AMRO
ASEAN +3 MACROECONOMIC RESEARCH OFFICE

Analytical Note

*China Economic Insights*

# Is Declining FDI into China a Cause for Concern? [1]

April 7, 2025

## I. Introduction

**1. China's foreign direct investment (FDI) inflows have declined significantly since 2022, raising concerns about potential capital flight from China.** Balance-of-payments (BOP) statistics indicate net FDI inflows fell sharply from a peak of USD 344 billion in 2021 to USD 51.3 billion in 2023 and further to just USD 18.6 billion in 2024—the lowest level in three decades. Moreover, BOP FDI recorded net outflows in Q3 2023, Q2 and Q3 2024 of USD 10.9 billion, USD 15.0 billion, and USD 11.6 billion, respectively (Figure 1). While China is not alone in experiencing a global downturn in FDI, this marked decrease has triggered widespread discussions and concerns about a mass exodus of foreign investments, driven by strategic de-risking and/or decoupling by foreign enterprises.

**2. Understanding recent dynamics of FDI is crucial for China's economy, as it impacts industrial development, employment, and technological advancement within the country.** Foreign investment has played a pivotal role in driving the economic development in China since its economic reform and opening-up started in 1978. From 2012 to 2022, foreign-invested enterprises accounted for less than 3 percent of firms in China, but they contributed 22.5 percent of industrial value-added, 16 percent of tax revenue, 38.7 percent of the total import and export, 20.7 percent of research and development investment, and nearly 10 percent of urban employment.[2] Foreign enterprises have also contributed significantly to the modernization and upgrading of domestic industries. While indigenous innovation from local companies is on the rise, China continues to rely on international enterprises to access global production and supply networks, as well as talent and R&D

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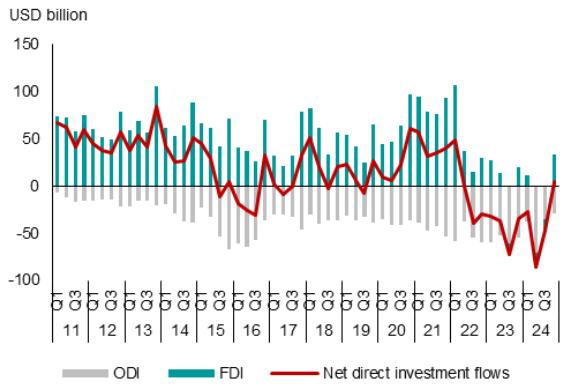
[2] According to China Council for the Promotion of International Trade.

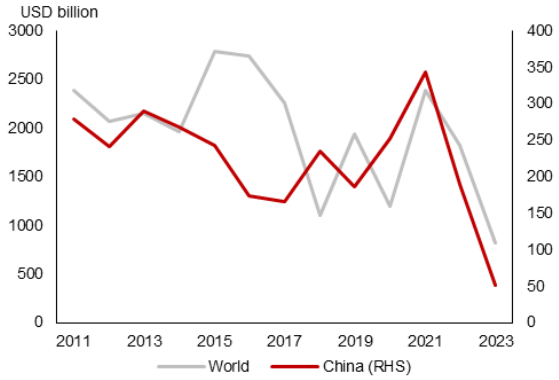
networks, which remain essential for realizing technological development and high-quality growth over the long run.

**Figure 1. China's Direct Investment Flows from BOP**




Source: China SAFE; AMRO staff calculations.
Note: Net inflows of direct investment equals FDI minus ODI.

**Figure 2. Global and China's FDI from BOP**




Source: IMF, World Bank; AMRO staff calculations.

**3. This Analytical Note aims to delve into the recent decline in China's FDI inflows.** We explore three pertinent questions: Does the drop in foreign direct investment signal a broader withdrawal from foreign investments? To what extent can this reduction in FDI be linked to geopolitical tensions and other drivers? Additionally, what are the implications of the decline in FDI for the industry and economic development in the future? Our analyses suggest that the recent fall in FDI does not indicate capital flight from China. While tighter global financial conditions and widening interest rate differentials have been the main drivers of capital outflows, there is little evidence that political divergence amid heightened geoeconomic tensions have weighed on FDI in China. In fact, China continues to attract FDI inflows, with manufacturing and scientific research emerging as the bright spots. These favorable developments will continue to support China's pursuit of high-quality growth.

## II. Recent Dynamics of FDI in China

**4. Analysing China's recent FDI decline involves both BOP and utilized FDI, each capturing different aspects of foreign investment dynamics.** China has experienced a significant decline in BOP FDI following the global contraction in FDI, which fell from USD 2.4 trillion in 2021 to USD 0.8 trillion in 2023 amid tightened financial conditions, geopolitical turbulence, and falling FDI return (Figure 2). However, BOP FDI alone does not provide a complete picture. There are two main indicators that measure the FDI flows into China. One is the BOP FDI reported by the State Administration of Foreign Exchange (SAFE), and the other is the FDI in actual utilization (hereafter referred to as 'utilized FDI') published by the Ministry of Commerce (MOFCOM). The two indicators differ in both measurement and coverage. First, the BOP FDI measure is on a net basis—the net of FDI inflows and outflows,

but the utilized FDI measures gross inflows only.[3] Second, there are major differences in coverage, with BOP FDI including more items. While both series cover equity investments, utilized FDI does not include reinvestment of earnings and retained profits of foreign enterprises, and cross-border intracompany debts between affiliate firms and foreign parent enterprises (Table 1). Moreover, utilized FDI has a narrower focus on financial related investment; it excludes proceeds from offshore IPOs of Chinese companies, foreign venture capital and private equity investments with major shareholdings in Chinese start-ups, and direct investments from foreign financial institutions in China's financial sector (Lardy, 2023).

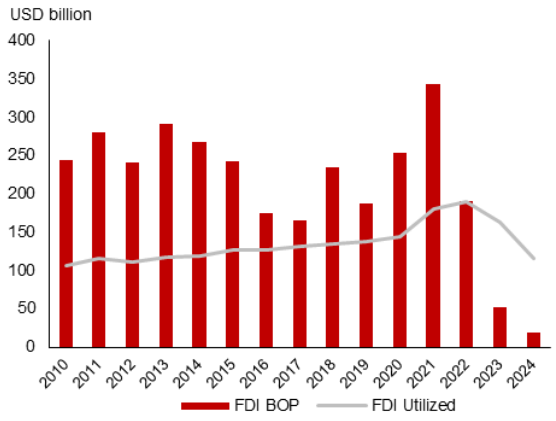
**Table 1. BOP vs Utilized FDI: Measurement and Coverage**

| Items | | BOP FDI | Utilized FDI |
|---|---|---|---|
| Measurement | | Net flows | Gross inflows |
| Equity | Capital investment | ✓ | ✓ |
| | Reinvested earnings | ✓ | × |
| Debt | Intracompany debts | ✓ | × |

Source: China MOFCOM, SAFE.

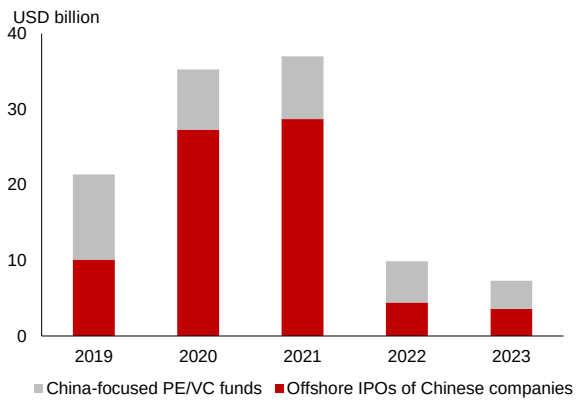
**5. While the BOP FDI data show a sharp decline, utilized FDI data suggest that China continues to attract foreign capital at a relatively steady level.** Despite declining from its 2022 peak, utilized FDI in China remained more robust[4], at USD 163.3 billion in 2023 and USD 116.2 billion in 2024, significantly exceeding the BOP FDI numbers (Figure 3). In 2023, China continued to be the world's second-largest recipient of foreign direct investment (UNCTAD 2024). The notable disparity between BOP and utilized FDI stemmed primarily from decreases in reinvested earnings and intra-company debts, as foreign firms in China remitted retained earnings abroad and repaid debt to their parent companies abroad. In addition, financial investments, including offshore IPOs of Chinese companies and China-focused PE/VC funds, experienced sharp declines in 2022 and 2023 due to tightened regulation and rising funding costs (Figure 4).

**Figure 3. FDI Inflows: BOP vs Utilized**




Source: China SAFE, MOFCOM; AMRO staff calculations.

**Figure 4. Financial Investment in BOP FDI**




Source: Refinitv; AMRO staff calculations.

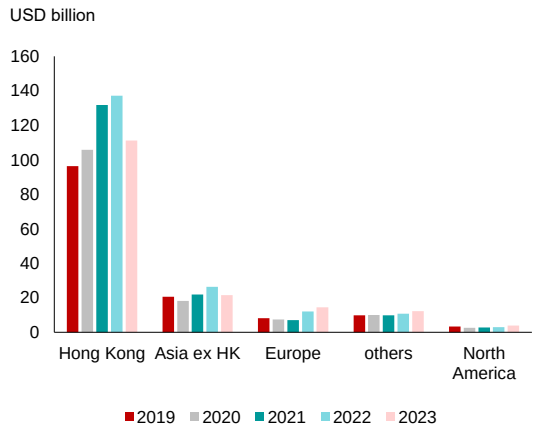
[3] The definitions of these two indicators are based on MOFCOM and the SAFE (2024) "2023 China International Balance of Payments Report." Since utilized FDI data do not account for outflows, this may lead to an overrepresentation of FDI flows compared to BOP basis data. Section III delves deeper into this gap.

[4] Utilized FDI total amount is up to 2024, while its breakdown by origin and by industry is available up to 2023.

**6. Concerning FDI sources, Asian economies have dominated investment in China, while Europe and North America have also seen increases.** Hong Kong, China continues to serve as the primary gateway for channeling investment into China. In 2023, Asia accounted for 81.2 percent of China's utilized FDI inflows. Despite heightened geopolitical risks and trade tensions, China has seen increased utilized FDIs from Europe and North America (Figure 5). In particular, FDIs from Europe increased by 21.1 percent in 2023, with investment from the Netherlands surging by 306.5 percent in 2022 and 19.2 percent in 2023.[5] Similarly, utilized FDIs from the US also increased by 35.4 percent in 2023. These trends underscore China's strengthened economic ties with Asia and expanding connections with Europe and the US, suggesting that geoeconomic fragmentation has not substantially impacted China's utilized FDI inflows.

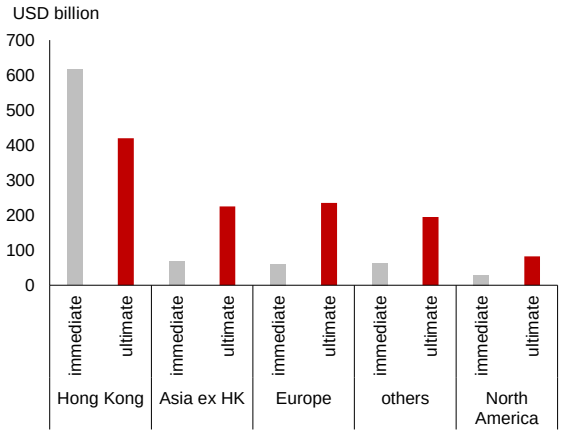
**7. Ultimate investor-based figures, adjusted for investments routed through offshore financial centers, reveal significantly stronger global linkages with China across diverse investor bases, with the strongest ties observed in Asia.** Because a significant portion of cross-border investments is channeled through offshore financial centers and tax havens, headline FDI figures based on the immediate country of investors underestimate the true scale of FDIs from most countries. When adjusted for the "Phantom" FDIs which go through OFCs, the ultimate country of investor-based FDI data reveal stronger linkages between China and the rest of the world.[6] Specifically, the adjusted FDI positions are around 2.3, 2.9, and 1.9 times higher than the original immediate country investor-based figures for Asia, Europe, and North America, respectively. Moreover, ultimate country investor-based FDI data also indicates that investment ties between China and Asia continue to strengthen.

**Figure 5. Utilized FDI flow by Origin**




Source: China MOFCOM; AMRO staff calculations.

**Figure 6. Ultimate Investor-Based FDI by Origin in 2022**




Source: IMF Coordinated Direct Investment Survey (CDIS); Orbis; AMRO staff calculations.

[5] MOFCOM also reports that investment from Germany in China increased by 18.1 percent in 2024 H1.
[6] This data uses FDI position data from the IMF CDIS, adjusted for 'phantom' FDI, which refers to investments through offshore financial centers and tax havens, to distinguish ultimate investor-based FDI (del Rosario et al, 2024).

## III. Drivers Behind Recent FDI Development

**8. The decline in FDI is more influenced by cyclical factors than by structural factors.** Structural factors such as increased protectionist policies, intensified geoeconomic fragmentation, and rising labor cost in China may have accelerated supply chain reconfiguration, leading to the fall in foreign investment in China. Meanwhile, tightened financial conditions amid higher interest rates in major advanced economies may also have a considerable impact on cross-border investment decisions globally in recent years. This section examines the extent to which these factors have affected foreign investment in China.

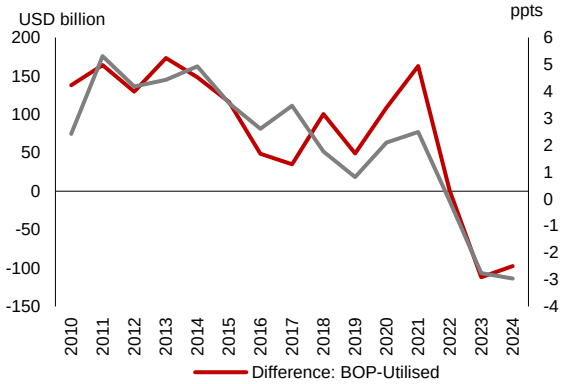
**9. Despite heightened US-China geopolitical tensions, political divergence has not significantly impacted China's FDI yet, which continues to grow due to strong investor interest in its large market and supply chain efficiencies.** In fact, China's utilized FDI inward flows continued to grow until 2022 and stand relatively robust afterwards (Figure 4). Moreover, if we include 'political distance'[7] to gauge political alignment between China and an FDI source country in an adapted gravity model, similar to that proposed by Hudecz et al. (2024), the regression analysis of FDI from 101 countries between 2009 and 2023 suggest that political distance does not significantly impede FDIs into China, for either FDI stock or utilized FDI flow (Appendix I). More importantly, utilized FDI flows into China has increased despite heightened political divide since the onset of the US-China trade conflict from 2018. These findings indicate that China's inward FDIs may not be affected by evolving political alignments even with heightened geopolitical tensions in recent years. The continuous influx of FDIs into China likely reflects the interest of multinational corporations in securing entry into the country's vast domestic market or leveraging China's efficient domestic supply chains for production, which may have offset the negative impact from growing geopolitical tensions. Similarly, rising labor cost remains uncorrelated to FDIs into China in terms of both FDI stock and utilized FDI flows.

**10. On the other hand, cyclical factors, including tighter global financial conditions and a rising interest rate gap between China and the US, have led to a decline in China's BOP FDIs.** Specifically, the interest rate gap between China and the FDI source country is found to be positively correlated with both FDI stock and utilized FDI flows into China, as demonstrated in the adapted gravity model regression results (Table A1 in Appendix). This suggests that relatively easy financial conditions abroad facilitate foreign multinationals in their investments in China. Tightened global financial conditions since 2022 have also been the key driver of the decline in BOP FDI flow into China. The gap between utilized and BOP FDI flows—which includes the debt and reinvestment components as well as financial investment flows, as discussed in Section II—shows strong correlation with the interest rate differential between China and the US (Figure 7). Indeed, the Fed's forceful interest rate hikes during 2022-2023 significantly increased the funding costs of the US dollar and tightened global financial conditions. As a result, foreign companies in China have increased their debt repayment to affiliated companies overseas (Figure 8) as reflected in the net outflow of USD 35.6 billion in 2023 and USD 54.3 billion in 2024 for debt repayments in the BOP FDI. Relatedly,

[7] Bilateral political distance is proxied by voting patterns at the United Nations General Assembly, see IMF (2023) Zhao (2024) and Bailey et al (2017) for details. Zhao (2024) finds significant negative relationships between China's export growth and its political distance to destination markets after 2018.

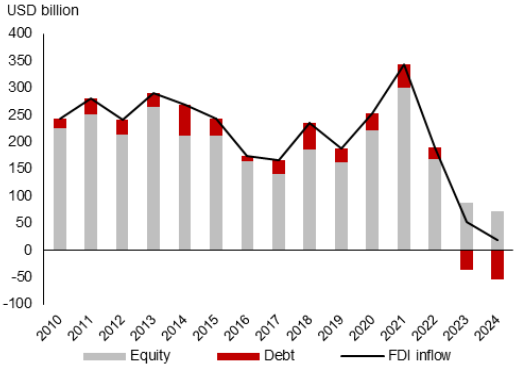
the reinvestment of earnings and unremitted profits by foreign companies, which are counted by SAFE as FDI in BOP statistics, have also declined. Indeed, foreign industrial firms' profits fell by 6.4 percent in 2023 and 4.3 percent in 2024. As interest rates differential between China and the US have reversed and widened in favor of the US, relevant financial investments into China have also decreased due to higher interest rates abroad.

**Figure 7. Gap Between BOP and Utilized FDI and its Correlation with Interest Rate Differentials**




Source: CEIC; AMRO staff calculations.
Note: Interest differential between China and US is measured by 3m SHIBOR and 3m Treasury bill rate.

**Figure 8. Debt Instruments of BOP FDI: Inflows and Outflows**



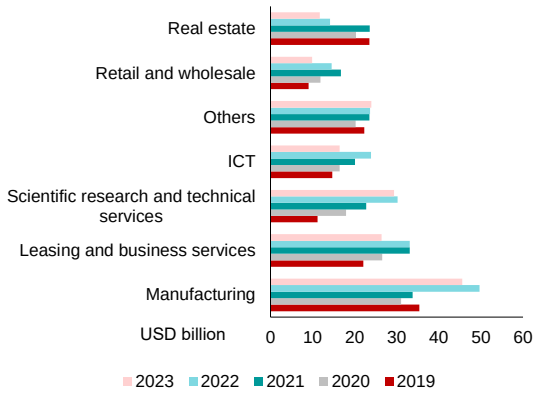

Source: China SAFE; AMRO staff calculations.
Note: FDI flows include equity (and investment fund shares) plus debt instruments.

## IV. The Evolving FDI Landscape in China

**11. Utilized FDI trends indicate that while overall FDI is declining, it does not suggest a mass exodus of foreign firms from China; instead, the evolving FDI landscape shows positive developments.** The industry structure of utilized FDI in China has shown encouraging progress. In particular, the decline in FDI was mainly in real estate, retail and wholesale sectors, while manufacturing and scientific research have seen a notable increase (Figure 9). For manufacturing specifically, the increase in foreign investment suggests that the decline in FDI inflows from industry transfer or relocation, due to cost reduction or geopolitical conflicts, were offset by stronger inflows into emerging and high-tech manufacturing sectors. At the same time, foreign enterprises have also stepped up their R&D investments in China, which also signals positive developments consistent with the country's efforts on industry upgrade and promoting high-quality development.

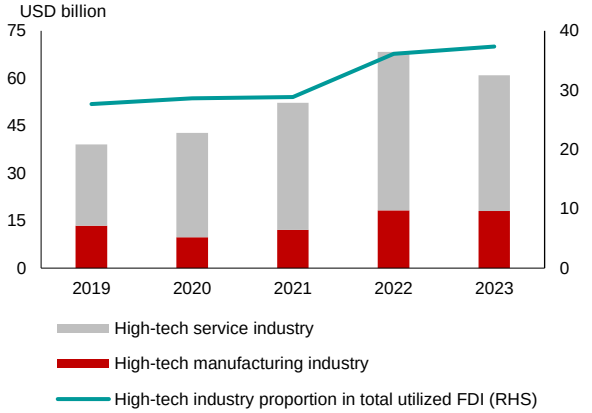
**12. The decline in utilized FDI is mainly concentrated in traditional sectors, reflecting both near-term challenges and ongoing structural transitions.** For instance, the ongoing property market adjustments have not only dampened domestic investment, but also reduced foreign investment in this sector. Indeed, utilized FDI in real estate sector declined from USD 23.5 billion in 2019 to USD 11.7 billion in 2023. Meanwhile, FDI in the services sector—particularly in retail and wholesale sectors, accommodation and catering—continue to decrease, reflecting competition from e-commerce as well as weakness in consumption. Significant adjustments have taken place for international enterprises involved in traditional manufacturing industries. Foreign companies have withdrawn investment in China due to excess capacity and intensified competition, such as the steel and conventional automotive industry.

**Figure 9. Utilized FDI Development by Industry**




Source: China MOFCOM; AMRO staff calculations.

**Figure 10. Utilized FDI in High-tech Industries**




Source: China MOFCOM; AMRO staff calculations.
Note: High-tech manufacturing industries entail pharmaceuticals, aviation, spacecraft and equipment, electronics and communication equipment, computers and office equipment, medical equipment and instruments, and information chemicals; and high-tech services industries include information technology, e-commerce, inspection and testing, professional technical services, research and development, technology transfer, intellectual property and related legal services, and environmental monitoring and governance.

**13. On the other hand, utilized FDI in high-tech industries and R&D have shown a significant increase in recent years.** In part driven by China's favorable policy on R&D and innovation**,** utilized FDI in the high-tech industries[8] has had an average annual growth rate of 15 percent between 2019 and 2023, with its share of total FDI rising from 27 percent to 37 percent over the same period (Figure 10). Both the high-tech manufacturing and the high-tech service industries have seen remarkable growth. Specifically, FDI in the high-tech manufacturing sectors increased from USD 13.4 billion in 2019 to USD 18.1 billion in 2023, accounting for around 40 percent of total FDI flows into the manufacturing sector. The automotive industry, in particular, foreign automakers, have increased investment to take advantage of the rapid expansion of new energy vehicles (NEVs) in China (Box 1). Meanwhile, FDI in high-tech services also rose from USD 25.7 billion to USD 42.9 billion, representing 40 percent of the total FDI inflows in the service sector. Foreign investment in high value-added and innovative industries should continue to promote industrial transformation and upgrading by enhancing the overall quality and efficiency of the sector.

**Box 1. Foreign investment in the auto industry in China**

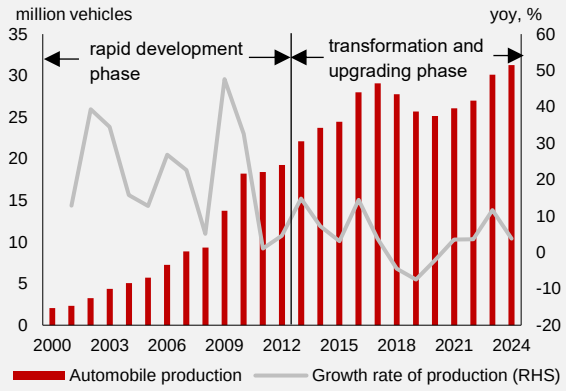
**Over the past few decades, foreign investment has played a pivotal role in fostering the growth of the automotive industry and broader economic development in China.** Foreign auto companies invest in China to leverage the lower production cost and to cater to the expanding domestic market. The presence of foreign companies has generated considerable positive externalities which have benefited the China's economic development. The auto industry is both technology- and capital-

[8]High-tech industries include both high-tech manufacturing and high-tech service sectors.

intensive. Its extensive industrial chain spans multiple stages, from raw material supply and component manufacturing to the final vehicle assembly. The rapid growth of this sector has not only generated a significant number of direct jobs but has also spurred the development of related industries through its broad upstream and downstream supply chains. As one of the key industries of China's economy, the automotive sector plays a pivotal role in shaping the nation's GDP. It has contributed around 10 percent to the country's overall economic output in recent years.

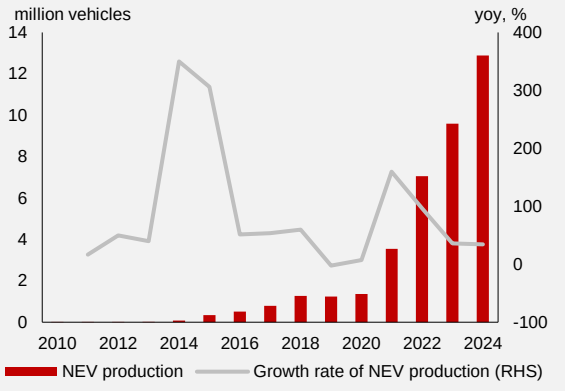
**The vast and burgeoning domestic market offers substantial opportunities for automobile manufacturers.** The development of China's auto industry has gone through four stages: the startup phase (1953-1978), the growth phase since opening-up (1979-2000), the rapid development phase since China joined the World Trade Organization (WTO) (2001-2010), and the transformation and upgrading phase combined with new energy vehicle (NEV) development (2011-present). Since 2001, China's automotive industry has entered a period of rapid growth (Figure 1.1), surpassing the United States in 2009 to become the world's largest automobile market. Starting in 2011, the Chinese government effectively harnessed the emerging opportunities, ramped up policy support and investment, and actively promoted the development of NEVs. By 2024, NEV sales in China accounted for over 40 percent of the total automotive market (Figure 1.2).

**Figure 1.1. Auto Industry Development**




Source: China Association of Automobile Manufacturers; AMRO staff calculations.

**Figure 1.2. NEV Development**




Source: China Association of Automobile Manufacturers; AMRO staff calculations.

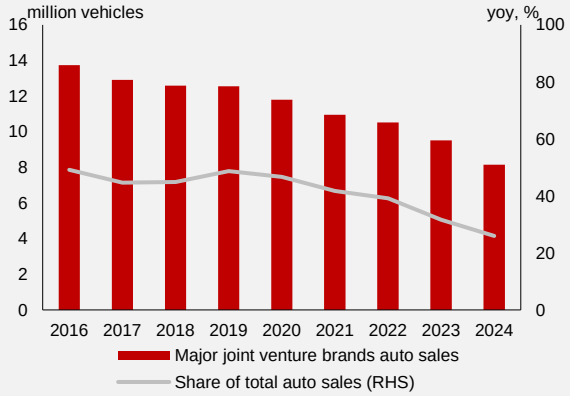
**The expansion of foreign automakers in China has benefited the advancement of local auto companies.** In 1984, Volkswagen established the first joint venture in Shanghai to produce passenger cars in China, marking a significant milestone in the country's automotive industry as it officially entered the era of international cooperation. In the past, joint venture car companies primarily focused on reducing production costs and enhancing market competitiveness by manufacturing foreign car models in China. Until recently, foreign and joint venture brands have been the leaders in the auto industry in China. There are more than 30 joint venture car brands in China, accounting for as high as around 50 percent of total sales volume in China in 2016. The joint ventures in China have provided vital financial, technological, and managerial support to local automakers**.** These partnerships have helped Chinese automakers establish a comprehensive framework for product development, manufacturing technology, value chain management, dealership networks, brand maintenance, and employee management, thereby laying the groundwork for China's modern automotive industry.

**In recent years, foreign investment in China's automotive industry has evolved from simple cooperation to a more symbiotic relationship, fostering mutual growth and innovation.** The rise of NEVs and domestic brands has led to fierce competition in China and overseas. As a result, sales of joint venture brands have declined notably in recent years (Figure 1.3). While some foreign car companies have scaled down operations in China, there are also some automakers increasingly focused on leveraging China's strengths in NEV supply chain and innovation. For instance, Volkswagen invested RMB 10 billion in the construction of an R&D center in Anhui, where a comprehensive NEV supply chain is well in place, and an additional RMB 5 billion in a local NEV maker Xiaopeng to jointly promote the research and development of pure NEV models.

**Rising trade tensions and the threat of geoeconomic fragmentation have created challenges to China's car exports.** In addition to supplying the growing domestic market in China, foreign

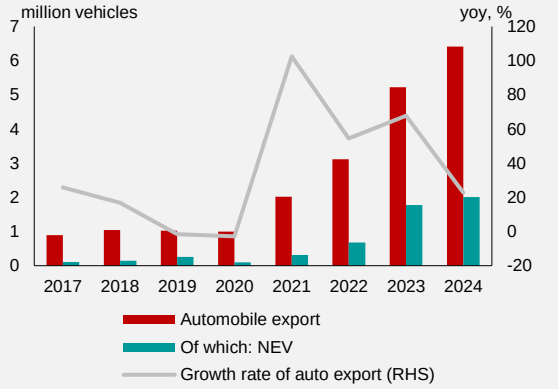
automakers also utilize production capacity in China as a vital node to supply global markets. For instance, BMW exports cars, produced in China, to other markets in Asia. Despite the challenges presented by the COVID-19 pandemic and geopolitical tensions, China's vehicle exports have experienced robust growth, becoming the world's largest automobile exporter since 2023 (Figure 1.4). However, uncertainties have increased amid the geoeconomic fragmentation. High tariffs on imports from China in the US and other major economies can reduce the competitiveness of cars made in China, forcing automakers to restructure their supply chains or to explore alternative shipping strategies — such as transshipment routes to bypass the tariff barriers via a third location such as Mexico and Brazil.[9] As a result, this may force some foreign and domestic car makers to move some production out of China. That said, in other cases, geopolitical conflicts have benefitted China's car exports, with Russia becoming the largest auto export destination over the past two years, up from eighth place in 2022.

**Figure 1.3. Joint Venture Brands Development**




Source: China Automobile Dealers Association; AMRO staff calculations.
Note: Major joint venture brands include Volkswagen, Toyota, Honda, Nissan, Audi, BMW, Buick, Mercedes Benz, Ford, Chevrolet, Jeep, Cadillac, Borgward, Jetta, Mazda, Mitsubishi, Hyundai, Kia, and Volvo.

**Figure 1.4. Auto Exports from China**




Source: China Automobile Dealers Association; AMRO staff calculations.

## V. Conclusion and Policy Implications

**14. The recent decline in China's FDI inflows does not mean a broad exodus of foreign companies from China.** The sharp decline in BOP FDI was mainly attributed to the reduced reinvestment of earnings and the repayment of intracompany debts driven by tightened global financial conditions and higher global interest rates. There is little evidence that heightened geopolitical tensions have led to the decrease in FDI inflows. China's FDI in actual utilization suggests that the country continues to attract foreign investment, bolstered by strengthening ties with Asia and Europe. At the same time, the evolving FDI landscape exhibits favourable developments as FDI flows into manufacturing, particularly high-tech industries in China, continues to grow.

**15. While our analyses suggest that the decline in FDI inflows may not be of great concern, as Chinese authorities will still focus on bolstering investor confidence.** The fundamental advantages of China remain unchanged: a large and expanding domestic market, comprehensive supply chains, strong manufacturing capability, a skilled labor force, developed infrastructure, and an established global network of free trade agreements.

[9] Russia followed by Mexico, the United Arab Emirates, Belgium, Saudi Arabia, and Brazil, collectively accounting for approximately 40 percent of China's total vehicle exports in 2024.

However, weaker growth performance and growing uncertainties from trade tensions and geopolitical developments have weighed on investors' confidence. Indeed, recent surveys by the American Chamber of Commerce (AmCham) in China confirm that China remains a top investment destination, but they also highlight the need for continued dialogue and efforts to address regulatory uncertainties and market access issues, alongside concerns about geopolitical uncertainties.[10] As FDI remains essential for China to attain high quality growth, the authorities will need to continue their efforts on restoring confidence and stabilizing foreign investment.

**16. The Chinese government has made notable efforts to enhance the business environment for foreign enterprises.** These include important initiatives, both at the central and local government levels, in lifting restrictions on foreign investment in manufacturing and services sectors, providing tax incentives and broadening financing channels, supporting foreign-backed R&D centers, and rolling out regulatory reforms to streamline cross-border data movement. The central government has issued guidelines in consecutive years—August 2023, March 2024, and February 2025—to further improve the foreign investment environment, focusing on shortening the negative list for foreign investment,[11] expanding the catalogue of encouraged industries, and offering various supportive measures.[12] More than 22 provincial governments have rolled out supporting measures tailored to local conditions to enhance policy synergy. For example, the Jiangsu government actively conducted overseas outreach and promotions to attract foreign investment, incentivizing capital expansion and profit reinvestment; Guangdong Province offers rewards for investments in high-tech manufacturing industries; and Anhui Province focuses on fostering foreign investment cooperation with both local and international investors. It is essential to maintain these efforts while also ensuring they are backed by effective implementation. At the same time, ensuring robust economic growth and reinforcing economic ties with China's trade partners will also be crucial.

[10] See China Business Climate Survey Report 2024, AmCham China.
[11] The 'negative list' for foreign investment removed all access restrictions to manufacturing sector and financial sector, it has been shortened from 31 items in the 2021 version to 29 items in the 2024 version. In November 2024, China unveiled a pilot work plan to allow establishment of wholly foreign-owned hospitals in major cities. According to 14th Five-Year Plan, more key areas in the service sector will open in the coming years, including telecommunications, internet, education, culture, and healthcare.
[12] Covering supportive measures, including tax reduction and exemption, production factors support, foreign mergers and acquisitions rules optimization, intellectual property protection, government procurement, convenient personnel exchange, extension of subsidies for foreign personnel and so on.

## Appendix I. Gravity Model for Foreign Direct Investment in China

To investigate the impact of political distance and other potential drivers of FDI into China, we apply a gravity model similar to Hudecz et al. (2024) and Damgaard et al. (2019). The FDI into China from another country is written as a function of political distance, physical distance, real GDP size, along with interest rates differential and real per capita GDP.

$$\ln FDI_{it} = \alpha_0 \quad +\alpha_1 PD_{it-1} + \alpha_2 PD_{it-1} D(\text{ year } \geq 2018)_{\text{t}} + \alpha_3 lnDistance_i + \alpha_4 lnRGDP_{it} + \alpha_4 \Delta Rate_{it} + \alpha_5 \Delta GDP\_PC_{it} + \mu_i + \nu_t + \epsilon_{it}$$

where $ln\ FDI_{it}$ is the log of FDI stock or log of utilized FDI flows from country *i* to China in year *t*,; $PD_{it}$ is the bilateral political distance between China and country *i* in year *t*, which measures the divergence in political orientation between countries based on their voting patterns in the United Nations General Assembly (Bailey, Strezhnev, and Voeten 2017). $D(\text{year} \geq 2018)_{\text{t}}$ is a dummy variable that equals 1 during the trade conflict period (from 2018 onwards) and zero otherwise, following Hudecz et al. (2024). This is to capture the potential effect from heightened geopolitical tensions since the onset of trade war; $lnDistance_i$ is the Euclidean (geographical) distance between China and source country *i;* $lnRGDP_{it}$ are the log of the real GDP of country *i* in year *t;* $\Delta Rate_{it}$ is the difference between the policy interest rate in source country *i* and China in year *t;* $\Delta GDP\_PC_{it}$ is the difference of real per capita GDP between country *i* and China in year *t* as a proxy measure of the labor cost gap; $\mu_i$, $\nu_t$ are source country and year fixed effects, respectively; and $\epsilon_{jt}$is the error term.

For the dependent variable FDI, we use FDI stock data from the IMF Coordinated Direct Investment Survey (CDIS) from 2009 to 2022, and the utilized FDI flow data from China Ministry of Commerce for the period 2009 to 2023, respectively. Political distance between any two countries is calculated as the gap between their ideal points which represent the country's political orientation using UNGA votes (Bailey et al., 2017). The policy interest rates are taken from the IMF IFS and BIS. Real GDP and real GDP per capita data are from the World Bank WDI. The final dataset covers 101 economies, including 9 economies from ASEAN+3[13], 16 from the rest of Asia, 18 from Africa, 36 from Europe, 16 from Latin America, 2 from North America, and 4 from Oceania.

Table A1 presents the regression results for the adapted gravity model. Columns 1-2 use FDI stock as the dependent variable while columns 3-4 use utilized FDI flows into China. Regarding FDI stock in China, political distance does suggest a negative impact, but it is statistically insignificant. However, during the intensified political divergence since 2018, the coefficient of political distance is positive and significant, suggesting that foreign companies have in fact continued to invest in China despite geopolitical tensions since the trade war. This is in line with the findings in Hudecz et al. (2024). In addition, column 2 indicates that interest rate differential is also a significant driver for FDI stock in China. Similarly, columns 3 and 4 also suggest that political distance does not significantly dampen the utilized FDI flows into China, especially when controls of interest rate differential and per capita GDP gap are included. Moreover, China continues to receive FDI flows even after 2018 despite the intensified geopolitical tensions. Again, the interest rate differential has a positive and significant coefficient as shown in column 4. Interestingly, per capita GDP gap does not have

[13] Including Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Thailand, and Vietnam.

a statistically significant coefficient, which may indicate that a narrower income gap amid higher labor costs in China does not reduce FDI into China in general.

**Tabel A1. Regression Results of the Gravity Model of FDI into China**

| Independent Variable | Dependent Variable | | | |
|---|---|---|---|---|
| | *lnFDI_stock* | | *lnFDI_flow_utilized* | |
| | (1) | (2) | (3) | (4) |
| $PD_{it-1}$ | -0.153 | -0.205 | -0.472** | -0.360 |
| | (0.129) | (0.125) | (0.204) | (0.221) |
| $PD_{it-1}D(\text{ year } \geq 2018)_t$ | 0.239** | 0.266*** | 0.389*** | 0.346** |
| | (0.102) | (0.094) | (0.146) | (0.147) |
| $lnDistance_i$ | -3.257 | 11.18 | -2.417 | 12.64 |
| | (28.061) | (29.433) | (45.953) | (51.410) |
| $lnRGDP_{it}$ | 1.173* | 2.223** | 1.170* | 1.019 |
| | (0.693) | (1.115) | (0.638) | (1.247) |
| $\Delta Rate_{it}$ | | 0.0295** | | 0.0245** |
| | | (0.014) | | (0.010) |
| $\Delta GDP\_PC_{it}$ | | -0.610 | | 0.467 |
| | | (1.156) | | (1.223) |
| Constant | -2.750 | -158.1 | -5.520 | -136.4 |
| | (250.792) | (265.539) | (412.006) | (465.581) |
| Country FE | Yes | Yes | Yes | Yes |
| Year FE | Yes | Yes | Yes | Yes |
| Observations | 957 | 908 | 972 | 923 |
| Adjusted $R^2$ | 0.144 | 0.224 | 0.594 | 0.537 |

Robust standard errors are reported in parentheses.
* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

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