CONTENT

Abstract

One of the manifestations of the globalization of the world economy was the opening of China to investments of multinational enterprises. This process had such a powerful influence on the further development of international economic relations that it changed the structure of world trade and international production. Over the past forty years, China has become a major recipient of foreign direct investment and a key actor in global value chains (GVCs). The opening of the Chinese economy to FDI gave a huge reverse impetus to further globalization and significantly intensified the economic interdependence of countries.

In recent years, China has consistently ranked second as a recipient country of FDI, but at the same time, it is rapidly increasing the volume of capital outflows from the country. Chinese MNEs caused more and more competition for Western companies in the markets of third countries. In 2020, the total assets of multinational enterprises in China exceeded $3 trillion, equal to approximately 20 percent of China's GDP. Subsidiaries of foreign firms have employed 12 million people, or about 3 percent of China's urban workforce (McKinsey Global Institute, 2023). If we consider the employment at the firms of local contractors, subcontractors of foreign companies, this figure will increase by 3–4 times.

Among the main motives for multinational companies to enter China are its huge market, low cost of labor, the availability of qualified workers, scientists, engineers, as well as a relatively high level of industrial and urban infrastructure in the eastern regions. China's experience clearly confirms the conclusions of Narula and Dunning's 'Investment development path' theory. Over 40 years this country has accumulated a significant potential for innovation, knowledge and created new comparative advantages for FDI inflow. The state policy of this country was aimed at the consistent implementation of structural changes in industry and exports. It contributed to the growth of the country's competitiveness and the appearance of new areas of investment with greater added value.

As China moved through investment development, the configuration of OLI advantages for foreign and domestic investors continued to change. In 1980–1990-s FDI were focused only on its cheap labor or natural resources. Later MNEs have changed their priorities and focused on new advantages of the developed technological infrastructure and the availability of a highly qualified workforce. These comparative advantages not only attracted new foreign investors, but also provided an opportunity for domestic companies to develop their ownership advantages and start exporting capital.

China's economic growth has become a powerful magnet that attracted more and more FDI to this country. Between 1990 and 2019, China's real GDP grew by an average of nearly 10 percent per year, contributing more than a quarter of global GDP growth. During that time, median household income rose from about US$750 to US$13,000. China's GDP now accounts for 18 percent of global GDP. This is a share that is equal to the share of the entire European Union and second only to the United States (24 percent) (McKinsey Global Institute, 2023).

Almost all economic studies of Chinese and other international scholars, revealed a significant positive correlation between GDP growth rates, per capita incomes, China's market size and FDI inflows. Most of the MNEs put the factor of economic growth of China and the optimistic prospects of the fast-growing market of this country in the first rank. The low cost of labor is traditionally considered to be one of the important determinants of FDI inflows to China. This was especially noticeable in the first decades of the influx of foreign investments, when the main part of MNEs projects was related to labor-intensive products. Over time, this factor has become less important as labor costs have risen (compared to some neighboring Asian countries) and multinational firms have become more focused on human capital and innovation. When evaluating the importance of cheap labor, one should also consider its productivity, discipline, and other features of the local labor market. For a long period of time, the combination of these factors has placed China in the top position among countries with cheap labor.

State policy, a stable political system, and successive steps taken by the Chinese government to liberalize economic life were extremely important for the inflow of FDI into the country. Without considering the extremely important role of public policy, it is difficult to understand why China has overtaken almost all other countries in terms of the volume of

inflow of foreign direct investment and turned into one of the main global centers of multinational firms' operations.

Strategic competitive considerations were also an important factor in the location of multinational firms in China. Global competition among MNEs forced many of them to "follow the leader". The example of China clearly confirms many arguments for such strategic behavior. Unlike the eclectic paradigm and internalization theory, which underestimated the importance of strategic competitive interaction of firms as determinants of FDI location, other theories of strategic management of multinational firms show the importance of the influence of competitors on business location.

The entry of the flagship MNEs in the Chinese market inevitably caused the effect of copying such actions by their main competitors. They perceived the actions of the flagship as a future threat to their global market positions and therefore followed the leader and made FDI in China. Such firms viewed their investment in China as part of an offensive or defensive global competitive strategy. The logic of their behavior is quite simple: "if we don't do it today, tomorrow competitors with the help of their enterprises in China can simply push us out of our traditional markets."

All locational advantages of FDI in China became possible only due to stable macroeconomic policy of the country. The consistent state policy of liberalization and deregulation of the economy allowed foreign firms to reduce the risks of entering the country's specific market. Maintaining a relatively low level of inflation and a stable exchange rate became the constituent parts of such a policy. The flexibility of the labor market and the improvement of infrastructure also have increased China's attractiveness as an investment area. Three stages of privatization (1984–1992, 1993–2002, 2002–2004) created a competitive environment in the country, which was extremely important for the formation of cooperative alliances of MNEs with local suppliers or subcontractors.

State policy to lower and eliminate the barriers to the movement of capital, have also significantly reduced microeconomic risks for foreign firms. The FDI attraction policy was consistent, predictable, and based on clear guidelines and goals that were understandable to foreign investors. The consequence of such a purposeful policy was an increase in the country's investment attractiveness and competitiveness. Almost 20 years have passed since the beginning of the liberalization of China's investment regime and market reforms, until this country began to

occupy the first rankings in all global reviews of investment attractiveness and became one of the main centers of MNEs operations.

After China's joining the WTO in 2001, this country turned into one of the world's leading exporters. Multinational enterprises have played a major role in the growth of the country's industrial exports, its structural transformation, and China's inclusion in global value chains. In 2005, foreign enterprises accounted for 28% of the country's added value in the industrial sector and 20% of all tax revenues from industrial enterprises. At this stage, multinational firms were the main driver of exports. According to estimates, they accounted for 57% of exports of goods and services from China.

The total accumulated amount of foreign direct investment after the country's accession to the WTO continued to grow steadily and reached almost $2.1 trillion in 2021. It was equal to 4.6% of the world's accumulated investment in historical prices. Only in 2010–2021, foreign investments increased by 1.5 trillion dollars.

Joint ventures were the original and most widespread form of MNEs entry into China. Legislative changes in the 1979–1980s opened new opportunities for the setting of joint ventures. They have gained popularity and have become the main form of FDI inflow for a long time. Some of joint ventures were established as the equity joint ventures (EJVs). The distribution of EJVs profit was carried out based on the proportion of invested capital. Another type of joint ventures was a contract joint venture (CJVs). For such enterprises the distribution of profits was determined by the contract and did not reflect the proportion of invested capital. After the adoption in 1986 'The Law on Enterprises with Full Foreign Ownership', the share of 100% owned subsidiaries began to increase. Although there were many sectoral restrictions on the inflow of FDI in this form. Only at the third stage of the influx of foreign investments (after China's accession to the WTO) their share began to grow rapidly.

The multinational enterprises' choice to set a joint venture is fully consistent with the Uppsala theory of internationalization. It was a way to acquire knowledge about the local market and reduce the risks of operations. Joint ventures opened the opportunity for MNEs to use the state support. In this case, the government often contributed to the provision of the joint venture with all infrastructure conditions, land plots, raw resources and permits for construction or production.

Chinese government also recommended for state enterprises to buy the products of such joint ventures.

We may trace several stages in how the proportions between different forms of MNEs operations have been changed over time in China. Until the 1990s, joint stock JVs were the main form of operations. More than 60% of all companies with foreign capital were set in this form. The Chinese government believed that JVs was an effective channel for the transfer of technology, experience, and marketing skills, and therefore encouraged MNEs to use this entry mode to the country. Only less than 10% of foreign enterprises were 100% owned branches or fully controlled subsidiaries. After China's joining the WTO, the entry of new multinational firms into the country took place mainly in the form of fully owned enterprises. Some joint ventures were also transformed into MNEs subsidiaries. In such situations, a foreign participant acquired a share of Chinese partners.

At the beginning of the third period of FDI inflow into China (since 2001), subsidiaries with 100% foreign ownership accounted for more than 60% of all enterprises with foreign participation. Contractual joint ventures have practically lost their former importance. They have been gradually substituted by subcontracting agreements of local enterprises with MNEs subsidiaries. Joint stock joint ventures stabilized their position at the level of 20–23 percent. Multinational firms use this channel if there is a restrictive government policy on 100% ownership in certain sectors, and when they want to have a local partner for a better understanding of the local environment.

Most multinational firm operations in China were associated with joint-stock enterprises (full or partial ownerships). But some foreign firms tried to develop contractual networking with local suppliers of raw materials or intermediate products. In the 1980s, such activity was limited because there were simply no local suppliers of quality intermediate goods that could be included in MNEs value chains. In addition, there was risk of non-compliance with the terms of the contracts because of different business ethics and the behavior of managers. In recent decades, the development of network partnerships of MNEs has become very widespread. Such alliances grew especially intensively in technological parks, and free economic zones. One of the empirical studies covered 2,387 cases of MNEs network contracts with suppliers in China. It showed that these foreign companies bought 91%

of the necessary components, parts, and raw materials from subcontracting network their local companies (Wei, Liu, & Wang, 2012).

Despite the slowdown of global FDI because of Covid-19 in 2020–2022, investment flows to China have had a different dynamic. In 2021–2022 China has resumed robust industrial growth and exports. After a brief disruption in global supply chains, multinational enterprises continued to operate and even began to scale up. Multinational enterprises activity was also facilitated by certain steps taken by the government to reduce barriers to investment and improve the business environment. According to the UN Conference on Trade and Development, China was the world's second recipient of foreign direct investment, attracting $149 billion in 2020 and $181 billion in 2021. Particularly significant increase of new annual investment was observed in 2021. In 2021 FDI inflows to China even outperformed the FDI inflows in EU. In 2016–2021, the volume of FDI stock in this country (excluding data on Hong Kong and Macau) increased by more than $700 billion, or 52%. The main part of the inflow was directed to the service sector – about 75% of new investments. The manufacturing industry, which until twenty years ago was the main sector of MNEs operations in the country, attracted only $34 billion in FDI, or less than 20% of inflow. The second and third most important sectors according to the classification of China's national statistics were the leasing and business services industry and research and development – 18% of total FDI inflows.

Beijing, Shanghai and Shenzhen have become important clusters for FDI and foreign companies headquarters in China. These cities are among the world's largest economic agglomerations. However, there are important differences between them regarding certain aspects of the investment climate. For example, the following criteria can be distinguished: (1) political center versus business center; (2) the influence of Chinese cultural values; (3) geographic location within China. These differences played a significant role in the MNE's choice of location for its regional headquarters.

Three factors determine the importance for MNEs to have a regional headquarters in China. First, it is a long distance from China to the global headquarters in the USA and Europe. The second reason is the greater specificity of China, the need to adapt the company's strategy to the needs of the market, local competitors, suppliers, or government regulation. The third reason is the huge volume of the market, the need for significant investments, large-scale production programs. The

extremely rapid growth of the market requires the adoption of many important management decisions on the spot.

The innovative activity of foreign firms in China has become an important factor of their competitiveness. Multinational companies had 1,500 R&D centers in this country in 2016. The growth rate of such centers was the highest among all countries receiving FDI. But such a large-scale research activity of multinational enterprises was the result of the evolution of their strategy, which lasted for almost thirty years. During this time, MNEs has fundamentally changed its attitude to China's local innovation potential, its role in the global production chains.

The first research centers were set to support the production operations of foreign subsidiaries. They were targeted at cost reduction. At the next stage of FDI inflow in the 1990s, MNEs started adaptation of their products or processes to the Chinese market. The profile of R&D centers has changed – they have become centers of adaptation or development of new products specifically for the Chinese market. From the 2000s foreign firms started intensive R&D in China with the aim of creating new knowledge and developing modern technologies. Multinational enterprises began to move their laboratories to China and open innovation centers. Most of these research centers were located near university centers and scientific agglomerations in Beijing, Shanghai, and Guangzhou. This type of innovative activity was aimed at developing pioneering knowledge for their global production network.

According to the Chinese government policy joint ventures have played important role in the transfer of technology to the country. It was assumed that joint ventures would form channels for the assimilation of new knowledge for Chinese partners. Private Chinese firms became the main recipient of the positive technological spillover effect. However, the effect of technology diffusion was imperceptible for state-owned firms. This was especially evident in the example of joint ventures of large state-owned firms with automobile MNEs. The most common mechanism for the diffusion of technology and knowledge from joint ventures or subsidiaries of foreign firms to local enterprises was the copying of technology and imitation of production by the local firms.

Over the last 40 years, China's economic development model has focused on attracting external financial resources in the form of foreign direct investment. This helped the country avoid a large debt burden. According to some estimates, more than 12 percent of China's total growth during 1986–2005 was provided by FDI (Chen, 2011, p. 231).

But at the provincial level, empirical studies have shown different results of the influence of multinational enterprises on economic growth. Multinational enterprises have had a significant positive effect on the increase of China's exports. It should be noted that only since the 2000s, a clear positive effect of foreign subsidiaries on the country's trade balance has been felt.

Another important consequence of the FDI inflow was the spillover effect of multinational firms on national enterprises. This created the most important mechanism for the transmission of growth impulses. In the 1980s and 1990s, foreign enterprises had multiple advantages over local firms in the efficiency of production factors and labor productivity. This generated spillover channels and incentivized local firms to borrow knowledge, innovations, and marketing experience from foreign companies. The co-production partnership, fluidity of the labor market, and training of local personnel have triggered such spillover channels.

Multinational firms also have developed subcontracting of raw materials from local partners and supplied intermediate or final products to domestic firms. Such practice facilitated the diffusion of technologies through vertical integration. Numerous empirical studies have shown that the inflow of FDI had significant positive vertical spillovers for private and state enterprises.

Competition with Western MNEs forced national firms to improve production and start innovations. Another competitive strategy of local enterprises was the tactic of copying the business models of multinational enterprises or their products.

In the coming decade China will continue to be the largest importers of direct investment and an area of active operations of MNEs. However, there is more and more evidence that the position of multinational enterprises in this country and their strategy may change significantly in the future. The lower influence of multinational firms on the dynamics of exports, capital formation, innovations and other parameters of China's economic development is quite evident and understandable, if you consider the very fast growth rate of the potential of local firms. Multinational firms should adjust their strategy to this reality as well as cope with the growing geopolitical unpredictability and risks in world economy.