDI) ACCOUNTING – FLUFFED UP STORIES OR TRUE FINANCIAL REPORTING?

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ABSTRACT

China's foreign direct investment (FDI) has always played an important role in China's economic development since China's open-door policy in late 1980's, and China will continue to attract FDI in the future.

One critical issue regarding China's FDI has been its accounting. In general, researchers and investors alike have always been skeptical of China's FDI reporting practices. The motivation of this paper is to analyze China's FDI accounting practices. Specifically, I provide anecdotal evidence from literature research to show major problems in China's FDI reporting, including "double counting," "round-tripping," and "off-shore financing." Results from this research may provide additional insight for researchers and decision makers in establishing a more rigorous FDI accounting reporting for China in the future.

INTRODUCTION – CHINA'S ECONOMIC GROWTH

Since the initiation of economic reforms in 1979, China has become one of the world's fastest-growing economies. For nearly three decades – from 1979 to the present, China's gross domestic product (GDP) grew at an average annual rate of 9.7%. For the most recent report, it grew by 11.1% during the first quarter of 2007, and it is expected to continue to grow over the next several years. (See Table 1.)

1990	3.8
1991	9.3
1992	14.2
1993	14.0
1994	13.1
1995	10.9
1996	10.0
1997	9.3
1998	7.8
1999	7.6
2000	8.4
2001	8.3
2002	9.1
2003	10.0
2004	10.1
2005	9.9
2006	11.1
First Quarter 2007*	11.1

T**able 1.** China's Average Annual Real GDP Growth: 1990-2007 [13, p. 4]

Trade and foreign investment continues to play a major role in China's booming economy. Most recent record showed that its exports reached $969 billion and imports to $792 billion in 2006, which generated a trade surplus of $177 billion [13]. It is projected that, if the trend continued, then China could surpass the United States to become the second largest (only after European Union) merchandise exporter soon.

Amid the rapid economic growth and improved GDP, lately Chinese officials have expressed concern over a number of areas that they perceive as threats to its future growth. To minimize some of those threats, the government has indicated its goal over the coming years to create a "harmonious society" that would promote more economic balanced growth and address a number of economic and social issues. This report provides an overview of China's economic development in foreign direct investment (FDI), one of the key aspects of China's recent economic growth.

CHINA'S FOREIGN DIRECT INVESTMENT – AN OUTLOOK

Most recent research has attributed China's economic success to its ability to attract foreign direct investments (FDI) that generates sufficient capital to sustain its blooming business activities [5]. In 2006, China attracted US$70 billion FDI inflow. It is projected that, from 2006-2010, China will continue to attract FDI in major ways – It is projected to account for 30% of the $250 billion of FDI inflow to all developing countries.

Despite its great success in attracting FDI, there has been growing concerns about whether China can sustain its FDI and economic growth in the future. Signs of trouble concerning China's FDI include the following:

1. China has been the largest growing economy for the past decade, and the trend appears to be continuing, but it has begun to show signs of saturation. A recent report in *Business Week*, for example, projects that China's overheated stock market could mean a serious market backslide in the near future [2].

2. China is by far the largest recipient of inward FDI in the world. Unfortunately, it is widely believed that low wages but not other factors may be the major driver of all those prosperous trades and FDI flows [3]. It is likely that China's FDI may have negatively affected its environment.

3. Currently, foreign invested enterprises account for nearly 50% of China's exports, but they only account for about 3% of its overall employment [19]. There is an urgent need to study factors that contributed to this unfavorable trend.

4. Even though China has started its convergence with International Financial Reporting Standards (IFRS), there are still major discrepancies on the reliability and accuracy of Chinese financial reporting [7]. Issues such as "double-tripping," off-shore financing, and corporate governance continue to be major barriers to sound financial reporting and business practices in China's FDI accounting.

My objectives in this research is to study various issues related to China's FDI accounting, specifically, I will suggest that the following three issues to be of utmost importance in figuring out China's proper FDI accounting and reporting:

1. China's inclusion of extra items to boost its FDI figures,
2. China's round-tripping in its FDI accounting, and
3. China's use of off-shore financing that twists the proper FDI accounting.

CHINA'S FDI ACCOUNTING – SOME POTENTIAL PROBLEM AREAS

There have always been doubts about China's economic and financial statistics ranging from GDP growth to FDI inflows [10], particularly after the publication of business reports such as [6, 11]. China's FDI accounting has always been not as straight-forward and exaggerated as some researchers have claimed [10]. For example, many researchers pointed out that China's FDI figures are likely to be exaggerated by "round-tripping" - domestic capital disguised as foreign investment (passed through Hong Kong, Taiwan, or Macaw) to qualify for special investment incentives reserved for foreigners [11, 14]. This paper will add additional information in the following areas:

China's FDI Accounting Practice – What to Include in FDI?

Relative to China's continuous economic growth, India has always been mentioned as the other growing economy that can compete equally well as China in international trade. Just a quick glance would reveal that, in terms of resources, population, stages of economic growth, and trade policies, China and India are quite similar thus should show similar economic growth and attract FDI in similar ways. In some aspect, India may have even higher potential to lead in economic progress. For example, economic reports show that India has the world's largest youth population hence the largest potential market. However, in 2006, while China reported a USD $69 billion FDI inflow, India only showed $17 billion [8]. How do we account for the big gap in China's FDI accounting versus that of India? According to International Monetary Fund [12][1] definition, FDI includes the following twelve categories (see Table 2):

1.	equity capital
2.	reinvested earnings of foreign companies
3.	inter-company debt transactions
4.	short-term and long-term loans
5.	financial leasing
6.	trade credits
7.	grants
8.	bonds
9.	non-cash acquisition of equity
10.	investment made by foreign venture capital investors
11.	earnings data of indirectly-held FDI enterprises
12.	control premium and non-competition fee

Table 2: International Monetary Fund's Definition of Foreign Direct Investments [12]

In its FDI accounting, China included all categories above while India only reports Category 1 Equity Capital, which would generate huge reporting gap. In addition, China also includes imported equipment as FDI, which is always listed as import data on India's FDI accounting.

China also includes domestic investments that are routed through Hong Kong, Taiwan, Macau back to China ("round-tripping") as "foreign" investments [1]. The inclusion of all the items above plus imported equipment in FDI accounting, as well as the investments primarily coming from domestic sources but yet counted as FDI both overstated the true FDI accounting in China. There are estimates that such overstatement of FDI could amount to about one third of China's overall FDI inflow. Some even estimated that such FDI accounting could overstate China's real FDI figure by thirty to fifty percent [10].

Another area of concern to China's FDI accounting regards the inclusion of reinvested earnings by foreign affiliates in China. Some believe that such inclusion is misleading, in that, by default, these FDI are nothing but funds reinvested back to MNC's China affiliates, therefore they should not be counted as

[1] Organization for Economic Co-operation and Development (OCED) has just revised its benchmark definition of foreign direct investment in April 2008 [15], which is consistent of the categories listed in Table 2.

new FDI inflow to China. Information from year 2002 showed that such reinvestment accounted for about one-third of China's 2001-2002 FDI inflows, about twenty percent of China's industrial production, about eighteen percent of China's tax income, and about half of China's total exports [10]. All the statistics indeed pointed out the key roles that MNC's reinvestments played in China's FDI accounting thus causing some doubts about China's FDI accounting practices. However, IMF standards [12] as well as the Benchmark Definition of FDI published by the OECD [15] both do not rule out the inclusion of such reinvestments to be included in FDI accounting. Therefore, despite the apparent high volumes in all these FDI indicators, China does not violate the general FDI accounting rules imposed by IMF and OECD.

Round Tripping and China's FDI Accounting

Unique to China's FDI inflow, round-tripping probably represented the largest FDI accounting problem in China. As early as 1993, World Bank [9] estimated that round-tripping accounted for 25% of China's FDI in 1992. A more recent report in Pfeffermann [16], round-tripping is estimated to be about half of the total China's FDI inflow from 1999 to 2000 – it is estimated to be about USD 20 billion out of the total of USD 40 billion.

Favorable tax treatments and other incentives for foreign investors attracted many MNC's to invest in China, which is mutually beneficial to foreign investors as well China's FDI. However, these special tax treatments and incentives have motivated many domestic investment funds to disguise as foreign capital. Exactly how much or what percentage of China's capital flight is from domestic sources is hard to estimate. Economists usually use the Net Error and Omission under China's Balance of Payments account as a reference to the size of the flight. One report showed that, from 1997 to 2000, the amounts were more than USD 10 billion each year for four consecutive years [10].

How is round-tripping done? First, companies in China intentionally overstate the value of exports and understate that of imports, thus creating extra capital from international trade. This can be done with a simple procedure of transfer pricing. These companies in turn would then get the money out of China. Despite Chinese government's tight control on foreign exchanges, there are nonetheless many established channels to allow these companies to get the money out to places such as Hong Kong, Taiwan or Macaw. And, finally, these funds are transferred back to China, disguised as foreign investments to special economic zones, which adds value to China's FDI inflow.

Xiao [20, p. 2] describes China's FDI round-tripping as:

> *"The evidences suggest that a large part of the capital originally created in PRC has managed to go abroad and has stayed aboard waiting for opportunities to return back to PRC. On average the round tripping FDI, e.g. the returning Chinese capital, is about 20% to 30% of the capital flight of various estimations. "*

Due to their geographical closeness to China, also due to their cultural backgrounds, Hong Kong, Taiwan, and Macaw are always listed as major destinations where the double-tripping of China's FDI inflow take place. Hong Kong, in particular, has always been the major source and destination for these FDI double-tripping. Table 3 shows the key role Hong Kong played in China's FDI inflows from 1985 to 2001.

	1985	1990	1992	1993	1993	1994	1995	1996	1997	1998	1999	2000	2001
Share	49%	54%	55%	68%	63%	58%	53%	49%	46%	41%	41%	38%	36%

Table 3: Hong Kong's Role in China's FDI (1985-2001) [10]

If we add about 6% or so from Taiwan, and 2% or so from Macaw, these cross border FDI inflow could easily accounted for forty to sixty of overall China's FDI inflows for the past two decades [20].

Even though Hong Kong, Taiwan, and Macaw's role in China's FDI can be easily identified from China's FDI data, double-tripping does create a loophole in China's FDI accounting, though. Xiao [20] asserts that, from China's FDI inflow, Hong Kong plays an important role in each of all three stages of capital's journey: (1) the original creation of new capital in China, (2) the capital flight out of China, and (3) the round tripping FDI back to China.

However, about half of Hong Kong's FDI to China as reported by China sources cannot be verified or confirmed from the related statistics collected in Hong Kong.

Chinese governments have realized the severity of the FDI round-tripping problem, and have drafted a bill to abolish the preferential tax rate for FDI. It is expected to come into law in 2008 [4]. Once the amendment is passed, there will be a uniform twenty-five percent rate, instead of the traditional fifteen percentage rate for FDI and thirty-three percent for domestic firms, which will almost certain to curb some of the round-tripping loopholes in China's FDI accounting [18].

Off-Shore Financing and China's FDI Accounting

In recent years, FDI from tax havens such as British Virgin Islands (BVI), Cayman Islands and Bermuda's share in China's FDI inflow continues to increase. In 1997, FDI flows from of BVI, Cayman Islands and Bermuda accounted for 4.36% of China' s total FDI, such figure increased to 17.8% in 2001 [6]. Such trend continued in 2005 -2006. As Table 4 indicates, BVI continued to be accounted for significant part of China's FDI inflow. Tax havens such as BVI, Cayman Islands and Western Samoa are ranked among top ten origins of China's FDI inflow.

Country/Region of Origin	Amount Invested 2005 ($ biliion)	Amount Invested 2006 ($ billion)	Year-on-Year Growth (%)
Hong Kong	$17.95	$20.23	13
British Virgin Islands	$9.02	$11.25	25
Japan	$6.53	$4.60	-30
South Korea	$5.17	$3.89	-25
United States	$3.06	$2.87	-6
Taiwan	$2.15	$2.14	-1
Singapore	$2.20	$2.26	3
Cayman Islands	$1.95	$2.1	8
Germany	$1.53	$1.98	29
Western Samoa	$1.36	$1.54	13

Table 4: Top 10 Origins of China's FDI [18]

Like Hong Kong, these tax havens provide tax exemptions on dividends and offshore earnings, confidentiality, fast and easy procedures for setting up a company and an established legal system. In some sense, these tax havens are even more favored by MNC's that will likely to invest in China, because they are perceived to be politically more independent than Hong Kong [10]. Apparently Chinese companies listed in these tax havens do not have any major manufacturing or production activities, they are nothing but shell companies that allow Chinese companies to gain access to flexibilities in financial arrangements.

Offshore tax havens have always been favorite locations for special-purpose vehicles used for investing in China. Major reason for using an offshore shell to hold a China investment is to bypass the mainland's maze of regulations and restrictions on foreign investment.

Chinese government has strict regulations prohibiting foreign companies from investing in certain telecom segments, such as internet content providers (ICPs). Therefore, a web of offshore companies could be set up to help foreign companies to invest indirectly but legally in such mainland-based concerns. For a similar reason, for high-tech start-up companies that China has tight control, Chinese venture capitalists go offshore to circumvent China's unclear and restrictive laws on exiting a short-term investment. Such type of off-shore arrangements would provide necessary financial flexibility for transfer of venture capitals while at the same time bypass complicated process that will typically involve layers of governmental approvals.

For Chinese private firms that have problems getting listed in the domestic stock market due to biases against Chinese companies in favor of foreign MNCs, an easier way to gain access to financial capital is for them to set up an offshore company to control their mainland assets and then list the shell abroad company as foreign-owned one. The funds they raise are then sent back to China as "foreign capital" subject to preferential treatment, which, in turn, boosts China's FDI inflow figures without any major economic contribution to China.

CONCLUSION

I have briefly reported the following three major problems in China's FDI accounting: 1. the inclusion of additional items to boost its FDI inflow figure, 2. Round tripping that have exaggerated China's FDI inflow amount by at least 25% for the past decade, and 3. The use of off-shore financing in tax havens that have severely twists the true FDI accounting numbers. Each of these three problems have twisted China's FDI accounting and bears dire consequences. I believe that it is necessary for the Chinese government to change regulations to fix these misleading financial reporting practices to allow true FDI accounting. The identified FDI accounting problems can also provide guidance for future China's policy making in its economic developments.

Further research into China's FDI accounting is still needed, as some of the data in this report is outdated. In addition, additional analysis is needed in order to identify other factors that may have caused China's FDI accounting.

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