ECONOMIC REFORMS AND KAIFENG : FOREIGN DIRECT INVESTMENT IN THE P.R.C. AND THE US ROLE (1985-1995)

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Certified that the dissertation entitled "**Economic Reforms and Kaifeng : Foreign Direct Investment in the PRC and the US Role (1985-1995)**"; submitted by **Mr. P.A Mathew** in partial fulfilment of the requirements for the award of the degree **MASTER OF PHILOSOPHY** has not been previously submitted for any other degree of this or any other university. This is his own work.

We recommend that this dissertation may be placed before the Examiners for evaluation.

Prof. G.P. Deshpande
Chairperson

Dr. Alka Acharya
Supervisor

In memory of my Father

P.M. Abraham

To learn about another great culture is to enrich one's life, to understand one's country better, to feel more at home in the world and indirectly add to that reservoir of individual goodwill that may generations from now, temper the cynical use of National Power.

Vikram Seth in 'From Heaven Lake'
Travels through Sinkiang and Tibet

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- P. A. M.

TABLE OF CONTENTS

INTRODUCTION

Since the death of Chairman Mao, winds of change have been sweeping across the People Republic of China, both in the realm of domestic as well as International policies. The tumultuous decade of the 80's witnessed China discovering itself among the comity of nations and gradually assuming an identity of a "Socialist market economy". Progress since 1978 when Deng Xioaping gave a new impetus to the modernizations in Agriculture, industry, Defence and Science and Technology, has been steady and China has recorded double digit economic growth for three consecutive years since 1992.

Since the formulation of the economic reforms, the role of the foreign sector has burgeoned in a manner that very few anticipated. By the mid 1990's China had become one of the world's largest trading nations, the recipient of more foreign direct investment than any other country in the world, the largest borrower from the world Bank, and the largest recipient of official development assistance in the form of low interest, long term concessionary loans from industrialized countries (except for the Czech Republic, the only country in the process of economic transition with ready access to international capital and equity mortents).[1]

The opening up of the economy to the outside world was a major shift from the policy adopted in the preceding decades, after the revolution of 1949 which promised an egalitarian state on the road to communism. The agricultural, industrial and trade policies were a reflection of this promise and the system was effective in focussing national efforts on key goals and penetrated deep into the socio-economic life. The thrust of the policies was on self reliance. It meant that the country should carry on its general economic construction on the basis of its own human material and financial resources. International markets were regarded as economically anarchic systems from which China's domestic economy was to be insulated. International Trade was monopolised by the State and enterprises were cut off from direct contact with the International economy.

This policy helped China to achieve a high degree of self sufficiency in capital goods, even though it led to a fall in China's share in the world markets. Inspite of mass movements the gross national product grew, there was shift of

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1. Nicholas. R. Lardy 'The Role of foreign trade and investment in China's Economic Transformation'. **China Quarterly** , no.43, p.1065. 1995.

economic structure from Agriculture to Industry and long term growth in consumption.

Deng Xioaping's taking over the reigns of power radically altered the balance of power. The Third plenum of the 11th Central Committee of the CPC in December 1978 was an epochal event and it ushered in the reform which radically altered the policies followed till then.

Deng was a pragmatic but committed revolutionary through out his political carrer, attempting to ensure that the Communist Party of China achieved power and China's economic modernization. For him communism was an organizational as much as if not more than, an intellectual response to the problems China faced in the 20th Century.[2]

In the reforms of the late seventies, there was a discernable a certain historical continuity with the goals of the reformers at the turn of the century when China's backwardness and enslavement was attributed to the lack of advanced western science and technology. The debates of the mid-seventies seemed to echo those of the twenties and thirties when the primary concern was to lift China out of its economic stagnation and decay and infuse new life in its

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2. David Goh, **Deng Xiaoaping and the Chinese Revolution**, Routledge, London, 1994 p.23

efforts at economic progress and thereby achieve the tremendous potential that China had. However, in the 1970's the global scenario had undergone a drastic change and the internal circumstances in which the PRC sought to fulfill its long cherished ambitions had altered dramatically. The manner in which China would achieve its goals therefore would obviously be different as well.

The new economic strategy was aimed at improving the low standard of living of the masses and enhancing the technical capacity and efficiency of Chinese industry and agriculture. There was a shift from extensive growth strategy to intensive growth which meant modernizing and tapping the potential of existing plants. Allocation priorities shifted to light and consumer goods industry rather than the constrution of capital goods industry. Creative specialization and comparative advantage was the focal point of the programme.

The opening of the economy to the outside world was a logical follow up to the policy of comparative advantage and shedding the garb of isolationism. This was followed up with a set of incentives which made investing in China attractive even though it was a command economy. Creation of special economics zones, opening of 14 coastal cities etc were a part of the preferential policy package of offering various incentives to export oriented investment. In course of time more deltas were opened to foreign investors.

The thrust of the efforts was to bring in advanced technology which is the life blood of any industry. Other objectives included increasing the competitive ability of exported products and the influx of foreign exchange, accelerating technical transformation of existing enterprises etc.[3]

China has recorded rapid progress in attracting foreign investments since the introduction of the reforms. Till the end of 1995 the country had approved 2,59,379 foreign funded project involving total negotiated foreign investment of US $ 395.12 billion. Thus far, some 1,20,000 foreign funded enterprises with a total workforce of 16 billion have gone into operation. Foreign Investors have come in from nearly 160 countries and regions including 200 of the world's top 1,500 transnational industrial and service companies. Industrial projects account for 70 % of the total investments and the number of major energy, raw material and infrastructure projects has increased dramatically.[4]

3."China - Facts and Figure", **Foreign investment in China** Foreign language Press - Beijing, 1988. p.3-6.

4. Minister Wu on Foreign Investment in China, **Beijing Review**, March 18-24, 1996. p.26.

Then were various forms of investment depending on the interest of partners. Equity joint venture, cooperative joint developmnet (energy sector) and compensation trade were the major forms of investment flowing into China.

Inspite of the efforts to promote foreign investments and reap its benefits the Chinese authorities also understand the need to preserve China's authority, and sovereignty over its domestic market and to protect state owned enterprises from unequal competition. Deng Xioaping underscored the need to preserve this concept of self reliance by which he means "that a country should rely on the strength and wisdom of its own people, control its own economic life lines, make full use of its own resources, strive hard to increase the food production and develop its national economy step by step and in a planned way.[5]

This policy does not mean that it should be divorced from the actual condition of the country. It is beneficial and necessary for the development of the national economy that countries should carry on economic and technical exchanges on

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5. 'Speech by Deng Xioaping at U.N. General Assembly-April 9th 1974, **Peking Review**, April 18, 1974. p.19.

the basis of respect for State Sovereignty, equality and mutual benefit and the exchange of needed goods to make up for each others deficiencies. The problems faced by foreign investors emerged as a consequence of the policies followed by Chinese authorities to protect these interests. Non convertability of Chinese currency, problems concerning labour monopoly, press, etc. forms a part of the problem.

This study makes an attempt to look into the open door policy of the economic reform package initiated in China and the role played by Foreign Direct Investment in it. The main focus is on the dynamics of FDI and its contributions to economic growth. China qualifies as a good example for analysing this because of the drastic changes brought about by the open door policy and the contribution of FDI towards these changes in a relatively short period of less than two decades. It looks into the role played by the government in acting as a catalyst in the interaction between FDI and economic growth. In the the case of China the above aspect is crucial because the country is still a one party state claiming to follow the socialist path.

The theoretical foundations are provided by looking into the various theories with regard to FDI and its motivating determinants. Attempt has been made to look into the sector specific and country specific factors. The main theoretical foundation rests on John Dunning's work on "Investment Development Path" using the framework of eclectic paradigm which was further developed by Rajneesh Narula.

The Investment Development Path represents an attempt to relate a country's net international direct investment position to its stages of development, relative to that of the rest of the world. This is used in the context of China and Rajneesh Narula's analysis is used for this purpose.

Chapter I focusses on the open door policy and its historical antecedents in China. Various philosophical ideas are discussed and it focusses more on the changes over the years and the role of the foreign sector in it. Chapter II providede the thoeretical framework underlying FDI. Investment Development Path is introduced here. Chapter III analyse the Chinese appoach towards FDI like legislations, and incentives provided. Chapter IV discusses the contributions made by different countries in relation to FDI in China. And finally an analysis is made with regard to investment development path and its different stages in China.

At the outset, the focus of the FDI in China was to be on the U.S. and its role. However, a serious dearth of statistics and figures covering the last decade, regarding U.S. investment in China proved to be a major handicap. An indepth study of the U.S. role could therefore not be done adequately. Hence, there has occured a slight shift in focus. Despite what the title suggests, Chapter IV has attempted to consider the U.S. share in the overall FDI picture of China. The attempt has also been to look at the political facets of the U.S. role and to examine how the U.S. has gradually declined in both investment terms and importance as China's Open Door policies are increasingly turning towards its immediate neighbourhood and to the region largely. The U.S. role thus gets highlighted more by an indirect approach.

Chapter 1

Economic Reform in the Historical Perspective

After the death of Mao, The People's Republic of China gave a new thrust and impetus to its foreign relations in its policy of opening up to the outside world. For China, opening up meant the adoption by the state of new methods to promote national economic strength and encourage the involvement of foreign partners in China's Economy at a price and subject to government loss and policies. It has led to increase in Trade, decentralised and liberalised the mechanisms by which trade is conducted in the sphere of foreign economic policy.

The Chinese leadership led by Deng Xiaoping pursued five major goals in its open door policy.

1. Import of foreign capital;
2. Import of advanced Western technology;
3. Import of Western management knowhow;
4. Export promotion and import substitution;
5. Upgrading the skills of, and creating jobs for Chinese manpower.[1]

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1. Petra Pissula and Deietr Losch, "Special Economic Zones in the P.R.C.", **Inter Economics** , Vol. 25, No.5 September/October, 1990. p. 25

In keeping with the goals of the open door policy China welcomed foreign direct investment (FDI), accepted aid, loans and credit from foreign governments, international organizations and commercial banks. Considering its backward technology, China multiplied the channels through which it hoped to acquire advanced technological knowhow and managerical expertise. China also opened up to the world certain parts of its territory, specifically four Special Economic Zones in the South East, fourteen cities, and Hainan Island and three larger development zones along the southern coast which would be the front runners in absorbing foreign technology, introducing foreign capital and expanding Chinese export to foreign markets.

This opening up in foreign economic policy coincided with a remarkable decollectivisation of agriculture, allowing private economic activities, some cultural and ideological relaxation as well as a new legal system.

But the policy changes were rooted in China's historical past. Since the 1840s the Chinese have been concerned with drawing a line between Western technology and the Chinese moral essence. The conservatives of the 19th century emphasised the need to master Western technology but wanted to preserve the unique Chinese moral values.[2] As they put it, "Zhong xue wei ti, Xi xue wei yong" (Chinese learning for moral essence, Western learning for functions or use).

Although the Ti - Yong distinction failed as a philosophical principle and as a practical guideline, the idea provided a broad guideline in China's interaction with the outside world even in the 20th Century. Confucianism dominated the body politic of China for centuries. From the middle of the 18th Century to the 20th, both internal and external factors adversely affected China's relatively advanced traditional economy. Rising population and diminishing margins of return on land gave rise to peasant uprisings in the 19th and the mid 20th century.

The coming of the Europeans towards the 18th century established China's first contact with a technologically superior culture. China's stunning military defeats in the two Opium wars of 1840-42 and 1856-60 convinced some Chinese of the need to combine the efforts of officials and merchants to absorb foreign technology and launch a programme of industrialization to meet the military challenge from the West.

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2. Joseph R. Levenson, **Confucian China and Its Modern Fate : A Triology**, University of California Press, Berkeley, 1958, 1964, 1965, p. 59

After 1895, foreigners also gained the right to invest in industrial and commercial enterprises in the coastal areas.

After the establishment of the People's Republic of China in 1949, the Communist Party of China (CPC) chose to rely heavily on Soviet models of economic structure and development strategy. Other than the ideological reasons, the Korean War had foreclosed the possibility of gaining technology, capital, markets, and advice from the West. China had little self confidence yet in its ability to achieve economic modernisation and industrial transformation on its own. And the conviction that the Soviet Union as the world's first Socialist State, offered in valuable experience that China could emulate.[3]

The distinction between the Chinese essence and Western technology was maintained during the Maoist period. In a famous speech on 'Ten Great Relationships' in April, 1956, Mao firmly supported selective absorption of foreign technology and methods of operation.[4] Mao's optimism about adopting capitalist techniques and scientific management did not extend to allowing capitalist investment. International

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3. Harry Harding, **China's Second Revolution** Brooking Institution, Washington. D. C., 1987, P.15

4. Mao Zedong **Selected Works** Vol. 5, Foreign Language Press, Beijing, 1977, p. 305.

markets were considered economically anarchic systems from which Chinese domestic economy was to be insulated. Thus international trade was monopolised by the state and enterprises were cut off from the direct contact with the international economy.

Ideologically, Mao was opposed to undesirable influences and dependence on foreigners. East-West tensions prevented the possibility of adopting a more conciliatory stance. But Mao did promote an opening up in 1950s, when China accepted massive technical assistance and capital investment from the Soviet Union. Hundreds of turn key projects in metallury, machinery and coal production were imported and laying the foundations for Chinese economic growth until the 1960s.[5]

The adoption of the Soviet model meant fundamental transformation in the pattern of ownership in the Chinese economy, and with the means of production were transferred from private hands to collective ownership through a series of mass movements. Mandatory central planning followed collectivisation of agriculture and the nationalisation of industry. The distribution of capital goods was regulated as was the allocation of investment and utilization of labour.

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5. Ten Weizao in Xudiyin (ed) **China's Search for Economic Growth**, New World Press, Beijing, 1982, p. 169.

But the Soviet model enlarged the gap between the city and countryside, brought economic activity under excessively tight control and created an unresponsive bureaucracy interested in perpetuating its own power and previleges and produced serious tensions between the party and ordinary citizens.

The subsequent break in relations with the Soviet Union came about partially as a result of the Great Leap Forward which was among other things, an effort to introduce more egalitarian, self reliant and populist elements into the economic model. However, Mao never succeeded in thoroughly uprooting all the characteristics of the Soviet system. Instead Maoist components were grafted onto Leninism - Stalinism, much as the Soviet Model had been superimposed on the traditional economy.[6]

By mid 1970s there was dissatisfaction in urban China with the political and economic trends that had emerged in the latter years of the Maoist era. This dissatisfaction was intensified by international factors some of which increased the pressure for reforms and helped facilitate China's eventful structural transformation. One factor was the unfavourable comparison between China's economic perfor-

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6. Harding n.3 p. 17

mance and that of the rest of East Asia. As China's economic growth declined to an average of 7.4 % between 1965 and 1973, growth rates accelerated in Japan (9.8 %), Taiwan (10.3%), South Korea (10%), Hong Kong (7.9 %) and Singapore (13%).[7] To China, which had traditionally regarded itself as a power in the region this particularly galling.

In the post- Maoist-era, the leaderships views on International economic policy were made explicit in Deng Xiaoping's 1975 speech on "Some Questions on Accelerating Development of Industry", also known as the "Twenty Points". The need to Learn from the positive aspects of foreign countries and the danger of adopting a closed door attitude were clearly spealt out in this document.[8]

More recently Deng, cautioned that any country that closed its doors to the outside world could not achieve progress and he attributed the slow pace of China's moderni-sation to its international isolation since the middle of the Ming dynasty era through the period of the 'Opium Wars' and

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7. **Asia Pacific Report**, "Trends, Issues and Challenges", East West Centre, Honolulu, 1986, p. 96

8. The Kenneth Liebathal **Central Documents and Politburo Politics in China** Michigan Papers in Chinese Studies, No. 33, University of Michigan, 1978, p.29

the Sino-Soviet split of the late 1950s until the cultural revolution.[9]

The international environment offered Chinese leaders the opportunity to change this. China and the West, specially the United States of America, first implicitly and then explictly had a common interest in opposing the expansion of Soviet influence in Asia. Their parallel perspectives meant that United States and Japan as well as Western Europe were willing to actively cooperate in China's modernisation. In addition, China's links with many Overseas Chinese in the rest of Asia offered a ready bridge for facilitating the transfer of capital and technology.

Deng Xiaoping's policy of opening up the Chinese economy can be considered as a necessary response to world conditions. The Chinese analysis of the opening up policies during the decade after 1978 describes an international system of competitive states using economic policies to serve national and not class interests. It affirms that the world economic system through competition gives China opportunities

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9. Xinhua News Agency, December 31, 1984 in FBIS January 2nd, 1985 as quoted in Harry Harding's **China's Second Revolution**, Brooking Institution,Washington D. C., P.123.

to develop its wealth by obtaining foreign exchange to purchase technology, promote exports and restrict imports.[10]

China's policies were intended to raise technological levels of production, and then increase productivity and national economic output. It was argued that as imported technology upgraded the productive forces, it would increase the quality of export production, and earn foreign exchange which the state could use to buy more equipment and technology. To accumulate foreign exchange the economy could have to adjust to international market pressures. To raise efficiency of export production, each region would go in for specialised production in the sector in which it had most strength and the entire country would promote labour intensive industries.[11]

A radical shift also occured in the Chinese attitude towards foreign trade, involving a fundamental rethinkng regarding its role in economic development. China's leadership shifted its view of international trade from being an exploitive activity to an explicit recognition of the enor-

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10. Chen Qiwei, 'Why is China Opening to the outside?, **Beijing Review**, April 1, 1985, p. 22.

11. **J.P.R.S.**, 79742, December 24, 1981, p. 117.

mous contribution that international trade could make to economic advance.

With an abundance of certain natural resources, a large pool of low wage surplus labour and many regions with strong commercial and manufacturing tradition China could, given the right set of policies, there were considerable opportunities to expand export earnings and hence its capacity to import. A number of measures were undertaken to reduce the overcentralised administration of international trade, so that more direct contacts could be established between the domestic enterprises and international buyers and suppliers. Alongside the decentralisation of the organisation of foreign trade went a considerable devaluation of the Yuan and exporting enterprises were even permitted to retain a proportion of the foreign exchange earned from exports. The increased role of market forces within the domestic economy meant that domestic enterprises were keen to take advantage of opportunities to profit from international trade.[12]

Administrative structures were modified to allow localities and enterprises greater authority over key trade decisions. This loosening of control encouraged growth of trade because enterprises wanted imported equipment and localities

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12. Peter Nolan, **Chinese Economy and its Future** (ed) Peter Nolan, Don Fureng, Polity Press, Cambridge. p. 16

wanted to export to earn foreign exchange to buy imports. After 1978, foreign trade corporations became more product specialised and new professional agencies were created to control foreign exchange, administer foreign investment and promote foreign trade.

An import substitution policy was adopted while expanding trade. Trade barriers were erected to prevent foreign goods from competing with Chinese goods in the domestic markets. Further Quotas on imported comodities mentioned in intergovernmental agreement limited quantities of goods by country of origin. The government instituted a provincial import licencing system run by the Ministry of Foreign Trade. In general, flexibility was provided by granting exceptions, to licencing for urgently needed production goods or set quotas of certain other goods during periods of trade surplus. Further the government maintained custom duties to discourage import of consumer goods that might be produced domestically. Reduced rates were applied to natural raw materials for industry, commodities in temporary short supply, machine parts and instruments.[13] The otherside of the coin was that to sustain surpluses, the state promoted exports by any available means. The state played, and contin-

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13. James P. Horsely, "The Regulation of China's Foreign Trade in Michael J. Moser (ed.) **Foreign Trade, Investment and Law in the PRC**, Oxford University Press, Hong Kong, 1984, p. 24.

uous to play active role in fostering and subsidising export industries.

The theory of Comparative Advantage in international trade and the theory's domination by the advanced capitalist countries was the main element of the thinking of the pre-reform period. It is changed to emphasise that in order to expand exports despite limited financial backing, it is necessary to make the most of China's latent advantages especially that of cheap labour. There was also a recognition of the fact that there was need to link industry and technology to foreign trade and emphasize the importance of improving the export structure. The price system and exchange rates were, hence rationalised and the policy of discriminating against exports abandoned.[14]

Decentralization of foreign trade took different forms. Prior to reform, China had less than ten specialised foreign trade companies and no general companies with local branches. Provincial foreign trade management organizations generally took orders from the Central Foreign Trade Department. Under the new system the special economic zones were authorized to establish of foreign trade companies in Guangdong and Fujian

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14. Zhou Xiaochuan, "Foreign Trade" in Peter Nolan and Dong Fureng, (ed) **Chinese Economy and Its Future**, Polity Press, Cambridge, p. 33

provinces for export and, later, for import as well. Local governments gradually acquired increased rights and incentives and set up their own foreign trade companies.

Although foreign trade was partially decentralised, overall substantive guidance remained under state control. The state reserved to itself the right, keeping in view the national advantage, to grant or to retract enterprise, foreign trade management rights. The government's supervising and regulatory powers over enterprises was intended to continue the import substitution policy. Import substitution would foster growth in a broad base of domestic industry, and protect it from the danger of bankruptcy under the pressure of foreign competition.[15]

Beijing authorities used protectionist tariffs, import quotas, licencing, currency restrictions and negotiated trade agreements for the imports substitution policy. Chinese economists justified such measures as necessary until the country reached a high level of economic development. Only then would China be able to replace import substitution with a fully outward orientation.

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15. Robert Kleinberg, **China's Opening to the Outside World**, West View Press, Boulders, 1990, p. 33

China has a long historical experience with the selection of certain cities as points of contact with the outside world. In a decision that carries intriguing echos from the past, China's post Mao leadership has also selected several parts of the country to serve as linkages between China and the rest of the world. Rather than using the historical .ls2precedence of restricting and channelising trade, the central government has selected certain parts of the country to spearhead economic relations with foreigners.

China designated four areas along the southern coast - Shenzhen, Zhuhai, Xiamen and Shantou as special economic zones (SEZ) in 1979. Like the export processing zones established in developing countries in the 1960s and 1970s, the SEZ's encouraged foreign investment in export projects. In these areas the government projected the creation of a modern infrastructure, a well trained labour force who would be offered preferential tax rates, exemptions and holidays. Since the four SEZs were coastal cities, they acted as bridges linking China to Hong Kong and Macao, and through them to the rest of the world. One of the most important functions was to serve as mechanisms for the introduction, study and absorption of technology in a wide range of industries. The zones were to be centres of services, agricultural processing and tourism as well as manufacturing. These areas were designated to absorb advanced technology.[16]

In addition to this, SEZ's were to serve as a kind of economic laboratory, an experiment to test economic reform policy before applying it to the rest of China. The impact of a largely free economy based on free enterprise principles was to be monitored in a regionally confined setting.[17]

Since the beginning of the 1980s the Chinese open door policy has developed rapidly. Except for Shenzhen, the territories of the first four SEZ have been enlarged. A large number of additional provinces, areas and urban centres have been opened up to foreign direct investment while the dividing lines between the "open areas" and the rest of China have become sharply demarcated. 14 coastal towns were opened up in 1984 and on the fourth of May 1988, the island of Hainan was placed on an equal footing with the SEZ. At the same time it was decided to open up the entire coastal region

from the province of Liaoning in the north upto the province

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16. Clyde. D. Stoltenberg, "China's Special Economic Zones - Their Development and Prosperity", **Asian Survey**, Vol. 24, June, 1984, p. 637 to 654.

17. Petra Pissula and Dieterlosch, "Special Economic Zones in the PRC", **Inter Economics**, September, 1990, Vol. 25, No. 5, p.34.

of Guangxa adjoining the Guangdong province.

The major point of attraction is the proximity of the SEZ to Hong Kong, Macao and Taiwan. The scarcity of land and shortage of labour in Hong Kong and low wages and favourable real estate prizes in the special economic zones made them attractive for industry to reallocate of its wage intensive production stages. Promotion of technology transfer was one of the goals of the SEZ's. The SEZs were set to attract modern manufacturing technologies in the hope of achieving spillover effects for the modernization on the whole China's economy. Investment patterns in SEZs show that service industry is in the forefront and more labour intensive industries dominated.

One of the consequences of this is that the Volume of technology transfers from the SEZ's to the Chinese hinterland are low. Most modern showcase factories in the zones are infact, closely interlinked with the Chinese economy. Here on the whole, the economy's capacity to absorb foreign technology is low because of the lack of qualified skilled workers, technicians and engineers.

With regard to the goal of export promotion, the SEZs are only now moving beyond the stage of development where rapid export growth is usually followed by equally expensive imports. Neverthless, special economic zones are making a respectable contribution to overall Chinese exports.

Serious social and political problems have accompanied the establishment of SEZs. In Shenzhen, both the local currency and the indigenous culture are being driven out by the counterparts from Hong Kong. Prostitution, smuggling and corruption have become widespread.[18]

On the whole, a comparison of the goals and results of China's SEZ policy presents only a modestly successful picture. Possibly, the zones might have been able to contribute more to national economic development if the goals had been defined differently. Profound contradictions exist between export promotion and technology transfer. In China only simple assembly work is carried out and local content in the final product remains as minimal as the technology transfer via supply relationships.

From a national viewpoint, the cost-benefit analysis of the Chinese policy of SEZ's is viewed positively in terms of regional economic development. The relative success of the zone experiments was a condition for the broader outward

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18. **Harding**, n.3 p. 166

looking policy of the Chinese economy. Furthermore the zones have convincingly performed their window function.[19].

Reunification with Taiwan and Hongkong remains one of China's paramount priorities. The Chinese government is well aware that the economic zones specially Shenzhen dominated by Hongkong capitalist will be seen by overseas Chinese as a bell weather of China's openness to this partnership. Existence and development of the economic zone have given confidence to the reunification moves.[20].

Perhaps the most dramatic turnaround brought about by the process of reform and opening up was the shift away from prohibiting foreign direct investments (FDI) in China towards an active encouragement of FTS. The primary purpose of this regime change was to gain access to modern technology, both embodied and disembodied, packaged with capital management schemes and international networking.[21]. Along with this went the hope that the change could generate foreign exchang earnings from resulting exports, though in practice this has always been a secondary objective.

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19. Petra Prussula, n. 1. p.37

20. Liang Xiang, 'Shenzhen SEZ sees Dramatic changes'Beijing Review, Feb24,1986, p17

21. Chu Baotai Foreign Investment in China- Questions and Answers, Foreign Language Press, Beijing, p. 8

Investment from foreign countries more than doubled in 1992 and 1993 causing an investment boom. Total world investments in China have increased by a rate of nearly three hundred percent from 1991. China was able to attract investments to the tune of $ 45 billions in 1994.[22].

It was inevitable that as foreign investments grew, problems would emerge from time to time. As patterns of foreign investments emerged, the State Council proposed new regulatory legislations to the National People's Congress. In October 1986, a major legislation on foreign direct investment was introduced in response to the concern that much investment was using low technology consolidated in the service sector (hotels, restaurants and tourism) and aimed at the domestic market. The "Provisions for Encouragement of Foreign Investments" contains 22 articles giving it the common name of the "22 articles law". This represented a turning point in China's policy towards foreign direct investment.

Chinese authorities diffrentiated amomgst differenrt types of FDI and singled out "export enterprises" and technologically advanced enterprises for specific encouragement.

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22. IDE spot survey, "Investment Risk in Post-Deng Chinga", Institute of Developing Economics, Tokyo, March 1995, p4.

The encouragement was provided partially through the removal of obstacles about which investors complained, such as their inability to hire and fire workers in line with the company's need, and partially through the introduction of extra tax inventives and privileged access to input materials.[23].

The main attraction for foreigners to invest in China are China's absolute and comparative advantages and the existence of a large domestic market. Comparative advantages of cheap labour, abundance of mineral wealth like coal, oil, etc., and the dreams of exploiting the country's vast domestic market of 1.2 billion people make the investments attractive. Incentives were also provided to foreign investors. The aim was to raise the return from investments above those of other activities as well as government intervention that simply sought to restrained cost raising obstacles to investments. Tax concessions in the form of reduced tax rates, tax holidays, and Preferential deductions were introduced. Central legislation and administrative order have been introduced along with provisional and municipal action to enable foreign funded enterprises to cope with the vagaries of dealing with the government mechanisms of a command economy. Such interventions cause, for example, labour mobility, the leasing of land, arbitrary financial impositions, one stop

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23. China's Long March to Open Economy - **OECD Report**, TD/TC/WP (94), Paris, p60.

shop and dispute productions.[24]

According to Bucknall foreign sector accounted for only 8.7 % of total accumulation in China in 1986 and averaged around a mere 5 % of total investment in China in the period 1979-86. He therefore, argues that foreign funds are not an important source of investment in China. In the period January 1979 to September 1985, 69.5% of foreign capital used by China was in the form of loans from international financial organizations and only 30.5% came in the form of direct investment. However, the latter component has increased over time. Neverthless, given Bucknall's view, direct foreign investment is relatively insignificant as a contributor to total investment in China.[25]

Direct foreign investment, however has an economic value which is not reflected in its proportionate contribution to capital accumulation in China because it is a source of new technology and methods. But even in that respect according to Bucknall, "experience in other countries suggests that spill over effects are often small and slow to arrive and whether joint ventures are willing to listen and

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24. Liu Jianju, "Decade of Successful foreign investment", **Beijing Review**, Nov.6, 1994. p.14

25. Bucknall, K.B. **China and its Open Door Policy**, Allen and Unwin, Sydney and London, 1989, p. 127.

learn is not sure".[26] In addition the technology transferred from abroad is often inappropriate to China's need and conditions. The most advanced technology is not always suitable for China. Questions are also raised about the capacity of foreign investors in China to earn and repatriate sufficient profits to make the investment worthwhile.

Despite these problems foreign aid and investment have had a stimulating effect on the economy and led to an increase in output, a higher quality of goods, an improved standard of living and higher levels of employment. The benefits in terms of technology added dynamism and economic growth easily outweigh the problems.

The historical dimension and philosophical contours of China's opening up to the outside world cannot be overlooked. The "conservatives" of 19th Centuries emphasised the need to master western technology but wanted to preserve the unique Chinese moral values. Although Deng Xioaping initiated many policies which could be considered path breaking, selective absorption was the corner stone. Deng's embrace of foreign trade and investment always sought to protect state control of key sectors of the economy to limit the political sideeffects of economic change and to restrict

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26. Ibid., p. 125

allegedly harmful foreign influences on China's culture and morals.

The conviction that some unique Chinese moral essence could and should be preserved in a rapidly modernising society underlines the opening up policies. The defence of Chinese uniqueness from western style modernisation, found philosophically untenable and practically impossible in old China, now has wide spread acceptance. It colours political rhetoric in China such as Deng Xioaping's catch phrase, "Socialism with Chinese Characteristics". In general it encourages confidence that international trade and contacts will not jeopardise ti the moral essence of China. But it also supports a policy of economic nationalism.[27]

Economic nationalism which could be define as 'self reliance' is now redefined to mean diminished dependence on foreign control - not rejection of all direct foreign investment. Yet, the international tendencies increasingly evident in post-Mao China have had to compete with a strong and resilient strain of economic nationalism and protectionism.

As an ideological thought economic nationalism draws

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27. Robert Kleinberg, **China's Opening to the Outside World,** West View Press, Boulders, p. 9

on Marxism, Leninism and Maoism. In addition, China's experience with Western and Japanese penetration and aggression in the late 19th and first half of the 20th century serves as a useful reminder about allowing unhindered access to China's mainland to powerful outside forces. This anxiety has a cultural dimension too. Extensive contact with foreigners is anticipated to produce an infusion of unorthodox ideas like individualism, consumerism, political pluralism and human rights - the ideas which challenge the basic principle of the Chinese state.[28]

Economically, opening up fully may threaten the very existence of domestic firms. Chinese consumers may increasingly demand more of foreign goods and local manufacturers may come to largely depend on external sources of supply. This could endanger the country's political stability, social order and cultural integrity.

There is, however, a fundamental change in the way the Chinese view the world now. Rather than viewing the world as divided into two competing economic blocs - socialist and capitalist, the Chinese leaders assert that although tensions remain, compromise and cooperation rather than confrontation is the most effective way to find solutions to the

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28. Kleinberg n.15, p.9.

problems. Although disputes over economic and cultural issues have been apparent ever since the reform of China's foreign economic policy after 1978, compromise is often employed. Just as the tension between a reformist spirit and socialist ethics has been the principle characteristics of the continuing discussion over domestic reforms, so has the interplay between the elements of internationalism and protectionism have been the critical dynamics in the evolution of China's foreign economic policy in the post Mao era. Chinese leaders have attempted to resolve the tension between internationalism and protectionism by promising to use the power of the state to regulate the countries cultural and economic relations with the rest of the world.

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CHAPTER II

Theories of FDI and its Relevance to the PRC

Foreign direct investment [FDI] has long been a subject of interest to both developed and developing countries. This interest has been renewed in recent years because of the rapid increase in global foreign direct investment flows and the possibility offered by FDI for channelling resources to developing countries . Although FDI has not been a significant component of total capital inflows into developing countries, its relative importance has increased because many of developing countries have quite limited access to other sources of funding.

Thus, the importance of foreign investment in development is being emphasised by an increasing number of developing countries. It is considered as a means of obtaining not only capital but also technology, scarce management and other skills, and improved marketing know how and outlets for nontraditional exports. FDI is also seen as creating employment opportunities and raising domestic wages.[1]

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1. V. Cable and v. Persand **Developing with Foreign Investment** (London, Croom Helm, 1987) P. 1.

FDI is also known to be a cross cultural agent. "Foreign Investment is an agent in the process of cultural borrowing that constitutes industrialization. The aspect of culture transferred tends to get diffused throughout the host society by the reemployment of trained personnel, backward and forward linkages and competitive emulation".[2]

However, it is not certain that net results are always positive. Empirical studies often depict a picture of costs as well as benefits with cultural imperialism often the out come of cultural transfer.

Approaches to the Theories of Foreign Investment

Foreign investment and its impact in the development of developing countries has generated a vast literature. On a general level there are four approaches to theories of FDI.

The first of these could be called 'pro-foreign' approach. It is based on the belief that national and foreign private sector enterprises, if permitted to operate in competitive market conditions, offer developing countries the best possible prospects for speedy national economic growth. Harry Johnson, Peter Drucker, P.T. Bauer and John Piebold are

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2. Stephen J. Kobrin **Foreign Direct Investment, Industrialization and Social Change** (Jai Press, Greenwich, Connecteicut, U.S.A, 1977) p.27.

some of the important proponents of this approach. FDI accordng to them adds new resources in terms of capital, technology, management and marketing to the host economy in a way that improves efficiency and stimulates change. FDI can also create jobs, foster growth and improve the distribution of income by increasing the wages while driving down the returns to capital.

T.D. Santos, Ronald Muller, F.H. Cardoso, Faletto and James Weaver are the advocates of the 'Dependencia' perspective.[3] FDI in developing countries is looked upon as a measure by which local capital is systematically taken out of the country for project outside. The stress is more on the risks associated with the investment rather than the advantages that may ensue from the inflow of more capital and resources. They emphasise the fact that inappropriate technologies are developed in response to the labour-capital technology proportions in the home country and domestic produces are driven out of the market. There is outside domination of key sectors of the economy, which creates a small labour elite and exacerbates unemployment.

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3. Ramesh C. Chitrakar **Foreign Investment and Technology-Transition in Developing Countries** (Hongkong, Avebury, 1994) P. 12.

The 'Bargaining School' approach developed by Greico[4] suggests that the distribution of gains emerges from negotiations between the governments of foreign firms and the host country. This approach is more concerned with micro level surveys and focusses directly on the outcome of individual investment negotiations. Although the need to encourage foreign investments exists, care should be taken to build up national institutions to enhance a country's share of the resulting benefit.

The fourth approach to foreign investment-the 'Structuralist Approach' has many point in common with 'dependencia approach' but does not find either delinkage as a valid option for developing countries. It, however, challenges the bargaining schools optimism about the long term negotiating prospects of the third world. The structural characteristics of the international oligopolies and the developing country elites, it argues may interact in a way that reduces the power of the host governments. Manufacturing multinationals may be at their weakest prior to entry into the host country but once established they acquire domestic allies and the bargaining position vis-a-vis the government improves.[5]

4.J.M.Greico **Foriegn Direct Investment and Development- Investment in Development;New roles for private capital** ed. T.H.Morgan (U.S.Third World Perspective,No.6,ODI,1986)

5.Ramesh C. Chitrakar n. 3 P. 13.

Motivating Determinants of Foreign Investment

Attracting foreign investment is often a difficult task and it is rarely undertaken with a single motive in mind. An examination of the reasons for inviting foreign investment determines the areas into which foreign investment is likely to flow and it also detemines the minimum acceptable terms under which the foreign investors are likely to come to the host country.[6] The motives, the process of direct investment and the entry strategy into a particular foreign market vary greatly according to the characteristics of the entrant firm, its past relationship to the market and the nature of the market.[7]

The determinants of FDI are two fold : (a)Macro economic determinants, and (b) sectoral determinant for manufacturing, the private sector and services. It is generally argued that the most important considerations are the host governments attitudes, political stability, the prospect of market growth and the threat to established markets. Cost considerations, tax incentives or short term gains are often seen as less significant though this may not be true in all cases.[8]

6.Deepak Lal **Appraising foreign investment in Developing Countries** (London, Heinnmann, 1975) p.27.

7.P.J. Buckly and Brook **Studies in International Business** (Hongkong, Macmillan, 1992.) P. 15.

8.Ramesh C. Chitrakar n. 3 P. 14-15.

Various other studies have emphasized the importance of macro factors. OECD studies[9] have found that the most important determinants of direct investment are the macro determinants of a long term nature i.e., the demand prospects of the market which are being aimed at, whether local or world wide, and cost considerations as long as the host countries policies are not extreme and remain relatively stable. This report also points out that the recent deterioration in international direct investment arises from decreased domestic markets when they are in need of more investment.

Among the regulatory or policy aspects influencing investments, the above study identifies four factors; namely authorization for new investment and attached conditions; investment incentives; ownership, and transfer of funds. The most frequently encountered requirements are in conformity with the objective of development policies and the national economic planning of developing countries. They often involve local content exports, imports, technology transfers, use of appropriate technology training and use of local manpower and management.

9.OECD **International Investment and Multinational Enterprises** Recent trends in International Direct Investment Paris- 1987).

Investment incentives can be a deciding factor with regard to the conditions and performance requirements. Various forms of incentives like direct subsidies, fiscal deductions, easing of import restrictions, the setting up of export processing zones, offshore banking and insurance facilities are used to attract FDI.

Theories of FDI have been framed with regard to firm specific factors-Dunning's work known as the 'Dunning Eclectic Theory' is considered significant with regard to firm specific factors.[10] This theory integrates the theories of International trade and foreign investment into a unified theory of international production and identifies three types of advantages motivating foreign direct investment and foreign production.

(a)location- These include resource endowments and proximity to market, infrastructure and government policies and physical distance.

(b)ownership- Advantage possessed by the enterprises concerned include proprietary technology ,management skills, natural resources, information and the advantages associated with size and established positions.

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10. J.H. Dunning "Explaining Changing Patterns of International Production" **Oxford Bulletin of Economics and Statistics** November, 1979, 41 (4) p. 269-295

(c)industrialization- These are the advantages which favour a decision to exploit an advantage within the firm. They include market control,reduction of transaction and negotiating costs and assurance of stability.

The views held by Hodson and Herander are different from that of Dunning. The establishment of a foreign subsidiary was considered as a means of maximization of profits or sales. Closer contact with the customers, need to establish after sales service on a regular basis, avoidance of trade restrictions etc, can be considered as motivatory.

A firm attempting to maximize profits would also find many incentives in a foreign nations. The difference in cost of production that exists among nations, particularly labour cost, difference in corporate tax systems to obtain direct control of raw materials etc, are incentives for direct investment.

Deepak Lal argues that the theory of direct investment is an integral part of the theory of monopolistic competitions.[11] Foreign investors must possess some advantages which allow them to overcome socio-economic cost and earn

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11. Deepak Lal **Appraising Foreign Investment in Developing Countries** (London,Heinneman, 1975) p.25

higher rate of returns than local investors. Monopolistic advantages leading to FDI are many --

(i) Departure from perfect competition in goods market including product differentiation, special marketing skills and administered pricing.

(ii) Departure from perfect competition in factor market including the existence of potential and unavoidable technology and discriminating access to technology.

(iii) Internal and external economies of scale, the latter being taken advantage of by vertical integration.

(iv) Government limitation on output or entry.

Sector specific factors

Growth rate and costs of production in the host country are the most important factors in sector specific considerations. The other motivating factors are trade barriers, investment incentives/disincentives and the availability of skilled labour.[12]

One dominant model explaining foreign investment is the 'product cycle' model evolved by Vernon Huffbauer and Hirch. According to this model, the advanced countries generate new technology incentive products with the technological and

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12.OECD 'International Investment and Multinational Enterprises : Recent Trends in International Direct Investment' (OECD, Paris, 1987) P.36.

skilled manpower they have and export it to the developing countries. With the increasing imitation of the product by the competitors, the investors in the last stage of product cycle move to developing countries which have cheap labour.

However, the 'product cycle' theory may not explain a large part of foreign investment. This is because one form of direct investment has been through the vertical division of labour assembly industries. Moreover, a substantial part of foreign investment in the manufacturing sector has been in 'simple technology' products like soap, textiles, cement and tobbacco. The chief explanation for foreign investment in these products is the market imperfections mainly arising out of import restriction tariff, high transport cost and the economies of experience and scale possessed by investing companies over local competitors.[13]

Country specific factors

There are many country specific explanatory variables that have attracted and deterred foreign investment. Malaysia, one of the fastest developing countries in South East Asia had the advantage of natural resources, an abundant supply of petroleum, natural gas, rubber, oil palm. Other factors like the country's socio-political stability, the

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13. Ramesh C. Chitrakar - n.3 p.19

openess of its financial system, an unprotected domestic market, abundant supply of young and skilled labour, a good infrastructure and an environment conducive to innovations and technologies that helped the country to attract foreign investment.[14]

Various countries have different explanatory variables which attract FDI. There can differ in the case of developed and developing countries. In terms of the factors motivating FDI in a developed country like the USA, the study of Giese, Kahley and Riefler[15] points to economic and strategic factors, transactional and intangible assets and political factors as the factors behind the surge in foreign investment in the 1990s. In addition to minimisation of labour, capital and resource cost, the economic factors mentioned are trade barriers, difference in economies of scale and difference in technological know-how. The factors included under transaction and intangible assets are technology and patents, skilled labour and transportation and communication systems and non-production activities like research and development, advertising and marketing. Similarly the primary political

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14. F.C. Omm "Malaysia; In Pursuit of newly Industrialising Economy", **Asian Development Review** vol. 7, No. 2, 1989. p.87.

15. A.S. Giese, W.J. Kahley, R.F. Riefler "FDI - Motivating Factors and Economic Impact", **Regional Science Perspective** vol. 20 (1), 1990, p. 105-112.

factors that attracted FDI are a stable government and a 'laissez faire' attitude.

Political instability, tax policy and government regulations have been incorporated in various theories, but their importance justifies a more explicit consideration.

Political Instability

An unstable political and social environment is not conducive to inflows of foreign capital. The fear is that large and unexpected modification of the legal and fiscal framework may drastically change the economic outcome of a given investment.

The role of political instability has been examined empirically using both surveys and econometric analysis. Most survey studies have concluded that political risk is an important factor affecting foreign direct investment. The other type of study has used econometric techniques such as regression analysis to test for the effect of political risk. The results have been mixed. The mixed results may reflect a variety of factors. First, it is difficult to measure political instability. Second, a given political event may give rise to different levels of risks depending on the country of origin of the investment or the type of industry in favour of the development of a particular industrial sector, to reduce regional disparities and reduce unemployment. These regulations have got the ability to affect decisions on the size, timing, location and sectoral allocation of foreign direct investment. These can be classified as incentives and disincentives. Disincentives include a number of impediments to FDI which may range from slow processing of authorisations to outright prohibition of foreign investment in specified regions and sectors. Disincentives, regulations seem to have a more definite impact on foreign investment than incentives regulations.

On the whole there are various hypotheses emphasising different micro-economic and macro-economic factors that are likely to affect foreign direct investment. While most of the hypotheses have some empirical support, no single hypothesis is sufficiently supported to cause others to be rejected. Regardless of various theories and their rankings in explaining the determination of International capital movements, direct investment flows must be distinguished from portfolio flows. The basis of this distinction is that direct investment implies control of the foreign firm and therefore expected returns and diversification do not provide a satisfactory explanation. The different reasons motivating direct investment flows do not necessarily move together. As a result a given pattern of foreign direct investment flows does not necessarily have to be associated with a particular pattern of overall capital flows.

John Dunning in his work on the Investment Development Path (IDP) using the framework of the "eclectic paradigm" has shown that the structure and level of development of the economy of a country are related to the extent and nature of the FDI activity undertaken by its domestic firms (outward direct investment) as well as those of other nationalities within its national boundaries. (Inward direct investment).

The nature of the relationship is a symbiotic one - FDI activity is influenced by the structure of the economy and at the same time influences its development. The theory of international production based on this approach suggests that propensity of firms to engage in international production will depend on three main factors.

(1) The extent to which they possess or gain access to technology, know-how, resources or some other form of income generating assets which their competitors either do not possess or to which they do not have access; these are referred to as ownership specific advantages (O).

(2) Given that firms possess certain 'O' advantages, the extent to which it is to their advantage to utilize

themselves and add value to them in a foreign location, or to sell the rights to do so to foreign firms through licencing or some other contractual arrangement. To engage in FDI the firm must consider it advantageous to own or control these value adding activities. These advantages are called internalisation advantages (I).

(3) Locational advantages (L) are the extent to which it is in the interests of the firm to internalise the use of property rights in a foreign location. There must exist natural endowments or created assets in a foreign country that find it beneficial to combine with or add value to their ownership advantages.

The character and composition of international investment undertaken has to deal with two sets of country specific factors. The nature and value of ownership locational internalisation (OLI) advantages are not assumed to be constant. They will change over time. Further their configuration will vary with, and by, country or (region), industry and firm. Thus the propensity of firms of a particular nationality to engage in foreign production will be affected by the level of political, cultural, and economic conditions of both home and host countries. Attributes such as suggest government policy and attitude, natural factor endowment, the quality of human capital, the technological and communication infrastructure and the enterpreneurial and business culture of its people are most important.[16]

Types of International Production

The first type of foreign production is intended to supply the market in the country or region in which it is located. The important variables likely to influence such production include the size of the market, the relative production cost, cross border transportation costs and barriers to export.

Trade supportive FDI are primarily designed to support the value added activities of the investing firms by providing sales outlet and distribution facilities.

The third type of FDI is intended to supply raw materials, intermediate or final products to the investing company and to other foreign consumers.

The efficiency seeking kind or rationalised investment is directed towards achieving economies of scale through the cross border vertical or horizontal integration of produc-

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16. Rajneesh Narula ,"**Multinational Investment and Economic Structure** - Globalisation and Competitiveness". (London, Routledge, 1996.) p.35.

tion. Strategic assets seeking investment seek to acquire created factor endowments or intangible assets.

The Investment Development Path represents an attempt to create a country's net international direct investment position to its stage of development, relative to that of the rest of the world. The stage of economic development is provided by its GNP per capita and is assumed to be an indicator of its absolute and comparative competitive advantages. Therefore changes in its OLI characteristics indicate a country's propensity to invest abroad or to attract inward direct investment, and as changes occur in its OLI configuration, its net outward investment position changes.

FDI operate at different stages of economic development. The IDP framework suggests that countries tend to go through five main stages of development. The IDP as described here is a normative, idealised example.

The aggregation of countries for a given time period assumes that countries follow a broadly similar IDP whereas in fact each country follows its own particular path which is determined by four main variables.

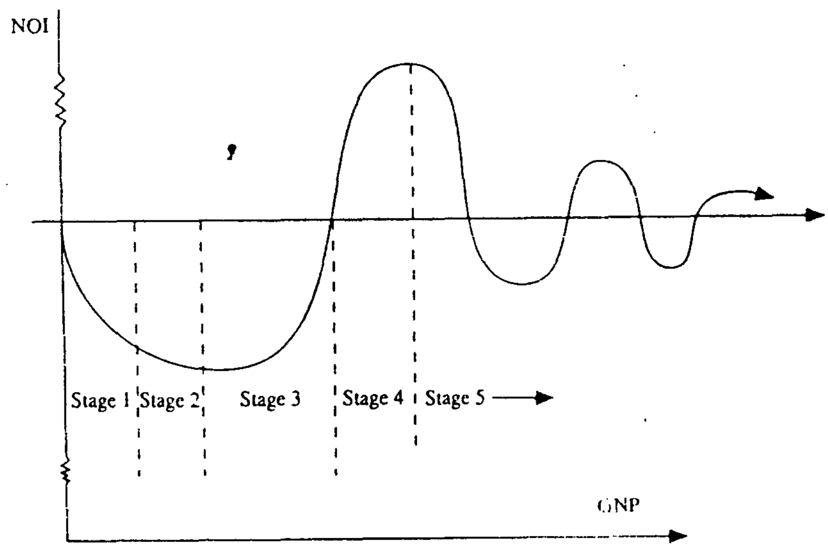
(a) Its Resource Structure

(b) Market Size

(c) Strategy of Economic Development

(d) Role of Government in the organisation of Economic Activity.

Figure I



During the first stage the 'L' advantages of a country are insufficient to attract inward direct investment, with the exception of those rising from the possession of natural assets. This may reflect in inadequate domestic markets and a poorly educated and trained labour force. Government induced 'L' advantages are likely to be significant at this stage. 'O' advantages of domestic firms are few as there is little or no indigenous technology accumulation and hence few created assets. Domestic firms at this stage do not have the necessary 'O' advantages to engage in outward direct investment. At the same time there is unlikely to be much inward direct investment too.

Government intervention during stage (1) normally takes two forms. First, Governments attempt to reduce some of the endemic market failures that hold back development by providing basic infrastructure and upgrading human capital via education and training. Second, they engage in a variety of economic and social policies which for good or bad, affect the structure of markets. Import production, domestic content policies and export subsidies are examples of such intervention.

In stage (2) inward direct investment rises while outward investment remains low or negligible. Domestic markets may have grown in size or in purchasing power, making some local production by foreign firms a viable proposition. The country must possess some desirable 'L' characteristics to attract inward direct investment. The 'O' advantages of domestic firms will have increased from the previous stage through technology accumulation. These 'O' advantages will exist as a result of the development of support industries clustered around primary industries and production will move towards semi-skilled and moderately knowledge intensive consumer goods.

Outward direct investment begins to grow at this stage. The extent to which outward direct investment is undertaken will be influenced by the home country government induced push factors was subsidies for export and technology development or acquisition as well as by changing 'L' advantages such as relative production cost.

Countries in stage (3) are marked by a gradual decrease in the rate of growth of inward direct investment and increase in the rate of growth of outward direct investment that results in increasing net outward investment. The technological capabilities of a country are increasingly geared towards the production of standardised goods. Outward direct investment will be more to countries at lower stages in the investment development path. The original 'O' advantages of the foreign firms also begin to be eroded, as domestic firms acquire their own competitive advantages and compete with them in the same sectors.

The motives of inward direct investment will shift towards efficiency seeking production and away from import substituting production. Domestic firms 'O' advantages will have changed to, and will be based less on, government induced action. There will be increased outward direct investment directed to stage (1) and (2) countries both as market seeking investment and as export platform. The role of Government induced 'O' advantages will have become less significant as those of FDI induced 'O' advantages take on more importance. The government may attempt to attract inward direct investment in those sector in which the comparative 'O' advantages of its enterprises are the weakest but the comparative advantages of location bound assets are the strongest, while encouraging its own enterprises to invest abroad in those sectors in which its own 'O' advantages are the strongest and its comparatative 'L' advantages are the weakest.

Stage (4) is reached when a country's outward direct investment flows exceed or equal the inward investment flow from foreign owned firms and the rate of growth of outward direct investment is still rising faster than that of inward direct investment. The domestic firms can effectively compete with foreign owned firms in the domestic sector in which the home country has developed a competitive advantage, but are able to penetrate foreign markets as well. The inward direct investment into stage (4) countries is increasingly sequential and directed towards rationalised and asset seeking investment by firms from other stage (4) countries. Outward direct investment will continue to grow as firms seek to maintain their competitiveness to offshore locations. Role of the government moves towards reducing transaction cost of economic activity and facilitating market to operate efficiently.

In stage (5) net outward investment begins to fall back as outward and inward investment become more balanced. Nature and scope of activity gradually shifts from arms length trade between nations producing very different goods and services to trade within hierarchies between countries producing very similar products. Unlike the previous stages, stage (5) in the investment development path represents a .ls2situation in which no single country has an absolute hegemony of income creating assets. Another development is that as firms become globalised, the nationalities become blurred.

In terms of their inward and outward direct investment positions, stage (5) countries after an initial burst of new inward direct investment may be expected to settle down to a fluctuating equilibrium around a roughly equal amount of inward and outward investment.[17]

Investment Development Path and its applicability in China

John Dunning's work on Investment Development Path using the frame work of the eclectic paradigm emphasized the connection between the level of development of the economy

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17. Rajneesh Narula,"Multinational Investment and Economic Structure - Globalisation and Competitiveness". London, Routledge, 1996. p.16.

and the nature of the FDI activity through outward direct investment and inward direct investment. Since the opening up of the economy, China has recorded economic growth on a scale which justifies the reform under taken by Deng Xionping and his team. An attempt is made here to show the nature of relationship between the growth achieved and the role played by both Inward and Outward Investment in the economic development of China.

The four main variables affecting the Investment Development Path are :-

(a) Its resources structure

(b) Market size

(c) Strategy of economic development

(d) Role of the Government in the organization of economic activity.

In the case of China the resources structure played a dominant role in attracting the FDI. With its vast size, China could be considered as a goldmine with regard to both material and human resources. The abundance of human labour which is skilled and cheap attracted FDI in no small measure.

In the second half of the 1980s, International factors - specially major exchange rates realignments and increased Western protectionalism have forced firms in Japan and other advanced industrial and newly industrialising economies that have lost out in the international competitiveness to re-allocate some industrial production to cheaper countries.[18] China with its cheap labour was able to attract much of the investment in a short time from countries like Taiwan, USA, etc.

The second variable - market size is another important factor which helped China to attract FDI. With a population of 1.2 billion and growing middle class, China promised the foreign investors an opportunity which was difficult to pass by. The 1980s presented a growing preference for locations close to customers and sources of supply which facilitated customization and minimization of inventories and turn around time. They also offered opportunities for a regional division of labour which both exploits individual countries differential comparative advantages and allows for strategic penetration of markets that may otherwise be closed.

China which opened up an economy presented all these advantages. The vast market which thus an important factor which led to the spurt in FDI in the 1980s and 1990s.

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18. Linda. Y. C. Lim and Pang Eng Fong, **FDI and Industrialization in Malaysia, Singapore, Taiwan and Thailand,** OECD, Paris, 1991, p. 175

The third variable - Strategy of economic development is a main factor which distinguishes China from other developing countries which embarked on the path of development through the means of attracting FDI. Considering the nature of the economy and the type of government it has, Chinese choose to concentrate on the coastal areas first rather than the whole country. The establishment of special economic zones and other coastal towns were part of this strategy. Consequently they were able to concentrate on areas like Guangdong, Jiangsu, Shenzhen, Zhuhai, Shantou, Xiamen, Hainan, etc. These areas were used as a laboratory which deternmines a speed an extent of economic reforms government must adopt on the whole.

One of the main objectives was to bring in technology which was very much needed and special concessions were given to FDI of this kind. The principle adopted was to actively, rationally and effectively used the foreign capital. Policies and measures designed to encourage foreign investment were to facilitate China's industrial policy implying that it would be steered to agriculture, infrastructure development basic industries etc.

Role of the government in actively supporting the FDI is a pre-requisite for the success of any reform process. An activist state is important and necessary for the creation of an enviornment which attracts foreign investment and maximises the benefits from it. State policy has an important role to play in shaping the host economies comparative advantages, which in turn determines the volume and the type of foreign investment it attracts and influence their effects.[19]

China epitomises the strategic use of state policy to ensure that foreign investment strengthen the countries industrial capabilities by using selective investment incentives in selected areas like special economic zones and other coastal cities, the country benefitted tremendously. By differentiating the different type of investments like Equity Joint Ventures, Contractual Joint Ventures, Compensation Trade, and hundred per cent foreign owned ventures, China was restrictive towards foreign investment, protecting its market and acquiring foreign technology. The policy makers clearly understood their different economic history, political economy and initial factor endowments.

In general, policies that make a developing host country more attractive to foreign investment also make it more attractive to local investment and to help to maximise the benefit from investment. Political and microeconomic stability, trade and financial liberalisation, and infrastructure

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19. Linda. Y. C. Lim and Pang Eng Fong, n.18, p. 177

and skill development all contribute to a more efficient and profitable economy. The policies adopted by the government brought in benefits of the above mentioned kinds in China and the success can be measured by the amount of success it achieved in attracting FDI.

China and the type of International Production

There are various types of international production (as discussed earlier). In the case of China, of the five types of international production - Trade supportive FDI, and the type of foreign production intenting to supply the market in the country or region in which it is located, is the most important.

In the case of China the type of production for supply in the market is important because of the vast size of the market and the availability of cheap labour. This enables the foreign investors to manufacture products at comparatively lower price when compared to other countries and supply the domestic market and foreign market. China presents less barriers to export and thus the product manufacture there can be exported to foreign locations.

Trade supportive FDI are primarily designed to support the value added activities of the investing firms by providing sales outlet and distribution facilities. In the case of

China this type of FDI is also important because of the increasing middle class and size of the market. Special Economic Zones were used as a manufacturing base by many foreign investors to expand their activities. China was able to provide sales outlets and distribution facilities various fully owned foreign firms as well as Equity Joint Ventures.

The efficiency seeking or rationalise investment and strategic asset seeking investment is not, in the case of China, due to the political and economic factor determining FDI.

As discussed earlier Rajneesh Narula has analysed the five stages of Investment Development Path with regard to Inward and Outward Investment. An attempt is made here to analyse this in the context of China's efforts to attract FDI.

In the first stage of the Investment Development Path, the 'L' advantages of the country (extent with the interest of the firm to internalise the use of property right in a foreign location) are insufficient to attract inward direct investment. But the role of the government is indeed very important. In the case of China considering the flow of inward direct investment the period between 1979 to 1984 represents the first stage.

This period saw the introduction of various policies like rise in agricultral procurement prices, experimental introduction of 'guidance prices' for above quota industrial output, passing of the Joint Venture Law, opening up of first four special economic zones etc. All these measures represent an attempt to reduce some of the endemic market failure that holds back development. The government also produce the scope of material distribution system by reducing the number of category I and II goods (producer and investment goods). Reform the commercial system also took place during this phase by deregulating entry and exist.

The changes introduced were reflected in the foreign trade sector too. There was decentralization of the foreign trade cooperation which became responsible for their own performance. Thus, rural reforms increased agricultural activity and external reforms were designed to increase exports and FDI. The latter reforms started with the setting up of the SEZ's.

There are hardly 'O' advantages of Chinese domesitc firms and there was hardly an indigenous technology accumulations. There was no outward direct investment by Chinese firms outside and inward investment showed only a marginal increase. In 1979-82 the cumulative investment was only 1767 million dollars. In 1983 it was 916 million dollars. In

1983 it was 9.6 million government induced locational advantages helped China to embark on the path of economic development and move the second stage in Investment Development Path.

In stage II the inward direct investment rises while the outward investment remains low or negligible. In the case of China stage II is represented by the year between 1984 and 1988.

The government adopted various measures which led to the growth in the size of domestic markets. In 1985-88 there was progressive enlargement of market price role for industries. In 1986 remaining controls on prices of most consumer goods were decentralised to local government. Regarding the foreign trade sector there was removal of prohibition on creating foreign trade corporation, reduction in scope of the trade plan and in 1987 there was exemption of certain sectors from trade plan and the sharing of foreign exchange between central and local government. In addition to this state enterprises were permitted to market directly and establish two banks.

Consequently the 'O' advantages of the domestic firms increased as a result of the changes brought about and production of consumers goods increased with technology accumulation going up.

China's inward direct investment increased tremendously during this period from 2875 million dollars in contracts it increased to 6294 million dollars in 1989. On actual terms of actual investment it rose from 1419 to 3773 million dollars in 1989. China's outward direct investment during this phase was concentrated in Hong Kong and Macau. In the case of China, the outward direct investment was low during the stage and home country induced push factors like subsidies for export did not increase the level of investment.

The third stage is marked by an increase in the rate of outward direct investment and gradual decrease in the rate of inward direct investment. In China's case the period from 1990 represents this stage. Due to the Tiananmen crisis actual investment showed less growth in 1990. However, beginning in 1991, China attracted larger amount of FDI. It more than double in both 1993 and 1994 and rose a further one fifth in 1994 to reach almost 34 billion dollars in actual investment.

In the case of outward investment China's FDI outflows average 2.4 billion dollars annually during the period between 1990-1994. The motives of inward direct investment are access to foreign markets and there is a shift towards efficiency seeking production. Although the majority of inward investment is in Hong Kong, investments are also increasing in Africa, Latin America and Oceania - the countries which belong to stage I and stage II.

Thus we see that Dunnings Investment Development Path can be shown with regard to the countries net International Direct Investment positions to its stages of development relative to that of the rest of the world. In the case of China, the 'OLI characteristics indicate a country's propensity to invest abroad and to attract inward direct investment. Rajneesh Narula's research has focussed on the activities which bring about the changes in 'OLI Characteristics and the dynamics that lead to and result from these changes. In the case of China we have seen the changes were part of the opening up of the economy and the dynamics of the change is slowly being felt.

CHAPTER - III

PRC's Policies concerning FDI's

The PRC which initiated open door policy in 1979 has witnessed sustained development in the foreign sector. The volume of foreign trade and the role of foreign capital are both far greater than could have been foreseen based on the modest Chinese economic reforms initiated in the late 1970s. By 1995 China had become one of the world's largest trading nations, the recipient of more foreign direct investment (FDI) than any other country in the world.[1]

The role of FDI and its increase over the years has been a cause of surprise to many observers. It has increased rapidly as statistics reveal that 2,59,375 foreign funded projects, involving a total negotiated foreign investment of U.S. $ 395.12 billion covering a total workforce of 16 million had gone into operation.[2]

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1. World Bank, "World Debt Tables; External Finance for Developing Countries, 1994-95, World Bank, 1994, Vol. I, Washington D.C., page 16.

2. "Minister Wu On Foreign Investment in China", **Beijing Review**, March 18-24, 1996, p.12

Foreign investors have come to China from nearly 160 countries including 200 of the world's top transnational industrial and service companies. China currently leads all developing countries in the absorption of foreign investment.

China's progress in attracting FDI has been gradual. Total amount of actual investment between 1979 and 1983 was just 1.8 billion dollars[3]. The cummulative amount from 1979 to 1989 is estimated at 15.4 billion dollars. Since then actual investment each year increased rapidly to 3.5 billion dollars in 1990, 4.4 billion dollars in 1991 and 11 billion dollars in 1992. It more than doubled in both 1993 and 1994 and rose further one fifth in 1994 to reach almost 34 billion dollars (Table-1)

In 1995 the process continued. A total of 37126 foreign funded enterprises were approved, involving total negotiated foreign investments of U.S. 90.29 billion dollars. The actual investments used during the year reached U.S. $ 37.74 billion. Despite the fact that total number of foreign funded projects dropped 21.8 % from the previous year, the respective amount of negotiated and allocated foreign investment registered prices of 10.9% and 11.7%.

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3. U.S. dollars.

Table - 1

Year	Contracted	Actual
1979-82	6999	1767
1983	1917	916
1984	2875	1419
1985	6333	1959
1986	3330	2244
1987	4319	2647
1988	6191	3739
1989	6294	3773
1990	6987	3755
1991	12422	4666
1992	58736	11292
1993	111435	27514
1994	81406	33787

Source :- Nicholas. R. Lardy, "Role of Foreign Trade and Investment in China's Economic Transformation" The China Quarterly no.43, 1996.

The PRC has used foreign investment as a long term strategy to speed up economic development. The methods China employs fall into two categories - one is to borrow money from other countries including loans provided by foreign government, international financial organizations business banks and consortiums, as well as to issue bonds to other countries. The other method is to bring in direct foreign investment, including operation of enterprise with foreign investment, Chinese foreign joint venture projects as well as compensation trade and processing materials by clients and assemblage of parts and components supplied by them.[4]

The long term strategy of speeding up the economic development through FDI was considerably helped by both domestic as well as international factors. Global economic growth has been sluggish in the 1990s. Most of the developed countries markets (domestic) have been affected by this slow growth and the bulk of international investors were seeking a favourable foreign market. China, currently in the initial stage of an economic take off characterised by rapid economic growth and annual double digit increases in Gross National Product, provided in attractive for FDI. The mode of economic growth has shifted in the PRC from labour - intensive to capital extensive and from intensive to intensive activities.

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4. "Foreign Invested Enterprises", **China - Facts and Figures**, New Star Publishers, Beijing, 1992, p. 3.

With the world's largest population, huge domestic market, abundance of resources, improved investment climate, strong industrial foundation, large technical force provided additional insentives.[5]

The government adopted well defined industrial policies and medium to long term economic development plans, while at the same time drafting a series of laws, regulations and policies for foreign investors. Thus, the number of regions and areas open to foreign investment continues to expand, with diversified and flexible forms of investment. In short China offers an ideal market for foreign investment.

Basic Policies and Guidelines in Utilizing Foreign Capital in the PRC

Adhereing to the principle of equality and mutual benefit.

'Equality and mutual benefit' is the basic principle to which China adheres in its foreign economic affairs. When signing an agreement on economic and technological cooperation with foreign countries China takes steps to protect its own political and economic sovereignty and interest, and avoids accepting any political stipulations. At the same

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5. Lin - Senmu, "China's Investment Policies for the late 90s", **Beijing Review**, November 28 to December 4, 1994. p.36.

time protection is guaranteed for foreign enterprises creating favourable conditions for investment and lawful interest.

- Relying mainly on domestic efforts while making external assistance subsidiary.

PRC instituted the policy of opening to the outside world merely to draw beneficial influences from abroad. When utilizing foreign capital, emphasis is placed on its capacity to digest and repay it. The end result of utilizing foreign funds depends mainly on the work of the Chinese people and how they adapt to it in the long term.

- Promoting the development of China's national economy.

The policy of utilizing foreign capital has been adopted for the purpose of promoting the development of the national economy. Therefore, it is practiced only under the preconditons of protecting the national industry and establishing a national economic system suitable to the Chinese situation. Therefore, foreign investors were not allowed to control the State's economic life lines or certain key trades and commodities. The amount of foreign capital is limited to a certain proportion of the State's overall investment in basic construction so that any mishap in the utilization of foreign capital would not influence the entire economic situation.

- Concentrating Foreign Capital in certain fields according to the needs of economic development.

A major portion of foreign investment was concentrated in certain fields based on the criteria of increasing exports to earn more foreign currency and improve the capacity to digest and repay loans. Construction of the basic facilities of energy resources, transportation and communication and raw material especially electric power, ports and petroleum etc. were given prominence. Foreign capital was invested in producing goods for exports or for replacing imports in order to gain foreign currency and to reserve foreign currency for utilization.

- Attaching importance to the economic logic of investment and guaranteeing the capacity both to repay and to attain reasonable profits.

Stressing the principle of "following the contract and keeping one's words", China guarantees the repayment of the loans and reasonable profits of investors. An all round feasibility study is made to ensure the completion of the project on schedule, normal production and the product's competitiveness in terms of quality and cost. In each project repayment of the principle and interest within a certain period of time and reasonable profit is guaranteed.

- Part of domestic market accessible to the foreign enterprise.

Products of joint ventures can be sold within Chinese territory if they are urgently needed in China. If foreign investors provide advance technology, and highly sofisticated, high quality and competitive products urgently needed in China preferential treatment on the proportion and time limit of domestic sales is available upon the examination and approval of the petition by the authorities responsible for the work.[6]

The main thrust of the policies with regard to FDI is self reliance. China has worked out its own way of practising self reliance in the light of specific circumstances. This does not mean isolationism and rejection of foreign aid. Deng Xiaoping's pragmatism is evident in these policies. Deng believed that by carrying out economic and technical exchanges on the basis of respect for state sovereignity, equality and mutual benefit and the exchange of needed goods to make up for the deficiencies the country could make over

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6. Foreign investment in China, **China - Facts and Figures** Foreign Language Press, Beijing, p.8-22.

all progress.[7] By protecting the domestic economy but giving freedom to the foreign investor in investing in areas where the required technology was needed, China was able to pragmatically progress in its path to development through FDI.

FORMS OF DIRECT FOREIGN INVESTMENT

There are many forms of FDI namely (a) Chinese - Foreign Joint Ventures (b) Chinese - Foreign Co-operative Enterprises (c) Foreign Owned Enterprises.

(A) Chinese Foreign Joint Ventures also called Equity Joint Undertaking are established within China jointly by Foreign Companies, Enterprises and other Economic Organizations. Each party may contribute their respective investment in currency or may use as their investment, buildings, plants, machinery and equipment. The foreign partners usually contribute not less than 25 per cent of the total investment. Joint Venture partners share the profits, risks and losses in proportion to their respective contributions to the registered capital.

(b) A Chinese foreign co-operative enterprise is sometimes called a Contractual Joint Undertaking. The responsibilities, rights and obligations of each party to the coop-

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7. Speech by Deng Xiaoping at U.N. General Assembly, **Peking Review**, April 9, 1974, p.32.

erative enterprise include investment, cooperative conditions, distribution of profits and share of risks and losses. Investment in the Chinese Foreign Cooperative Enterprises is flexible and the Chinese investors can contribute in cash or in kind. Distribution of profits or products or other forms of distributing income through consultations are generally adopted. The goods imported by Chinese Foreign Cooperative Enterprises are exempt from Custom Duties.

(c) Foreign owned enterprises are established by foreign investors exclusively with their own capital within the territory of the PRC in accordance with the Chinese Law. Foreign enterprises are established in such a manner to help the development of China's economy with advanced technology and equipment. They usually market all or most of their products outside China. Therefore, a foreign owned enterprise must be productive. It enjoys full independence in its business operation and management in accordance with the approved contracts and is free from interference.[8]

LEGISLATIONS CONCERNING FOREIGN INVESTMENT

First legislation on foreign joint ventures was introduced in 1979 and was supplemented in 1983. Sino - Foreign Relations has covered various matters such as

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8. China - Facts and Figures, n.3, p.11-16

Income Tax (1980, 1981, 1982, 1983).

Banking and Loans (1985)

Technology import and licencing (1985)

Wholly Owned Foreign Enterprises (1986)

Trade Mark Law (1982)

Patent Law (1984)

In addition to these legislations, the PRC has introduced 'twenty two articles' which are essentially provisions for the encouragement of foreign investment, promulgated by the State Council in 1986. It had also entered into bilateral agreement for the promotion of foreign investment in China with 18 countries and avoidance of double taxation with 17 countries by 1987.[9]

There were many alterations in the legislation concerning income tax (1991), tax exemption for import and export of goods of foreign enterprises (1992), Establishment of Foreign Law Firms (1992) etc.

China introduced reforms in its taxation system in the beginning of 1994 to correct the anormalaties in the taxation system. The changes included new tax sharing system between

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9. U.N.C.T.C - **Transnational Corporations in World Development - Trends and Prospects**, United Nations, New York, 1988, p. 26.

the Centre and the provinces, and the introduction of value added tax. In essence the Centre was trying to regain its power over the provinces.[10]

In December, 1993, China's National People's Congress promulgated a company law, to be effective from July 1st, 1994. The company law provides for the establishment of two forms of companies - a joint stock company and a limited liablity company. There is minimum registered capital requirements and a number of founders for three different forms. The new law allows for passive portfolio investment possibilities to foreign investors and allows the establishment of branch offices of foreign companies in China.[11]

Latest in the series of policies guiding foriegn investment was issued on June 20th, 1995 which was known as, 'Interim Provisions and the Catalog'. The goals in formulating this were to enhance the transparency of the government's industrial policies, guide foreign investment to urgently needed industries and optimized of the foreign investment structure to better facilitate the development of the national economy. Interim provisions stipulate that foreign in-

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10. Alexander Nicoli - Chinese Tax Reform, **Financial Times**, April, 29, 1994, p. 5.

11. Preston. M. Torbert; "Broadening the Scope of Investment", **The China Business Review**, May-June, 1994 p.48-55.

vestment shall be encouraged for projects involving agro-technology, comprehensive agricultural development, the development of energy, transportation and important raw materials and five additional sectors. The catalog lists 172 types of industries and projects in 18 categories.[12]

EVOLUTION OF CONDITIONS

Encouraging FDI was one of the key areas in the opening up of the economy. There was a broad consensus regarding the benefits of FDI and that they were to be encouraged because they brought both global and national benefits. Further, they stimulated growth through more efficient production and they lowered prices through greater competition. These benefits can best be achieved in a policy environment of neutrality or non-discrimination. In the case of FDI neutrality has two dimensions. The first is identical to that for non discriminatory trade policy; equal treatment of foreign and domestic firms in the home market. Second neutrality conditions for FDI also provide that policy should be neutral between trade and investment as alternative vehicles for reaching the target market.[13]

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12. "Authoritative View on China's Policies guiding Foreign Investment", **Beijing Review**, October 30 to November 5th, 1995, p. 11.

13. De Anne Julius, **Global Companies and Public Policy - The Growing Challenge of FDI**, Pinter Publishers, London, 1990, p. 97.

Inspite of the benefits accuring to FDI there are problems as well. The Chinese authorities examined the exceptional cases of FDI that could subvert market processes or threaten other policy objective. Four types of problems associated with FDI emerged. They were related to :

(a) Non Economic Concerns

There are the non-economic concerns over threats to national security or culture posed by foreign take overs of industry vital to the nation or parts of the media. In the case of China this is particularly crucial because the system of government is socialist and the PRC is a one party State.

(b) Strategic behaviour and the use of competition policy.

This is analogous to trade policy concerns over dumping to take advantage of economies of scale or over government subsidies and other forms of unfair industrial policy. The practical and political difficulties of dealing with such fears, even if they are justified, are enormous. The potential for monopolistic behaviour by global companies is a possible scenario with FDI led market integration. The spectre of predatory behaviour by global companies would, however, be a growing threat.

(c) Employment creation, technology transfer and local content rules.

One of the most attractive aspects of FDI is the indirect benefits in terms of employment and technology transfer. But there is concern about 'screw driver plants' which assemble products designed and produced elsewhere. Local content targets or requirements are negotiated as a quid pro quo for investment subsidies or tax holidays. Such incentives to attract FDI to a particular location run exactly the same international risks as those which accompany export credit subsidies. If they are matched by incentives offered by competitor governments, then eventually they are taken to the point where the foreign company capture all the benefit that would otherwise have gone to the host economy.

(d) Reciprocal Market Access.

There are two main areas where this arises. Those countries which have been at the forefront of liberalisation in sectors like banking and telecommunication are naturally concerned that their industries are exposed to external competition in their own home markets from those firms which are unable to compete in the markets of their foreign rivals. The second area where issues concerning market access oper.ls2ates is over the question of takeovers and mergers.

Differential regulations cause firms in some countries to be more exposed to takeovers.

Considering all the above mentioned aspects, PRC policy makers decided on FDI as a means of inducing the much needed push the country needed to achieve more foreign exchange, better technology, better living conditions of the people and overall development. Policies were framed with the interest of State in mind and precautionary steps were ensured to limit the extent of the role FDI could play in shaping the basic objectives of the PRC.

The Peoples Republic of China began calling for Sino-Foreign Joint Ventures in 1978. U.S. firms were the first firms to recognize the potential and try to enter the market. Inspite of differences in business practices, political systems, laws, customs and infrastructure, the flow continued. Other countries like Japan followed suit and China increased the amount of FDI year after year.

The history of Sino-Foreign Ventures can be divided into four phases. <u>1980-83 were the years of "Enchantment"</u>

The year 1978 marked a momentous change in China's economic policy. But the policy changes were gradual. The .ls2Special economic zones (SEZ's) were the laboratories for economic reform and although they constitute only about 0.35 per cent of China's total area and 0.8 per cent of its population, the special economic zones were quite successful in attracting foreign investment.

The good performance of the SEZ's in attracting foreign investment can be illustrated by the success of Shenzhen, the largest of the original four. From 1979 to 1993 Shenzhen SEZ administration approved 10015 foreign funded projects. During the first six years (1980-85) Shenzhen SEZ managed to attract U.S. 830 million dollars FDI in actual terms of which 85 per cent had come from Hong Kong, 4 per cent from United States, 4 per cent from Japan, and 1 per cent from Singapore. Over the last few years Shenzhen has come to be a hot bed for luring overseas investment.

During the initial years foreign investment was concentrated in service industries such as hotels and foreign trade companies.[14] A relatively small number of projects were dedicated to infrastructure facilities and basic industries. Concentration was on large number of labour intensive industrial projects and a limited number of technologically advanced projects and those with high value added or substantial foreign exchange earnings from Exports.

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14. Development Centre Documents, **OECD**, Paris, 1994, p.195

One of the major problem areas was with regard to the rules and regulations concerning FDI. Taking cognizance of the fact, a foreign investment control commission (FICC) was set up whose major functions were

- to examine and approve joint venture projects
- organize and conclude foreign economic cooperation agreements.
- investigate general state of international development and trade.

This body was responsible for a vastly improved state of affairs and was instrumental in framing new rules and regulations concerning FDI.

<u>1984-86 were the years of "Stability"</u> The FICC was the apex body responsible for foreign investments and problems concerning them but major problem still remained. The problems faced were that, in joint ventures there were general lack of work rules, foreign exchange and red tapism associated with the local bureaucracy. Due to this, high costs were incurred by the companies established by foreign investors.

'22 provisions' for the encouragement of foreign investment promulgated by the State Council on October 11, recognized the faults in the system. It provided many incentives like reduced site fees, priority for water, electricity, transport and communication, short term credit and tax concessions. The State Planning Commission announced the measures concerning the substitution of imports with products manufactured by Chinese foreign joint ventures. In another development the 7th Peoples Congress enacted the law of PRC on Chinese - foreign contracted joint ventures. This is different from equity joint ventures in that the latter represented a standard joint ventures with an ownership pattern, a board of directors and profit participation on the basis of equity proportion.

1987-89 were the years of "Renewed hope" The 22 Articles provisions proved a turning point in infusing confidence in the mind of investors and giving them grounds for an assessment of their enterprises in the years to come. Measures like designing the work rules and devising the pay system, etc, led to better management practices. There was an experiment allowing Brisol-Meyar Squibb's 50 per cent joint venture to offer shares in the Chinese Stock Market.[15]

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15. S. Shiva Ram - **The Dragans of Asia - Asia - Pacific Rim Countries and their Multinationals**, Wheeler Publishers, New Delhi, 1995, p.81-84.

After Tiananmen Square Incident on June 4, 1989

There was a major set back to the efforts aimed at building confidence among investors. This led to the departure of many executives of foreign ventures and put the whole reform process in doubt.

However, the Tiananmen crisis of 1989 provided graphic evidence that the dilemma of the open door had not yet been fully resolved. Huge anti government protest in Beijing, calling for greater freedom and democracy illustrated the disruptive impact of the liberal values that were accompaning China's economic growth. Economic and diplomatic sanctions imposed by many countries specially the United States, suggested that willingness to cooperate in China's modernization was much more tentative and conditional than previously realised.[16]

But the clouds of doubt regarding the policies to be adopted cleared with regard to Chinese as well as foreign investors. For Chinese policy makers the results of previous years reminded them of the advantage of open-door. For the foreign investors the lure of the Chinese domestic market was too much to resist. By the beginning of 1991, China attract-

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16. Harry Harding, China's American Dilemma, **The Annals of American Academy**, 519, January, 1992, p.12.

ed an increased amount of FDI. It more than doubled in both 1992 and 1993. It rose a further one-fifth in 1994 to reach almost U.S. 34 billion dollars in actual investment (Table1).

According to Nicholas. R. Lardy the dramatic increase in the first of 1990s appear to be caused by four factors.[17]

China's seeming political stability in the wake of Tiananmen, combined with the explosive growth of the domestic economy after 1990-92 led to a fundamental reassessment by foreign firms of China's economic and investment potential. China was deemed a less risky political and economic environment by risk assessment organizations such as the 'Economist' intelligence unit.[18] Many multinationals decided that they could not afford to miss the opportunity to invest in the world's fastest growing market.

Secondly, efforts taken by China in systematically liberalising its foreign investment regime were an added incentive to many investors. Some of the special provisions to attract FDI which in the late 1970s and early 1980s had

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17. Nicolas R. Lardy, Role of Foreign Trade and Investment in China's Economic Transformation, **The China Quarterly,** No. 43, 1996. p.1066

18. On a scale in which 100 is the riskiest rating, China rated 15 in 1988 (one of the EIU's lowest risk ratings). This jumped to 35 in 1989 but by 1992 had fallen back to 25. **The Economist**, 21st May, 1994, p.120

only been available in the special economic zones in South .ls2China, were made much more widely available. Special tax concessions, liberalised land ceiling and other inducements were made available in a growing number of open coastal cities, economic development areas, and high technology development zones. Certain sectors such as retailing, power generation and port development which was out of bounds for foreign investors was also opened to them.

Thirdly, FDI flows also increased due to the phenomenon of recycled capital of Chinese origin. This process is called Round Tripping. It involves the circular flow of capital out of China (in most cases to foreign affiliates of Chinese TNC's) and the subsequent "re-investment" of this "foreign" capital in China for the purpose of benefitting fiscal entitlements accorded to foreign investors.[19] Round Tripping is therefore a form of "system escape" whereby Chinese investors avoid the regulatory regime governing domestic investment by channeling capital through foreign affiliates and thereby bringing this capital under the more favourable regime governing the foreign investment. It is estimated that Round Tripping gives rise to an inefficient use of scarce resources by Chinese TNC's. It retards the commitment of domestically generated capital to productive

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19. Transnational Cooperations and Competitiveness - Regional Trends, **World Investment Report**, 1995.p.59.

uses, requires expenditure on the international network through while Round Tripping capital flows, and diverts Chinese managers away from real competitiveness enhancing intiatives. It is estimated that Round Tripping inward FDI accounted for 25 per cent of China's FDI inflows in 1992.[20]

Lastly, the magnitude of aggregate FDI flow into developing countries increased significantly in the 1990's. The flow of investment to developing host countries depends on international, regional and domestic, economic and political factors. In the second half of the 1980s international factors - specially major exchange rate realignments and increased Western protectionlism have forced firms from Japan and other advanced industrial and newly industrialising nations that have lost international competitiveness to reallocate some industrial production to cheaper countries. Most of this FDI going to developing countries has been concentrated in relatively few economies which is due to a combination of regional and domestic factors. At the regional level the location of Asian economies like Malaysia, Singapore, Thailand, Taiwan and China in the relatively stable and rapidly growing Asia Pacific Area including their geographical proximity to each other specially to Japan has

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20. Peter Harrold and Rajiv Lall, **China; Reform and Development in 1992-93** World Bank discussion papers - No. 215, August 1993, the World Bank, Washington D.C. p. 24.

made them favoured host locations for foreign investment serving both regional and world market.[21]

Characteristics of FDI in China

Improved investment structure

The absorption of FDI has helped China overcome its shortage of construction funds, enabled the country to introduce advanced technology and scientific management expertise, expanded foreign economic and technological exchanges and cooperation, and revitalized the national economy.[22] The number of foreign funded projects involving machinery, electronics, infrastructure and raw materials has been on the rise. The textiles, electronics, telecommunications equipment, machine buiding and chemical industries were leading sectors in terms of foreign investment.

Coastal areas hold lion's share

The eastern coast accounted for the major share in foreign investment. Major foreign capital consumers included Guangdong, Jiangsu, Fujian, Shandong, Liaoning, Zhijiang and Hainan province and Shangai, Tianjian and Beijing Municipali-

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21. Linda. Y.C. Lin and Pang Eng Fong, **FDI and Industrialisation in Malaysia, Singapore, Taiwan and Thailand,** OECD, Paris, p. 176-180.

22. Authoritative Review of China's Policies guiding Foreign Investment, **Beijing Review** October 30, 1995, p. 11

ties, the majority of which are spread along the Chinese coast.

Balanced Foreign Exchange Income

Foreign funded enterprises maintain a balance in their foreign exchange income and expenditure. In addition, their tax payments constituted 10 per cent of the countries tax avenue, a rise of 60 per cent in 1994, a figure representing the highest percentage increase in tax payment by various sectors.[23]

Increased share of Foreign Trade

In 1995, the import and export value of foreign funded enterprises totalled U.S. 109.82 billion Dollars, a rise of 25.3 % on the previous year and accounting for 39 per cent of the national total. The export value grew by 35 per cent while import value rose by 18.9 per cent. Foreign funded enterprises have emerged as a major factor promoting rapid development of the nations for trade. (Table2)

The small amounts of FDI in the late 1970s and early 1980s initially made a negligible contribution to China's total exports. As late as 1985 six years after the passage of China's foreign investment law, and five years after the

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23. **Beijing Review**, n. 22, p.12.

establishment of SEZs, the exports of foreign invested enterprises were only U.S. 320 million dollars, barely over 1 per cent of China's total export. From that modest base, they expanded drastically reaching about U.S. 35 billion dollars by 1994, almost 30 per cent of total exports.

Table 2

Exports of Foreign Invested Enterprises 1985-94

Year	Million of US $	Percentage of total Exports
1985	320	1.1
1986	480	1.6
1987	1200	3.0
1988	2460	5.2
1989	4920	8.3
1990	7800	12.5
199	12100	16.8
1992	17400	20.4
1993	25240	27.5
1994	34710	28.7

Source : - Nicholas. R. Lardy 'Role of Foreign Trade and Investment in China's Economic Transformation' **China Quarterly**, No. 43, p.1074.

Problems and Prospects - FDI in China

China has followed a policy of 'actively, rationally and effectively using foreign capital' and it has recorded rapid progress in this regard. However, two problems related to inward and outward FDI have arisen over valuation and round tripping.

Over valuation

In general, about 70 per cent of FDI inflows into China are 'n kind' i.e. equipment and technology, translating the amount of this investment into cash tends to overvalue the amount of FDI. Overvaluation relates to discrepancies in the face value and the real value of assets that TNC's actually bring into their Chinese affiliates. The motive behind over valuation includes a large share of dividends vis-a-vis local partners, lower taxes arising from large capital expenditure and depreciation credits. Over valuation reduces the potential contribution of FDI to the development of the Chinese economy. It lowers tax revenue for the government as well as the share of revenue accuring to the local partners in joint ventures.[24]

Round Tripping

As discussed earlier this involves a circular flow of

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24. **World Investment Report**, p.59.

capital and its subsequent reinvestment. It leads to inefficient use of scarce resources by Chinese TNC's. It retards the commitment of domestically generated capital to productive uses, requires expenditures on the international networks through which round tripping capital flows, and divert the attention of Chinese managers away from real competitiveness enhancing initiatives.

Inflation

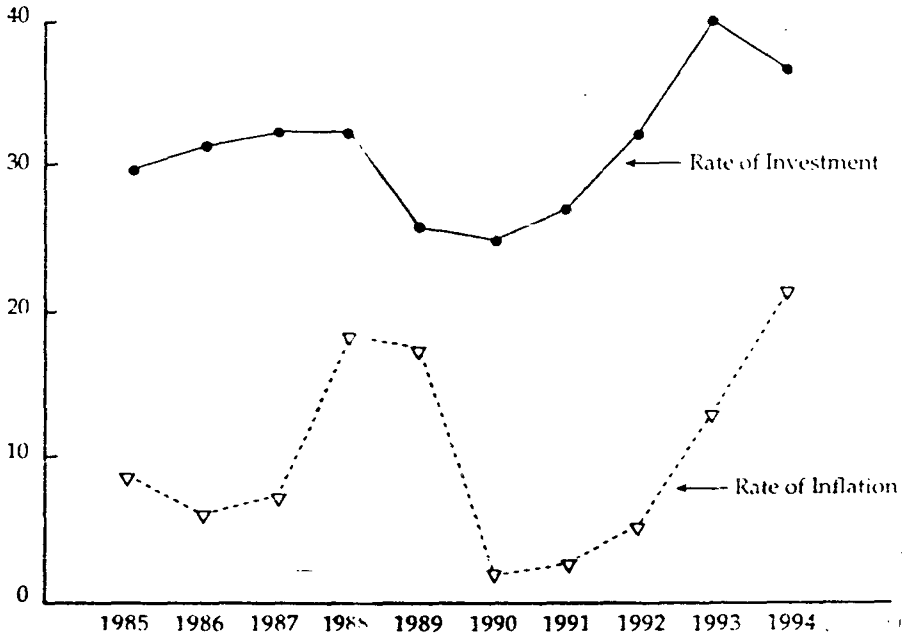
China has suffered from complex inflationary pressures since the beginning of its programme of economic reforms. In the period of transition from a control economy to a market economy, neither of those mechanisms functioned fully, resulting in inflationary factors.

The liberalisation of prices of manufactured goods and a subsequent rise in prices have created 'cost push' inflationary pressures. The reforms made in the physical and financial sectors not only fail to restrain the money supply but caused it to increase and contributed to inflation. With the system of unclear responsibility for management in state owned enterprises, reform of these enterprises aimed at primarily increasing their discretionary powers can only cause investment, wage and benefit expenditures to ballon and strengthen 'demand pull' inflationary pressures. The root cause of inflation are the structural contradictions brought by the transition from a planned system to a market system.

Ballooning investment leads to inflation. If the rate of investment exceeds to 30 per cent this will lead to a rise inflation rate for one or two years. High rates of investment in 1986 to 1988 led to a high inflation in 1988-89. The rampant inflation from 1993 to 1994 was due in large part to the higher rate of investment since 1992.[25]

Figure II

Rate of Investment and Inflation



Source: IDE Spot Survey, p. 18
Institute of Developing Economies, Japan.

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25. IDE spot survey, **Investment Risk in Post Deng China**, Institute of developing economies, Tokyo, March, 1995, p. 18

The scope of FDI in China is bright by any standards. The idea is to increase the scope of FDI gradually open and expand on the basis of experimentation. The landmark aspect of new changes introduced in the registration concerning the FDI is with regard to expanding the use of foreign capital to spur development in the central and western regions. These regions still lag behind when compared to coastal areas inspite of the fact that abundant natural resources are available. These regions are also the base of China's major energy and raw material production as well as the sight for a large number of key state industrial enterprises. The areas also offer relatively developed agricultural, animal husbandary and forest sectors.

The problems related to uneven economic development needs to be removed and during the 9th Five Year Plan period (1996-2000) the government has placed priority on the central and western regions in tapping local resources and introducing additional infrastructure construction projects. While increasing its own investment, the government intends to encourage domestic and overseas businessmen.[26]

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26. **Beijing Review**, n.21, p. 14

Attracting investments from small and medium size overseas enterprises needs to be encouraged to develop these .ls2areas. Europe, U.S and Japan are home to an untold number of small and medium size enterprises. Such enterprises have access to advanced technology and management expertise and the quality of their products are generally high. China's vast central and western regions can offer overseas investors a large number of small and medium sized resources and labour intensive projects.

TABLE 3

POLICIES AND MEASURES ON ECONOMIC REFORM AND THE OPEN DOOR

The first period of reform and open-door policy

1978 Dec.	The Third plenary Session of the 11th Central Committee of the Communist Party of China; the decision to accelerate the development of agriculture
1979 June	The Second Session of the 5th National People's Congress; the adoption of an open-door policy
July	Five documents on the reform of the management system in state-owned industrial enterprise.
July	The Law of the People's Republic of China on Chinese-Foreign Joint Ventures
1980 Feb.	Reform of the fiscal system, setting down the resources of revenue for the central and local governments.
Feb.	Experimenting with a profits-retention system for state-owned industrial enterprises.
Aug.	Regulations on the Special Economic Zones in Guangdong Province.

Nov. Loans for capital construction by the People's Construction Bank of China.

1981 Jan. Many agreements for the import of plants from Western countries were canceled.

Oct. The national working conference on the rural districts, upholding the variety of responsibility systems for production.

1982 Apr. The dismantling of the People's Communes (separating the administrative unit and the economic organization) is incorporated into the Constitution.

May The State Commission for Restructing the Economic System is established (the presiding minister is Zhao Ziyang).

1983 Jan. The plan for forming seven economic blocs.

1984 Apr. The open-door policy is applied to fourteen coastal cities and Hainan island.

May Provisional regulations on further extending the decision-making power of the state industrial enterprises.

Aug. The regulation concerning the improvement of the planning system.

The second period of reform and open-door policy

1984 Oct. The Third Plenary Session of the 12th Central Committee of the Communist Party of China; the decision on reforming the economic system.

1985 Jan. Abandonment of the policy of state monopoly for the purchase of grain and adopting the policy of purchase by order.

Feb. The open-door policy is applied to three delta zones.

May The abolition of state-determined prices for meat, fish, eggs, vegetables, and fruits. (At the end of 1985 the state-controlled prices for these items were reintroduced)

Sept. The regulation concerning the energizing of state-owned large and medium sized enterprises.

1986 Mar. The regulation concerning the accelaration of horizontal economic combinations between enterprises.

Mar. The policy concerning economic reform during the period of the Seventh Five-Year Plan (1986-90).

Apr. The Law on enterprises owned by foreign capitalists.

Aug. The abolition of state-determined prices for monochrome television sets, refrigerators, washing machines, and others.

Sep. Adoption of the contract system for employing new laborers, and promulgating regulations concerning the dismissal of employees and unemployment insurance.

Oct. Three regulations concerning the management of state-owned enterprises, including the regulation on the systems of factory director's responsibiliity.

Dec. The Law for the bankruptcy of state-owned enter prises.

1987 Oct. The open-door policy is extended to Shandong Peninsula and Liaodong Peninsula.

The third period of reform and open-door policy

1987 Oct. The 13th National Congress of the Communist Party of China recognizes the present stage of China as the primary stage of socialism, and permits the existence of private enterprises.

1988 Apr. The 7th National People's Congress adopts the Law concerning state-owned industrial enterprises and the strategy for developing of coastal districts.

May The re-abolition of the re-controlled prices for non-staple food.

Aug. The preliminary program for price and wage reform.

The adjustment policy

1988 Sep.	The Third Plenary Session of the 13th Central Committee of the Communist Party of China adopts the adjustment policy.
1989 Jan.	Controls over prices by local government is restored in most regions.
June	The Tian-anmen incident and the start of economic depression.
Aug.	The plenary session of the state Council declares the stability of prices, the pomotion of agricultural development, the reducing of investment, and the restriction of wage increases as the main points of the adjustment policy.
1990 Feb.	Revision of the adjustment policy toward stimulating the market.
Apr.	Presentation of the development program for Shanghai Pudong new district.
1991 Mar.	The general outline of the Eighth Five-Year Plan and the ten-year program for developing the national economy and society; both call for accelerating reform and the open-door policy during the latter half of the 1990s.
May	The second version of the regulation of 1985 concerning the energizing of state-owned large and medium-sized enterprises.
Sept.	The Central Committee of the Communist Party of China Working Conference declares the end of the adjustment policy.

The fourth period of reform and open-door policy

1992 Jan.	Deng Xiaoping's visit to South China accelerating reform and extending the open-door policy to inland cities. By June 1992 the open-door policy had been applied to 28 cities and 8 perfectures along the banks of the Changjiang River and 13 border cities in the Northeast, Southwest, and Northwest. In August inland provincial capitals such as Zhengzhou, Taiyuan, Xi'an, Lanzhou, Xin ing, Yinchuan, Harbin, Changchun, Huhehaote, and Shijiazhuang were added to this line.
June	Top leaders as well as reformist scholars propose forming "the socialist market economy".

Source : Kyoichi ISHIHARA
China's Conversion to a Market Economy
IDE Occasional Papers Series No. 28
Institute of Developing Economies,
Tokyo, 1993, p. 95 to 96.

CHAPTER-IV

Expansion of FDI's in the PRC.

Foreign Investments consists of two aspects : A) Inward investments (Investment made by Foreign Countries in Domestic Economy). (B) Outward Investment (Investment made by the Domestic Country in Foreign Locations).

China's leap outward

As much as the inward investment of a country, the outward investment too determines the level of FDI on the whole. China was one of the largest outward investors among developing countries in the 1990s. By the end of 1994, over 900 Chinese TNC's had established 4600 foreign affliates in 130 countries with estimated accumulated FDI outflows ranging between 5.2 billion dollars and 16 billion dollars. China's FDI out flows average 2.4 billion dollars annually during the period 1990-1994.[1]

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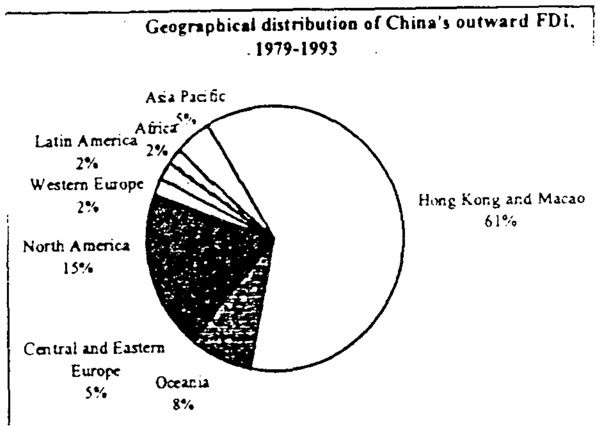
1. **Transnational Corporations and Competitiveness,** World Investment Report, 1995, p.56

Figure III



Source : World Investment Report, p. 57.

The two major motivations for China's TNC's to invest abroad were access to foreign markets and a stable supply of resources. A few large conglomerates in technology intensive industry such as aviation, astronautics and electronics have established foreign affiliates but such advanced technologies have been few in number. Trading has accounted for over 50 per cent of total FDI outflows, although total volume of the average size of Chinese affiliates in trade and other services is small. Conversely, resource seeking foreign affiliates are fewer in number but larger in scale, and accounted for approximately 30 per cent of total FDI outflows upto 1994. The manufacturing sector accounts for a relatively small share of total outward FDI (approximately 15 per cent) and this investment is directed mainly to Africa and Asia and the Pacific.

Most Chinese FDI in manufacturing is motivated by the need to circumvent trade barriers. There is little incentive for efficiency seeking outward investment since China itself has an ample supply of low cost, productive labour and inexpensive land. North America accounted for largest share of China's outward FDI (32 per cent) in the non trade sector (figure).

Hong Kong has absorbed a significant portion of China's total outflows. It has been used by some Chinese TNCs as a springboard for furthering their transnational objectives. The attractiveness of Chinese TNCs of using regional headquarters in Hong Kong for outward FDI relates to its geographical and cultural proximity to China and the much lower levels of administrative control excercised by the Government of China with respect to Chinse companies operating in Hong Kong.

The open door policy and economic reforms have stimulated a wealth of international business partnerships in the Chinese Economy. The number of contracts entered into by foreign investors with Chinese Partners as also on their on, has seen a tremendous increase. Close to 120 countries have invested in China and its attractiveness has intensified the competition for FDI in Asia with possisble implications for FDI flows to other host countries of the region.

The table 4 shows the details of foreign investment by major partners.

Table 4

FDI in China (Cummulative to the end of 1993)

(In US $ billion)

Country	Contracted	Actual
Hong Kong	147.27	38.51
Taiwan	18.43	5.04
U.S.	14.65	5.77
Japan	8.93	5.19
Others	27.63	1.97
Total	216.91	56.48

Source: S. Shivaram - "The Dragon's of Asia - pacific Rim Countries and their multinationals", Wheeler Publishing, New Delhi, 1995.

The global economic growth rate in the 1990s remains sluggish, with most developed countries having less than promising domestic markets, and the bulk of international investors seeking a favourable market. China is currently in the initial stage of an economic take off, characterised by rapid economic growth and annual double digit increases in Gross National Product. The mode of economic growth has shifted from labour intensive to capital intensive and from extensive to intensive activities.

The PRC, with the world's largest population, abounds in resources and has a huge domestic market. In addition, the country's investment environment has improved dramatically in recent years and social stability and unity have safeguarded efforts centring on economic construction. More than that it has a strong industrial foundation and a large technical force, and provides attractive preferential policies in terms of cost and quality of labour. The government has adopted well defined industrial policies and medium to long term economic development plans while at the same time drafting a series of laws, regulation and policies for domestic investors. The number of regions and areas opened to foreign investment continued to expand with diversified and flexible forms of investment.[2]

China's economic boom has been subject to a number of major fluctuations between 1957 - 91. Economic development experienced seven major fluctuation with an interval of four

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2. Lin Senmu, "China's Investment Policies for late 90s", **Beijing Review"**, Nov. 28 to Dec. 4, 1994, p. 7

to six years each. The frequent fluctuations were the result of dramatic changes in annual investments in fixed assets. The highest rate of fluctuation in investment was 146.8 percentage points, with the lowest being 21.5 percentage points. Comprehensive surveys have revealed that economic growth in countries across the world has been subject to periodic fluctuations, intrinsic phenomenon in the development of productive forces. On the other hand, fluctuations in economic growth in China has often been the result of political intervention. Economic fluctuations in China have greatly eased since the initiation of the reforms and opening policies thereby indicating improvements in the government's macro-economic effort.[3]

Table II shows the countrywise contribution of inward investments in China. Among the major contributors are Hong Kong, Taiwan, Japan and United States.

Hong Kong

Hong Kong capital has been a driving force of investments in China. Since the end of the 1970s when China opened its door to the outside world Hong Kong capital has always led foreign investments there. Hong Kong companies used their local ties and blood relations to secure guarntees for

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3. **Beijing Review** n.2, p. 11

themselves which substituted for still under developed market mechanism.

If we look at the investment in China from 1979 to 1985 by the accumulated value of contracts, 64 per cent involved Hong Kong and Macau capital, which was way ahead of the second place investors. In 1993, the figure showed was 147.27 U.S. billion dollars and an actual of 38.51 billion dollars (Table 4).

These figures cover only Joint Venture contracts and 100 per cent foreign investment which include investments in outward processing which the Hong Kong capital is well known for. The value of outward processing in 1993 reached 160 billion Hong Kong Dollars, equivalent to 47.9 per cent of the total trade between Hong Kong and the PRC. In other words, Hong Kong capital has a larger impact on the Chinese economy than indicated by official statistics.[4]

Hong Kong capital is concentrated geographically in South China, especially in Guangdong Province, and specialises in the manufacturing industry, particularly in labour intensive, simple assembly processes. Since 1992, Hong Kong capital has widened its geographic range of investment from

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4. **Investment Risk in post Deng China**, IDE Spot Survey, Institute of Developing Economies, Tokyo, March 1995, p. 31.

Guangdong to Shanghai, Beijing, Dalian and other major coastal cities in the North and spread even further to Hunan, Sichun, and other interior provinces. A trend towards diversification in industry has also become apparent. The number of companies engaging in real estate development and infrastructure, such as construction of highways and power station has started to increase.

However, there is a slowing down in the rate of Hong Kong capital invested in China. The main reasons are:-

(1) Simple Assembly Process, an area in which Hong Kong capital is concentrated has been excluded from the preferential treatment list for the foreign investment incentive in China.

(2) The Chinese government has advocated a policy which limits foreign investment in real estate and infrastructure, where large scale capital from Hong Kong has been concentrated.

(3) There are concerns over the impact of 1997 when the PRC resumes sovereignty over Hong Kong. Different political set up in both countries has reduced the confidence of investors and thus a fall in foreign investments in the PRC.

Taiwan

Another major player in terms of Inward Investment is Taiwan. Since the late 1980s, foreign investment by Taiwanese firms have surged in mainland China. The labour intensive export industry which had fueled the industrialization of Taiwan lost their competitive edge due to rising wages and the appreciation of the new Taiwanese dollar and as a result transferred to the mainland with its lower wage limits.

Table 5

Taiwanese Investment in Mainland China (Accumulative permits)

Year	Projects	Value (US $ 1000)
1991	2503	7.53,915
1993	9100	29,64,604
1994	10362	40,24,273

Source: IDE Spot Survey, Investment Risk in post Deng China, Institute of Developing Economies, Tokyo. 1995, p. 86

Since 1992, investment in China has grown further. This is because entry into China's domestic market was facilitated after Deng Xiaoping gave his official approval to the reform process in his tour of South .

China in 1992. Since then many changes occured along with the changing objectives of investment.

First, investment flowed not only to labour intensive industry but also to capital intensive industries.

Second, large cooperations as well as small and medium sized firms increased their investment.

Third, the size of investment expanded bringing in more inward investments to the PRC.

Fourth, investment locations were scattered with an eye to future access to markets. Investments in the labour intensive industries have been concentrated in South China, which is more convenient in terms of export to third countries. But since 1992, the most popular investment location has shifted to Shangai and its environs, with a trend for investments to spread to China as a whole.[5]

Taiwanese firms continued to invest heavily in mainland China and economic relations between mainland China and Taiwan have steadily become closer. But political relations have moved into the opposite direction. Relations between

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5. **IDE Spot Survey**, n.3, p.36

the two countries have become more strained due to the issue of Taiwanese unification with mainland.

Japan

Japanese investments in China have steadly improved. China has risen from 13th place in 1991 to sixth place in 1992 and fifth in 1993.

Table - 6

Japanese Investment by Country

Countries (1-6)	1991	1992	1993	1994
U.S.	43.3	40.5	40.9	38.8
U.K.	8.6	8.6	7.0	6.3
Netherlands	4.7	4.2	6.0	3.1
Australia	6.1	6.3	5.3	5.8
China	**1.4**	**3.1**	**4.7**	**6.7**
Panama	3.7	2.7	3.9	4.9
Hong Kong	2.2	2.2	3.4	3.6
Indonesia	2.9	4.9	2.3	3.7
Malaysia	2.1	2.1	2.1	2.3
Germany	2.7	2.3	2.1	2.3

Source: - IDE Spot Survey, Institute of Developing Economies, Tokyo, 1995, p.5

The average size of investment in China however, is still a mere fraction of that in Western countries. Japanese investment in Western countries involves the construction of new factories, household electrical appliance and electronic industries with the aim of participating in local market. However, investment in China is still insignificant in terms of both quality and quantity.

Japanese investment has gone into the manufacturing of machinery products, steel products, equipment industries such as, transportation machinery and basic material like petro-chemicals, ferrous metals etc. There has been dizzying spurt of investment by the service industry targeting rising domestic demand in the large coastal cities of China. The electrical machinery, electronic, and other industries on the other hand have seen numerous major manufacturers investing in China aiming to penetrate domestic Chinese market using as a passport cooperation in domestic production of VTR's, microwave ovens, and other household electrical appliances, communication equipment etc.[6]

<u>**United States of America**</u>

China and United States are two important countries playing a major role in world politics. The Asia - Pacific

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6. **IDE Spot Survey**, n. 3, p. 2

region in which both countries are located has attracted world wide attention by sustaining a remarkably high growth rate from many years. Technological and economic advancement have made the earth smaller, the vast pacific ocean narrower and the ties among the countries a lot closer. All this has made it necessary to look at the ties between both countries in a different perspective.

Deng Xioaping's agenda of development and progress emphasized the need to expand economic and cultural exchanges with the outside world. The open door policy produced a dramatic expansion of trade, investment and tourism in 1980s and 90s. China's US trade volume for 1994 reached US $ 35.43 billion, 14 times that of 1979 when the two countries first resumed diplomatic relations. By the first half of 1995, the number of projects with US investment had reached 17,572 with a total contractual value of US $ 21.2 billion out of which US $ 8.1 billion have already been invested.[7]

In the 1970s American view of China was visualised as that of an anti-Soviet partner in the strategic triangle. There is a dominant view that the end of the cold war has diminished the strategic content of US-China relations. However there are more areas of cooperation and set of far

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7. "Jiang Reviews China US Relations", **Beijing Review**, November 26, 1995 p. 8

tougher challenges concerning international security, environmental protection, trade, development and human and political rights.

These policy issues cannot be addressed without full Chinese participation. The policy of "constructive engagement" is followed considering the importance of China in world affairs. American policies have realised the importance of engaging their Chinese counterparts in both bilateral and multilateral forums. Searching for solutions to the problems that for the reminder of this century and beyond will test all countries capacities for international cooperation.[8]

America is in fact turning out to be an important player in the economic affairs of China in terms of both trade and investment. It is the pivot on which the relationship continues to grow in the 1990s. (See figure IV)

China's total exports have increased at the breakneck rate of more than 13 % a year since 1980s. In the first half of the decade, manufacturing accounted for only about 50 % of China's export. By 1994 more than 80 % of China's export are

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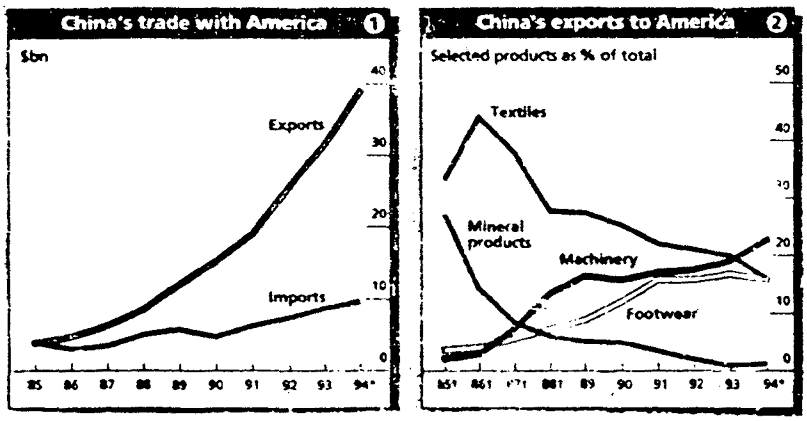
8. Steven. I. Levin, "China and America - The Resilient Relationship", **Current History**, volume 91, no.566, September,1992, p. 16

manufacturers, particularly labour intensive products, reflecting its comparative advantage in low wage labour. The share of clothing, footwear, toys, and sports goods for example, climbed from 16 % of its exports in 1995 to 35 % in 1990. There is a jump in the share of electrical and telecommunication equipment, which tend to be high tech, from 1.6 % in 1985 to 14.7 % in 1990.[9]



Source: Economist, February 11, 1995, p.66

China's export to America have undergone similar transformation. Since 1995 the share of minerals (oil) has

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9. "One Reason not to Chastise China", **Economist**, February 14, 1995, p. 66

dropped sharply. Machinery (including electrical goods) now accounts for 23 % of exports to America; compare with less than 2 % in 1985. The strength of American industries lies in high tech less labour intensive products which makes sense for Americans to import the things China makes.

There is a growing fear over the increasing trade deficit with China. America's official statisticians reckon that the deficit which was a measrly $ 10 million in 1985 has swollen to and $ 30 million by 1994.

Nicholas Lardy's[10] study on the above aspect reckons that America's statistics over estimated its bilateral deficit with China since 1990 by about one third, because they count Chinese goods reexported through Hong Kong to US as imports from China. Cheap Chinese labour has pursuaded firms from Hong Kong and Taiwan to move their labour intensive production to China. Therefore goods that America ones imported from Taiwan and Hong Kong now count as Chinese, increasing its ideas recorded imports from China and cutting the corresponding figures for Taiwan and Hong Kong.

Chinese policy towards foreign investment has undergone sea changes since the relations between both countries sta-

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10. Nicholas Lardy, **China in the World Economy**, Institute for International Economics, 1994, p.56

blised. US companies were the first to invest in China. Rather than concentrating on assembly goods plants, American investment were more in high tech industries. Some of the companies like Pepsico and Walls (part of the Unilever group) are example of companies from US which was the first to come in. Pepsico inc transformed its cooperative joint venture in Shanghai into a full equity one by investing US $ 8 million to bring its total investment to $ 22 million. Pepsico has committed more than $ 450 million to China upto May, 1994.[11]

U.S. investments however, has not kept pace with other countries investing in the region. For example, Japanese share of FDI has grown rapidly (Table 6). Infrastructure development - an area in which US is keen to invest has seen bottlenecks and indecisiveness of Chinese policy makers over how much foreigners should be allowed to earn.[12] A string of bad debts, soured deals, and broken contracts cast a shadow on the China's play.

There are increasing tensions over the intellectual property rights, human rights and future of Taiwan. Copy right violations in the form of Chinese factories .ls2manufacturing CDs

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11. S. Shivaram, "The Dragons of Asia - Pacific Rim Countries and their multinationals", Wheeler Publishing, New Delhi-1995 p.56

12. "Grid Lock, Anyone ?" **Far Eastern Economic Review**, November 10, 1994, p.50

and Microsoft Computer programmes has soured the relations. Although since Tiananmen human right issue has considerably taken a backseat, China baiters in Washington have increasingly used this as a weapon when the annual renewal of the issue of most favoured nation status to China comes up.

The future of Taiwan has always been an issue of contention. Growing sympathy for the nationalist Chinese government in Taipei has been a serious impediment to stable Sino-American relations and has figured prominently in any crisis between the two countries. Controversy over the visit by Taiwanese President to US and Chinese Naval show was the latest in the series.

Neverthless, PRC - US bilateral relations are unlikely to deteriorate or worsen drastically. The cost in terms of both international position and their domestic political support has made both countries more realistic in their approach. Economic relations will increasingly determine the level of cooperation between both countries.

Increasing problems with the US has seen Chinese policy makers moving more towards their neighbourhood and the far east. The Chinese leaders strategy in seeking the investment from these regions reflects both their countries industrial plans and their conceptions of its evolving role in the economic development of east asia, a role which itself brings into focus what may well become one of the major issues of the 21st century. Economic development of countries like Japan and Korea holds important lessons for China and the Chinese leaders themselves have stressed its relevance.

Contemporary Japan has often been regarded as a paragon of free enterprise but the pre-eminence of planning there places it in the ranks of developing countries rather than western market economies. The close relationship between government and business has persisted during the post-war period and planning mechanisms have been more in evidence since the end of American occupation. In this respect both China and Japan have much in common and a fruitful relationship between both countries can lead to the economic development of the region on the whole.

Japanese experience is not the only influence on China's development. China is a member of World Bank and the International Monetary Fund and close consultation with International institutions will increasingly be a feature of Chinese decision making. But Japanese type practices are given great weight and their application to China in such sectors as monetary and fiscal control are important.[13]

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13. Robert Taylor, **Greater China and Japan - Prospects for an Economic Partnership in East Asia** Routledge, London, 1996, p.24-27

Chinese leaders policies towards regional integration in East Asia are both economically and politically motivated. In the decades to come policy makers consider their destiny will be inextricably linked to that of East and South East Asia. While Western markets are not precluded and will continue to play a role in China's development, their share in China's total trade and investment could be reduced if protectionist sentiments continue to grow in Europe and North America.

The Asia Pacific has the highest growth rate of any region and, given Japan's economic super power status and China's gradual ascent to the ranks of developed countries, its weight in the world economy is likely to increase. East Asian Sector of that region, encompassing Japan, China, the Two Korean states, Taiwan and Hong Kong accounts for 7.8 % of the world's land area, 26.1 % of its population, 20.24 per-cent of its GNP and 14.5 % of its import - export trade. In addition in 1990 for example 53.5 per cent of China's total two way trade was with Japan, North Korea, Taiwan and Hong Kong and the same status accounted for 58.5 percent of China's inward investment.[14]

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14. Robert Taylor, n.13, p.12

Table 7

East Asian Countries Investment in China.

Country	Total Investment (US $ 100 million)
Japan	20.36
South Korea	N.A.
North Korea	0.001
Hong Kong	77.00
Taiwan	10.00
Total Overseas Investment in China	183.5
Share of East Asian countries	58.5

Source - China's statistical year book, 1991.

This integration is part of two major trends in the world economy after the second world war. They are economic globalisation and regional economic integration. Running parallel and interacting with each other, these two major trends exerted a profound influence on the evolution of the post war economic and political structure. After the end of the cold war arms race gave way to the competition in overall national strength, thus accelerating a process of economic globalization and regional integration, the development of which would profoundly shape the outlook of the world in the .LS221st century.[15]

The Chinese leadership is aware of the limitations as well as the potential of such cooperation. In the CPC view it is said to differ from economic associations else where in that cooperation between major partners take place within territories of the same nation, with varying social and economic systems.

The political agenda behind Beijing's policy towars the region also needs analysis. China's unification with Taiwan and Hong Kong remains one of the paramount policy goals. According to this agenda greater economic integration could result if these two territories were reunited with the main-land under CCP rule. There is little doubt that the leader-ship has used the promise of further trade and investment as incentives for political consensus, especially from Taiwan's establishment.

China's increasing dominance in the region is also evident in the way it asserts its strength through military

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15. Shen Jiru, "Economic Globalization and Regional Economic Integration : Two Major Trends in World Economy", **Foreign Affairs Journal**, No. 36, June, 1995, Chinese People's Institute of Foreign Affairs, p. 41.

superiority especially naval power. Spartly's Island dispute is a case for this. With the closing down of the American bases in Philipines, the emerging scenario is that of China asserting its strength through Naval Superiority. China's Naval Power has seen tremendous increase over the years and its Navy could be considered one of the best in the world. The power vaccum created by the absence of US in the region is increasingly being filled by the Chinese.

But the Chinese do understand the need to balance the military and economic interests. U.S. being a major market for Chinese goods cannot be ignored. U.S. investments in the form of multinational investments are crucial to the development of China because of the high technology content. But China is fast emerging as a nation where almost all countries interested in outward investment wants to play a dominant role due to the large population and increasing middle class. This puts China in a very advantageous position and the Chinese policy makers make the best use of it.

US investments is increasingly replaced by the Japanese companies. Japan has emerged as a major competitor for US and the increasing shift in Chinese policy of looking more towards East Asia for cooperation has put US in disadvantage. Adding to this problem is the increasing US pressure on matters which China considers as interference on its domestic policy.

On the whole, the US role in the PRC has seen a gradual decline over the years. The 21st century could witness China emerging as the powerful player in the region in military and economic affairs replacing United States. It does have the potential as well as the resources but the role played by the other players in the region like Japan, South Korea etc. will be a determining factor. Nevertheless there can be no doubt of the fact that East Asia will be the area to take note of in the years to come.

Conclusion

Since the implosion of the Soviet Union and the break up of the communist eastern bloc countries, the debate over the path a developing country should follow in its goal of development has tilted in favour of a policy of liberalising their economies and increasing the national economic strength.

China remains a paradox in more ways than one - a socialist, one - one party state initiating the policy of opening up its economy, and reaping the benefits of it in short period.

This research was a case study of the Chinese experience in its efforts to attract foreign direct investment. It focusses on the contradiction that presents itself: a communist party state adopting and implementing policies which could be termed capitalist if we go by the way they are practiced throughout the world.

This study shows that the nature of transition was gradual and the opening up policy evolved over a period of time. It has a crucial link with the Chinese history of the turn of the century where the importance of Western technology and the need to master it was emphasized. But equal importance was placed on Chinese moral essence which was seen as a binding force. The new policies were in many ways a continuation of that tradition.

But the policies also reflect the lessons learned from the past. Pragmatism is evident in almost all policies concerning economic reform and specially FDI. Chinese needed FDI to develop its resources, at the same time wanted to keep the Chinese moral essence intact. The need to preserve the political and social structure made it adopt rules and regulations which encouraged but at the same time limited the scope of the activities.

In other words the opening up policies adopted in China are unique, both in terms of the system as well as structure. The basic premise underlying this policy stressed the advantage China offered when compared to others. Chinese policy makers knew its strength - possessing the world's largest population, a growing middle class, untapped resources - and used all these to its advantage. It did not allow the foreign investors a free play in all the regions and areas they were interested. Instead they were given areas and regions the Chinese wanted to develop. The lure of the market was too much for the investors to resist - Chinese understood this more than anyone else and benefited tremendously.

There can be no getting away from the fact that it was under the leadership of CPC that China achieved this. In other words China is a classic example of how an authoritarian system could be used effectively to fulfil the need of the people. So in this way foreign investment proceeded with other state policies and priorities.

The various contributors to FDI in China reflect the amount of success China achieved. It also shows that competition amongst them and the areas they specialised. The role played by the east asian states like Japan, Hong Kong, Taiwan reflect the cultural as well as social similarities amongst them. It also shows that given to identical opportunities, there is an increasing trend towards more investment in areas which belong to the same region. This regional cooperation which encompasses cultural, economic and political factors has made China attractive to other place in the region.

Growing regional cooperation has also seen the diminishing US role in the region. The changing international equations, especially China's relationship with the erstwhile USSR and the fear of Soviet expansionalism motivated both China and US to come together. Since Tiananmen incident the fear that cultural and economic ties with the West could subject the Chinese society to unacceptable new ideas still dominates the thinking of many. America's increasing clash with China over human rights are a reflection of this fear. This has seen an amount of American investments flowing down over the years.

The Investment Development Path was an attempt to show the gradual progress of the policies and its effects on the main goal of development. It shows that although the progress has been smooth, FDI levels have to increase if benefits from it have to reach the cross section of the people. Shifting of the priority areas from service sector to industrial sector with contribution on high technology areas may reduce the quantum of FDI but bring in the intended foreign investment which will benefit the country tremendously the years to come.

But there are increasing number of problems : the growing inequality, concentration of investment in already wealthy areas, allowing enterprises to expand wage differentials among grades of work etc. These are glaring contradictions in the idea of making capitalism a long term participant in the peaceful development of socialism. In the long term these factors will work against the power structure of CPC.

Although doubts remain, the PRC's strategy of attracting FDI has been a success on the whole. Efforts to ensure that no priviledged group of workers and managers threaten to become a disruptive pro foreign pressure areas need to be taken seriously. This has happened in the case of many developing countries and China needs to take effective steps in this matter. Balancing the inequalities that may disrupt social structure is another issue. The basis on which PRC works is towards the goal of equality and any obstacle in the path whether in the form of FDI or otherwise needs to be removed in a timely manner to achieve its goals.

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