FDI and Export: The Monetary and Financial Dilemma in China

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Abstract
This paper focuses on the Monetary and Financial Dilemma in China recently. As is known to all, the FDI (Foreign Direct Investment) has a significant effect on the economic development of this country in China. The increase of FDI and the export by foreign funded enterprises not only lead to a double surplus of balance of payments, but also speed up the growth of China’s foreign exchange reserves which leads a change on the monetary base in this country, and eventually impact on monetary and financial condition. Paper based on the monthly data from 2001 to 2014 including China’s FDI and export by foreign funded enterprises and money supply. Firstly, test the causality among FDI and FDI export and the money supply used the Granger Causality Tests. Secondly, build two functions of pulling rate and contribution rate. The results of Granger Causality Tests have proved that FDI and FDI export is the granger cause of money supply. FDI and FDI export make a significant contribution to China’s money supply and it is one of the factors that lead to monetary and financial condition changed with a dilemma.

Keywords: FDI, Granger Causality, Monetary & Financial Dilemma, Pulling and Contribution

1. Issues Raised
Whether is a country’s monetary and financial environment much influenced by the Foreign Direct Investment (FDI) and the goods exported with which the foreign funded enterprises produced for export? According to the prevailing view in the existing literature, foreign direct investment inflows in a country will speed up economic growth, increase capital stock and improve the quality of capital, in short, FDI is expected to help raising the output level in economy, and promoting technological development. Also the literature show to us, because FDI is the long-term investment on manufactory or farmland or firms, it is also of relative stability on the capital flows, so usually speaking, there has no negative effect of FDI on a country’s monetary and financial environment. However, under the conditions of persistent attraction of large volumes of foreign investment for the financial environment in China5 discussed the financial security issues under the condition of persistent attraction of large volumes of foreign investment, from the profit-orientation of foreign investment and the adverse impact on the balance of payments, as well as the domestic capital exclusion. Ba Shusong et al.2 calculated that nearly 65.8% of profit was kept in china by FDI enterprise used the data from 1979 to 2011. Although it is the ‘tax avoidance’ by multinationals used their profits which was kept in china, the propose many of the foreign-funded enterprise have in mind is two: one is to gain more profit from revaluation of RMB and investment in china, the other is to gain profit from the domestic investments in real estate and stock market. Thus they believed FDI has an impact on this country’s financial environment. Sun Hong and Lu Xiaoyong4 analyzed the effect of FDI on China’s international balance of payments, i.e. the current account and capital and financial account, used the series data from 1995 to 2003. The paper’s conclusion is that the
profits and losses on the changes both FDI and China’s international balance of payment were the same. With the increase of scale of FDI, the marginal contribution of FDI to the international balance of payment has enlarged. So the FDI has a very important role to the Balance of Payments for supporting it. Guan Tao\textsuperscript{3} discussed the effect of FDI on credit policy and the fixed interest rate as well as exchange rate policies from the perspective of FDI on the local currency value stability.

On the whole, all the research above concentrated in the effect of the FDI on the international balance of payments and the policy of central bank. We know that the foreign exchange reserve which accumulated from the international payments surplus is the bases of a country’s money supply, but no scholars or less person pay attention to the effect of continuous double favorable balance ‘the trade surplus come from foreign funded enterprises and the surplus come from FDI capital inflow’ on a country currency financial environment, especially the dilemma that the FDI brings to the financial policy of China.

We know that in a closed economy, the domestic credit offered by the National Central Bank is the basis of money supply of the country; in an open economy, the domestic credit + import and export surplus (reserve) is the basis of a country’s money supply. If the import and export surplus has risen steadily, if the domestic credit offered by central bank unchanged, the money supply of a country not only increases with the increased of foreign exchange reserves, but double the rate via the multiplier effect in the increasing. Under the present system in China, FDI has the multiplier effect on the basis of money supply from two perspectives: One is that, the FDI capital inflows has to go to the Designated Foreign Exchange Banks to exchange the foreign currency into local currency (RMB) according to the System of Exchange Settlement and Sales\textsuperscript{4} (the policy issued by Chinese government), thus the Funds Outstanding for Foreign Exchange formed which leads to the increase of the monetary base in china in past decades. The second is that, the large sums of foreign exchange which made by foreign funded enterprises in the host country by export, must sell to the Designated Foreign Exchange Banks to exchange the foreign currency into RMB which increase the Funds Outstanding for Foreign Exchange, so increase in the monetary base.

In recent decades, the Funds Outstanding for Foreign Exchange increasing in China which made the monetary base increased (Table 1):

\textbf{Table 1.} The contribution of the funds outstanding to the monetary base incremental Unit: US$ 1 m

| Year | Funds Outstanding increments (1) | Base increments (2) | (1)/(2) |
|------|--------------------------------|---------------------|-------|
| 2001 | 3565.29                         | 3360.25             | 1.061019 |
| 2002 | 5366.91                         | 5286.45             | 1.015220 |
| 2003 | 11623.58                        | 7703.18             | 1.508933 |
| 2004 | 17745.72                        | 6014.75             | 2.950367 |
| 2005 | 18618.48                        | 5487.02             | 3.393186 |
| 2006 | 27769.15                        | 13414.70            | 2.070054 |
| 2007 | 29397.05                        | 23787.57            | 1.235816 |
| 2008 | 40053.79                        | 27676.93            | 1.447190 |
| 2009 | 24681.36                        | 14762.67            | 1.671876 |
| 2010 | 32682.68                        | 41326.08            | 0.790849 |
| 2011 | 27791.87                        | 39330.68            | 0.706621 |
| 2012 | 4946.47                         | 27703.41            | 0.178551 |
| 2013 | 27770.34                        | 18677.92            | 1.486801 |

Source: http://www.pbc.gov.cn/

We can see from the data in the Table 1, from year 2001 to 2013, the increment of Funds Outstanding for Foreign Exchange is more than the increment of monetary base by central bank during past ten years. In 2004, 2005 and 2006, the increment of Funds Outstanding for Foreign Exchange is more doubled or trebled than the increment of monetary base. While in 2010-12, the increment of Funds Outstanding for Foreign Exchange declined compared to the monetary base (easy monetary policy in china after 2008), but from the early of 2013, the increment of Funds Outstanding for Foreign Exchange begin to multiply. Therefore, the Funds Outstanding for Foreign Exchange has become the main delivery channels of the money supply in china in past decades.

Some scholars supposed there have not any correlation in increment between the money base and the Funds Outstanding for Foreign Exchange at the same time. This paper, from the purpose of this thesis and the policy of the government, intends to examine the correlation of both by Granger Causality Tests. This paper also make a different statement on the policy (for the encouragement of foreign direct investment) of the Chinese government has pursued consistently, that is to say, this policy (for the encouragement of foreign direct investment) was obedience to its principles that contributed so largely to financial dilemma.

\textsuperscript{3}Designated foreign exchange banks refer to banks duly authorized by the exchange administration agencies to undertake the sale and purchase of foreign exchange.
and resulted in the local land being more valuable now for houses; send commodity and financial products prices up. This paper intends to focuses on the financial dilemma the policy leads to and make some suggestions later.

Paper argues that FDI capital inflows and the foreign currency earned via goods exports by foreign funded enterprises are considered the major source of Funds Outstanding for Foreign Exchange. The variables this paper uses for testing the correlation are two: one is the foreign-invested enterprises’ goods export; the other is FDI capital inflows. This paper also believes that M2 (monetary supply) is a good index for show the country’s monetary and financial condition, so this paper takes M2 as dependent variable in the Granger testing model, the time-series data of M2 from 2001 to 2013 come from the website of the People’s Bank of China, which a total of 156 set of monthly figures. The data of foreign trade export from 2001 to 2013 come from ‘the import and export statistics’ of The Ministry of Commerce. Among them, the measurement units of FDI and export by foreign-invested enterprises are ‘ Billion dollars’ and the measurement units of the money supply is ‘Billion RMB’. It is convenient to shift from US dollar to RMB Yuan at this point using period-average exchange rate.

2. Granger Test: FDI, Exports and M2

This paper here define variables X and M. X is explanatory variables which means the FDI and foreign trade export; M is explained variables, means monetary supply, M2. We test the correlation between X and M for showing the effect of FDI on the money and financial condition in China. For we can show the log linear trend by modifying the natural logarithm of data, and has not change the co-integration relationship, but eliminate the fluctuations heteroscedasticity of the time series data, so this paper log the two set of data processing.

2.1 ADF Unit Root Test

In order to avoid ‘spurious regression’, this paper has to make sure the stationary of the data before Granger causality test. In most of cases, it is non-stationary time series; we need to use the econometric methods such as ADF test of unit root for LN (x) and LN (m) of two sets of data fort stationary time series. Test results are as follow: According to Table 2, the data illustrates that ADF critical value at 1%, 5%, 10% levels is non-stationary time series; at first order difference, LN (x) is non-stationary but LN (m) is stationary. At second order difference, the ADF statistic value of LN (x) and LN (m) is smaller than the critical values under significant difference at 1% level. So, the LN (x) and LN (m) are stationary at same time by significance test.

2.2 Co-integration Test

The prerequisite for Granger causality testing is that there exists a co-integration relationship between two variables. We know that the second order difference of LN (x) and LN (m) is stationary according to above ADF test, so it consistent with the prerequisite of the co-integration relationship. First we keep the residual series from LN (x) and LN (m) in the series K, and draw the Sequence Diagram (Figure 1). As shown in the Figure 1, according to the analysis of the Sequence Diagram, the K of residual series has always fluctuate around a fixed value specified, which can be primarily concluded the sequence k is a stationary time series.

| Variable       | Critical Value | ADF Test Statistic Value | Prob.     | Conclusion     |
|----------------|----------------|--------------------------|-----------|----------------|
|                | 1% level       | 5% level                 | 10% level |                |
| LN(X)          | -4.023975      | -3.441777                | -3.145474 | -2.521669      | 0.3174 | Not stationary |
| LN(M)          | -4.019561      | -3.439658                | -3.144229 | -2.502306      | 0.3267 | Not stationary |
| Δ(LN(X))       | -4.023975      | -3.441777                | -3.145474 | -2.776573      | 0.2085 | Not stationary |
| Δ(LN(M))       | -4.020396      | -3.440059                | -3.14465  | -6.438918      | 0.0000 | Stationary     |
| Δ²(LN(X))      | -4.023975      | -3.441777                | -3.145474 | -13.61843      | 0.0000 | Stationary     |
| Δ²(LN(M))      | -4.023506      | -3.441552                | -3.145341 | -8.689740      | 0.0000 | Stationary     |
We first on the K of residual series of unit root tests before further testing stationary time series. Test result shows the K of residual series is stationary under the condition. The results of ADF unit root test under the condition are as follows:

Table 1. Residual series ADF unit root test

| Lag time | t-Statistic | Prob.* |
|----------|-------------|--------|
| 2        | -11.72874   | 0.0000 |
| 3        | -4.023975   | -4.886426 |
| 4        | -3.441777   | -3.828975 |
| 5        | -3.145474   | -3.362984 |

Table 3 shows that the results of unit root tests on the K of residual series, the t statistic which smaller than the MacKinnon 1 % level critical value, so reject the joint hypothesis. This speaks no unit root in residual series, it is the stationeries. It is clearly, there is a co-integration relationship between LN (x) and LN (m), and a long run equilibrium relationship between both.

2.3 The Granger Causality Test

For further analysis of the variable LN (x) and LN (m), the Granger causality test was introduced. Because the Granger causality test sensitivities on the choice for the lag length some times, different lag may have different results, for improving the accuracy of testing, we have to test the different lengths of lag. Respectively, let lag for 2, 3, 4, and 5, and test the Granger causality both LN (x) and LN (m), the results are listed in Table 4.

Table 4. The results of granger causality test

| Null Hypothesis:          | Lag time | F statistic | P statistic | Conclusion |
|---------------------------|----------|-------------|-------------|------------|
| LNX is not Granger cause of LNM | 2        | 11.8702     | 2.E-05      | refuse     |
| LNM is not Granger cause of LNX | 2        | 6.40540     | 0.0021      | refuse     |
| LNX is not Granger cause of LNM | 3        | 13.2669     | 1.E-07      | refuse     |
| LNM is not Granger cause of LNX | 3        | 8.18544     | 5.E-05      | refuse     |
| LNX is not Granger cause of LNM | 4        | 12.9100     | 5.E-09      | refuse     |
| LNM is not Granger cause of LNX | 4        | 3.95516     | 0.0045      | refuse     |
| LNX is not Granger cause of LNM | 5        | 12.6866     | 4.E-10      | refuse     |
| LNM is not Granger cause of LNX | 5        | 3.76087     | 0.0032      | refuse     |
| LNX is not Granger cause of LNM | 6        | 10.5132     | 1.E-09      | refuse     |
| LNM is not Granger cause of LNX | 6        | 3.86443     | 0.0014      | refuse     |
| LNX is not Granger cause of LNM | 7        | 9.85336     | 7.E-10      | refuse     |
| LNM is not Granger cause of LNX | 7        | 3.56204     | 0.0015      | refuse     |
| LNX is not Granger cause of LNM | 8        | 8.61730     | 2.E-09      | refuse     |
| LNM is not Granger cause of LNX | 8        | 3.59762     | 0.0008      | refuse     |
| LNX is not Granger cause of LNM | 9        | 7.69906     | 5.E-09      | refuse     |
| LNM is not Granger cause of LNX | 9        | 1.87650     | 0.0611      | accept     |

Test results show that, in lag length for 2, 3, 5, 6, 7, and 8, LN (x) and LN (m) interact as both Granger cause and effect, significantly different from p-test (p < 0.05); but it change when lag is for 9, LN (x) is Granger causes of LN.

Figure 1. The residual series K.
(m), but LN (m) is not the Granger causes of LN (x). The results of Granger causality test illustrate that FDI and the export by foreign funded enterprises are the Granger causes which cause the variations of measure of money supply to a large extent. This conclusion is consistent with previous theoretical assumptions and theoretical hypothesis. In other words, the growth of foreign exchange reserves from FDI and foreign trade is an important element of the growth of M2. So the conclusion is that FDI together come in the train of it have an important effect on China's monetary and financial condition.

3. Contributions and Pulling to M2 by FDI and Foreign Trade

The tests above show that there is granger causality between FDI and M2, but no mention of the test that what magnitude of the contribution and pulling to M2 by FDI and foreign trade come in the train of FDI. In order to measure the pulling effect of FDI on M2, and examine the contribution of FDI to M2, We have to adopt the contribution rate and pulling rate for testing the contribution of FDI to the M2 at quantification. For a short time the effect of FDI to M2 is insignificant to be taken into account, we converted monthly data into annual data. The contribution rate of FDI to M2 is the ratio of $\Delta X$ (FDI + export come in the train of FDI) and $\Delta M$ (M2); The pulling rate of FDI to M2 is the product of FDI contribution rate for economy and growth rate for M2. We can compute based on the formula the contribution of FDI to M2 of this country (Figure 2), so that we can judge the effect of FDI on China's monetary and financial condition.

We learn some points as following from Figure 2. The first, the contribution and pulling by FDI to M2 is positive (above zero) except for the year of 2009. This signified that FDI would have positive effect on M2, so in shortly, M2 is steadily picking up in past years by the increment of FDI. The secondly, the contribution and pulling to M2 by FDI are negative for both at same time in 2009, the reason about this is the case of the global financial crisis in 2008 the foreign trade and FDI consequential reduction in amounts. In 2008, the foreign capitals actually utilized stood at 90.034 billion US dollars, year on year down by 3 percent, the export of goods is 1.202 trillion US dollars, year on year down by 16 percent. And thirdly, the changing trend of contribution and pulling to M2 is similar (see the curves in Figure 2), There has been a progressive decrease in FDI effect of pulling and contribution on M2; for example, in 2002, the contribution rate and pulling rate to M2 are 20% and 3.39% Respectively, 5.15% and 0.7% in 2013. The one of the reason for decreased in the effect of contribution and pulling of FDI on M2 maybe that a lot of Chinese companies went out abroad and enlarged the scale of external investment continuously recently, which offset the foreign exchange reserve growth, or China's trade surplus has narrowed, as its exports were depressed by the collapse in global demand; imports recovered on the back of the government's sweeping stimulus program. Another reason for that is the physical form assets entered in this country as FDI which accounted for FDI of a large part, but inflow of funds accounted for FDI of a smaller part, so the increase in china's reserves for a long time decreased, the effect of FDI on M2 consequential weakened, so the same to monetary and financial condition.

4. Conclusion and a Dilemma

4.1 Conclusions

In general, China's huge international payment surplus (Current Account Surplus and Capital and Financial Account Surplus for 20 years since 1994) and foreign exchange reserves have become one of the important factors leading the growth of M2 as well as over-hot economy. In our opinion, the current accounts, capital and financial accounts presented 'double surplus' with the international reserve assets continuously rising in china for a long time, if we analyze the balance of payment closely, we can see that the surplus of capital and financial account basically come from Foreign Direct Investment
(FDI), and more than 50% surplus of current-account come from foreign investment enterprises come in the train of FDI. Accordingly, this article argues that FDI is the major source for influencing in China's monetary and financial condition. This paper used the Granger causality test model and contribution and pulling functions based on the data of monthly time series from 2001 to 2013 (FDI and foreign trade by foreign funded enterprises), to test the effect of FDI on M2 of China. The results show that FDI and goods export by foreign funded enterprises come in the train of FDI are granger cause of money supply (M2), and that, with time going by, the effect of these two factors to money supply becomes stronger. This conclusion is consistent with previous hypothesis, so hypothesis tenability. That is to say, FDI and goods export by foreign funded enterprises come in the train of FDI, are the main driver of China's reserve buildup, also one of main sources of the growth on M2. So FDI has a important effect on China's monetary and financial condition.

4.2 A Dilemma

This situation on the monetary and financial condition makes China a big trouble or a dilemma. First of all, the monetary policy operation by Central Bank will be more difficult than before. Due to the passive release of monetary base by the Central Bank increased significantly, which results in excess liquidity, excess investment, asset price booms and the price of goods fluctuate. All of these make the Central Bank of china a big trouble or a dilemma in its monetary policy operation. This trouble mainly reflects in a challenge of the central bank's monetary policy operation in the view of internal and external equilibrium. In one of respect, the trouble is exchange rate policy from inside to outside. For policy choice, the Central Bank takes not only the international balance of payment into account, but also the domestic issues such as economic growth, employment and financial stability. Nevertheless, if Central Bank wants to balance all these aspects, it must be inevitably result in additional pressure on macro-control of exchange rate policy. In other of respect, the trouble is interest rate policy from inside to outside. For this policy choice, if the Central Bank choice to raise interest rates for tightening in this country's rapid economic expansion, it can also attract foreign capital inflow, it will upward pressure on the Renminbi, a stronger Yuan grow stronger. Secondly: the trouble above is getting to be a real problem. We know that there are two sources for funds outstanding for foreign exchange. One of inflow is from capital and financial account, the other inflow is from current account. Let us look at firstly the capital and financial account, under this account, the volume of FDI funds inflow have been larger than that of surplus under capital and financial account. Such as in 2006, the surplus under the capital and financial account reached 39.3 billion U.S. dollars, but FDI funds inflow 124.1 billion dollars\textsuperscript{a}. In 2012, the surplus under the capital and financial account reached 44.8 billion U.S. dollars, but FDI funds inflow 61.1 billion dollars. In short, the surplus under the capital and financial account are mainly from FDI under capital account. Turn to current account, under this account, the surplus are mainly from goods export under the current account. In 2006, the surplus under the current account was 231.8 billion U.S. dollars in which 217.7 billion U.S. dollars was under goods account. In 2008, the surplus under the current account was 420.6 billion U.S dollar in which $ 360.6 billion U.S. dollars was under the goods account. In 2012, surplus by foreign-funded enterprises accounted for about $ 21.9 billion of the surplus 28.6 billion US dollar under the current account. Therefore, the main sources of the foreign exchange reserve come from firstly the FDI under the capital account, secondly the goods export under current account. That is so called the 'Double Surplus' in int'l payment in recently.

However, the surplus from goods under current account in fact from the goods exports by foreign-funded enterprises. The goods Exports from foreign-funded enterprises in 1991 was 12.047 billion US dollar, and in 2005, reached 444.2 billion dollars, 36.87 times increased for the past 14 years with an average growth rate of 193.62%, and increased year by year. The proportion of export by foreign-funded enterprises in 1991 was 12.047 billion US dollar, and in 2005, reached 444.2 billion dollars, but FDI funds inflow have been larger than that of surplus under capital and financial account, under this account, the surplus of FDI funds inflow have been larger than that of surplus under capital and financial account. Such as in 2006, the surplus under the capital and financial account reached 39.3 billion U.S. dollars, but FDI funds inflow 124.1 billion dollars\textsuperscript{a}. In 2012, the surplus under the capital and financial account reached 44.8 billion U.S. dollars, but FDI funds inflow 61.1 billion dollars. In short, the surplus under the capital and financial account are mainly from FDI under capital account. Turn to current account, under this account, the surplus are mainly from goods export under the current account. In 2006, the surplus under the current account was 231.8 billion U.S. dollars in which 217.7 billion U.S. dollars was under goods account. In 2008, the surplus under the current account was 420.6 billion U.S dollar in which $ 360.6 billion U.S. dollars was under the goods account. In 2012, surplus by foreign-funded enterprises accounted for about $ 21.9 billion of the surplus 28.6 billion US dollar under the current account. Therefore, the main sources of the foreign exchange reserve come from firstly the FDI under the capital account, secondly the goods export under current account. That is so called the 'Double Surplus' in int'l payment in recently.

Exports of goods not only accounted for the main sources of foreign exchange, it also accounted to the one-third of China’s GDP (Table 5).

\textsuperscript{a}Sub items were deficit this year.
Table 5. The proportion of goods export by foreign funded enterprise of GDP

| years | Total export(100 million) | GDP(100 million) | Percentage (%) | Contributed to GDP(%) by Foreign-funded enterprises(1) |
|-------|---------------------------|-----------------|---------------|-----------------------------------------------------|
| 2001  | 22024.4                   | 109655.2        | 20.10%        | 10.05%                                               |
| 2002  | 26947.9                   | 120332.7        | 22.40%        | 11.20%                                               |
| 2003  | 36287.9                   | 135822.8        | 26.70%        | 13.30%                                               |
| 2005  | 62648.1                   | 183867.9        | 34.10%        | 20.50%                                               |
| 2006  | 77594.6                   | 210871          | 36.80%        | 22.10%                                               |
| 2007  | 83369.7                   | 257306          | 32.40%        | 19.50%                                               |
| 2008  | 97709.4                   | 300670          | 32.50%        | 18.00%                                               |
| 2009  | 82029.7                   | 340902.8        | 24.06%        | 13.30%                                               |
| 2010  | 107022.8                  | 401512.8        | 26.65%        | 14.65%                                               |
| 2011  | 123240.6                  | 473104          | 26.05%        | 14.33%                                               |
| 2012  | 129359.3                  | 518942.1        | 24.92%        | 13.71%                                               |
| 2013  | 136580.6                  | 564916.3        | 24.18%        | 13.30%                                               |

Source: http://www.stats.gov.cn/

Note (1) calculated according to data.

The problems posed based on these analyses and these data. If the government wants to eliminate the effect of funds outstanding for foreign exchange on M2, it has to reduce the FDI capital inflow, but if the government does like this, it would reduce the exports of goods by more than half which would result in a trade deficit of china's balance of payments. At the same time when the deficit appeared which in turn, has a negative effect on GDP of china, more important, the economic downturn and the unemployment rate growing will incurred as a result.

4.3 What are the Best Policy Options?

As a matter of expedience, we have to choose the policy without reducing the FDI capital inflow. At bottom we knew there are three kinds of forms in FDI capital inflow: (1) the FDI is the investment in kind with imported equipment; (2) Chinese party import equipment from abroad when the funds of FDI inflow, according to contract; (3) Chinese side change foreign currency into local currency (Renminbi), when FDI capital inflow without imported equipment. If the case is the first, there have no funds inflow; it shows a plus under capital account and a minus under current account after the equipment entered the customs. There is no change for the foreign currency reserves just cancel each other out. If the case is second, also there is no change for the foreign reserves when the canceling effect of the surplus and deficit after imported equipment by Chinese party. However, if it is the case the third, there are no changes in the sub account (goods) under current account, but surplus under capital account which result in the increase of foreign exchange reserve, so increasing the funds outstanding for foreign exchange.

In consideration of the situation in china in recently, i.e. 'Double Surplus' in int'l payment, and the surplus under FDI (the sub account) is far above the surplus under Capital Account. So what actually case appeared in china is the third which has endanger the financial market and property market, further endanger the development of economy of China.

So what are the best policy options for the Central Bank of China?

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