A study on the Determinants of FDI Inflows to China

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Master’s dissertation 30 credits
Spring semester 2022
Abstract

Since the Chinese government proposed the "reform and opening-up policy" in 1979, China has achieved remarkable economic development. Foreign direct investment (FDI) has played an important role in stimulating economic development and alleviating capital shortages. This thesis explores FDI by choosing China as its destination country. Due to the boost of FDI inflows in China since the 1990s, we focus on the period 1978-2018 in this thesis; the last four decades before the COVID-19 pandemic. Location advantage theory is used as a theoretical framework to analyze the main determinants from the perspective of host countries. This thesis studies five selected factors: market size proxied by Gross Domestic Product (GDP), currency valuation proxied by exchange rate, labor cost proxied by annual wage, economic stability proxied by consumer price index (CPI), and infrastructure proxied by railway length in service in China. The autoregressive distributed lag (ARDL) method is used as the regression model, which can study the relationship from both the long-and short-run perspectives. We find that GDP, exchange rate, and railway length in service have a significant influence on FDI during the 1979-2018 period, while wages and CPI are not significant for FDI. The results indicate that market size, exchange rate, and infrastructure were strong determinants of FDI inflow in China from 1979 to 2018.
Acknowledgment

First, I would like to acknowledge my supervisor Xiang, whose patience and helpful feedback have helped me throughout the process of writing this thesis.

Second, I would like to thank my girlfriend Sining for her support during the COVID-19 period.

Finally, I want to thank my parents for their unconditional love and encouragement throughout the entire study period.
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Chapter 1. Introduction

1

Introduction

Since the 1980s, foreign direct investment (FDI) has been growing rapidly globally, and since the 1990s, FDI has become a significant source of external capital for developing countries. Today FDI has become one of the main driving forces for economic globalization and world economic growth. With the continuous development of globalization, which is led by multinational corporations, FDI plays an increasingly important role in the process of economic and social development for developing countries (Zhang, Zen, and Xie 2019). China's history of attracting FDI inflows dates back to 1979. From 1992 to 2015, except for only a few years, China's annual FDI inflows have been among the top three globally (Ahmad 2015).

Since the 1990s, along with the expansion of the international economy, China has gradually become a major global FDI inflow country due to its favorable investment environment that has attracted investment and technology expansion from worldwide. China's foreign direct investment inflows reached $131.04 billion in 2017, making it the second-largest foreign direct investment inflow after the United States. Hence, China is also considered by the World Bank as a typical example of successful use for foreign investment. The massive utilization of foreign capital has solved the problem of capital shortage in China's economic construction process, improved technological innovation, promoted the development of the manufacturing industry, and played an essential role in enhancing China's position in the global economy. In 2019, there are 59,800 more foreign-invested enterprises added in China, and the amount of foreign investment utilized reached $134.578 billion (Gao and Yan 2020). A large body of empirical evidence has confirmed that FDI is one of the critical drivers for China's economic growth. Especially since the accession to WTO, the simultaneous growth of foreign direct investment and the economy has become a typical feature for the rapid development of China's economy (Behname 2012).
Although foreign direct investment (FDI) may have a negative impact on the host country's economy, it is conducive to improving people's lives, raising national production levels, creating new jobs, and increasing technology transfer, as FDI inflows directly affect economic growth by stimulating domestic investment. At this time, foreign capital inflows are considered incremental, increasing the balance of payments, having a positive impact on the welfare of the host country and the development of knowledge infrastructure, providing a huge boost to the national economy. Thus, countries compete to attract FDI inflows worldwide (Zhang, 2007).

Therefore, it is necessary to explore the factors affecting FDI inflows to each country. The strong economic base of host countries is the main reason for attracting FDI inflows. However, the study of the factors influencing FDI inflows should also include the common problems affecting FDI inflows from a global perspective. In this study, we use FDI inflows as the research object and empirically analyze the influencing factors of FDI inflows to improve the relevant factors to stimulate this FDI inflow.

The purpose of this paper focuses on analyzing the following research question:

**Which determinants does China possess to influence FDI inflows during the last four decades?**

In this thesis, the determinants of FDI inflows to China are investigated from 1979 to 2018. Unlike most other FDI studies, which use general linear models and multiple linear regression, e.g., Ahmad (2015), Wang (2010), Wani and Rehman (2017), etc., we use the autoregressive distributed lag with an error correction mechanism (ARDL-ECM) method in this study which is more advanced and realistic. According to Location Advantage theory and other previous literature, we select five determinants of FDI inflows to study that are market size proxied by Gross Domestic Product (GDP), currency valuation proxied by exchange rate, labor cost proxied by annual wage, economic stability proxied by consumer price index (CPI), and infrastructure proxied by railway length in service. The aim is to investigate which are critical factors for FDI inflows in China. The time series used in this thesis covers a period of 40 years, which is much longer than many previous studies on this topic. For example, a period of 12 years was included in the paper written by Zhang, Zen, and Xie (2019), and a time series of 29 years was used in Behname’s (2012) paper concerning the impact of urban infrastructure on FDI, etc. The reason to select the year 1979 to be the beginning year is that in 1979 the Chinese government proposed the "reform and opening-up policy," and FDI inflows started to occur and increase obviously from that year.
1.1 Outlines

This thesis is divided into five sections: In the next section, the location advantage theory is raised along with related previous studies on FDI determinants. In section 3, the overall background of the improvement in China’s foreign investment policies from 1979 to 2018 and China’s FDI development are illustrated. In Section 4, it begins with a brief explanation of the database used in the subsequent regressions. The autoregressive distributed lag (ARDL) model is introduced. Also, the theoretical hypotheses are presented in this section. In the last section, the regression tests and results are discussed.
Chapter 2. Theoretical Framework and Literature Review

2

Theoretical Framework and Literature Review

I introduce the location advantage theory (John Dunning) and some previous studies on diverse FDI determinants to gain a better understanding of the potential FDI determinants from the perspective of host countries. All potential determinants explored from the location advantage theory and empirical studies are presented.

2.1 Foreign Direct Investment (FDI)

As defined by the OECD, foreign direct investment (FDI) is a category of cross-border investment in which investors residing in one economy establish a lasting interest and have a significant degree of influence over firms in another economy (OECD, 1996). Warner (1999) also defined Foreign Direct Investment (FDI) as ordinarily occurring when an entity from one country, such as a corporation, makes a physical investment in another country. Overall, FDI is an economic activity in which investors invest in an enterprise outside of their home country to achieve benefits and exercise effective influence and control over that foreign enterprise. FDI includes both initial transactions between the two economic entities mentioned above and subsequent transactions between them and between all affiliated enterprises. Since the capital ratio usually influences the management rights of an enterprise, the IMF recommends a minimum standard of 10% ownership of foreign enterprises for international direct investment. However, some countries use other evidence rather than capital ratios to make their determinations (IMF, 1993).

The difference between foreign direct investment and indirect investment: 1. The foreign direct investment includes both intangible and tangible assets. The foreign indirect investment includes only monetary capital. 2. Foreign direct investments do not involve a change of assets
ownership. With foreign indirect investment, ownership of the assets changes between the buyer and the seller. 3. The purpose of foreign direct investment is to obtain control of the management of the invested enterprise. The purpose of foreign indirect investment is to obtain a profit on financial assets. 4. In the balance sheet, foreign direct investments are classified as tangible and intangible assets investments. Foreign indirect investments are classified as items of marketable securities held by enterprises (Maitena and Banco, 2003).

FDI can be divided into three types depending on the direction of production and operation of the subsidiary and the parent company: 1. Horizontal FDI: the same or similar products, generally used in machinery manufacturing food processing industry. 2. Vertical FDI: It can be the product of different procedures of the same industry, such as the automobile and electronic industry; it can be the product related to different industries, such as resource extraction and processing industry. 3. Hybrid FDI: producing completely different products, only a few giant multinational companies take this approach. FDI can be divided into two types from the perspective of whether the investor is newly investing to start a business: 1. Start a new business: also known as greenfield investment, including sole proprietorship and joint venture. 2. Control of foreign enterprise's equity: Foreign investors purchase certain percentage shares of the host enterprise through certain procedures to control the enterprise (Maitena and Banco, 2003). In this study, FDI is considered as an overview without elaborations on these types. This study focuses on FDI inflows in China. For the sake of convenience, all “FDI” in the following sections expresses “FDI inflows”. Furthermore, I named the country, which attracts inward FDI as the “host country” while “foreign country” stands for the country with outward flows to other countries or regions.

Why is there an interest in the determinants of FDI inflows? Empirical studies suggest that FDI inflows may affect many aspects of a host country’s economic growth. Panagiotis (2015) finds that the stock of foreign direct investment is a significant factor that positively affects economic growth in the Eurozone countries. Hayat (2018) also believes a positive and significant effect of FDI inflows on the economic growth of the host country. Furthermore, Eldin, Sabina, and Vesna (2014) claim that the impact of foreign direct investment (FDI) on economic growth in the transition countries of southeast Europe is positive and statistically significant. Since there could be a significant contribution to the economic growth of the host country from FDI inflow, the elements that drive inward FDI flows to the host country are deemed crucial.
2.2 Location advantage theory

Location advantage is a crucial element of ownership-location-internationalization (OLI) in FDI theory and was proposed and developed by John Dunning in the 1990s. In accordance with OLI theory, three determinants must exist simultaneously to give rise to FDI: ownership, location, and internalization advantages (Bora, 2002). In the OLI theory, ownership advantage and internationalization advantage are firm-specific advantages that emphasize a firm’s strengths, such as capacities of enterprise, capital, management, and other specific features. However, this study focuses on determinants from the perspective of host countries at a macro level. Thus, location advantages are primarily emphasized here.

Location advantage refers to the selective advantage that multinational enterprises (MNCs) have in terms of investment location, whether the area available for investment has advantages in certain aspects. The choice of investment location is influenced by the geographical distribution of production factors and markets, transportation costs, investment environment, and other factors. When MNCs with ownership and internalization advantages make direct investments, they first face the choice of location, i.e., whether to invest in their home country or abroad. If producing abroad makes MNCs more profitable than having at home, it will lead to outward FDI (Kim, 2016). Therefore, the flow of FDI depends on the attractiveness of locational endowments. Various factors determine location conditions in the investing and host countries, including government policies, market characteristics, labor costs, local production levels, the availability of raw materials, etc. (Rosle, 2011).

Location advantages can be divided into direct location advantages and indirect location advantages. Direct location advantage refers to the location advantage formed by certain favorable factors of the host country, such as broad product sales market, low factor costs, various preferential investment policies of the government, etc. Indirect locational advantage refers to the locational advantage formed by unfavorable factors in investing and host countries, such as high transportation costs of commodity exports and trade barriers (Findlay, 1991).

Location advantages determine the attractiveness of the different locations for production. A firm minimizes production costs and takes advantage of large or knowledge spillovers if an advantageous location is found. Unlike ownership advantages, location advantages are non-transferable.
Location advantage means the objectively favorable conditions or superior position of an area in terms of economy. The main factors of location advantages include natural resources, geographical location, science and technology, management, politics, culture, education, etc. Location advantage is a comprehensive concept, and a single advantage is often difficult to form a location advantage (Rosle, 2011). The location advantage of a region is mainly determined by natural resources, labor, industrial gathering, geographical location, transportation, etc. Also, the locational advantage is a developmental concept that changes with the relevant conditions (Findlay, 1991). The size of the location advantage determines whether and in which region the MNCs make outward FDI. In conclusion, location advantage promotes that the strengths of host countries, such as government policies, national stability and infrastructure, market size, and labor cost can influence FDI.

2.3 Selected determinants of FDI with previous studies

In this study, we select five significant determinants of FDI detected from location advantage theory: market size, labor cost, currency valuation, economic stabilities, and infrastructure. These determinants are represented with previous research in this section.

Market size
Market size is a measure of the total volume of the market. Shan, Lin, and Zeng (2018) claim that market size plays a significant role in attracting foreign investments in Africa. In Muhammad’s study (2011), he observes market size as the most crucial factor that affects FDI inflows. His study emphasizes the significant role of the market size in attracting FDI inflows to a developing country. On the other hand, it highlights the importance of regionalization to increase the market size for availing higher FDI inflows and other supplementary benefits. Mumtaz (2014) also finds that market size significantly affects inward FDI in around 90 developing countries. Besides, Khachoo (2012) highlights that market size is the primary determinant of FDI inflows to developing countries over a long period. This result is commensurate with Dunning’s OLI Paradigm, according to which a great deal of investment flows into the countries with a large market size.

Gross Domestic Product (GDP) can be used as a measure of market size. Meanwhile, GDP can also be a measure of the quality of market demand. A high GDP implies a high demand for more advanced goods of higher quality (Merlevede and Schoors, 2004). Furthermore, Khachoo (2012) believes that countries with higher GDP imply that they have a large market size,
attracting a large number of overseas investments. Thus, a higher GDP implies larger market size and potential.

**Labor cost**
In Vijayakumar, Sridharan, and Rao’ study (2010), they examine the factors determining FDI inflows of BRICS countries, including China, from 1975 to 2007 and find that labor cost is the insignificant determinant of FDI inflows. Moreover, when Hubert and Phanindra (2006) examined the FDI between the members of the European Union and central and eastern European candidate (CEEC) economies, they found that the labor cost in the host country is the key determinant of FDI. Besides, in Vinit and Gaurav’s study (2011), they explore Foreign Direct Investment inflow determinants in BRIC countries (Brazil, Russia Federation, India, and China) from 1975 to 2009. They claim that investors want to search for lower labor cost destinations, and thus they are highly attracted to the countries that provide them with lower labor costs. Khachoo and Khan (2012) also find that higher labor costs would discourage inflows of FDI. In other words, countries with cheap labor are preferred FDI destinations.

Wages are used to measure labor costs. Thus, when wage is higher, the cost of production is also high for enterprises. In addition, the gradual loss of labor resource advantage (WAGE) may lead to an outflow of international capital, mainly FDI, to invest in countries with lower production costs. Therefore, lower wages can be a competitive advantage to produce at lower labor costs.

**Currency Valuation**
The exchange rate reflects the valuation of one currency against another. The higher the exchange rate, the cheaper is the domestic currency. Furthermore, exchange rates, defined as the domestic currency price of a foreign currency, matter in terms of both their levels and volatilities. According to international macroeconomics theory, depreciation in a country’s currency (host country) triggers the cost of production to decrease relative to the price of another currency, which attracts more investment in the host country.

Lots of research shows that the exchange rate is significant for FDI. Khandare (2016) found that the exchange rate is highly significant with FDI in the case of India but does not exert a significant influence on FDI in the case of China. Muhammad (2011) claims that the exchange rate is an essential negative impact determinant for FDI in the long and short run for Pakistan. Vijayakumar, Sridharan, and Rao (2010) expected that devaluation of a currency would result
in reduced exchange rate risk. As a currency depreciates, the purchasing power of the investors in foreign currency terms is enhanced. Thus, there is a significant positive relationship between the currency value and FDI inflows. But in their study, they found a significantly negative relationship between FDI and Currency value in BRICS countries, which is a contradictory result as they expected.

However, some research shows that exchange rate and FDI are positively correlated. Joseph, Peiming, and Dongyun (2010) examine the impact of exchange rates on foreign direct investment inflows into the United States and find that the exchange rate has a positive and significant effect on the average rate of FDI inflows. Shinji and Zongying (2011) also believe that FDI declined with currency depreciation and increased with a stronger exchange rate. Moreover, Fayyaz, Muhammad, and SuChang’s study (2019) investigate the relationship between China's exchange rate and FDI inflows and found a significant positive correlation between FDI and exchange rate from 1981 to 2013.

**Economic Stabilities**

Vijayakumar, Sridharan, and Rao (2010) claim that the economic stability measured by inflation is negatively insignificant in determining the FDI inflows in BRICS countries, including China, which means economic stability is a potential determinant of FDI inflows. Besides, in Vinit and Gaurav’s study (2011), they find that economic stability is one of the determinant factors of FDI in BRICS countries (Brazil, Russia Federation, India, and China). Rashid, Looi, and Wong (2017) believe that trade openness and political stability positively influenced FDI inflows, while the inflation rate negatively impacted FDI inflows in the Asia Pacific region. Economic and political stability is one of the most influential variables for FDI.

Consumer Price Index (CPI) can be used to test economic stability. The CPI is a measure of the overall level of prices that contribute to the cost of a fixed basket of goods relative to the cost of the same basket in the previous year. It is also an indicator of inflation, making the CPI an integral element of economic stability (Jamie and Mike, 2004).

**Infrastructure**

According to the authoritative definition of the World Bank (Bhasin 1994), infrastructure generally refers to engineering and public service facilities that provide public services for social production and people's lives. The former is called economic infrastructure, which refers to the long-term use of engineering structures, equipment, facilities, and services for economic
production and households, including power, transportation, water, and communication facilities.

After Aschauer (1989) suggested the important role of public infrastructure capital stock in increasing private sector total factor productivity, the importance of infrastructure development on FDI inflows and related theoretical studies began to receive academic attention. Ehrenberg (1993) pointed out that if various public infrastructures do not serve local firms and multinational corporations well, these firms will operate inefficiently because they will have to build their own infrastructure, which will lead to duplication and waste of resources; thus, public factor inputs could reduce their transportation costs. Besides, Khachoo and Khan (2012) find that countries with better and improved infrastructure facilities out-compete others in attracting foreign investment. Well-developed infrastructure facilities increase the productivity of the investments and, therefore, may stimulate FDI inflows into the country.

Infrastructure can be reflected in various perspectives such as education, transport, and telecommunication facilities. In the later section, I will use the length of railway lines in service to represent the capacity of the domestic transport infrastructure. We assume that longer railway lines in services can stimulate more communication and trade. Thus, there is an appositive correlation between the length of railway lines in service and FDI.

Other FDI determinants
Other FDI determinants, such as the level of education and trade openness, can also be traced in previous research. Aneta, Michaela, Zuzana, and Rastislav (2018) identify that the level of gross wages and the share of the educated labor force are the most significant determinants with a positive effect on FDI inflows in Visegrad countries. Omar and Mishra (2015) also emphasize that better institutions and educated labor forces may play a key role in attracting FDI inflows to Arab economies. Furthermore, Liargovas and Skandalis (2012) prove that trade openness contributes positively to the inflow of FDI in developing economies in the long run by using a sample of 36 developing economies from 1990 to 2008. In Abimbola’s study (2010), the results show that the interaction between trade openness and infrastructure leads to an increase in FDI inflow in Sub-Saharan African Countries. Hence, he suggests that policymakers increase further efforts toward trade openness to enhance the level of FDI inflow.
3

Background

This section introduces China’s historical evolutionary national foreign investment conditions and presents an overview of FDI development in China.

3.1 Evolutions of China’s economic policies

China's economy has undergone radical changes in the last 70 years, especially in the 40 years after the reform and opening-up. As an important engine and highlight of China's rapid economic development, foreign investment has made world-renowned achievements. Over the past 70 years, as foreign investment has increased, China's position in the global industrial chain has grown, and its influence on the world economy has improved. The rapid development of China's foreign investment inflow and the reform of the foreign trade system complement each other.

Furthermore, the continuous optimization of the policy system is the inexhaustible impetus and basic guarantee for the development of the foreign investment. With the development and changes of domestic economic conditions and national economic policies, China's foreign trade policy objectives and development direction have been adjusted several times. In general, the 70-year history of China’s economic policies for foreign investment can be divided into five historical stages.

3.1.1 Planning and management stage (1949-1978)

At the beginning of the establishment of New China, the United States and other major Western countries adopted a containment policy of siege and blockade against China. At that time, Chairman Mao stated, "Relying mainly on our own efforts while making an extended assistance
subsidiary." (Jenmin Jih Pao, 1977) This is regarded as the fundamental principle of foreign economic relations. Meanwhile, Premier Zhou Enlai pointed out at the Council of State meeting in August 1950: "foreign trade should be more planned to avoid blind exports and imports, to reduce trade with the U.S. and to gradually get rid of U.S. influence" and "the purpose of foreign trade is to develop production." (Central Documentary Research Office, 1997)

Because of the highly centralized planned economic system, the foreign trade policy was well executed during this period. China and the Soviet Union signed the China-Soviet Trade Agreement on April 19, 1950, which led to the expansion of total China-Soviet trade and the establishment of many joint ventures between China and the Soviet Union and other Eastern European countries. This is considered the starting point for China in absorbing FDI. (Zhao, 1989)

After 1960, relations between China and the Soviet Union deteriorated, China-Soviet trade was disrupted, and most joint ventures were terminated. There was a brief setback in developing foreign investment in China, and the total amount of foreign investment hit bottom in 1962. The Cultural Revolution of the 1970s created major obstacles to foreign capital, especially foreign direct investment. Moreover, China's low industrial productivity and slow technological progress during that period put it at a disadvantage in international competition.

### 3.1.2 Pilot reform stage (1979-1991)

In December 1978, China and the United States issued the "Communiqué on the Establishment of Diplomatic Relations between China and the United States," and the door to the Western market was officially opened to China. In the same year, the Third Plenary Session of the Eleventh Central Committee was held in Beijing, and China issued several laws and regulations to attract foreign investors. In 1979, the Central Government approved the adoption of particular policies and flexible measures in foreign trade and economic activities in Guangdong and Fujian provinces on the southeast coast and the establishment of local foreign trade companies in Shanghai, Beijing, Tianjin, and other cities, and the gradual liberalization of foreign trade policies in the pilot areas. At the same time, the Joint Venture Law was introduced, which depicts the legal framework of equity joint ventures between foreign partners and domestic companies.

In 1985, the three "Developing Triangles," the Yangtze River Delta, the Zhujiang River Delta, and the Mingnan triangle area were turned into "Open Economic Zones" (OEZs). Together with the Liaodong- Shandong Peninsula and Huang- Bo Sea regions, they were unlocked to foreign
investors by degrees (Fung, Lizaka, and Tong, 2002). In 1986 and 1988, “the Law on Foreign Capital Enterprises” and “the Law on Chinese Foreign Entrepreneur Joint Ventures” were formulated by the Council of State. As a result, the laws provided the same price costs, low interest loans, and additional tax benefits in foreign joint ventures.

During this period, the implementation of preferential policies was promoted to bring in foreign investment and encourage exports in labor-intensive industries where China has a comparative advantage, while in the capital- and technology-intensive industries where China does not have a comparative advantage, the import-substitution strategy was implemented to actively attract foreign investment. Owing to the launch of the restructuring of foreign investment policy, FDI increased by leaps and bounds compared to the previous period.

3.1.3 **Expanding and opening up phase (1992-2001)**

In 1992, Deng Xiaoping summarized the achievements of China's reform and opening up in the previous phase and pointed out the direction of development for the new phase, "deepening reform and expanding opening up." At the level of foreign trade policy, a greater range of market mechanisms are introduced, and economic levers such as exchange rates, tariffs, interest rates, and legal instruments are used to mediate foreign trade development (Hu, 1993).

On the other hand, the region of China's opening up to the outside is advancing from the southeastern coast to the broader inland areas and changing from a special pilot zone to a full-scale opening area. Since the beginning of WTO entry negotiations, China has carried out a series of reforms such as lowering tariffs, eliminating some export subsidies, opening up trade policies, and liberalizing prices referred to WTO rules, further promoting foreign investment (Ho, 2004). In 1999, Zeming Jiang (the General Secretary of the CPC Centre Committee) presented the “Going out Strategy,” which proposed developing domestic economies by utilizing foreign capital and investment.

3.1.4 **High-growth stage (2002-2012)**

China officially entered the WTO in November 2001. Since then, the Chinese economy has become an undivided part of the global economy. During this period, China actively practiced the concept of free trade and participated intensely in the global trading system. For the sake of integration with the global market, China committed to ensuring that its investment environment was up to the WTO standard. The reforms comprised transparency of legislation, protection of property, reducing taxes and tariffs, implementing bilateral or multilateral trade, and so on.
In terms of specific data, Chinese foreign investment inflows grew further at a high rate during that period, gradually becoming a significant driving force for the recovery and development of the world economy (Information Office of the State Council, 2011).

**3.1.5 Optimizing phase (post 2013)**

The "Belt and Road Initiatives" policy, officially proposed by Xi Jinping in 2013, is an essential exploration for a new model of global economic governance. It also opens up new areas for China to participate in and lead international openness and cooperation. The importance of foreign investment is also emphasized in this policy (Gao, 2017).

Since 2013, foreign direct investment inflows to China have further developed. From 2013 to 2015, China's annual FDI inflows have been among the top three globally (Ahmad 2015). China's foreign direct investment inflows reached $131.04 billion in 2017, making it the second-largest foreign direct investment inflow after the United States (Gao and Yan 2020).

**3.2 Overview of FDI in China**

In Section 3.1, I introduce changes in foreign investment policies in China, which contain five major stages of economic evolution and assess whether FDI are attached to these historical stages.

![Figure 3.2.1: FDI in China (USD 100 million)](Source: National Bureau of Statistics China. Statistics yearbook 2012, 2019)

Figure 3.2.1 shows the FDI (Hundred million USD) in China from 1979 to 2018 and Figure 3.2.2 shows the annual FDI growth rate from 1986 to 2018. The FDI growth rate is calculated as \( \frac{FDI_{t+1} - FDI_t}{FDI_t} \), where \( t \) is the time period (year). From the observations, FDI growth started at the beginning of the 1980s, which can be traced back to the pilot reform stage (1979-1991). During this time, FDI increased slowly but steadily, and small investment projects were the main trend in this period. Large investments did not occur because of poor infrastructure (OECD, 2000). During the expanding and opening up phase (1992-2001), FDI gradually increased. In 1991, FDI in China almost doubled compared to 1987. Further, in 1991, FDI increased by 25.21 percent compared to the previous year. This was followed by continued rapid growth in the 1990s. In 1992, FDI surged nearly three times more compared to the FDI in 1991. Since then, China has become the largest host country for FDI among developing countries and the second-largest host country in the world (UNCTAD, World Investment Report 2010). During the expanding and opening up phase (1992-2001), FDI maintained a marginally fluctuating range and reached a small peak of 4.55 billion USD in 1998, followed by a slight decrease in 1999 and 2000. During the optimizing phase, FDI increased stably until 2018; FDI in 2018 was nearly three times higher than that in 2002.
Chapter 3. Background

Table 3.2.3 FDI inflows in China at different stages

<table>
<thead>
<tr>
<th>Phase</th>
<th>Annual average FDI (USD 100 million)</th>
<th>Annual average growth rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986-1991</td>
<td>31.662</td>
<td>15.01%</td>
</tr>
<tr>
<td>1992-2001</td>
<td>370.169</td>
<td>36.09%</td>
</tr>
<tr>
<td>2002-2018</td>
<td>967.352</td>
<td>6.65%</td>
</tr>
</tbody>
</table>

Note: All calculations above are based on annual FDI data from the National Bureau of Statistics China, Statistics Year Book 2012, 2019.

To obtain an overview of FDI in different historical phases, I calculated the annual average FDI and annual growth rate (the sum of yearly growth rate/number of years) in each period. We can conclude that there are significant distinctions in FDI in different periods (Table 3.2.3). The annual average growth rate during 1992-2001 reached 36 percent; more than double that of FDI during 1986-1991. In the 21st century, China has been ranked in the top five worldwide with the highest confidence index (by A. T. Kearney), which explains why FDI has kept a stable increase at around 6-7 percent yearly from 2002.
4

Data, Models and Hypotheses

This section begins with a brief explanation of the database used in the subsequent regressions. I will focus on the autoregressive distributed lag (ARDL) model to analyze the relations between economic determinants and FDI. The theoretical hypotheses are presented in this section.

4.1 Data sources

Five factors are selected to be investigated in this study according to section 2: market size proxied by Gross Domestic Product (GDP), currency valuation proxied by exchange rate, labor cost proxied by annual wage, economic stability proxied by consumer price index (CPI), and infrastructure proxied by railway length in service.

This study used annual data for China from 1979 to 2018. Data on GDP, wages, length of railway lines in service, and CPI are collected from the National Bureau of Statistics China. The FDI data are based on the National Bureau of Statistics China (Year Book 2012 and 2019) and the Ministry of Commerce of the People’s Republic of China. Exchange rate data were collected from the State Administration of Foreign Exchange of the People’s Republic of China and the People’s Bank of China. All data are yearly, and the period of all observations is between 1979 and 2018. Regarding the units of each variable, the unit of FDI is 100 million USD, and the unit of length of railway lines (LRS) is one thousand kilometers respectively. The wage was collected as the domestic average annual wage, and the unit was Chinese yuan. CPI (%) was calculated based on the preceding year (preceding year=100). The exchange rate is the historical ratio between the Chinese Yuan and the USD.
Data obtained from official authoritative databases ensured the validity of the data in this study. The indicators, data symbols used to characterize the indicators, interpretation, and units are listed in Table 4.1.1.

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Data</th>
<th>Interpretation</th>
<th>Unit</th>
<th>References</th>
</tr>
</thead>
<tbody>
<tr>
<td>FDI</td>
<td>FDI</td>
<td>Annual volumes of foreign direct investment inflows</td>
<td>100 million USD</td>
<td>Mah et al(2010); Eicher &amp; Kang (2005)</td>
</tr>
<tr>
<td>Market size</td>
<td>GDP</td>
<td>Gross domestic production of China</td>
<td>100 million USD</td>
<td></td>
</tr>
<tr>
<td>Labor cost</td>
<td>Wage</td>
<td>The domestic average annual wage</td>
<td>Chinese Yuan</td>
<td>Bayraktar-Saglam, &amp; Boke (2017); Hou et al (2021)</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>LRS</td>
<td>the length of railway lines in service</td>
<td>1000 kilometers</td>
<td>Chakrabarti et al (2017); Bellak et al (2009)</td>
</tr>
<tr>
<td>Economic Stabilities</td>
<td>CPI</td>
<td>Consumer Price Index calculated basing on the preceding year (preceding year=100)</td>
<td></td>
<td>Wardhani &amp; Haryanto (2020); Olorogun (2021)</td>
</tr>
</tbody>
</table>

4.2 Model setting

The autoregressive distributed lag (ARDL) model is based on the autoregressive model (AR) using the principle of adding lagged terms of explanatory variables to improve its explanatory and predictive power. The autoregressive distributed lag model can be adjusted for a time series with autocorrelation. The ARDL model was used because our sample size was small and since it is appropriate for the application of variables in their horizontal form I(0) position, variables in first-order integration in their difference I(1), or a combination of I(0) and I(1). Additionally, the ARDL model can calculate both long- and short-term coefficients. The short-term coefficients indicate the association between the dependent variable and long-term trend. Therefore, the ADRL regression model is established as follows, referring to the methods of Uzar and Eyuboglu (2019), Faisal et al., (2021) and other scholars:
\[
\Delta \ln FDI_t = \alpha + \sum_{i=1}^{n} \beta_i \Delta \ln FDI_{t-i} + \sum_{i=0}^{n} \varphi_i \Delta \ln GDP_{t-i} + \sum_{i=0}^{n} \gamma_i \Delta \ln W_{t-i} + \sum_{i=0}^{n} \lambda_i \Delta EXR_{t-i} \\
+ \sum_{i=0}^{n} \sigma_i \Delta \ln LRS_{t-i} + \sum_{i=0}^{n} \mu_i \Delta \ln CPI_{t-i} + \theta_1 \ln FDI_{t-1} + \theta_2 \ln GDP_{t-1} \\
+ \theta_3 \ln W_{t-1} + \theta_4 \ln EXR_{t-1} + \theta_5 \ln LRS_{t-1} + \theta_6 \ln CPI_{t-1} + \epsilon_t
\]

(Equation 4.2.1)

Equation 4.2.1 can be further renormalized in the form of an error correction mechanism (ARDL-ECM):

\[
\Delta \ln FDI_t = \alpha + \sum_{i=1}^{n} \beta_i \Delta \ln FDI_{t-i} + \sum_{i=0}^{n} \varphi_i \Delta \ln GDP_{t-i} + \sum_{i=0}^{n} \gamma_i \Delta \ln W_{t-i} + \sum_{i=0}^{n} \lambda_i \Delta EXR_{t-i} \\
+ \sum_{i=0}^{n} \sigma_i \Delta \ln LRS_{t-i} + \sum_{i=0}^{n} \mu_i \Delta \ln CPI_{t-i} + \theta_1 (\ln FDI_{t-1} - \phi_1 \ln GDP_{t-1}) \\
- \phi_2 \ln W_{t-1} - \phi_3 \ln EXR_{t-1} - \phi_4 \ln LRS_{t-1} - \phi_5 \ln CPI_{t-1}) + \epsilon_t
\]

(Equation 4.2.2)

Here the long-run coefficients \( \phi_1 = \frac{-\theta_2}{\theta_1}, \phi_2 = \frac{-\theta_3}{\theta_1}, \phi_3 = \frac{-\theta_4}{\theta_1}, \phi_4 = \frac{-\theta_5}{\theta_1}, \phi_5 = \frac{-\theta_6}{\theta_1}, \phi_6 = \frac{-\theta_7}{\theta_1} \) measure the short-run FDI adjustment speed. \( \beta, \varphi, \gamma, \lambda, \delta, \) and \( \mu \) in the equation are the long-run coefficients of elasticity for FDI, GDP, W, EXR, LRS, and CPI, respectively; \( \alpha \) is the constant term; \( \theta \) is the short-run coefficient of elasticity; and \( \epsilon \) is the random error term.

### 4.3 Theoretical hypotheses

Section 2 theoretical framework and literature review show that the location advantage theory can explain the determinants that affect FDI inflow, including Market size, Labor cost, Exchange rate, Infrastructure, and Economic stability. For these different influencing factors combined with the theoretical analysis, we propose the following five hypotheses:

**Hypothesis 1:** The greater the market size and market potential, the greater the FDI inflow.

**Hypothesis 2:** The lower the labor cost, the higher the FDI inflow.

**Hypothesis 3:** The stronger the exchange rate, the higher the FDI inflows.

**Hypothesis 4:** The better the infrastructure, the higher the FDI inflow.
Hypothesis 5: The better the economic stability, the higher the FDI inflows.

Furthermore, in this study, based on the above hypotheses we can set up five corresponding testable hypotheses as follows:

**Hypothesis 1:** GDP and FDI are positively correlated; that is, the coefficient of the model $\varphi > 0$.

**Hypothesis 2:** Wage and FDI are negatively correlated; that is, the coefficient of the model $\gamma < 0$.

**Hypothesis 3:** Exchange rate and FDI are positively correlated; that is, the coefficient of the model $\lambda > 0$.

**Hypothesis 4:** The length of railway lines in service and FDI are positively correlated; that is, the coefficient of the model $\delta > 0$.

**Hypothesis 5:** CPI and FDI are positively correlated; that is, the coefficient of the model $\mu > 0$. 
5

Tests, Results and Discussion

Autoregressive Distributed Lag method (ARDL) is conducted, and the results are provided in the remainder of this section.

5.1 ARDL bound test

The existence of co-integration between the variables should be checked before applying the ARDL model. In addition, to investigate the variables in short- and long-run relationships, an ARDL bound test is required. The ARDL bound test for this study is presented in Table 5.1.

<table>
<thead>
<tr>
<th>Model</th>
<th>F-value</th>
<th>Significance (%)</th>
<th>Critical bound value</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARDL(4,4,2,0,4)K(5)</td>
<td>7.728</td>
<td></td>
<td>Lower I(0)</td>
<td>Co-integration</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Upper I(1)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10</td>
<td>2.26</td>
<td>3.35</td>
<td></td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>2.62</td>
<td>3.79</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2.5</td>
<td>2.96</td>
<td>4.18</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1</td>
<td>3.41</td>
<td>4.68</td>
<td></td>
</tr>
</tbody>
</table>

To make the model results of the ARDL-ECM accurate, further co-integration tests, based on AIC or SIC, make the definition more concise and standardized. The original hypothesis H0 and alternative hypothesis H1 are as follows.

H0: There is no co-integration relationship.

H1: There is a co-integration relationship at X% significant level.
Specifically, the original hypothesis $H_0$ is accepted when the calculated $F$-statistic is below the lower critical value $I(0)$, and the result is uncertain if the $F$-statistic is between the lower critical value $I(0)$ and the upper critical value $I(1)$. The original hypothesis $H_0$ is rejected if the $F$-statistic is above the upper critical value $I(1)$. The model ARDL-ECM (4,4,2,2,0,4) used in this study has an $F$-value (7.728) higher than the upper critical value (4.68) at the 1% level, which suggests that there is a long-term relationship between FDI, GDP, W, LRS, EXR, and CPI in China.

### 5.2 Descriptive and correlation statistics

It is necessary to observe the minimum, maximum, standard deviation, and other relevant characteristics of the variables by drawing trend graphs to understand the basic properties of all variables. The results of the descriptive statistics are presented in Table 5.2 and Figure 5.2. There are no significant time trends in the variables; however, they should have constant terms. Therefore, the DF test with constant terms without a time trend is used. Further, there is a certain linkage between GDP, EXR, and W. Using the co-integration rank trace test (trace statistic), the results show a co-integration relationship.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Obs</th>
<th>Mean</th>
<th>Std. Dev</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>LnGDP</td>
<td>40</td>
<td>9.52</td>
<td>1.34</td>
<td>7.88</td>
<td>11.84</td>
</tr>
<tr>
<td>LnW</td>
<td>40</td>
<td>8.92</td>
<td>1.56</td>
<td>6.50</td>
<td>11.35</td>
</tr>
<tr>
<td>LnLRS</td>
<td>40</td>
<td>4.27</td>
<td>0.27</td>
<td>3.97</td>
<td>4.88</td>
</tr>
<tr>
<td>LnCPI</td>
<td>40</td>
<td>4.65</td>
<td>0.037</td>
<td>4.59</td>
<td>4.76</td>
</tr>
<tr>
<td>EXR</td>
<td>40</td>
<td>592.78</td>
<td>233.60</td>
<td>149.84</td>
<td>861.87</td>
</tr>
</tbody>
</table>

**Table 5.2: Variable descriptive statistics**

**Figure 5.2: Variable trend**


## 5.3 Unit root test

A unit root test is required for the time-series data. In this thesis, we use the DF test with a constant term and without a trend term to determine whether the time series is stationary in conjunction with the results of the trend plot and descriptive statistics in Section 5.2.

### Table 5.3: DF unit-root tests

<table>
<thead>
<tr>
<th>Variable</th>
<th>Z (t)</th>
<th>1% Critical Value</th>
<th>5% Critical Value</th>
<th>10% Critical Value</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>lnGDP</td>
<td>1.626</td>
<td>-3.655</td>
<td>-2.961</td>
<td>-2.613</td>
<td>0.9979</td>
</tr>
<tr>
<td>lnLRS</td>
<td>4.755</td>
<td>-3.655</td>
<td>-2.961</td>
<td>-2.613</td>
<td>1.0000</td>
</tr>
<tr>
<td>lnW</td>
<td>-0.043</td>
<td>-3.655</td>
<td>-2.961</td>
<td>-2.613</td>
<td>0.9548</td>
</tr>
<tr>
<td>EXR</td>
<td>-1.998</td>
<td>-3.655</td>
<td>-2.961</td>
<td>-2.613</td>
<td>0.2876</td>
</tr>
<tr>
<td>LnCPI</td>
<td>-2.814</td>
<td>-3.655</td>
<td>-2.961</td>
<td>-2.613</td>
<td>0.0596</td>
</tr>
<tr>
<td>D(lnGDP)</td>
<td>-4.786</td>
<td>-3.662</td>
<td>-2.964</td>
<td>-2.614</td>
<td>0.0001</td>
</tr>
<tr>
<td>D(lnLRS)</td>
<td>-3.080</td>
<td>-3.662</td>
<td>-2.964</td>
<td>-2.614</td>
<td>0.0281</td>
</tr>
<tr>
<td>D(lnW)</td>
<td>-3.552</td>
<td>-3.662</td>
<td>-2.964</td>
<td>-2.614</td>
<td>0.0068</td>
</tr>
<tr>
<td>D(EXR)</td>
<td>-5.305</td>
<td>-3.662</td>
<td>-2.964</td>
<td>-2.614</td>
<td>0.0000</td>
</tr>
<tr>
<td>D(LnCPI)</td>
<td>-6.491</td>
<td>-3.662</td>
<td>-2.964</td>
<td>-2.614</td>
<td>0.0000</td>
</tr>
</tbody>
</table>

The Z statistic in the unit root test is the basic statistic of the unit root test. Based on the Z-statistic and the critical values of different confidence intervals, the existence of a unit root can be determined at different confidence levels. The p-value is also a visual representation of the judgment. p<0.01 means that there is 99% certainty that the variable is stable. Similarly, p<0.05, and p<0.1 mean that there is 95% and 90% certainty, and the variable is stable. Using the DF unit root test, the null hypothesis of the test is the presence of unit root, that is, the series is non-stationary. Here in this study the p-value is obtained is greater than significance level of 0.05 and the Z statistic is higher than any of the critical values. Hence, the variables lnGDP, lnLRS, lnW, EXR, and LnCPI are non-stationary and have unit roots, whereas the first-order difference variables D(lnGDP), D(lnLRS), D(lnW), D(EXR), and D(LnCPI) can be estimated using the ARDL model on I(1).

## 5.4 Regression results

According to Equation 4.2.2, the regression results are shown in table 5.5.

### Table 5.5: ARDL Short-run and long-run relationship estimates selected model

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. error</th>
<th>t-statistic</th>
<th>Prob</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long run coefficients</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The regression results under the long-run multiplier show that the effect of GDP on FDI is significantly positive at the 5% level, that of EXR on FDI is significantly positive at the 1% level, and that of LRS on FDI is significantly negative at the 5% level. W and CPI have no significant effect on FDI. Specifically, a 1% increase in GDP raises FDI by 3.769%, a 1% increase in LRS decreases FDI by 7.613%, and a 1-unit increase in EXR raises FDI by 0.00672%.

5.6 Discussion

The long-run regression results of ARDL-ECM show that Hypotheses 1 and 3 hold, whereas Hypotheses 2, 4, and 5 do not hold. The short-run data, lagged two-period GDP has a significantly negative effect on FDI, lagged one-period W has a significantly negative effect on FDI, and lagged one-period LRS has a significantly positive effect on FDI. Specifically, a 1% increase in GDP leads to a 1.346% decrease in FDI, a 1% increase in W leads to a 1.564% decrease in FDI, and a 1% increase in LRS leads to a 2.684% increase in FDI. Since the data are cointegrated, it makes sense to consider the long-run multiplier. Combining the short- and
long-run multipliers, the effect of GDP on FDI is negative in the short-run, while the effect of GDP on FDI is positive in the long run. This indicates that the expansion of market size inhibits FDI input in the short run and increases it in the long run. One possible reason is that the expansion of market size in the short run prioritizes the demand for domestic capital, which will inhibit FDI inflow, whereas in the long run, the expansion of market size will lead to the entry of a large number of market-oriented enterprises and thus attract more market-oriented foreign investment (Encinas and Villegas, 2019; Lal, 2017). The effect of wages on FDI in the short run is negative, and in the long run, the effect is insignificant. One possible reason is that higher wages lead to higher labor costs, which will cause foreign investors to seek cheaper labor in other markets and abandon this market (Fan et al., 2018; Chen, et al., 2016). The effect of LRS on FDI in the short run is positive, while in the long run, the effect is negative. One possible reason is that in the short run, the increase in infrastructure construction will boost consumption and stimulate the market to reduce production costs, thereby attracting foreign investors to set up factories for profit. In the long run, convenient infrastructure will also promote the development of the domestic economy and thus put capital suppression on foreign investment, making foreign investment gradually decline (Gopalan et al., 2019; Johansson and Liu, 2020).
Conclusion

This thesis focuses on the determinants of FDI in China during the last four decades before the COVID-19 pandemic, introducing the background of China’s historical economic reforms on foreign investment policies and the FDI development in China since the “Open Door” policy in 1978. We obtain an overview of the continuous improvement in China’s foreign investment atmosphere. I detected five potential determinants of FDI based on the location advantage theory and other relevant empirical studies. The variables, GDP, annual wage, exchange rate, length of railway line in service, and consumer price index, were used to represent market size, production cost, currency evaluation, infrastructure, and economic stability, respectively.

The ARDL-ECM is applied by running a multiple regression between FDI and the five chosen economic determinants. The regression results show that the effect of GDP on FDI is significantly positive, which confirms Hypothesis 1: the larger the market size and market potential, the greater the FDI inflow. Wage level W is not significant for FDI, and therefore Hypothesis 2 which is the lower the wage, the higher the FDI inflow is not valid. The effect of EXR on FDI is significantly positive, which indicates that Hypothesis 3 is valid because foreign corporate investors make investment decisions based on future expected returns. The trend of China's currency represents the economic development situation: the better the economic development trend, the stronger the currency, and the higher the future returns of current investment. Foreign corporate investors also choose to invest more in China, which promotes the growth of FDI. In contrast, the ARDL model shows that the effect of LRS on FDI is significantly negative, which is contradictory to Hypothesis 4. One possible reason is that the better the infrastructure, the higher the comprehensive strength of the country, and the easier it is to be suppressed by capital. CPI is not significant for FDI, which means that Hypothesis 5: the better the economic stability, the higher the FDI inflows is also not valid.

From a comprehensive view, the higher the market size, market potential, and exchange rate under the long-term multiplier, the greater the inflow of FDI. In the medium- and long-term,
maintaining the relative stability of the RMB exchange rate, increasing GDP and foreign exchange, and increasing the market size will have a positive promotion effect on China’s FDI attraction. Therefore, China should further improve the market economy system and increase the degree of economic openness to attract FDI inflow in the long term, which will lead to the rapid and healthy development of China's economy.

In this thesis, some variables selected for regressions might be limited to representing determinants. For instance, the length of the railway put into service was chosen to represent the infrastructure in China. This may not comprehensively reflect the capacity of the transport infrastructure. In further studies, more elements, such as expenditure on domestic transport and the number of open ports, can be considered. In the case of China, FDI developments in the southeast coastal area, midland, and west area are quite uneven. Thus, different areas may have different economic advantages. Regional FDI and other relevant economic data on China before the 1990s were difficult to find. However, these regional data became increasingly detailed after the year 2000. Future studies can analyze the determinants of the different regions in China and their specific economic conditions.
References


[34] Ho, Owen C.H. (2004). Determinants of foreign direct investment in china: A sectorial analysis, School of Economics and Commerce University of Western Australia.


[65] The UNCTAD. FDI inflows as a percentage of gross fixed capital formation, 1990-2010. Webtable 5.


Non-technical Summary

Around 40 years ago, Deng Xiaoping's "reform and opening up" policy allowed foreign investors' capital to enter China from the free trade zones in southern China. Forty years later, tens of millions of farmers have been lifted out of poverty, villages have become modern cities, and high-tech trains run between the metropolises. During this time, foreign direct investment has played a significant role in China's economic development and is considered a key element for a country's economic integration. We wonder which factors of a developing country can attract and affect foreign direct investment. This study attempts to provide a deeper understanding of the measures and factors which could encourage capital transfers into developing economies like China. Our results suggest that well-functioning market size, market potential, and exchange rate are indeed relevant determinants of FDI inflows in developing countries like China, thereby suggesting that policies to attract FDI should focus on improving these countries’ market economy system, market size, and the relative stability of the exchange rate.