An Evaluation of the Three Periods of China's FDI Development: 1978-2000

by

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Abbreviations

AICs	Advanced Industrialised Countries
CJVs	Contractual Joint Ventures
COCs	Coastal Open Cities
DFI	Direct Foreign Investment
EJVs	Equity Joint Ventures
ETDZ	Economic and Technological Development Zone
FDI	Foreign Direct Investment
FIEs	Foreign Invested Enterprises
GDP	Gross Domestic Product
JVs	Joint Ventures
LDCs	Less Developed Countries
LSAs	Location-Specific Advantages
MNEs	Multinational Enterprises
OLI	Ownership-Location-Internalisation
RMB	Ren-Min-Bi (name of Chinese currency)
SEZs	Special Economic Zones
TNEs	Transnational Enterprises
WFOEs	Wholly Foreign-Owned Enterprises
WOFS	Wholly-Owned Foreign Subsidiary
WTO	World Trade Organisation

Abstract

This thesis explores the impact of the fundamental changes in China's FDI related policy, on the development of Western inward FDI in the country. To achieve this, this study, first of all, establishes a definition of the fundamental changes, then divide FDI in China into the different development periods based on the definition, and finally evaluate the fundamental changes in terms of why and how they take place, and what their impact is on FDI development periods.

The research covers the duration from 1978 until 2000, when FDI in China experiences three different periods led by three fundamental policy changes respectively: (a) in 1978, China made a historical decision: permitting western FDI to the country, to replace its long-pursued traditional strategy of "self-reliance"; (b) in 1986, China started to adopt a new approach to deal with western FDI, which is promoting FDI, instead of permitting it; and (c) from 1995, the Chinese government adjusted FDI policies according to its economic development strategies and international practice. This shift indicated that China moved from FDI promotion to FDI management.

Each fundamental policy change brings China into a particular FDI development period. Looking at these three fundamental changes together, the shift from one change to the next, would provide an overall and consistent picture of China's FDI development periods between 1978 and 2000.

In addition, this research explores the root cause for three fundamental policy changes by looking at China's approach to western FDI. The Chinese special approach to FDI is discussed by comparing it with the world generally accepted approaches to FDI in terms of: (a) What is FDI – a definition of FDI. In this section, the world dominant definition of FDI is reviewed and discussed, and China's view on defining FDI is introduced; (b) Why does FDI take place – the theory of FDI. In this part, established FDI theories are examined, ranging from Marxist approach, and the Neoclassical Paradigm, to generally accepted theories of FDI, including Theory of Monopolistic Advantages, Theory of Product Cycle, Kiyoshi Kojima Thesis of Japanese Model of FDI, The Internalisation Theory, and Eclectic Theory of International Production; China's explanation for western FDI in China is given; and (c) How does FDI take place – the form of FDI. This section reviews the worldwide principal forms of FDI, and then looks at how the form of FDI is developed in the country.

Moreover, the relationship between the movement of different periods of China's FDI and the development of China's approach to FDI practice is examined. This thesis therefore concludes that it is Chinese special approach to western FDI which generates fundamental changes of China's FDI policies, then turns FDI in China from one period to the next.

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CHAPTER 1

Introduction

West foreign direct investment (FDI) in China has become topical since late 1978 when the country adopted an open door policy to welcome FDI. Much has been written about the significance of FDI in developing China's economy, the way the government has dealt with FDI, and successful stories of China's introduction of FDI.

Much of the existing research is, therefore, centered on the impact of FDI on China's economic development. Little attention is given to the impact of the government policy and its changes on the development of FDI in China, in particular, the research with in-depth and comprehensive analysis of major and overall China's FDI related policy changes and their impact on FDI further development is rarely seen (Lin, 1998). It has been increasingly important to examine that why and how both general theory and practice of FDI has been developed in China along with the development of China's FDI policy, as China is a socialist country, as well as a world major FDI recipient country (Pang, 2003). In addition, China's experience with FDI has, in turn, provided "lessons for other non-market economies. Apart from limited experience of foreign investment in Yugoslavia, and Hungary, China's policy was a novelty which has been followed by the USSR and other Eastern European countries, as well as the communist countries of south-east Asia. It is also relevant to large market economies which are heavily regulated such as India and Indonesia" (Pomfret, 1991, pp. 7-8).

This study will cover the period from 1978 to 2000. This period sees FDI in China experience three different development phrases in the country, as a result of the three fundamental changes in government FDI related policies. These fundamental changes lead to the turning points of China's FDI development, and these turning points lead China to different FDI development periods. The main aim of this study is to look at the impact of these policy changes, on the FDI practice in China. To achieve this, the author of this study will, first of all, establish a definition of the fundamental policy changes, then identify a number of key fundamental policy changes based on the established definition, and finally evaluate them in terms of why and how these changes take place and what their impact is on the FDI development period in China.

In addition, this research attempts to explore the root cause of China's FDI development from one period to the next by looking at China's approach to western FDI, since it is believed that the shift of FDI in China from one development period to the next is in fact the result of Chinese special approach – politically oriented approach, together with their growing understanding of FDI itself, as well as the importance of FDI to its economic development.

1.1 Three Major FDI Development Periods in China

As Mark and Zheng (1991) claim, the continuous change of the policy environment is one of the fundamental features of China's FDI development. Major policy changes lead to important turning points of China's FDI development, and the turning points lead FDI in China to a new development period. Much existing research usually gives attention primarily to how much more or less of FDI inflows into China due to these changes. In addition, many researchers have paid only partial attention to this issue, as China's FDI development periods have been only a part or minor part of their research. Therefore, an in-depth and theoretical analysis of this topic is hardly seen. For example, little research has been done about why and how the fundamental changes in China's FDI policy take place, and how they affect FDI in a particular development period, and why China's FDI moves from one development period to the next. The research the author undertakes attempts to discuss this issue from four important aspects which have largely been ignored:

(a) To establish a definition of the China's FDI development period;
(b) To identify the major FDI development periods based on the established definition;
(c) To discover the relationship between one period and the next; and
(d) To examine the relationship between the movement of the turning points and the development of China's approach to FDI practice in the country.

Three different criteria are set up by this research in order to define the FDI development period:

(a) The period is defined in terms of the important changes in China's specific foreign investment policies. For example, according to Roehrig (1994), two turning points have been discovered from these three major phases of China's policy changes (1983 – 1986) in foreign exchange balancing towards foreign invested enterprises: (i) from the universal tough foreign exchange requirement to relieving particular joint ventures form this requirement (1983); (ii) from partially relieving the foreign exchange balance problem to attempting overall resolution of the problem (1986).

(b) The period is defined according to the important qualitative and quantitative changes of FDI, as a result of changes in FDI policies and important events. Quantitative changes in FDI refer to how much more of how much less China attracts FDI after its FDI policy changes in terms of the number of FDI projects, or the amount of foreign capital. Qualitative changes in FDI, on the other hand, refer to changes in the form of FDI (Equity Joint Ventures, Contractual Joint Ventures, and Wholly Foreign Owned Enterprises), changes in the development of China's openness to FDI, and changes in the industrial fields to which foreign firms make their investment. This is a common approach followed by many researchers. This kind of research is useful in providing information on how and why China's FDI has been erratic up and down, but does not provide an in-depth analysis and theoretical implications.

(c) The period is determined by the important FDI related policy changes, which have more general, overall, and longer-term impact on China's FDI development, or have led to a fundamental change in all China's FDI environment. These FDI related policies can be the governmental political decision, overall economic development strategy, and important FDI policies, or a combination of these above.

Since this thesis attempts to look at the FDI development periods which are derived from overall and fundamental changes in China's FDI related policies and which have general and longer-term impact on China's FDI development, logically, the third approach out of the above three will qualify to fulfill this study.

According to this criterion, three major periods have been identified:

(a) Allowing or permitting western FDI to China, to replace China's long-pursued traditional strategy of "self-reliance". This historical change is a result of the governmental political decision and economic development strategy – opening

China's door to the outside world, in order to largely improve the country's backward economy and finally reach its ambitious long-term goal – realising four modernisations of its industry, agriculture, technology and military. This change is apparently fundamental as it makes western FDI possible to locate in China. As Ho (1984) states, the open door policy adopted in December 1978 is the "historical turning point" (p.3), as, for the first time, capitalist investment is allowed. More specifically, Pomfret (1991) recognises that "direct foreign investment (DFI) was permitted by the July 1979 Law on Joint Ventures" (p. 23), this Law was believed by Fan (1992) as "marking the China's open door policy" (p. 28). This dramatic policy change leads China to the first period of FDI development from 1978 until 1986, during which FDI is welcomed, but under strict socialist control.

(b) Encouraging FDI, instead of permitting FDI. The insurance of "the Provisions for Encouragement of Foreign Investment (also known as "22 Articles") in October 1986, marks another important turning point. As Pomfret claims (1991), the Provisions "indicated for the first time, China's FDI had moved from Permitting FDI to Promoting FDI" (p. 2). Fan (1992) regards "the significance of the Provisions as equal as the Joint Ventures Law, as it marked another new stage of FDI development in China" (p. 28). This second period of FDI development is led by important FDI policy change in 1986, since then FDI is treated much more positively as a result of the government's growing confidence in and understanding of FDI, and pressure from FDI makers and the need of further economic development of the country.

(c) Managing FDI according to China's economic development strategy, rather than simply stimulating FDI. Since 1995, the Chinese authority has made strategic changes in FDI policies. On June 7, 1995, the government promulgated "Interim Provisions on Guiding Foreign Investment Direction", and "Catalogue for the Guidance of Foreign Investment Industries", which classify FDI projects into four different categories: encouraged, permitted, restricted, and prohibited. From April 1986, China started to withdraw preferential policies offered to foreign invested enterprises, and gradually replace them by "the National Treatment" for foreign investors. These significant changes indicated that the government, for the first time, decided to strictly and systematically direct the FDI based upon their priority projects, industries and regions, and started to consider treating FDI in line with international practice, such as "the National Treatment", and requirements of international organisations, such as World

Trade Organisation (WTO) in pursuing the membership of this organisaiton. This new and fundamental FDI policy change is seen as an important turning point "as Beijing shifts from investment promotion to investment management" (Brecher, 1995, p. 15).

This thesis sees each of the above three fundamental changes in China's FDI policy as equally important in the sense that they have all changed the general direction of China's FDI history. In addition, because these three changes are equally important, and they represent respectively a turning point in a different period of time, looking at all three changes together, the shift from one change to the next, would provide an overall, general, and consistent picture of China's FDI development form 1979 until 2000, and give answers as to how and why the turning points take place respectively. Moreover, this study will also seek to establish the relationship of the fundamental changes in China's FDI policy and the development of China's approach to FDI practice, as the Chinese government's understanding and interpreting of FDI could be a key to the development of FDI in China.

1.2 World Dominant Concept of FDI and China's FDI Theory and Practice

The concept of FDI is introduced and developed in China along with its introduction and practice of western FDI from late 1978 when it conducted an open door policy.

Since the country is a socialist country, as well as a recipient country of FDI, the concept of China's FDI carries special features: (a) It is based on inward investment, rather than outward investment, which is the basis of the world dominant concept of FDI; (b) China's concept of FDI is directed by the Marxist-Leninist approach, together with Chinese characteristics; (c) China's concept of FDI is created by government officials and official scholars, rather than by independent scholars; (d) There are primary parts of China's concept of FDI, such as the coverage of FDI forms, which are not clearly stated.

This research will look at China's concept of FDI by comparing it with the more generally accepted FDI approaches. This issue will be discussed from three aspects: (1) What is FDI - a definition of FDI; (2) Why FDI takes place - the theory of FDI; and (3) How FDI takes place -

the form of FDI. Through this comparison, the author attempts to bring out sharply the explanation for the root cause of turning points and their impact on China's FDI development.

(1) *What is FDI? – a concept of FDI.* The generally accepted definition of FDI is centered on the extent of the investor's control over the foreign enterprises and the amount of equity the foreign investors has in the business. Therefore, it provides a general criterion to distinguish direct investment from other types of investment.

The definition of FDI in China given by Chinese scholars and government officials, however, is somewhat different: (a) It is flexible, as some forms of foreign investment are included in FDI in China, which is not regarded as FDI by countries other than China; (b) political belief is involved. For example, the experience of joint ventures with several Eastern European socialist countries in the 1950s is not seen as FDI, although it is FDI based on the generally accepted model. With regard to the FDI from Hong Kong, Macao, and Taiwan, because the major proportion of China's FDI has come from these regions since 1979, and while these investors are all Chinese and these regions are not perceived as foreign countries, we must take into account the explanation of the Chinese government as to why their investment can be accepted as foreign investment even after the Hong Kong handover in 1997, and Macao's return to China in 1999.

(2) *Why FDI takes place? – Theories of FDI.* The global dominant FDI theories are based on the analysis of the motives of investors, while China's FDI theory is a special one, which sees FDI from the viewpoint of a recipient nation. In addition, China's FDI theory is based on the Marxist approach, that is, an analysis of political systems and class relations between the investing countries from the west and the host of China.

China's FDI theory believes that direct investment from western countries is capitalist in nature and thus opposed to socialism. While China introduces FDI, it should always monitor the behaviour of foreign investors. The reasons for China permitting capitalist FDI to enter the country are: (a) foreign invested enterprises are well monitored under China's political and economic requirements; (b) China's economy is dominated by the "socialist element", that is, in the entire country, the public ownership system is the dominant element, the proportion of FDI is regarded as a deal between the Chinese government and foreign investors, where the

Chinese side is perceived to be the winner, as they believe that with FDI, they benefit from western advanced technology and management skills, as well as taxation and employment, and thus benefit more than the capitalist investors. Consequently, the country's productive forces can be improved, and the socialist system can be strengthened.

In comparing China's FDI with the existing well-known FDI theories, especially the more popular one – Dunning's eclectic paradigm, this study has reviewed and discussed points that some independent Chinese scholars have made. These scholars have claimed that China's FDI is so special that modifications or redefining of world dominant FDI theories are required. For example, in an attempt at modifying Dunning's model, Chen (1994) suggests that, in terms of why FDI takes place, there are three elements in the decision of a firm to invest abroad: the ownership – specific advantages it possesses, the location – specific advantage it seeks abroad, and its ability to internalise operations. However, for the case of China, the principal reason for direct investment as apposed to other forms of foreign participation in China appears to be the location – specific advantages (such as cheap labour and large potential market) provided by China. The ownership-specific advantages possessed by foreign firms represent a necessary but only partial reason for FDI. In the absence of location-specific advantages, ownership-specific advantages cannot be exploited. The decision by foreign firms to locate their production process in China rather than exporting or licensing is determined by the Chinese location-specific advantages. Chinese location-specific advantages are the huge potential domestic market, cheap labour and land, and the endowment of certain raw materials including coal and oil.

Liu (1994) argues, the peculiar features of China's inward FDI have challenged the dominant FDI approaches, including Dunning's eclectic paradigm, as they do not readily and satisfactorily explain some of these peculiar features. One of the peculiar features of China's inward FDI is that the Chinese party often behaves as the initiator to allow and to promote China's inward FDI, rather than western firms taking the initiative to make FDI. Therefore, in order to explain the special case of FDI, an extended analytical framework based on the existing dominant FDI theories is required.

According to Kojima (1982), a FDI model should pay attention to macro-economic contribution of FDI, to increase employment, transfer of technology, orderly industrialisation, growth of GNP, and balance of payment in both investing and host countries. China's FDI theory implies that the strategic reasons for China to introduce FDI include: (a) overcoming a shortage of funds; (b) gaining access to the international market; and (c) raising the tax revenue for the Chinese government; while Dunning's approach lacks the macro analysis.

Dunning (1993) himself is aware that relevant issues including China's inward FDI "remain unresolved" when he focuses his attention on "the opening up of Central and Eastern Europe and the People's Republic of China to FDI". However, to resolve this issue, Dunning considers this only needs "minor modifications (p. 9)" to the general paradigms. What sort of modifications is needed? Are these modifications minor or major? Dunning neither specifies nor makes the modifications. Nevertheless, as discussed above, the author of this dissertation has made recommendation of the possible modifications based on existing research.

(3) *How FDI Takes Place - the Form of FDI.* According to usual international practice, FDI is divided into two major forms: the traditional form and the new form. A wholly-owned foreign subsidiary (WOFS) is considered to be the traditional form of FDI. The major new form of FDI is equity joint ventures (EJVs), which require that foreign investors acquire "equity stake" and "control". In the case of China, three key forms of FDI are developed: equity joint ventures (EJVs), contractual joint ventures (CJVs), and wholly-owned foreign enterprises (WOFEs), which are also known as *San-Zi-Qi-Ye* (three types of foreign invested enterprises).

EJVs are the Chinese government's first choice of FDI form in the country, since the government believes this form of FDI, under supervision and monitoring of Chinese partners, can avoid domination of foreign sector enterprises by foreign investors, and the worries of western investors' transfer some undesirable western political and ideological trends along with the transfer of their technology to the country, ideas which are seen as harmful to China's socialist construction. Thus, the Law on EJVs was published in 1979, soon after the government's announcement of the open door policy, which is the first legal document governing FDI in China.

Interestingly, CJVs, another key form of FDI, was created by Guangdong province and developed in practice as the most attractive one, in the absence of the CJVs Law. This contract based FDI form has important flexibilities which suit both the Chinese and foreign sides, especially in the initial years of China's open door policy, when both the Chinese side and foreign sides lacked experience of working together in China where legal systems were yet to be established. There are two key flexibilities of this form: (a) the investments contributed by each party to the ventures are not computed in shares, which means that the foreign party may gain a bigger proportion of profits against the lesser proportion of their investment; (b) for Chinese parties, they can make contributions to the ventures by providing the right to use a site, the right to exploit resources, plant and equipment, services of labour. In other words, the Chinese can become the partner of CJVs by contributing what they have. This provides a flexible way for the Chinese to learn western technology and managerial expertise from their foreign partners without investing money, which most of them lack. This is called "make do with whatever is available".

Most foreign investors initially preferred CJVs to EJVs, as they wanted to test the investment climate in China, as this form is chiefly project-specific and short-term in nature in comparison with longer-term and wide ranging equity from EJVs. However, as time passes, the disadvantages of CJVs surfaced, such as increased conflicts of each party's pursuit of short-term interests; since no laws relating to the CJVs were formed until 1988. CJVs are eventually taken over by EJVs since 1986 in terms of the growth rate of the annual actual FDI, as increasing numbers of foreign investors became confident and felt safe to invest in the longer-term in China, and the Laws on CJVs did not put CJVs on an equal footing with EJVs for gaining access to materials, financing and tax benefits.

As for WFOEs, they were permitted as one of the forms of FDI a year later (1980) than EJVs (1979), and were allowed to be set up in only four special economic zones (SEZs) until 1984, because they are solely operated by foreign investors, therefore they were thought to be beyond the control by the Chinese government. However, WFOEs have been encouraged by the government since 1986, when reductions in FDI occurred, and since 1992, when a growing number of large transnational enterprises (TNEs) have been contributing to China's inward FDI, and the government believes these firms transfer the most advanced technology. As a result, WOFEs have increased dramatically and they have overtaken CJVs in 1990, and have grown faster than the EJVs.

In conclusion, the concept of FDI in China has undergone a process of introduction, creation, and development. Accordingly, the process has gone with the three turning points of China's FDI development in practice. The stage of introduction of the FDI concept is from the end of 1978 when the first turning point of China's FDI takes place. For the first time, permission was given to western FDI to enter China. At that time, because the term FDI was fairly new to the Chinese, the focus was on the introduction of western basic FDI concept and theories. From the theoretical perspective, western FDI concept was mainly introduced in terms of the Marxist approach, emphasising that western FDI was useful, and that FDI and China's socialist construction could coexist under socialist control. In terms of concept creation, China's FDI was created between late 1986 and 1995, when the second turning point of China's FDI development occurs. For the first time, the government started to promote FDI, rather than permitting it, as the government was eager to attract more FDI to China, and much more confident in dealing with FDI. In this period, especially from early 1990s, FDI began to play an increasingly important role in the Chinese economy, which led to China's FDI very topical not only in China, but also all over the world. In 1995, the book entitled *Principles of China's Utilising Foreign Investment* was published by the Chinese government, which systematically analysed China's inward FDI within a Marxist framework, but in a flexible way, leading to the formation of China's FDI concept. The stage of FDI concept development appears from 1995, when the third turning point of China's FDI development arises. The government started to adopt the approach of managing FDI, to replace the previous approach of promoting FDI, giving priority to FDI quality based on the national economic development strategy, and to treat foreign invested enterprises more equally based on the principles of "the National Treatment". One the one hand, China intends to control as well as to develop inward FDI in an independent way; on the other, the country will have to move closer to international practice, as it has been part of the international economic system (China became a member of WTO in December 2001).

The dissertation is structured as follows:

Chapter 2 will review and discuss in detail the world dominant concepts of FDI, including FDI theories and practice, then look at how FDI in China is interpreted and practiced by comparing it with the general concept of FDI. Three aspects of FDI will be compared, that is, What is FDI – a concept of FDI, Why FDI takes place – the theory of FDI, and How FDI takes place – the form of FDI.

Chapter 3 will look at the methodology issues, followed by Chapter 4, which defines the turning point which leads China's FDI to the different development period. This chapter will review existing study on the turning point. Three different criteria for defining the turning points are discussed, and one of them being selected for this thesis is established. That is, the turning points are determined by overall or general FDI related policy change, which has impact on every aspect of FDI activity. Three turning points are identified based on this criterion, and accordingly, three different FDI development periods are generated by the turning points with the same criterion.

Detailed evaluation of all three periods are presented in Chapter 5, Chapter 6, and Chapter 7 respectively, which explores the evolution of China's approach to western FDI by explaining thoroughly why and how the fundamental changes in China's FDI policy take place, and what their impact is on the development of China's FDI. As pointed out in Chapter 7, since the third period of China's FDI development in 1995, the government has given special attention to environmental issues such as air pollution and water pollution, as many highly polluted FDI projects introduced to China are worsening already seriously damaged environment. The severe problem costs China heavily in terms of the sustainable growth in its economy. To deal with the problem, the government issued the "Catalogue" to encourage environmental protected FDI projects and restrict polluted FDI projects. This dissertation is ended with the conclusion and recommendations in Chapter 8, in which, China's experience and ideas of dealing with western inward FDI is summarised and the further research about China's FDI is suggested.

CHAPTER 2

General Concept of FDI and China's FDI

2.1 *INTRODUCTION*

The explanations of FDI can be traced back to the early theories ranging from the Marxist Models to the Neoclassical Paradigm. "It was not until 1960 that anything approaching a separate theory of foreign direct investment was formulated" (Dunning, 1993, p. 4), although the activities of FDI has already existed since the nineteenth century.

FDI is a very new term in China and came into existence from the late 1970s when the country opened its door to the outside world and introduced FDI officially, although FDI came to China as early as the 1950s.

This chapter will evaluate the global general concept of FDI and China's FDI concept by considering: (1) what is FDI; (2) why FDI takes place; and (3) how FDI takes place.

Like many other issues in China, the concept of China's FDI and its operation in practice has clear Chinese characteristics.

The major features of China's conceptualisation of FDI are: (1) It is based on inward investment, rather than outward investment, which is the base of the general global concept of FDI; (2) China's concept of FDI is a combination of politics, economics, and FDI practice, and directed by the Marxist-Leninist-Maoist approach, which will be discussed in detail later; (3) Most '*foreign*' investment comes form Chinese origin companies in Hong Kong, Macao and Taiwan, rather than third parties; (4) Investors are generally from capitalist economies; whilst China remains a socialist country, with the relationships therefore focusing on mutual economic benefits, rather than political advantage or common purpose; (5) China's concept of FDI was created by government officials or official scholars, rather than by independent scholars; (6) There are quite a few primary part of China's concept of FDI, such as coverage of FDI, is not clearly stated.

This chapter attempts to draw a general picture of China's treatment of FDI concept and to compare it with more generally accepted FDI theories.

Section 2 considers a definition of FDI, in which the development of a general global definition of FDI is briefly reviewed, and China's definition of FDI is introduced and examined. In Section 3, the global FDI theory is summarised and China's FDI theory is described and analysed. The global common FDI forms are outlined and China's FDI forms are compared and assessed in Section 4. The conclusions are given in Section 5.

2.2. WHAT IS FDI ? - (A Definition)

2.2.1. A World Perspective

FDI has never been named until 1960 when its special features were identified and it became a more important part of international business study. However, its conception, or its definition is still not clear enough although many of the studies on this issue have been done since then.

A) A Backward, As Well As A Forward Concept

FDI is greatly concerned with transnational Enterprises (TNEs), as they are the most important participants of FDI and made majority of FDI worldwide (Ge and Liang , 1994). Dunning (1981) proposes a 'broad definition' of TNEs as "firms that engage in foreign direct investment" (p.3).

However, although there have been hundreds of TNEs investing in the manufacturing sector since the nineteenth century, and international business activity can be traced back to the Middle Ages in Europe (Jones, 1993), until the 1960s, direct investment was usually considered as just one form of international capital movement (Ragazzi, 1984).

The first person to give special considerations to direct investment was Steven Hymer. In his doctoral thesis (1960), Hymer argued that direct investment and portfolio investment "really are two different things" (p. 2). First, these two types of investment behave differently. For example, the pace of their growth is not the same: in the 1930s, portfolio investment dropped enormously, but FDI was just slightly decreased; in the postwar period, FDI expanded rapidly while portfolio investments had a little increase. Second, unlike portfolio investments, "direct investments are the capital movements associated with the international operations of firms" (p. 30). Hymer introduced a crucial factor in order to distinguish these two different investments, that is: control. He states, if the investor directly controls the foreign enterprise, his investment is called a direct investment. If he does not control, his investment is a portfolio investment. Control, Hymer believes, is connected with the equity of the firm, or based on the amount of equity in a local firm that a foreign investor holds.

Thus, according to Hymer, control and equity are the two key determinants in defining FDI. It is a fact that some questions relating to control and equity still remain unclear. However, to separate FDI from portfolio investment is Hymer's milestone contribution to FDI literature, which enabled later scholars to follow up and to develop the study of FDI.

B) An Ambiguous Definition

The existing definitions of FDI are ambiguous as revealed by the literature on the subject, including the work done by some influential FDI experts, such as Hymer. Some existing definitions proposed by several writers and organizations actually originate from Hymer's framework, as revealed by the following examples.

- FDI is the amount invested by residents of a country in a foreign enterprise over which they have *effective control*. (Ragazzi, 1973)

- Direct investment is a long-term *equity* investment in a foreign company that gives the investor *managerial control* over the company. (Griffiths, 1984)

- Direct investment refers to investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have *an effective voice* in the management of the enterprise. (IMF, 1977)

It can be seen from these examples that the determinants of the definitions of FDI are those which have been identified by Hymer, namely, that FDI refers to: *control* and *equity*. These examples differ from Hymer's approach in that they attempt a definition of FDI.

However, there are some problems with all definitions of FDI. First, what is the *extent* of '*control*' required to decide whether an investment is a *direct investment* rather than any other form of investment? In fact, many countries and organizations define FDI differently. Japan claimed in 1978 that FDI requires that the foreign investors: *(a). owns the whole stock or over 50 per cent of the stock of the Japanese companies; or (b). effectively control the Japanese companies by having more than half of the seats in the board of directors* (Ge and Liang , 1994).

A different definition is given by the US government, which asserts that an investment is a FDI when the investors have *more than 10 per cent of the ownership* in the foreign enterprises (Chen, 1991). According to the United Nations Department of Economic and Social Affairs (1973), the criteria for inclusion in the FDI category are: (a) as a subsidiary, it should have at least "25 per cent control of the voting stock by the parent company"; and (b) as an associate, "as little as 10 per cent of the voting stock may be judged adequate to satisfy the criterion". In general, the understanding of what proportion of ownership giving the investor control varies from country to country, which leads to the fact that FDI is unlikely to be defined precisely (Ietto-Gillies, 1992). However, it tends to be accepted generally that an investment which amounts to at least 10 per cent control of voting voice is direct investment (Ge and Liang, 1995).

Secondly, with regard to *equity*, there is a difference between theory and practice. In theory, as mentioned earlier, *equity* is another basic determinant of FDI other than *control*, and requires that the investor has ownership rights or holds stock shares (or other equities) in a foreign company (Griffiths and Wale, 1984). In practice, some non-equity forms of

investment, such as contractual joint ventures, are also recognized as FDI by the World Bank (Duan and Yang ,1993). Third, Casson (1985) asks: Does direct involvement mean that the investor has to be involved in *day-to-day management*, or holds *a high enough position,* say, senior manager level in an enterprise? If not, what is it, and why?
Therefore, as Hymer argues (1960), "control is not an easy thing to define", and it is hard to find "the dividing line between some control and no control" (p.1).

2.2.2. The Perspective from China

The term FDI was little known in China until late 1978 when China introduced its economic reforms. A growing number of foreign firms have participated in direct investment in China since then, particularly since the early 1990s. Consistently from 1993, China has been tremendously successful in introducing FDI and has become the second largest FDI recipient country, next only to the USA (Jiang, 2002). As a result, FDI has become an extremely important issue in the country. However, the concept of FDI in China is far from clear due to the following reasons: (a) FDI has only recently emerged in the country; and (b) China attempts to interpret FDI in its own way, in order to keep its explanation of FDI in tune with the political system of the country. The Government emphasizes that China is building up a socialist country with Chinese characteristics, while the FDI that China is introducing is basically from western capitalist countries. Therefore, it is understandable that the concept of FDI in China is interpreted with Chinese characteristics, and thus the concept of FDI based on this can be called "China's FDI".

A) Definition of FDI in China

There are three main ways of defining FDI in the country, which are based on the following approaches.

(A). The definition based on the well-known western model
Like the popular western definition of FDI, this type of definition is focused on either *control*, or *equity*. It served as the introduction of the western FDI definition to the Chinese:

- FDI refers to investment that is made in foreign countries, where the investors involve the process of production or operation, as well as the *control* of the enterprise. (Li, 1995)

- FDI is related to the investment, in which the investors are required to have a certain proportion of *equity stake*, so that they have the ownership in an enterprise and means of control over it. (Chen, 1991)

(B). The definition based on individual understanding

Some independent Chinese researchers have interpreted FDI - distinguishing it from other forms of investment - by defining the concept through its *literal meaning*:

- The term 'direct' investment is used to distinguish from 'indirect' investment (such as portfolio investment). 'Indirect' investment is the one which takes place in the *home country*, while 'direct' investment appears in the *foreign country* (Duan and Yang , 1993).

- Unlike '*indirect*' foreign investment, '*direct*' foreign investment implies that investors have to be '*directly*' involved in the invested-project, namely, to participate in the activities of operation and management in this enterprise (Ge and Liang, 1994).

Obviously, these explanations are centered on the terms 'direct' and 'foreign', and are useful to identify the features as well as understand the concept of FDI. However, they do not seem to resolve other questions, including: (a) *to what extent,* does 'direct' involvement make an investment become FDI; or can an investment be defined as FDI if the investor crosses the boundaries and then 'directly' involves himself in business activities in a firm whatever the level of investment he has in that firm? As discussed earlier, it is generally recognised that an investor who has at least 10 per cent of ownership in a foreign company can be thought of as a direct investor; therefore, it is not direct investment if the investment does not meet this criterion even though the investor is the foreigner who directly makes the investment; and (b) in the case of China, why does the government require that foreign investor should have no less than 25 per cent of equity stake in a joint venture, since it is generally accepted in the world that it is an FDI when the foreign investor owns as little as 10 per cent of the ownership?

(C). The definition based on existing inward FDI practice in the country.

The common forms of China's inward FDI include: (a) foreign loans. These may be loans from foreign governments, financial institutions, and foreign banks; (b) equity joint ventures; (c) contractual joint ventures; (d) wholly foreign-owned enterprise; (e) compensation trade; (f) processing assembly.

All these forms are classified by the different levels of Chinese official statistical bureaus into three major types: 1) External Loans; 2) Foreign Direct Investment; 3) Other Foreign Investment (see details from Table 2.1).

As can be seen from this table, there is a clear distinction between different types of foreign capital, so that any particular inclusion can be seen under various forms of foreign capital, including FDI. As to the type of *External Loans* (also known as Foreign Loans), it would seem clear that all the forms in this type belong to portfolio investment, because they only involve capital movement. Similarly, the forms in the type of *Foreign Direct Investment* (a detailed discussion can be seen from Section 4) are considered to be a separate type because they involve capital movement, as well as control, management over a venture. In addition, the definition of FDI given by some official statistical organisations also uses the same approach: "FDI (in China) refers to those foreign enterprises, economic organisations or individuals who, according to the relevant Chinese laws and regulations, set up a wholly foreign-owned enterprise, Chinese-foreign equity joint ventures, Chinese-foreign contractual joint ventures, or joint explorations, including reinvestment with profits from existing FDI projects" (Statistical Yearbook of Guangdong, 1994, p.178).

However, this distinction is not always used as a criterion to discuss the issue of FDI. From time to time, the investment under *other foreign investment* is treated as part of FDI by both Chinese and world official organisations, as can be seen from various published figures, although the World Bank Report (1988) refers to the collection and reporting of statistics describing foreign investment as "one of the less advanced aspects" (p.251) of the history of FDI in China (Pomfret, 1991). One possible reason is that this category is ambiguous or elastic. It is considered part of FDI in China because: (a) it does have some similar features to FDI, such as its involvement of

Table 2.1 Agreement of China's Utilization of Foreign Capital By Form

Amount in US$ 100 millions

Form	1989		1990		1991	
	No. of Projects	Amount	No. of Projects	Amount	No. of Projects	Amount
Total*	5905	114.79	7371	120.86	13086	195.83
1.External Loans	130	51.89	98	50.99	108	71.61
- Loans from foreign govts	121	14.71	82	7.19	93	22.43
- Loans from intern. financial institutions	9	8.56	16	18.93	15	21.27
- Loans on convertible currency from foreign banks		17.25		16.53		20.24
- Bonds and shares issued to foreign countries		1.41		0.03		1.09
2.Foreign Direct Investment	5779	56.00	7273	65.96	12978	119.77
- Equity joint ventures	3659	26.59	4091	27.04	8395	60.80
- Contractual joint ventures	1179	10.83	1317	12.54	1778	21.38
- Wholly foreign-owned ventures	931	16.54	1860	24.44	2795	36.67
- Joint exploiation	10	2.04	5	1.94	10	0.92
3.Other Foreign Investment		6.94		3.91		4.45
- Compensation trade		4.75		2.03		2
- International leasing		0.72		0.51		0.30
- Processing assembly		1.47		1.37		1.48

* The figures in total agreement number do not include the project numbers of other foreign investment since 1985.

(*Source*: China Foreign Economic Statistics: 1979 - 1991, complied by Department of Trade & Materials Supply of State Statistical Bureau, China; published by China Statistical Information & Consultancy Service Centre, 1992).

foreign assets like machinery, production materials, and technology; and (b) The Chinese government wants to show that it is successful in attracting large amounts of FDI to the country.

On other occasions, *other foreign investment* is not considered part of FDI because the investor is not required to control or own an enterprise. Hence, one must ascertain whether the figure of China's FDI includes this category or not when reading the publications and using data from them.

B) A Question Concerning the History of FDI in China

When did FDI start to emerge in China? This question relates to the basic concept and definition of FDI, and is therefore worth discussing.

Chinese officials and authors have continued to state the common view in the country that no FDI existed in China from 1949 (when new China was born) until the late 1970s when China started to carry out the "open door" policy (Hu and Ji, 1994; Fan, 1992; Liu, 1995). This means that the history of FDI in China started from the late 1970s.

At the same time, however, the *Directory of China's Foreign Economic and Trade Policies* acknowledges the fact that there were several joint ventures in existence before that time:

> Five joint ventures were set up from 1950 to 1951 in the new China, between China and the Soviet Union and Poland. Four of these were run by China and the Soviet Union, and each side had 50 per cent of equity stake. These were the Chinese-Soviet Union (Xinjiang) Petroleum Company Ltd. (30 year duration agreement), Chinese-Soviet Union (Xinjiang) Rare Non-ferrous Metals Company Ltd. (30 year duration agreement), Chinese-Soviet Union Civil Aviation Company Ltd. (10 year duration agreement); and Chinese-Soviet Union (Dalian) Shipbuilding Company Ltd. (25 year duration agreement). All these ventures were terminated in October 1954 before the venture expiration date. The fifth joint venture - the Chinese-Poland Shipping Company Ltd. was set up in 1951 and each shared half equity stake of the venture, and is still running because of its good performance' (p.863).

In addition, the figures for FDI in China between 1949 and 1978 show that China introduced USD6.4 billion of FDI during that period (Duan and Yang, 1993). This phase is not recognised as a part of China's FDI history in China itself due to the following reasons: (a) FDI should be an investment made or organised by foreign (private) companies, not by governments. The joint ventures between China, the former Soviet Union, and Poland do not fall under FDI according to the definition, because they were actually trade cooperation between the two governments (Hu and Ji, 1993); (b) the term FDI was introduced to China after the country allowed western firms to set up joint ventures in China from the late 1970s, which led the Chinese to believe that FDI business persons are those who come from western capitalist countries, while neither the former Soviet Union nor Poland could be classified as 'Western or capitalist nations', therefore, their investment can not be deemed as FDI.

In fact, the ventures between China and the Eastern European countries during the 1950s had all characteristics of the FDI definition discussed above, as: (a) they involved foreign investors; (b) they took the form of equity stake; (c) the foreign investors were able to effectively control the ventures by owning 50 per cent of the stake. Therefore, these ventures should be regarded as FDI, since the definition of FDI has nothing to do with the political belief of any nation, for as long as that nation has accepted overseas investment. This is irrespective of the fact of whether such an investment has involved the government or private enterprise. From this point of view, the history of China's FDI should start from 1951, much earlier than it is recognised in China, rather than from the late 1970s.

C) The Unique Phenomenon of China's FDI

Several previous studies have pointed out that overseas direct investment into China has been dominated by ethnic Chinese from Hong Kong, Macao and Taiwan (Kaiser, Kirby and Ying, 1996). This is one of the peculiar features of China's inward FDI (Liu, 1994). It can be seen from Table 2.2 that since 1979, investors from Hong Kong, Macao and Taiwan (since 1985) have been playing a dominant role in China's FDI.

However, earlier research does not seem to refer to the question of why these investments are treated as foreign investment, rather than domestic ones, since they do not come from "foreign countries", but from places from called "regions" by the Chinese government itself.

It is a fact that the people in these three "regions" are basically Chinese, and Hong Kong, Macao and Taiwan are not recognised as independent countries by the international community. It would not be incorrect to suggest that the investments from Hong Kong and

Table 2.2 ***FDI by Country of Origin:*** ***Leading Countries and Regions***

1979 -1991 Amount: US$ 100 millions

	No. of projects	its percentage in national's total %	Agreed amount	Its percentage in national total %
HK & Macao	31545	75.1	325.68	62.2
US	1944	4.6	37.91	7.2
Taiwan	3609	8.6	29.86	5.7
Japan	1882	4.5	28.54	5.5
German	111	0.3	10.85	2.1
Singapore	558	1.3	8.99	1.7
UK	128	0.3	4.18	0.8
Thailand	181	0.4	2.98	0.6
Australia	181	0.4	2.64	0.5
Canada	187	0.4	2.5	0.5

(*Source:* China Investment Manual, 1994, published by the Publishing House of China's Finance & Economy)

Macao was regarded as FDI because these two regions used to be governed by Britain and Portugal respectively. What will happen to the classification of these investments now after China takes over the charge of Hong Kong and Macao in 1997 and 1999 respectively? The answer is given by Wu Yi, then Minister of China's Ministry of Foreign Economic Relations & Trade. She explained (1995), because of the different economic and political systems between mainland China and Hong Kong (as well as Macao), the nature of the economic relations between them will remain the same - both sides dealing with each other as foreign partners. This seems to be the approach the Chinese government is adopting, which is based on the theory of 'one country, two systems' adopted by Deng Xiaoping (1).

The relationship with Taiwan is somewhat different. Unlike Hong Kong and Macao, Taiwan is governed by the Chinese themselves. In addition, both Beijing and Taiwan insist on a 'one China (China covers both Taiwan and mainland)' policy. Why, then, should investments from Taiwan be treated in the mainland as '*foreign*' investments? The reason is the same as above: that the political and economic systems on the mainland and Taiwan are different; the former follows a socialist system, the latter adopts a capitalist approach, so, it is needed to be sorted out in a special way. Again by the formula of 'one country, two systems ', it makes no difference whether the mainland and Taiwan are governed separately or by one central government.

It is worth recapitulating, therefore, one of the key characteristics of China's FDI concept, that is, the major proportion of China's FDI is not from '*foreign*' countries; but from some special '*regions*'. In addition, this characteristic of China's FDI is recognised by the world economic organisations because the figures of China's FDI produced by the Chinese government are accepted by them. This can be seen from any of these organisations' publications.

In addition, the Chinese government has recently realized that China should attract more FDI from western countries in order to improve the quality of FDI, as it has been disappointed with the level of technology it has acquired from these regions, most of these investment projects are small-scale and involve low level of technology and quick returns (Shapiro, *et al,* 1991).

Concluding Remarks

The generally accepted definition of FDI centres on the extent of the investor's control over

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(1): Deng Xiaoping, who was Chairman of the Central Advisor Commission of the Chinese Communist Party, formally proposed the strategy of "one country, two systems" when he met with the visiting British Minister, Margaret Thatcher, on September 24, 1982. The concept of this can be interpreted as meaning that while the socialist system will be maintained within the People's Republic of China, capitalism will continue to be practiced in Hong Kong, Macao, and Taiwan.

One Country, Two Systems and Reunification of China. New Star Publisher, Beijing, P.R. China, 1991.

the foreign enterprise and the amount of equity the foreign investor has in the business.

Therefore, it provides a general criterion to distinguish direct investment from other types of investment. However, there are some FDI related practical problems that arise due to these general criteria. For instance, the world FDI statistics obtained from different countries receiving foreign investment are based on different criteria (for example, country A may consider it is FDI only when the foreign investor has no less than 20 per cent of ownership over an invested enterprise. Country B, however, accepts a lower criterion, say, no less than 10 per cent).

In the case of China, the definition is even more ambiguous. The definition given by some Chinese scholars is based on the well-known western model, or an interpretation of FDI's literal meaning, and it does not seem to reflect the FDI practice in China. The definition given by the Chinese government is, again, different from the western definition: (a) it is flexible. For example, in addition to foreign invested enterprises, the form of *other foreign investment* is sometimes included in FDI, which is not regarded as FDI by countries other than China (Chen and Raftery, 1994), and should be thought as one flexible type of trading (Yao, 1993); and (b) political belief is involved: the experience of joint ventures with several Eastern European socialist countries in the 1950s is not seen as FDI, which actually is FDI based on the generally accepted model of FDI.

With regard to the FDI from Hong Kong, Macao and Taiwan, because most of China's FDI has come from there since 1979, and while these investor are all Chinese and these regions are not perceived as foreign countries, we must take into account the explanations of the Chinese government as to why their investments can be accepted as foreign investment even after Hong Kong and Macao handover in 1997 and 1999 respectively.

2.3. Why Does FDI Take Place ? - (Theory of FDI)

2.3.1. From the viewpoint of established FDI theories

A. The Marxist

As mentioned earlier, the relevant literature on FDI can be traced back to the Marxist theory, "partly because (the interpretations) were the first ones put forward, and partly because they relate to an early phase of foreign investment when colonialism and the securing of raw materials were still of paramount relevance" (Ietto-gillies, 1992, p. 41).

In general, Marxist explanations of the global spread of multinational enterprises are based on political analysis, such as social systems, class relations (Wiles, 1968). These Marxist scholars view the worldwide expansion of capitalist firms as a historical and natural process. This, therefore, leads the capitalist to 'forcing' new markets, enabling the educated middle and upper classes to gain their private interests (Hobson, 1988). The aim of capitalist states' 'exploitation' of foreign markets, is to control them in the international capitalist system (Moran, 1973).

However, some classical writers discuss foreign investment using their imperialist model. Lenin (1996) perceived capitalist countries' investing in foreign markets as an inevitable tendency. An enormous "surplus of capital" arises when capitalism reaches the monopolistic stage; it is in the nature of the capitalism that "surplus capital will be utilized not for the purpose of raising the standard of living of the masses in a given country, for this would mean a decline in profits for the capitalists, but for the purpose of increasing profits by exporting capital abroad to the backward countries" (p. 49). In these backward countries, capital is scarce, costs of use of land and labour force are low and raw materials are cheap. As a result, colonization is needed, which leads to imperialism.

Bukharin (1972) deals with imperialism in a way similar to Lenin's. He explains it as the need of the increased monopolisation, and the need of the capitalist's further development. But the specific motivation for the capitalism that Bukharin identifies is different from Lenin's explanation of imperialism when he writes: "the motive power of world capitalism' is 'the race for higher rates of profits" (p. 56).

Rosa Luxemburg (1971) explains the imperialism by describing *the Accumulation of Capital.* In this book, she points out, the realisation of the surplus value is "a vital question of capitalist accumulation". In her view, there is a lack of effective demand for the full realisation of the surplus value in capitalist countries, because "the workers and capitalists themselves can not possibly realise that part of the surplus value which is to be capitalised. Therefore, the realisation of the surplus value for the purposes of accumulation is an impossible task for a society which consists solely of workers and capitalists" (p. 57). As a result, markets in non-capitalist societies are needed as they are able to absorb that part of the surplus value which contains either consumer goods or means of goods or both.

Some later Marxist approaches focus on the relations between developed countries and underdeveloped countries. Baran and Sweezy (1966a) describe a new dominant class among the owners and functionaries of big monopolistic corporations, who constitute the leading echelon of the ruling class, not the owners of bankers or financial institutions who played that role previously, because these large TNCs no longer need to rely on banks. They are able to expand themselves independently from one country to another. Regarding the purpose and nature of 'foreign investment', these authors state, "it seems, far from a means of developing underdeveloped countries, it is a most efficient device for transferring wealth from poorer to richer countries while at the same time enabling the richer to expand their control over the economies of the poorer" (p. 61).

A recent theory of decentralisation of production under centralised control is based on more technological considerations. Adam (1975) introduces a term 'world sourcing'. One of the factors generating the motive of production locations to be spread worldwide is the improvement in technology, including that in the personal communication, cost of transportation, and efficiency of production activities in foreign countries. Frobel, Heinricks and Kreye (1980) argue that this worldwide relocation leads to a 'new international division of labour', which is determined by 'cheap'-cost labour in the LDCs, division of the production process which enables unskilled labour force to be employed for 'partial operations', improvements in technology, etc. This new international division of labour leads capitalism to undermining the traditional bisection of the world into a few industrialised countries on one hand, and a great majority of developing countries integrated into the world economy solely as raw materials producers on the other.

Some points in Marxist discourse continue to be significant. Some Marxist authors, for example, discuss foreign investment in terms of "Lenin's passage on the increased socialisation of production (as) very interesting and still applies today" (Ietto-gillies, 1992, p. 52); Bukharin's (1972) work moves closer to the concept of direct investment than that of other classical Marxist authors as he refers to 'fixed capital', which was identified by the later economists as one of factors of direct investment, rather than indirect investment. The theory based on technological development explains why developed and developing countries tend to be connected closer.

However, because the position of Marxist authors is greatly affected by their sharp political beliefs, their attitude and their conclusion towards foreign investment is in general negative. In their view, it is not fair that those who benefit from foreign investment are a few capitalist nations or the bourgeoisie, and not the underdevelopment nations or the working class. This leads to aggravate the conflict and contradictions of capitalism, and results in the ultimate demise of capitalism.

With regard to the possibility of which Marxist interpretations mentioned above can be considered to be successful ones in explaining the determinants of worldwide direct or indirect foreign investment, it is hard to come up with a positive answer. Firstly, there is no link between the colony, imperialism, and foreign investment, i.e. the colonisation as a universal phenomenon no longer exists, while the TNCs and their international investments keep growing. They "have become central actors of the world economy and, in linking foreign direct investment, trade, technology and finance, they are the driving force of economic growth" (Sauvant and Dunning, 1993, p. x). Secondly, the concentration of Marxist authors is on investments in LDCs, while a very large proportion of FDI is made among the advanced industrialized countries (AICs) themselves, even though LDCs are greatly affected by TNCs' activities. Thirdly, there is the question of why socialist countries of Eastern Europe, China and Vietnam invited FDI from western capitalist countries, despite Marxist groups everywhere drawing a negative conclusion about it. Finally, why are some socialist countries engaged in outward investment in non-socialist countries (for example, China has outward FDI in several western countries).

B. The Neoclassical Paradigm

It is worthwhile to briefly review these models because they "were dominant paradigms in international economics until the 1950s" (Dunning, 1993, p. 2). The following assumptions are essential for this trade theory: perfections in the markets, and in technology, and the need for certainty.

The determinants of capital investment, or portfolio investment are also discussed based on the same assumptions. Ohlin (1967) assumes that capital is usually immobile between two countries. The movement of capital takes place because there is an exogenous need such as the need of 'reparations or gifts', and the need of some country to 'borrow' and 'import' it. Nurkse (1972) presents a different explanation: capital movements are determined by an endogenous factor, that is, interest rate differentials. A differential in interest rates is derived from the relation of demand and supply conditions between different countries, and generates the 'profit motive' for the investors. Investing in the country with higher interest rates then follows. Analysing the relationship between international trade and international investment, Bhagwati and Brecher and Diaz Alejamdro (1973) concluded that foreign investment is motivated by trade tariffs because foreign capital receives the full (untaxed) value of its marginal product.

The Neoclassical approach has been strongly criticized since the 1960s, as many identify that the market is actually imperfect, rather than perfect (Hymer, 1960; Vernon 1966; Buckley and Casson, 1976; Dunning, 1993). Therefore, the theory with its unrealistic assumptions is not able to interpret the rapid growth of TNEs and cross-border investments.

C. Generally accepted theories of FDI

As pointed out earlier, economists have been trying to interpret FDI in one way or another since 1960. Consequently, various FDI theories have emerged. Among these theories, the more generally accepted ones include:

A) Theory of Monopolistic Advantages,

B) Theory of Product Cycle,

C) Kiyoshi Kojima Thesis of Japanese Model of FDI,

D) The Internalisation Theory,

E) Eclectic Theory of International Production.

A) Theory of Monopolistic Advantages (Steven Hymer)

One assumption of Hymer's theory is that direct investment abroad involves "risk" and "high costs" compared with the local firm because of high costs of communication and of access to information, less favourable treatment from the "government control" of the host country, and the "additional cost" from exchange rate risks.

Why, then, do companies decide to engage in FDI, rather than consider expanding their markets via exporting or licensing?

Hymer explained this by introducing a new concept: the existence of *market imperfections* (Hymer's theory is also known as ' Market Imperfection Theory'). He holds that the model of market perfections is not "relevant". Cross-investment occurs just "because of difference in risk preferences". On the basis of market imperfections, certain "unequal" abilities or advantages are generated for some companies over others. These special advantages include the ability: (a) to obtain production factors at a lower cost than other companies; (b) to command "knowledge or control of a more efficient production function"; and (c) to "have better distribution facilities" and "a differentiated product". Once it secures these advantages, a firm's investment abroad "would be profitable", as the firm can then overcome its disadvantages, and compete against local firms.

Hymer's pioneering work has laid the foundation of the modern theory of FDI as his approach is a departure from the neoclassical approach or the perfect competition approach, and has led and is continuing to lead to follow ups (Ietto-Gillies, 1992), including Buckley and Casson's internalization (1976) and Dunning's eclectic paradigm (1977). Nevertheless, Hymer's model also leaves some questions unanswered. Firstly, it does not provide any explanations about why firms prefer FDI to exporting or licensing, since the firm's special advantage can be exploited by either FDI or exporting or licensing; Secondly, Hymer's theory lacks "a time dimension", for the advantages may exist during a certain period of time and then disinvestment may be required (Robock and Simmonds, 1989). Thirdly, in his model, Hymer addresses direct investments as being concerned with a certain industry in a particular country, which obviously does not reflect the fact that direct investment is a worldwide phenomenon (Ietto-Gillies, 1992). Finally, Hymer's theory does not explain why developing countries that have little advantages are able to engage in outward FDI.

B) Theory of Product Cycle (Raymond Vernon)

The theory of FDI is developed by Vernon (1966) when he uses his approach of *product life cycle* to explain FDI.

Vernon's theory assumes there are three stages in a product cycle: *new product stage, maturing product stage,* and *standardised product stage.* Changes in the stages of a product result in changes of the cost of production and changes of consumers and markets. Consequently, FDI is required.

According to Vernon, new products would originate first in the most advanced country (in his case the USA) because American consumers' average income is far higher than that in any other country, including many Western European countries. This enables American firms to "offer a new product responsive to want at a high level of income..." (p. 46). In the *new product stage*, the product is unstandardised, and the price elasticity of demand is comparatively low because of the "existence of monopoly". Initially, American firms are unlikely to produce the new product abroad because the demand from other countries (advanced European countries where consumers have a high income to afford the new product) can easily be met by exports.

In the *maturing product stage*, the product begins to be stardardised, and "has a high income elasticity of demand". This leads to the possibility of "economies of scale through mass production" and lower costs of production. Thus, overseas investment becomes inevitable due to "the locational force": (a) the demand, in time, in relatively advanced countries such as those of Western Europe will begin to grow rather rapidly because American producers' "labour-saving products" are "satisfactory substitutes for high-cost labour" in western

Europe; and (b) compared to exporting, cross-border production would be more profitable for American companies because "the average cost" is lower than the "marginal production cost plus the transport cost of goods exported from the United States". In addition, western governments "begin thinking of ways and means to replace the imports", in order to generate employment or to promote growth or to balance their trade accounts. As a result, American firms would prefer to make an investment rather than export to these countries.

In the *final stage*, the product is so standardised that the production process tends to be much easier to follow. Therefore, the LDCs are the ideal production location as they offer "competitive advantages" such as low cost labour. In addition, these areas are willing to develop "import-replacing industries", which leads to "a threat of import restriction" to the resource country.

Vernon's model is quite interesting because it offers a number of insights into the process of global competition. Unlike Hymer's theory, Vernon's product life cycle model has a basis for analysis of a time dimension, which reveals the relationship of a certain phase of the product and direct overseas investment, and the motivations of the US enterprises' worldwide relocation. Like Hymer, Vernon also does not explain why US factories take the form of FDI, instead of licensing (Robock and Simmonds, 1989). To explain updated FDI events, there are some other difficulties with this theory, which include: (a) in addition to the US companies, European and Japanese firms, as well as some LDCs' companies, have also engaged in overseas direct investment since 1970 (Buckley, 1985; Ietto-Gillies, 1992); (b) it is not always the case that LDCs would like themselves to be merely sites for foreign investors to produce standardised products, because they too desire more advanced technology so as to catch up with the developed countries (Duan and Yang, 1993).

C) Kiyoshi Kojima Thesis of Japanese Model of FDI

The expansion of Japanese outward direct investment since 1970s cannot be explained by previous FDI theories because Japanese FDI is different from the American pattern (Wu, 1990): (a) Japanese firms that are actively involved in overseas direct investment are those that have no monopolistic advantages in Japan. Instead, these firms are those that have "lost competitive power" in the country; (b) LDCs (in Latin America and Asia) are chiefly recipients of Japanese FDI; and (c) unlike American firms which "may invest in setting up wholly-owned subsidiaries" abroad, a new form of FDI, that is, joint venture, is preferred by Japanese investors.

According to Kojima (1982), Japanese industry invest abroad because: (a) on the one hand, this industry is becoming the investing country's comparatively disadvantaged industry; on the other hand, however, it "is potentially a comparatively advantaged industry in the host country"; and (b) the investing country can benefit from the recipient country's lower production costs, and the host country can benefit from the transfer of efficient technology and management from the source country. The products can be improved back to the home country; or exported to third markets. As a result, this reorganized international division of labour would be beneficial to both nations in terms of increase of production and consumption gains from trade. Also, this type of FDI helps "create and increase international trade" where little of it existed.

With regard to "big Japanese firms" which have "a strong comparative advantage", Kojima claims that the best way for them to expand in the overseas markets is to "continue to export", rather to involve themselves in FDI. He offers negative comments on the American model of FDI and describes it as "anti-trade-oriented DFI"(2) because American direct investment participants are the leading firms with monopolistic advantages. American FDI then leads to: (a) "the loss of international competitiveness"; (b) the loss of profit opportunities at home; and (c) "deterioration of balance of trade, unemployment, and inflation".

Kojima's model accurately presents the characteristics and motivations of Japanese FDI in the 1970s with a new approach, that is, the macro-economic approach (3). It is "quite different

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(2) As Kojima explains, American FDI is "anti-trade DFI", because it substitutes for and decreases international trade; while Japanese FDI is "trade-oriented", because it complements international trade. See K. Kojima, "Macroeconomic Versus International Business Approach to Direct Foreign Investment", *Hitotsubashi Journal of Economics*, No. 23, 1982, pp. 1-19. Reprinted in J.H.Dunning (Ed), op, tit., p. 222.

(3) Kojima claims, "my approach is founded on the theory of international dividion of labour (called the macroeconomic approach), see Dunning, *ibid*, p. 219.

from the existing body of theories" (4); inasmuch as it is an approach which attempts to establish "a theory that integrates international trade and direct foreign investment" and it also provides a two way analysis: (a) FDI behaviour is "strongly influenced by the macroeconomic factors of their (multinationals') own economy"; as well as (b) "by those of the host countries". The latter is largely ignored by the existing FDI theories other than Kojima's. Therefore, it is reasonable to assume that this is why Kojima's approach is considered as one of the more general theories of FDI. However, Kojima's theory seems to lose its validity when Japanese industry with monopolistic advantages undertakes FDI (Buckley, 1985). In addition, the main problem with this model is that it has "no real supporting empirical evidence presented for testing of hypotheses" (Geroki, 1978).

D) The Internalisation Theory

Buckley and Casson (1976) suggest that, in order to explain or predict the post-war growth of MNEs, there is a need to develop a new theory on "a comprehensive theoretical basis", due to the "outdatedness" of previous studies or "the orthodox theories of production and trade". They infer from their 'internalisation' theory that FDI is essential. Internalisation refers to a firm that attempts to create internal markets for transactions with its branches or subsidiaries due to the difficulties and low efficiency of external markets.

Like Hymer, the internalisation approach is based on the postulate of market imperfections, but uses it in a different way (Hymer uses it for explaining the existent conditions of a firm's monopolistic advantages and the incentive for a firm's involvement in FDI; internalisation theorists rely on it for interpreting the necessity of internalisation). The theory then focuses on analysis of intermediate products rather than finished products.

Due to market imperfections, many intermediate products (such as raw materials and semi-

(4) These existing theories are called by Kojima as the "international business approach" such as Hymer's approach, as they are presented basically within the managerial economics of international administration; see Dunning, *ibid.*, p.219.

finished products) and particularly knowledge based products (such as know-how and management skills) are difficult to transact into external markets because: (a) the relationship between sellers and users is unlikely to be certain or reliable; and (b) the transaction cost is relatively high. Hence, the benefit to the firm can be generated from internal markets between the firm and its branches by internalisation because internalisation enables the firm: (a) to maintain stable and reliable relations; (b) to minimise the transaction costs; and (c) to improve its efficiency via transfer pricing.

FDI occurs when the firm extends its internalisation across national boundaries. The internalisation theory is seen by its authors as "a long theory, and systematically develops the theory" (Ietto-Gillies, 1992, p. 115) after their attempts at integration of the various strands of theory of the multinational firm. Indeed, this theory provides an explanation of: (a) how the advantages are generated, and (b) why firms invest in these advantages rather than in other types of assets (Buckley, 1985).

It is generally agreed that this theory is very successful since it systematically develops the theory of international production (Ietto-Gillies, 1993; Taggart and McDermott, 1993). Its major drawbacks are: (a) the determinants and importance of the firm's involvement in multinational activities have not been sufficiently analysed, as internalization is seen to be the by-product of the search for minimum cost production site and the internalisation of the markets (Kogut, 1983); and (b) little explanation of why a particular FDI location is selected. Such an explanation is needed because locational decisions play a strategic role and "are more likely to be prominent" elements in a firm's decision on international production (Ietto-Gillies, 1992).

E) Dunning's Eclectic Approach

In his search for an eclectic theory of FDI, Dunning briefly reviewed previous studies of the industrial organisation approach (such as Hymer's theory), and the location approach (such as Frank Southard's work on American industry in Europe) (5). In Dunning's view (1988), the

(5) This book, American Industry in Europe was published in 1931 (Boston: Houghton-Mifflin.

first approach explains *"why"* international production occurs by "identifying the characteristics of MNEs"; and the second approach answers the question of *"where"* the investment location is by analysing "the main factor leading to US investment in Europe and Canada". However, neither of them is fully satisfactory because they were put forward independent of each other. It is Vernon's product life cycle theory that covers both "why" and "where", and it "treated trade and investment as part of the same process of exploiting foreign markets" (p. 186).

Because "the same variables were being increasingly used to explain both trade and non-trade investment", it is necessary to formulate a single theory which can explain both foreign investment and foreign trade, "synthesise trade and investment theory", as no attempt (including Vernon's) was made until 1972 when Dunning took the initiative and wrote a paper entitled "the Location of International Firms in an Enlarged EEC" (6). His further efforts led to an eclectic paradigm based on three determinants: (a) **O**wnership advantages; (b) **L**ocation advantages; and (c) **I**nternalisation advantages (the ***OLI*** model).

Ownership advantages consist of: (a) benefits the firm can obtain from its size, monopoly power, and better resource capacity and usage; (b) benefits derived from the enterprise's ability of operation and management (such as know-how, organizational and marketing systems).

There are two types of location advantages. The first type accrues from 'attractions' - special location advantages provided by the host country, such as cheaper labour forces, market for the products and the government's preferential policies. The second one is generated from 'limitations' at home - the investors are forced to decide on direct investment abroad because they suffer from disadvantages in their own countries such as a small market for their products, lack of raw materials, higher production costs, higher transportation costs of exports and host country's protectionism.

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(6) This paper was published by Manchester Statistical Society in 1972, and "suggested that only by considering trade and foreign production as alternative forms of international involvement in terms of ownership and location endowments could the economic implications of the UK joining the EEC be properly evaluated.

Internalisation advantages refer to the benefits that the firm can secure by using its ownership advantages internally - between the parent company and its subsidiaries.

Thus, Dunning believes that *OLI* model covers three major aspects of FDI activities: *O* deals with the "*how*" of MNEs' activity; *L* is concerned with the "*where*" of production; and *I* explains the "*how*" of involvement.

Further, according to Dunning, the importance of the role played by *O, L* and *I* in his model is different, which determines the firm's choice of international trade or direct production abroad. Of the three advantages, ownership advantages are essential. An enterprise is unable to engage in FDI without any ownership advantages. If, however, a firm has only ownership advantages without the other two, it will benefit from licensing rather than FDI. If a factory has advantages of ownership and internalization but not location advantages, it will prefer to sell its products by exporting. FDI occurs only when a firm has all these three types of advantages. The combination of ***OLI*** not only makes the firm's FDI possible, but it also decides the firm's selection of FDI location or destination, that is, "countries with low labour costs and/or natural resources tend to have an above average inward investment because of their locational attractions, while rich industrialized countries have an above average outward direct investment, because their factor endowments favour mobile ownership advantages" (1980, p. 288).

Dunning's OLI model is so successful that it is widely used in FDI research in the world, including international business conference papers, dissertations, postgraduate theses, relevant publications, and university textbooks (Ethier, 1986). Nevertheless, it is doubtful, when Dunning claims, "all forms of international production can be explained" by his eclectic paradigm, for a single theory of FDI is unlikely to cover all the characteristics of FDI (Grosse and Kujawa, 1992). For example, this model can explain neither the case of some developed countries that are heavily involved in both inward and outward FDI, nor the fact that it is the developed countries, not the developing countries which have the largest share of inward FDI (Ietto-Gillies, 1992). In addition, the macro-economic issues of FDI are largely ignored and there is no thorough integration of some macro-economic issues and the theory of FDI. These macro-economic issues or effects may cover the political complexities in the MNEs's activities. Moreover, it is arguable that if ownership advantages play a necessary role in determining the firm's investment, as internalisation explains why firms exist in the absence of such advantages (Buckley, 1985) and firms in some developing countries without ownership advantages actively accept FDI.

2.3.2. From the Viewpoint of China's FDI Theory

The study of FDI in China began in the late 1970s as a result of the country's open door policy and inviting western FDI to set up ventures in the country. Accordingly, research on FDI, especially on China's inward FDI became an important issue in China.

Some independent Chinese scholars, particularly those who are based in western countries, have tried to interpret western FDI in China in the light of the existing well-known FDI theories, of which the more popular one is Dunning's eclectic paradigm. Others have used Dunning's framework to test FDI cases in China, such as Zheng (see Box 1):

Box 1

Stylised Fact about FDI Theory and the Case of China's Inward FDI

What must LDCs do to attract manufacturing FDI? Dunning suggests that multinational enterprises (MNEs) will only invest in a foreign location if the latter offers certain location-specific advantages (LSAs) in terms of resources and facilities which make it possible for the MNEs to better explore their firm-specific ownership advantages. In this context, market growth, availability of material supplies, physical infrastructure, and efficient administration are among the most frequently cited LSAs for host LDCs.

The question how these and other LSAs can be generated, however, has received little attention. This paper documents and interprets the case of Guangdong province in south China, where 15 years ago a programme was launched to implement the central government's policy of encouraging direct foreign investment to develop the province's economy. The policy has been regarded as a relative success among the many fields that the Chinese economic reforms have affected, and in comparison with similar policies in other LDCs.

Source: Zhang, 1995.

Other authors have attempted to modify Dunning's model and view FDI in China as a special one. For example, Chen (1994) points out that FDI in China implies that, in absence of location-specific advantages, ownership advantages cannot be explained (see Box 2):

Box 2

Stylised Fact about FDI Theory and the Case of China's inward FDI

We have shown above that the theoretical literature on the multinational enterprise emphasises three elements in the decision of a firm to invest abroad. These are the ownership-specific advantages it possesses, the location-specific advantages it seeks abroad and its ability to internalise operations (Dunning, 1981; Hood, 1979).

It is obvious that foreign firms investing in China possess ownership-specific advantages, including managerial and technical know-how, and marketing skills. They are also able to internalize operations. In the absence of import restrictions in China, exporting may be the best method for foreign firms to exploit the Chinese market. However, shortages of foreign exchange constrain imports in China. In technology licensing arrangements, the Chinese ability to absorb the technology licensed by foreign firms is the main problem existing with licensing agreements.

The principal reason for direct investment as opposed to other forms of foreign participation in China appears to be the location-specific advantages provided by China. The ownership-specific advantages possessed by Foreign firms represent a necessary by only a partial reason for FDI (Hood, 1979). In the absence of location-specific advantages, ownership-specific advantages can not be exploited. The decision for foreign firms to locate their production process in China rather than exporting or licensing is determined by the Chinese location-specific advantages. The Chinese location-specific advantages are the huge potential domestic market, cheap labour and land, and the endowment of certain raw materials including coal and oil. It is direct investment that provides an opportunity for foreign firms to exploit their ownership-specific advantages and the Chinese location-specific advantages.

Source: Chen, 1994.

Liu argues, "the peculiar features of China's inward FDI" have challenged the dominant FDI approaches, including Dunning's eclectic paradigm, as they do not readily and satisfactorily explain some of these peculiar features. Therefore, an extended analytical framework based on the existing dominant FDI theories is required (see Box 3).

Box 3

Stylised Fact about FDI Theory and the Case of China's Inward FDI

The first dominant theory on FDI determinants is the transaction cost approach, such as Buckley and Casson's internalisation theory. The second dominant theory is Dunning's eclectic paradigm. Dunning's main contribution to the theories of FDI is that he draws on several important approaches to set up his own "general" paradigm.

Some problems with these two approaches arise when looking at some peculiar features of China's inward FDI:

(1) These approaches suggest that: firms which launch FDI take the initiative in the whole process. In the case of the eclectic paradigm, firms with specific advantages perceive it profitable to internalise their use of these advantages. The transaction-cost or internalisation approach assumes that firms with the sole purpose of profit maximisation have an incentive to bypass the imperfect for intermediate products. Therefore, the two approaches are of two-pole analysis type: *the investing firm* internalises some advantage by looking for and investing in *a good location.* But the fact of China's inward FDI shows that the Chinese party often behaves as the initiator. The fieldwork conducted by the present author indicates that a particular FDI project could be originated by the Chinese government, Chinese establishments registered abroad, local Chinese firms, or individual Chinese.

(2) Much of the literature on the traditional transaction-cost approach predicts that, if there is no foreign restriction, foreign business will generally prefer wholly foreign-owned enterprises to joint ventures, because the former entry mode involves lower transaction costs. Again, China's inward FDI behaves differently. Between 1979 – 1989, wholly foreign-owned enterprises accounted for merely 7 per cent of the total. Joint ventures, either equity or contractual are so popular in China that they have become the basic entry mode.

Thus, a FDI project usually involves three poles: Foreign firms, host environment, and local firms; and in some cases, a local firm can be very enthusiastic about inviting the FDI.

Source: Liu, 1994.

Dunning himself (1993) is aware that some relevant issues including China's inward FDI "remain unresolved" when he focuses his attention on "the opening up of Central and Eastern Europe and the People's Republic of China to FDI" (p. 9). However, to resolve this issue, Dunning considers this only needs "minor modifications" to either the partial FDI theories or the general paradigms. What sort of modifications is needed? Be these minor or major? Dunning neither specifies nor makes the modifications. Nevertheless, we have seen modifications done by some overseas Chinese scholars (Box 2 and 3). We also need to examine the issues taken into consideration by the Chinese government when inviting western FDI to the country.

Why does FDI take place in China? There have been many discussions on this issue in China. However, a recently published book (1995) entitled *Principle of China's Utilising Foreign Investment* (*PCUFI*) answers this question rather systematically. A typical picture of China's FDI theory can be obtained from this book.

In general, China's FDI theory is based on the Marxist approach, that is, an analysis of political systems and class relations between the investing country and the host. *PCUFI* claims that direct investment from western countries is thought by the Chinese to be capitalist in nature and thus opposed to socialism. While China encourages FDI, it should always monitor the behaviour of foreign investors, because "the basic aim of western investors is to reach profit levels that may not be achieved in the investors' own countries" (p.53), and "western investors exploit developing countries via FDI, which is the price developing countries have to pay" (p.28). What is the reason then for China to permit capitalist FDI to enter the country, rather than to keep it away?

Firstly, according to *PCUFI*, this is because the Chinese government is confident FDI will not be harmful to China's "socialist construction". Although an increasing amount of FDI is pouring into China, the country's economy is dominated by the "socialist elements". Take Shenzhen for example (one of the five Chinese SEZs), where the proportion of FDI in the local economy is much higher than in any other area of China. The public ownership system is still the dominant element, because FDI accounts only for one quarter of its economy. Hence invested enterprises are well monitored under China's political and economic requirements. Therefore, there is no need for concern about western FDI in China.

Secondly, introducing FDI to China is regarded by these authors as a deal between the Chinese government and the investors, while the Chinese side is perceived to be the winner. On the one hand, foreign investors are keen to make direct investments in China because the country has something which can 'be taken advantage of' by them: (a) China is the world's biggest potential market with over 1.2 billion people, which enables western investors to sell their products in this attractive market; (b) China has abundant cheap labour and is rich in natural resources, which are the major factors for foreign enterprises to locate FDI there; and (c) in the final analysis, because of the nature of capitalism, China has to allow western investors to 'exploit' the country, in order to receive FDI. On the other hand, western investors are also "taken advantage of" by the Chinese government, because the country can benefit from western advanced technology and management skills, as well as taxation and employment through FDI. "Consequently, socialist country and its people will benefit more than capitalist investors" (p.23), as western FDI is seen as a major means of enabling the country to improve its productive forces, and eventually to strengthen the socialist system.

Unlike traditional Marxist interpretations which see foreign investment to be unfair as it helps transfer wealth from poorer to richer countries, the Chinese Marxist approach outlined above takes a positive view. FDI in China is considered as a more efficient way to "catch up" with advanced capitalism, for socialism needs to prove that it is superior to and grows faster than capitalism. As Deng Xiaoping said, "the central task for socialism is to expand the social productive forces. To accomplish this task, we should take advantage of any means, including the use of foreign investment and introduction of advanced technology" (p.21).

More positively, *PCUFI* concludes that China's introduction of FDI is based on a long-term strategy, rather than a short-term plan, as: (a) China has learned a big lesson from the adoption of the "close door" policy from 1949 to 1978, which is the major reason why China remained backward for such a long time; (b) China's "open door" policy is a reflection of the new international climate – the world of today is an open world, and open world leads to a new international division of labour, which transforms every single national economy into one interrelated economy. Therefore, "it is impossible for a single nation to become an advanced country without opening its doors to the outside world" (p.25), and China's "utilising FDI has not only become an inevitable trend, but also a long-term policy" (p.26).

With regard to the well-known FDI theory, this book suggests that it is useful for China to know the intentions of foreign investors in China. This helps China to deal with different foreign investors in different ways. The comments on prevalent FDI theories made by these Chinese official authors are as follows:

> If the investor is a transnational enterprise with monopolistic advantages, the recipient country should fully make use of the enterprise, in order to improve the host country's economy. Meanwhile, the country should take some measures to restrict TNEs' monopoly activities, in order to protect the host country's domestic industry - (learn from Hymer's FDI theory).
>
> If the firms aim to transfer their traditional/declining industry or sector to the host country, the local government should make a careful analysis in order to find out if the project of investment is still useful in terms of the domestic industrial development plan, and reject the project which contains low-technology or may cause environmental problems such as environmental pollution - (learn from Kiyoshi Kojima's FDI theory).
>
> The same product at the same time could be in a different stage in terms of the product cycle, because each country is at different levels of economic and technological standards. When a product is in the maturing stage in the developed country, it is possibly in the new stage in the developing country. It is therefore worthwhile for the developing country to introduce the product and the technique of its production, and then by adding other advantages the host country has, such as location advantages, a new and promising product and industry will emerge in the recipient country - (learn from Vernon's FDI theory).
>
> Both foreign investors and Chinese partners should be able to reveal their advantages and contribute them to the new firm. Foreign investors should provide capital, technology, and management skills to the host country; while the host country should make great efforts to offer special and attractive locations to the foreign investors - (learn from Dunning's FDI theory).

The book presents several characteristics of China's FDI theories including:

1. China's attitude towards FDI is greatly affected by the Marxist approach. It would be a mistake to ignore this basic point. Fundamentally speaking, western FDI is explained in China in terms of its political character.

2. Instead of rejecting FDI, it is thought to have a positive impact on socialist construction. Therefore, China opened its door and welcomed FDI. However, the government tries to take a decisive position towards FDI, as President Jiang Zeming states: "We must gain the initiative in FDI; otherwise, FDI may go wrong" (p.3). This explains why the Chinese are keen to attract FDI by organising local fairs, even by going abroad, as well as by opening new areas (in terms of regions and industries).

3, Unlike western FDI theories, China's FDI theory embodies official policy. It is created, interpreted and dominated by the Chinese authorities, rather than by economists. Also, this official theory directs FDI practice in China. This helps us to understand the way China deals with FDI and the pattern of China's FDI development. But can China's FDI theory be considered as one of the general theory for explaining FDI activities worldwide? Not quite because these are some major limits of the approach:

(a) Based on how a FDI recipient country, or a developing country considering inward FDI, this theory pays no attention to other important FDI movements, such as FDI between developed countries. There is limited reference to well-known western FDI theories, but it is only used to discover the motivations of the MNEs, in order to help the Chinese government to determine the countermeasures to deal with them in advance.

(b) The Marxist approach which is used as the framework by the Chinese is not generally accepted by the rest of world except perhaps by a few other socialist countries such as Vietnam and Cuba.

(c) All the Chinese analysis is focused on the macro level, such as the political relationship between socialist recipient countries and capitalist investors, the strategy of the host country vis-à-vis the investing countries. Micro analysis from a business angle such as analysis of concrete motivations of both foreign companies and Chinese partners (in the case of joint ventures) to set up a FDI project is largely ignored.

Therefore, it is fair to conclude that China's FDI theory can be regarded only as a theory explaining FDI in China from the point of view of Chinese officials, or it can at best be regarded as a candidate for a partial FDI theory with a modern Marxist approach, as it directs China's FDI practice. It may also represent some of the.socialist countries' position towards FDI.

We shall use Dunning's eclectic theory to see what "modifications" need to be made so as to allow his general FDI theory to satisfactorily explain China's FDI after its theory has been discussed. But unlike China's FDI theory, which requires further analysis on micro issues, Dunning's approach lacks macro analysis.

Firstly, as Liu points out, it is not always the case that investing firms take the initiative, and it is true that the Chinese side often behaves as the initiator for reasons discussed earlier. More importantly, the Chinese government has never given up gaining the initiative for FDI, which means it is China, not the western investors, which decides why FDI is needed for the country, what kind of FDI it prefers, and where the FDI should be distributed (industrial areas) and located (locational areas),

Secondly, as Kojima (1982) suggests, an FDI model should pay attention to "macro-economic contribution of FDI", to "increased employment, transfer of technology, orderly industrialisation, growth of GNP, and balance of payments in both investing and host countries" (p. 230). China's FDI theory implies that the strategic reasons for the country to introduce FDI include: (a) overcoming a shortage of funds; (b) gaining access to the international market; and (c) raising the tax revenue for the Chinese government.

Finally, China's FDI theory is a special one which sees FDI from the viewpoint of a recipient country. The global dominant FDI theories are based on the analysis of the motives of investors. It is therefore worthwhile for Dunning's general FDI theory to consider FDI from a different angle, in order to enable his approach to explain both outward FDI and inward FDI.

2.4. How does FDI take place? - (The Forms of FDI)

In addition to the questions of what FDI is and why FDI takes place, how FDI takes place is another significant issue, which may cover several aspects, such as how overseas investors use their ownership advantages – by internalisation. However, the focus of the discussion here will be on the different forms of FDI; in other words, the modes of the firms' involvement in international production.

2.4.1. The Worldwide Principal Forms of FDI

FDI is usually divided into two major forms - traditional forms and new forms - in terms of the development of international business (Buckley, 1985; Ietto-Gillies, 1992).

A wholly-owned foreign subsidiary (WOFS) is considered to be the traditional form of FDI, in which a parent company has 100 per cent ownership. This traditional type is based on the belief that no outside entity should have an impact on corporation management (Crinkota, Ronkainen, 1990). This enables the head office to effectively control its subsidiary, to transfer its advantages (such as capital, technology, and skills) through the internal market, so as to avoid market uncertainties, to reduce external interference, and to undertake long-term planning (Buckley and Casson, 1976; Buckley, 1983).

New forms of FDI include equity joint ventures (EJVs) and 'fade-out' agreement, as both the forms require that foreign investors acquire 'equity stake' and 'control'.

The term (equity) joint venture has been defined in various ways. At times it is taken to mean any joint relationships in a limited time. Friedmann and Kalmanoff state (1986), a joint venture is 'a type of association which implies collaboration for more than a very transitory period'. It is sometimes defined as a commitment for more than a very short duration, of funds, facilities and services, by two or more legally separate interests to an enterprise for their mutual benefits (Tomlison, 1970). Having identified four properties of joint ventures, Sukijasovic (1970) defines it as a community of interests involving doing business in common, the sharing of profits, the sharing of business risks and losses and longevity of cooperation.

Joint ventures may be undertaken by two or more different foreign firms without any local partners (Grimade, 1989). They are, however, most likely to be jointly set up by foreign firms and local firms, which is particularly the case in the developing countries. Joint ventures can also take different ownership patterns. For example, one of the partners may hold a majority share, a minority share, or an equal share in ownership. The extent of each partner's control over the equity joint venture then depends on the percentage of the equity stake of each.

As one of the new forms of FDI, EJVs have been emerging increasingly for several reasons:

(1) *As a matter of necessity:* (a) a single firm is unlikely to be able to engage in a large, capital intensive, long lasting investment or it may be unwilling to take the risks entailed in this kind of investment. Partners for joint ventures are therefore required in order to spread the risks. The exploration of resources deposits is an example of this kind of investment; and (b) foreign investors acquire important knowledge of the local market when transferring their knowledge to the host country (Dunning and Zheng, 1991) because by jointly setting up an EJV with local partners, foreign investors can easily acquire the relevant knowledge from their local partners.

(2) *As a condition of entering a local market.* The developing countries favour the EJVs because they believe that they can successfully learn the foreigner partner's skills if they become partners in the venture. Because of this, they often include local ownership participation as a condition for setting up EJVs with foreign investors.

Regarding WOFS and JVs, some scholars believe that WOFS is the "first best" form due to its importance for foreign investors in terms of outright control of production (Casson, 1987). In practice, however, there is an increasing recognition of the fact that JVs often play the "first best" role in an investing firm's strategy (Dunning and Cantwell, 1982; Killing, 1983; Beamish, 1984; Harrigan, 1985; Hladik, 1985), and there is a very strong tendency that more and more TNEs will take the form of JVs (Buckley, 1985).

'Fade-out' agreements - a new form of FDI - are primarily used in the Latin American countries. They are the host country's 'planned divestment' agreement which involves MNEs in liquidating the investment and selling the stake to local interests, usually the governments (Hirshman, 1972). These agreements are based on fixed term (normally between 5 and 10 years) in order to gradually reduce tension in economies where a high degree of foreign penetration is viewed as a political problem (Buckley, 1985).

Contractual joint ventures (CJVs) have also emerged as a new form of foreign investment, Wright (1981, p. 500) defines it as

> 'a risk-sharing venture in which no joint enterprise with a separate personality is formed. It is partnership in which two or more companies (or a company and a governmental agency) share the cost of an investment, the risk and the long-term profits. The contractual joint venture may be formed for a particular project of limited duration, or for a long-term cooperative effort, and the contractual relationship may terminate once the project is complete'.

However, as already noted, the status of CJVs - if they belong to FDI or a form of other investment - still remains uncertain because they are sometimes considered to be FDI by international organisations (such as the World Bank), as well as by some countries (such as China), and at other times are not regarded as FDI by theorists in terms of the globally accepted concept of FDI. The reason for accepting CJV as a part of FDI in China may be that CJVs and EJVs have much in common (Lin, 1987). For example, both of them require their partnerships to involve joint management, and joint operation, and to share the cost of an investment, the risks and the profits. The major reason cited for not accepting a CJV as a FDI is that, unlike EJV, WFOE, and 'fade-out' agreements, CJV involves no equity stake. CJVs are discussed here as they are regarded as one of the major forms of FDI both by China and world organizations.

2.4.2. The Forms of FDI in China

As shown in Table 2.1, four FDI categories are recognised in China: (a) EJVs; (b) CJVs; (c)

WFOEs; and (d) joint exploration (7). Of these four forms, joint exploration plays only a minor role in China's inward FDI, usually less than 1 per cent in terms of the annual total FDI value, and so is excluded in this study. The discussion will therefore centre on the key FDI forms in China, that is, EJVs, CJVs and WFOEs which are also known as *San-Zi-Qi-Ye* (three types of foreign funded enterprises).

A) Equity Joint Ventures

Unlike a global definition of JVs, which also includes the category of two or more than two different investors investing in a third country without a local partner, the Chinese definitions of JVs refer only to two groups of partners: the Chinese partner on the one side, and the foreign partner on the other. This is specifically termed as *Sino-foreign joint ventures.*

In order to avoid domination of foreign sector enterprises by western investors, EJVs were the Chinese government's first choice of FDI form in China, since the government believed that western investors might transfer some undesirable western political and ideological trends along with the transfer of their technology to the country, ideas which are seen as harmful to China's socialist construction (Casson and Zheng, 1993; Chen and Raftery, 1994). EJVs also offer a way for the Chinese to share the "control" over the venture with foreigners, and thus keep a watch on their western partners' behaviour. In addition, Chinese officials usually try to secure a dominant position for the Chinese partners by ensuring that the Chinese side holds a majority or at least a fifty-fifty ownership of the EJVs, although, in theory, the foreign side can hold up to 99 per cent of the equity stake in the venture (Pearson, 1991).

Furthermore, it was required by the Joint Venture Law (1979) that "the Chairman of the board should be appointed from the Chinese side", whatever the proportion of equity stake the

(7) Joint Exploration is a type of Sino-foreign cooperation in the exploration and development of offshore oil and gas resources. Under this type of arrangement, foreign investors agree to launch exploration projects at their own financial risks. Once petroleum is discovered, both parties make investments to develop the find jointly.

Chinese partner had in an EJV; the Chinese described the Chairman as the legal representative of the EJV and the general manager as the person who implemented the decisions of the board and administrated the day-to-day operations of the enterprise (Ho and Huenemenn, 1984). That appeared to be unreasonable, as in most EJVs outside of China, control over decision making in an EJV is directly tied to the division of ownership between partners, namely, the partner with majority ownership has the majority of votes on the board of directors (Lin, 1987, 1995).

Finally, EJVs are believed to be the best means to introduce western advanced technology and management skills because it is based on long-term co-operation (usually between 15-30 years), and requires that 'partners shall share the profits, risks, and losses in proportion to their respective contribution' (Chu and Dong, 1984). This means that the foreign investors not only have to invest their funds, advanced technology, and best knowledge, but also have to contribute their loyalty to the ventures in order to make the co-operation profitable; the Chinese partners can thus acquire advanced western technology since they jointly operate the ventures with western investors.

The geographical location of an EJV was also one of the careful political considerations of the Chinese government. Until 1984, only limited areas such as SEZs were selected for EJVs, as the government wanted to gain some experience before allowing other areas to establish EJVs.

Foreign investors on their part chose EJVs in the early years of China's reform for several reasons:

1. Other forms of FDI such as WFOEs were not permitted in China until much later;
2. They needed the help of their Chinese partners to overcome specific obstacles to operating within the country, for the business environment is not only different from that in developed countries, but also from that in many other developing countries. This included differences in political and economic systems, as well as differences in management system and governmental administrative procedures (Chen and Raftery, 1994).

It is unfortunate that EJVs have not grown as rapidly as the government expected because some requirements of the China's joint venture law did not follow the international practice, to which western investors were accustomed (Li, 1990). Secondly, the regulations to implement EJV law were not immediately issued until late 1983, "leaving potential investors somewhat uneasy about what the law actually required or permitted" (Shapiro, *et al,* 1991). As a result, a very flexible form of FDI, CJVs, took the lead in China's FDI development until 1986.

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B) Contractual Joint Ventures (also known as Cooperative Enterprises)

For reasons analysed above, CJVs may be described as a quasi-form of FDI. In China that particular model of CJVs was developed by the Guangdong provincial government, which is the first area in China to practice an 'open door' policy. It has more than 70 per cent of total CJVs in China (Lin, 1987).

As the most attractive form of China's FDI, CJV have the following features:

1. The Chinese investors make their contribution in a rather flexible way - by providing the right to use a site, the right to exploit resources, plant and equipment, and services of labour as a condition of co-operation with foreign investors. They do not necessarily contribute cash. Foreign investors make an investment by providing capital, technology, equipment and materials as the conditions of co-operation with the Chinese side.

2. The investments contributed by each party to the ventures are not computed in shares. Input in kind, rights or interests need not be converted into cash or counted in terms of the ratio of investment. The portion of investment contributed by each party to the enterprise is not stipulated either.

3. The responsibilities, rights and obligations of each party to the CJVs, including investment, co-operative conditions, distribution of profits, share of risks

and losses, are stipulated by a contract after consultations and negotiation with each party to the venture.

4. The contract signed by most cooperative enterprises stipulates that the foreign partner shall first retrieve investment upon the expiration on the terms of the venture. Therefore, the contract, generally speaking, also stipulates that all assets shall be owned gratuitously by the Chinese partner.

5. The first type of CJV (also called 'pure form') is more flexible than the second type (Burn, 1994). Each party to this type of venture co-operates as a separate legal entity and bears its own liabilities. The second type has a feature of EJVs: the parties form a limited-liability entity with legal-person status, which means that participants of the CJVs rely on each other much more than the first type, but more flexibly than in the EJVs, because foreign investors still enjoy other factors of flexibility than a CJV offers. This includes the ability to repatriate his original investment prior to the expiration of the ventures, and to distribute profits disproportionately to the value of his capital contribution. Most CJVs in China belong to the second type.

With such flexibility, CJVs certainly suit both Chinese partners and foreign investors. For Chinese partners, it is a way to learn western technology managerial expertise from their foreign partners without investing money, as most of them lack it. Therefore, the Chinese can become the partners of CJVs by contributing what they have – normally the right to use a site, plant and the services of labour. This is called "make do with whatever is available" (Lin, 1987).

Most foreign partners initially preferred CJVs to EJVs as they were concerned about the uncertainty of investing in China immediately after it launched its open door policy. The CJVs provided a way for them to test the investment climate in China, since this form is project specific and short-term in nature in comparison with long-term and wide ranging equity form of the EJVs. This feature of the CJVs is found attractive by many foreign investors, particularly those from Hong Kong, whose businesses are mainly small and medium sized and are labour intensive. Thus, many small sized, short-term, and quick returns projects were set up via the CJVs route. However, as time passed, some disadvantages of

Chinese-foreign co-operative enterprises surfaced, such as increased conflicts because of each party's pursuit of short-term interests, for no laws relating to CJVs were formed until 1988. Meanwhile, an increasing number of foreign investors realised that China was fairly safe for long-term investment. According to the Economic Intelligence Unit, China was generally assessed to be a less risky political and economic environment (*The Economist*, 21 May 1994). In addition, the Regulations and the Laws of the Chinese-Foreign Co-operative Enterprises which were issued later were marked by Chinese characteristics. The CJVs were not put on an equal footing with the EJVs for gaining access to materials, financing and tax benefits. The Regulation for the Implementation of the Law of the People's Republic of China on Chinese-foreign Equity Joint Ventures were earlier issued in 1983; they were chiefly based on international practice which was easier for foreign investors to get accustomed to. Consequently, Chinese-foreign cooperative enterprises have been overtaken by Chinese-foreign Joint Ventures since 1986 in terms of the growth rate of the annually actual foreign investment (see Table 2.3):

Table 2.3 Annually Actual Foreign Investment to Foreign-Invested Enterprises

US$ 100 millions

Foreign-invested Enterprises	1979-82	1983	1984	1985	1986	1987	1988	1989	1990	1991
EJVs	0.98	0.74	2.55	5.82	8.05	14.86	19.75	20.37	18.86	22.99
CJVs	5.32	2.27	4.65	5.85	7.94	6.20	7.80	7.52	6.74	7.63
WFOEs	0.40	0.43	0.15	0.13	0.16	0.25	2.26	3.71	6.83	11.35

(*Source*: China Foreign Economic Statistics, 1992, Beijing)

C) *Wholly Foreign-Owned Enterprises*

As the name suggests, WFOEs are set up and operated solely by foreign investors. They were closely watched by the Chinese government. Firstly, they were permitted to become one of the forms of FDI one year later (1980) than were joint ventures (1979), and were allowed to be set up in only four SEZs until 1984, because an WFOE is thought to be beyond the control of the Chinese partner. Secondly, they had to prove that they were investing advanced machinery and technology or had the ability to export all or a large portion of the production. Thirdly, unlike joint ventures, they were not allowed to be involved in areas like publishing and retailing. However, WFOEs have been encouraged by the Government since 1986, when reductions in FDI occurred (Casson and Zheng, 1991), and since 1992, when a growing number of large sized MNEs have been contributing to China's inward FDI. Many of them prefer to set up WFOEs; this, the Chinese government believes, is a good opportunity to improve its inward FDI because these firms transfer the most advanced technology (Chen and Raftery, 1994). As a result, WFOEs have increased dramatically and they have overtaken CJVs since 1990, and have grown faster than the EJVs (see Table 2.3). All this differs from the worldwide tendency mentioned which is that the EJVs are growing faster than the WFOEs.

2. 5. Conclusion

The concept of FDI in China has undergone a process of introduction, creation and development.

The stage of introduction of the FDI concept is from late 1978 until the early 1980s following the permission given to western FDI to enter China. Because the term FDI was new to the Chinese at that time, the focus was on the introduction of western or worldwide basic FDI concept and theory, which can be seen from a lot of relevant Chinese publications. From the theoretical perspective, western FDI concept was mainly introduced in terms of the Marxist approach, but there was no systematic Chinese official FDI theory available; in actual practice, western FDI activities were very carefully dealt with, being limited to a few regions (such as SEZs, and some major coastal cities), and in the forms of EJVs and CJVs.

In terms of concept creation, China's FDI interpretation was created between late 1980s and 1995 when FDI began to play an increasingly important role in the Chinese economy. This period also saw China's FDI becoming very topical not only in China but also all over the world. In 1995, the book, *Principles of China's Utilising Foreign Investment* was published by the Chinese government, which systematically analysed China's inward FDI within a Marxist framework, but in a flexible way, leading to the formation of China's own FDI concept.

The stage of FDI concept development appears from 1995 onwards, because FDI has been dramatically growing since the early 1990s. An increasing number of industries are being thrown open to FDI, such as retailing, insurance and banking. New forms of FDI like BOT (Built, Operation, Transfer) and holding co-operation came into existence. In addition, new FDI policies were issued in 1995 and 1996 respectively, aiming to balance its introduction of FDI between its quantity and quality based on the national long-term economic development strategy, and to balance its FDI policy between the governmental requirements and the requirements of international organizations, such as World Trade Organisation. In other words, on the one hand, China intends to control as well as to develop inward FDI in an independent way; on the other, the country will have to move closer to international practice, as it was seeking and now is a member of WTO. We will see continuous changes in the Chinese concept of foreign direct investment.

CHAPTER 3

Methodology Issues

3.1. Rationale for the study

It has been many years since China introduced its "open door" policy in late 1978, thereby allowing direct inward investment from Western economies. During the whole period, the development of history of China's foreign direct investment (FDI) has undergone several significant changes as a result of the changes to or adjustments of China's policies, particularly with regard to FDI (Brecher, 1995).

A number of previous studies have investigated these changes. Some of the work has suggested that the history of inward China's FDI development can be divided into several periods in terms of significant changes. These changes have been described variously as "stage", "phase", etc., implying that the situation with regard to FDI into China has changed over time (Fan, 1992; Hou, 1993; Hu and Ji, 1994).

However, this research has given no special attention to analysing the changes. Many questions therefore remain unanswered. For example, what criteria are applied in defining terms such as "stage" or "phase"? What are the causes and effects of China's policy changes? And importantly, what is the significance of looking at this issue?

It is to answer these kinds of questions that the current research study has been undertaken. It is hoped that, as a result, the study will lead to a greater understanding of the whole concept of China's FDI policies and that, in particular, it will lead to benefits for a number of key stakeholders:

(1) for FDI participants, including foreign investors and Chinese partners, how to assess, anticipate and adapt to China's particular FDI environment; and

(2) for FDI decision makers within China, including Chinese central and local governments, the gaining of an in-depth comprehension of the actual effects, both positive and negative, arising from the changes of FDI policies.

3.2. Research approach

In this study, the author attempts to use the world-wide accepted FDI concept as a framework to explain, analyse and compare it with FDI in China. According to this framework, the author found that FDI in China has many of its own characteristics in terms of its definition, theory, and form. As a developing as well as a socialist country, China needs to introduce FDI as a means of improving its economy. However, it also wishes to maintain control over FDI under its socialist principle (Pearson, 1991). As a result, FDI is treated in China as both a political and economic deal with Western investors. The definition and theory of FDI are directed by Marxism but with Chinese characteristics. As such, the pattern, form and development of FDI in China are controlled by the Chinese government. However, from time to time - particularly in the 1990s - China seems to have been forced to follow international practice in order either to meet the requirements imposed for membership of international organisations such as the WTO, or to introduce more FDI.

With regard to the level of the study of China's FDI, a research review has shown that the majority of publications focus on the micro level, namely, on the level of foreign-invested enterprises. Of these publications, the majority have examined such issues as how to set up a foreign-invested venture and the motivation of foreign investors' involvement in FDI in China. Conversely, less attention has been paid to analysing the problems of performance and management of such ventures (Kaiser, Kirby and Fan, 1996). Research at the macro level - both nationally and locally - has not received proper attention, therefore some questions are largely ignored. For example: why and how has China introduced change to its FDI policy; and the extent to which these changes have impacted on foreign invested enterprises and on FDI development in China as a whole, and particularly what kind of lessons can be learned from these changes. Research connected to both micro and macro levels is hardly seen, since the above questions need to be answered from all levels.

This research, therefore, will adopt a combined approach – both micro and macro, and the questions will be analysed at three levels - national, local, and company levels. Overall responsibility for policy rests with the Chinese Central Government, which in turn has a direct impact on local government, as well as on foreign investors and foreign investing companies. This covers areas of policy such as when and where FDI is allowed to be introduced, and what kind of FDI projects is encouraged or discouraged in certain period of time and in particular regions. Chinese local governments are allowed to issue local policy according to the principle of the Central Government policy and particular local circumstances, which makes FDI local conditions and environments different from one region to another.

In addition, different regions may be given different policies by the Central Government. Examples include Shenzhen and - currently - Shanghai, which have received the most favourable treatment and which at times has led to regional conflicts and disputes. Also, foreign investing companies are influenced by both central and local government-related policy and its change. This has a direct bearing on whether they decide to remain in a particular location or move to another one in terms of different local FDI policies, and whether, indeed, to invest in China or withdraw their investments there in response to changes in the Central Government policy (Pang, 2003).

In the final analysis, the response from local government on the Central Government policy will influence the Central Government to rethink whether it will retain the policy or change it. Also, an assessment by companies themselves of the national and local government policy will have a reciprocal influence on those same organs of government in respect of their FDI policies.

By addressing these issues at the three levels described above, the study will enable the author to analyse and answer these questions thoroughly and systematically. However, the research focus will be on the central level, since the author attempts to conclude these questions in China as a whole, and to draw some lessons from the Chinese government's policy changes and formulate and anticipate China's FDI policy change for people at all levels.

3.3. Research methods

Western FDI is a new issue in China in terms of its theory and practice. China's FDI policy making and its changes, on the one hand, reflect what kind of theory the government adopts; and on the other, produce an impact on FDI practice in China. Therefore, this study needs to cover both theoretical and practical analysis of China's FDI.

The research methods selected for and applied to this study include a review of published materials, mail survey, face-to-face interviews, and case study. A review of published materials helped build up a general picture of the Western FDI theory and practice, which was used as a framework to see how western FDI was regarded in China, including the theoretical explanation and practice, and also embracing FDI policies and changes of the Chinese government.

In order to analyse FDI practice in China, investigation and field study had to be carried out. The result of this research can provide FDI researchers and FDI practitioners with first-hand data and evidence. It also enables the author to supplement quantitative analysis and, more importantly, will support answers to the research questions raised by the author.

The research methods selected and applied were: mail survey, face-to-face interview, and case study.

- Mail survey is more efficient and economical than observation and has a good coverage (Emory, 1985); but unlike interview, it is difficult to probe for additional information or clarification of an answer (Zikmund, 1997).

- Face-to-face interview usually enables the interviewer to ask some questions in detail and trace the answer to a question (Hussey and Hussey, 1997). The disadvantages of the interview are that: (a) It is generally more expensive than mail survey (Zikmund, 1997), particularly when extensice travel is required; and (b) Face-to-face interview is more difficult to conduct than mail survey, as willingness to participate in a face-to-face interview is influenced by some cultures (Zikmund, 1997). In the case of China, undertaking an interview seems to be more difficult than in many other countries because of its different business and political culture.

- The samples of case study are selected from the author's interview and survey, which reflect some representative problems existing between different companies and different regions.

In short, reviewing published materials more or less helps the author to draw an overall picture of China's FDI in terms of its theory and practice, while field work enables the author to gain updated first-hand data and to explore some questions other researchers may not able to. This is because differences in culture, languages and political beliefs between western countries and China means that it is difficult for western researchers to do field work on China's FDI in China; and also because of media control in China by the government, some results of field work carried out by researchers - including western and Chinese - are not easy to be published in China.

However, because the author is Chinese, it has been relatively easy to undertake fieldwork in China; and because the author is studying in a western country, it is not difficult to review the result of the field work done by other people from western publications, research seminars, etc., and to do research independently, including raising any questions the author may have, discussing them, and getting research results published by western journals.

The following gives details relating to how the research methods were employed in undertaking the study, and may also suggest the specific characteristics of the research methods used in carrying out the research programme.

A. Published Materials

Published materials investigated for this study included academic articles, research reports, statistical figures, documentation materials, etc. These materials were divided into two groups: published materials in China, most of which were written in Chinese; and overseas publications written in English.

It is a fact that the viewpoints from Chinese publications in the subjects of social sciences have to be in line with the country's socialist principle (1) , including the issue of China's FDI. This leads to the problems of availability and reliability of the materials, because of media control. For example, news, reports and articles in People's Daily - a newspaper of the Central Communist Party of China - must be agreed politically by the editors before being published. Accordingly, all other Chinese national and local papers have to follow the tune set by People's Daily. This kind of media control leads to the problems of availability and reliability of the materials needed for the study, which had to be undertaken based on available source of information and reliable evidence.

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(1) In China, required by the constitution of the country, everyone, especially those whose work in the areas of social sciences have to follow the so-called "four cardinal principles", which "means to keep to the socialist road and uphold the people's democratic dictatorship, leadership by the Communist Party, and Marxism-Leninism and Mao Zedong thought. - Socialism with Chinese Characteristics (1993), New Star Publishers, Beijing, China.

The available publications in China relating to China's political and economic policies were generally supportive of the Government's position (Pearson, 1991). Articles written by government officials or official researchers focused on positive aspects of political and economic issues in China, and tended to tell readers how good things were in China, and how proper the Chinese government policies were. Some articles written by individual researchers may contain some of the author's own viewpoints and explore some of the problems of the Government policies. Nevertheless, these authors were not allowed to go as far as challenging the government position, and they had to primarily support the government policy and follow official rationale. Otherwise, these articles were not allowed to be published.

Negative aspects - including some important problems - usually remained hidden, and ordinary people were unlikely to know them (2). It was therefore difficult for the author, who worked as an independent researcher, to collect published materials which gave both positive and negative information in order to draw a true picture of China's FDI, since " Chinese press and journal articles reflected less opposition to and problems with negative effects of foreign investment than in fact may have existed " (Pearson, 1991). More importantly, the government's positive approach most likely led it to releasing false information to the public in order to meet its need of positive propaganda.

Because all figures relating to local and national economy were worked out, issued and published by government bodies, rather than by independent organisations, logically, it is easy for the Chinese governments or authorities to report the figures. For example, some local governments tended to give inflated FDI figures to the Central Government, especially when they had difficulty in attracting the planned target number of FDI, as higher figures of FDI introduction mean better performance of the local governments to attract FDI to their areas. These figures therefore gave a wrong indication that the governments had met the target

(2) The negative aspects of China's issues, especially some serious problems the government may have were usually published in an internal newsletter called "Internal Reference", which was allowed to be read by government officials. Different levels of officials read different levels of the newsletter, eg. highly ranked officials can read higher confidential newsletter).

which may be set by the Central Government or by themselves (3).

In order to resolve the problems of availability and reliability of China's published materials, and carry on the study properly, it became necessary for the author to take some effective measures. Theses measures included: (a) review of overseas related publications; and (b) use of the author's contacts in China to make some Chinese publications available, such as "internal reference"; and to build up a base on which the author was able to find out the true story in China.

As mentioned above, Chinese-published materials usually adopted a positive approach in order to protect the government policy and position, which did not give a whole picture of China's FDI. In contrast, overseas publications about China's FDI tended to identify and analyse the problems existing in China. This helped the author to conduct the study more comprehensively.

The author has various useful contacts in China's local and central government bodies, research institutions, and foreign investing companies after having worked there for many years. This enabled the author to gain valuable publications from time to time. These included internal FDI news and reports, FDI problems and analysis of them, the debates about China's government FDI policy and position, and un-inflated FDI figures. The author's China-based connections ensured that the necessary information reached the author in a timely manner. Some connections were also able on occasions to recommend new or good sources of information not otherwise available to the author outside China. This provided a good source of information on FDI in China and helped the author draw a real picture of China's FDI.

It is fortunate that the availability and reliability of Chinese publications has been improving in recent years, following the country's opening of its doors more widely to the outside world.

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(3) For example, in middle 2004, the author conducted field work in China. When he collected the annual statistical FDI figures (not yet published at that time) from a good friend who was a key person in a provincial foreign investment services centre, his friend asked him to note that the figures were inflated because his province had not met the target set by the Central Government.

For instance, statistical data published by the China State Statistical Bureau and MOFETR (Ministry of Foreign Economic and Trade Relations) is regarded as increasingly trustful and reliable by western researchers and international bodies, and widely used by them as sources of information (Pearson, 1991).

B. Mail survey and interview

Research data through questionnaire is primary data, and therefore primary data collection methods are required to be employed. In the case of the study (business research), surveying and interviewing are more appropriate and popular methods employed in business research (Zikmund, 1997).

Surveying was carried out by designing a questionnaire and sending it by mail. Research questions included were relatively general and basic and were designed to have adequate coverage of the topic. Interviewing was considered as the second stage of data collection, following up the results of the mail survey, in order to deepen the research. More detailed and specific questions were discussed at interview.

1. Surveys

(a) Main features

- Advantages

  As mentioned earlier, surveys are more efficient than observation and more economical than interview. The on-going study needs to be completed in a limited time. Mail-survey makes information possible to be gathered by a few well-chosen questions which would take much more time and effort to gather by observation. In addition, using the mail as a medium of communication, it can unlimitedly expand geographic coverage at a typically lower cost than interview.

- Disadvantages

  There are two major weaknesses of mail survey. One is the difficulty of securing the quality of information; the other is the poor percentage of mail return (Emory, 1985).

(b) Survey design : some measures were taken in order to improve the quality of information and mail-survey returns

- The mail questionnaire was designed and revised several times in order to make it as simple, clear, and easy to answer as possible, as it is generally believed that respondents are unlikely to co-operate with a long and / or complex mail questionnaire. In the questionnaire, the respondents needed to tick an appropriate answer(s). If they wished, they had the opportunity to add some comments to offer more detailed information.

- The questionnaire was designed in two versions, one in Chinese (for Chinese partners of joint ventures), and the other in English (for foreign partners of the ventures and foreign managers or representatives in wholly foreign owned enterprises).

- Some incentive was provided to the respondents in order to raise the mail return percentage :

  (1) Postage-paid self-addressed envelopes were enclosed with the original questionnaire; (2) A special way to send and collect the questionnaire. Because the study was carried out by the author based in the UK, while the survey was conducted in China, it would have been extremely expensive sending and returning the questionnaire internationally, as international postage is very expensive. Also, it is difficult for people in China to return post to a Western country, especially when the post carries comments on Chinese government policy. It is then better and perhaps necessary to obtain assistance in China, that is, by sending and receiving the questionnaire in China. By doing so, the cost of the postage can be largely reduced as China's local postage is very cheap, and the author can review the results of the questionnaire in China just before undertaking the interview in China; and worry of the respondents about their mail being intercepted by the government is removed. Because of the huge size of the country, two bases were built up to do this, one is based in Shanghai with responsibility held by a Chinese adviser, dealing with the respondents in the North and East parts of China; the second is in Guangzhou where the author's former colleague in a Chinese university is in charge or contacting the respondents in South and West parts of China.

- Special access to respondents was considered, since it is extremely important to seek assistance and get things done in China by having special relationships with people concerned. Therefore, most questionnaire were planned to be sent to companies with which the author has contacts and /or with whom his colleagues have contacts. A high returned percentage was then expected.

- With regard to the content of the questionnaire, the questionnaire was divided into two parts: the questions in the first part were general, relating to the background information about a venture, which may help create a case study at a later stage of the study. The second part questions gave a focus on the government FDI policies, which were most relevant to the research. In addition, difficult questions relating to China's policy issues were avoided, since political trouble could have been caused to the respondents if they answered the questions as such. Therefore, all the questions were carefully-planned, but relevant to the research questions.

- The approach employed in the questionnaire: There is only limited exploration. An exploratory investigation was planned to be taken until respondents indicated that they were interested in discussing some of the questions and until the stage of face-to-face interview started when the author would be able to ask the questions in detail based on the results of the mail-survey.

- The same approach would also be employed to determine the degree of question and response-structure. In the mail-survey, most of the questions and the responses would be the structured questions. In the interview, they change to a combination of semi-structured and unstructured. But in the final project they would be largely structured.

- Other practical issues of the questionnaire

The practical issues which were taken into account clearly and carefully prior to mail-survey action include:

- Number of firms involved

What is the appropriate number of firms to which the questionnaire would be sent? Two factors could decide this. One is the budget (envelopes, postage, and cost of labour - paying people for their assistance in the sending and collecting of the questionnaire), this allowed a maximum of 200 copies of the questionnaire to be sent out. The other is how many returned and completed questionnaires will be needed to make sense of the study. According to the usual return percentage and the author's expectation for the return percentage, around a 30 per cent response rate in 200 copies would be reasonable to provide data to support the research project. Therefore 200 copies were sent out to foreign invested firms in China.

- Selection of respondents

(1) Which side should be selected to contact? Foreign partners or Chinese partners? It is easy to decide who should be contacted for wholly foreign owned enterprises, as the author simply sends the questionnaire to the foreign managers or their representatives; whilst for the joint ventures, it needs to decide whether to contact one side or both. It was decided to contact both sides as (1) this will make them feel that they have been equally treated; and (2) this enables the author to collect the viewpoints for the questions from both the Chinese and the foreign sides, which is required by the research project.

(2) Both the Chinese and English versions were designed with the Chinese partners being sent the Chinese version and Foreign side receiving an English copy, making them easy to read and complete.

(3) Senior staff (chief executive, general manager, chief representative) of the enterprises will be contacted, as it is believed they are in the position to understand the questions thoroughly and complete the questions confidently.

- Type of firms

  Major forms of foreign invested companies in China are: equity Chinese-foreign joint ventures, non-equity Chinese-foreign joint ventures (also known as Co-operative Chinese-foreign ventures), and wholly foreign owned ventures. The survey will focus on the first type, as this type is the most popular in China, and also good for the author to gain the information from both Chinese and foreign parties relating to their co-operation.

- Size of the firms:

  The focus of the survey will be on large and medium sized ventures, including some world best-known multinational firms. These firms are more representative of FDI situations in China and more welcome by the Chinese government, as they are believed to bring more investment, advanced technology, and management expertise for China, which are badly needed by the country.

- Nature of firm's business:

Different kinds of ventures will be selected for the survey in terms of their nature of business, ranging from manufacturing to banking and other service industries. More attention will be given however to manufacturing as most FDI in China is in this area, and FDI in service industry cannot be ignored as it represents a new milestone of China's FDI development.

- Country of origin:

  All major Western countries are involved in FDI in China, including the UK, the USA, Japan, France, Germany, Italy, and so on. FDI from Hong Kong has consistently accounted for a large proportion in total China's inward FDI. In the mail-survey, the companies to which the questionnaire will be sent include investors from different countries and regions in order to gather information from different kinds of investors. However, the focus will be on British investors, as it is easy for the author to contact their UK head offices to gather further information when necessary, also the UK investment in China has been growing quickly compared to other European countries.

- Location of firms

  The majority of foreign invested firms are located in South China and coastal regions, such as Shenzhen, Guangzhou, and Shanghai, as a result of the Chinese government's strategic design for the FDI development pattern in China. Logically, more questionnaires will be sent to the firms in these areas. Few copies will be sent to the firms situated in Western and Central parts of China where are relatively poor, as it is necessary to know how FDI is working there when the Central Government is intending to make these areas into new development areas by offering incentives to local governments and foreign investors.

(C) Survey results:

Some 59 copies were finally received, of which 41 were completed, the valid copies therefore made 20.5 per cent (41/200) of respond percentage, and was not as good as the expected (percentage of around 30 per cent). This response percentage of mail-survey suggests that conducting a survey research may be costly in China, at least not as cheap as the usual practice, or not as cheap as surveys conducted in many western countries.

The following are probably some reasons why the response percentage of mail-survey was poor:

- Chinese partners normally have little interest in public affairs, and tend not to let others know their internal affairs, although the author had already pointed out in the head letter that "the reply would be strictly confidential". This would have been influenced by the Chinese tradition that "I only clean up the snow in front of my house, and it is not my business to clean up the frost above my neighbour's roof".

  Two examples give evidence of the poor response percentage of the mail-survey, and difficulties of carrying out a survey in China. (a) A Shanghai consultant company sent 700 copies of the questionnaire to locally targeted potential respondents. In order to increase the return rate, the company promised to provide gifts for the people who returned the questionnaire. In the required time, only 4 copies of the completed questionnaire were returned. The response percentage was poor as less than 1 per cent; and (b) A special method was used when a company conducted a survey. They hired university students to take copies of the questionnaire with them, together with certain amount of money. The students then went to the companies, and contacted managers, who got paid as soon as they completed their questions. This proved to be an efficient way of carrying out a questionnaire survey in China.

- Some foreign managers in wholly owned enterprises and foreign partners in joint ventures did not wish to disclose the situations of their companies to others. Some uncompleted copies of questionnaire were returned with a note stating their apologies to the author, such as "too busy to help". A note, as a response to the author's survey, from a foreign manager of DuPont China may represent similar thinking of these companies: "I regret that our company policy does not allow us to respond to unsolicited questionnaires such as yours". Some companies simply returned the original copies of questionnaire without any excuse.

- The mailing list of the foreign invested companies in the business directory was not sufficiently reliable.

  About 100 copies of the questionnaire (which accounted for 50 per cent of all copies, i.e., another 100 copies arranged through the author's personal links in the country) were added to the mailing list The problems came from a booklet called *Foreign*

Businesses in China, in which a number of China's foreign invested companies were listed, but with many of the addresses outdated. Around 24 copies (12 per cent) returned without reception from the addresses listed in the Directory. Two reasons given by the postal authorities were: no such company at that address, and the company has moved. A lesson the author learned from this was to make a telephone call to confirm that there is a company in the listed address before the questionnaire is posted.

It is fortunate that the author had more or less anticipated the difficulties in doing the survey in China, and had taken some effective measures, and therefore did not suffer a serious problem. In the valid returned questionnaires (41 copies), about 80 per cent (32 copies) of completed questionnaires came back from companies in which the author or author's Chinese colleagues and friends had good contacts. However, it should be noted that some of these respondents from these companies responded to the questionnaire not because they were eager to do so, just because they had to do so, in order to give you a face. This is why the author still needed to remind them to complete and return the copy from time to time.

Of 41 valid responses, 84 per cent (34 responses) were from Chinese-foreign joint ventures, the respondents varied from the general manager, chief representative, financial manager, marketing manager, and operation manager. 29 companies are large and medium sized, and the rest of them are small-sized companies from Hong Kong, Taiwan and Macao. 37 companies are manufacturers, ranging from chemistry, communications, banking facilities, construction, foods, and clothing; and 4 companies are involved in banking (2), insurance (1), and legal services (1). 32 companies are in south China, and large cities in the coastal area - Guangdong and Shanghai, 9 companies are located in Guangxi, Beijing, Fujian, and Sichuan respectively. There were more responses from British (7) and American (14) invested companies than other companies. The results of the questionnaire survey suggest that the data from these sources will be satisfied with the research project, as it provides the most relevant information to the study.

A crucial question about the result of the questionnaire survey is whether or not the 41 valid responses are sufficient for supporting the research analysis, since the first hand data and its analysis plays an important role in a PhD thesis, and serves as a means to give conclusive evidence for a new theory. According to some researchers, the relative number of 20 per cent of valid questionnaire responses against 200 copies is not poor (Hussey and Hussey, 1997), and the questionnaire survey proved to be an effective tool for examining the problem at hand. However, it is only one of the quantitative methods to supplement the quantitative analysis (Wang, 1995).

The methods employed to analyse the questionnaire result include: (a) coding the data; (b) grouping the codes into small categories; and (c) using two qualitative analysis methods : Cross tabulations, and Charts and Graphs.

A follow-up study of the questionnaire survey was carried out when necessary in order to correct the bias that occurred in the initial survey. The study was concentrated on those who completed the questionnaire and whom the author interviewed.

2. Interviews

Following the questionnaire survey, a face-to-face interview was carried out. As mentioned earlier, the author attempted to get more detailed information from the interview which was based on the survey. Therefore, some interviewees were selected from the people who had been involved in the author's questionnaire survey.

The author anticipated that the face-to-face interview could be much more difficult to arrange than the questionnaire survey, as it could concern interviewees to spend around an hour, which is seen as a very big favour in the country, and which is unlikely to make things happen, and get things done without relations with the people concerned, whether it is a minor or major issue. Results from the returned questionnaire indicated that only four of the respondents stated it was possible for the author to interview them. The author then tried to find other companies and organisations with which the author had personal contacts. The author also sought help from friends, former colleagues in China, who have links in targeted interviewees. Finally, twenty-eight interviews were arranged in China.

However, because the Chinese government and Chinese partners tend to control the ventures politically, they are strict as to the people who intend to talk to the foreign partners; this resulted in the author failing to arrange interviews with foreign partners, which is necessary for the research. When the author tried to arrange interviews in Chinese-foreign joint ventures after the author met with Chinese partners, the Chinese political head of the companies was extremely concerned about that. The author of this research understood it was time to leave. Interviews with foreign investors were rearranged in companies' UK head offices after the author returned to the country.

The twenty-eight interviews were conducted in four provinces: (a) Guangdong - located in the southern part of the country, China's first region to open for FDI, and which has attracted more FDI than any other regions of China; (b) Shanghai - China's largest city located in the south-east of the country, its introduction of FDI has been the fastest growing in the country in recent years, and has received more FDI from the world largest companies than any other regions of the country; (c) Beijing - capital city, China's political and information centre; and (d) Guangxi - next to Guangdong, one of the poorest regions in the country, which is a good example to demonstrate if the recent government policy of encouraging FDI to this kind of region is effective.

Two methods were employed in the interview. One was semi-structured (questions asked referred to the essential information about the company, together with some specific comments from the interviewed companies on China's FDI related policies), the other was unstructured (open-ended discussions with the companies interviewed about FDI related policies of local governments and the central government, etc). In general, each interview took an hour. In the first half an hour, for the semi-structured interview, the questions asked were based on the questionnaire, in the second half hour, the author tried to let the interviewees give information and their own viewpoints of and comments on the Chinese government FDI or FDI related policy, and on the events and situations of China's FDI.

The interview seemed to be more successful than the questionnaire survey, as (a) the interviewees tended to tell the author the truth about FDI in China and in their companies, which provided the author with valuable information and enabled the author to draw a real picture of China's FDI; (b) some detailed answers to and information on research questions were given, which helped the author to deepen the research programme; and (c) information from some companies and regions gave excellent sources of examples for the case study of the research programme.

Unlike the questionnaire survey, the interviews were carried out not only in the foreign invested companies, but also in the central and local government bodies, and research centres and universities. Therefore, the interviewees were different groups of people, including company managers, governments officials, and researchers. The author managed to interview an official from the Central government and a senior researcher from its research centre, from whom an overall situation of China's FDI was introduced. The outcome of interviewing researchers added the author's understanding of China's FDI issues. The evidence and examples given by company managers strongly supported some points the author made in the work.

From the interviews, various printed materials were also provided by the interviewees, including annual reports of companies, special government reports of China's and local FDI performance, and some articles and research papers written by interviewees.

CHAPTER 4

Defining the Turning Points of China's FDI Development

4.1 Introduction

One of the fundamental features of China's FDI development is the country's continually changing policy environment (Mark and Zheng, 1991). As many authors already identified and described, major policy changes led to several important periods - or phases – in the process during the late 1970s and the middle 1990s. These can be regarded as turning points.

Much has been written about the turning points of China's FDI development. However, an in-depth or theoretical analysis of this topic is rarely to be seen. For example, in order to reflect the effects of dramatic changes in China's FDI policies, much existing research has usually paid attention primarily to how much more or less FDI inflows into China due to those changes. In addition, many researchers have paid only partial attention to this issue, regarding the turning points of China's FDI development as only a part or a minor part of their research. Moreover, little research has been done about why and how the turning points take place, and how they affect the further development of China's FDI. Finally, four important aspects have been ignored when the turning points of China's FDI were discussed: (a) The turning point of China's FDI is not clearly defined; (b) The relationship between one turning point and the next is not well explained; (c) Overall and fundamental changes in China's FDI policy leading to changes in every aspect of China's FDI is not comprehensively and systematically identified and analysed, as much existing research is either centred on continued changes in a single FDI policy (e.g. China's foreign exchange policy), or only focused on one overall and fundamental change of China's FDI policy (e.g. China's permitting western FDI to China by announcing an open door policy); and (d) The explanation of the relationship between the movement of the turning points and the development of China's FDI theory and practice is not given, since a change of FDI policy in the country, to a great extent, is a result of Chinese leadership's understanding and explanation of FDI.

It is becoming more and more important to pay greater attention to the above issues since: (a) China has many years of FDI experience and has undergone several dramatic FDI policy changes since it opened its doors to the outside world. This experience contains important theoretical as well as practical implications for FDI participants and for FDI further development in the country; (b) as a socialist country as well as a developing country, China's experience in developing its FDI has been different from many other countries'; and (c) China has consistently become the second largest FDI recipient nation (next only to the US) since 1993, although this has been accompanied by changes in FDI policies in the country.

The research the author is undertaking attempts to give emphasis on the above issues by defining, identifying, describing and analysing those FDI turning points. The research questions relating to this research topic will include:

- How and what turning points are defined in this research?
- When, why and how did these turning points take place?
- What are the impacts of these turning points on China's FDI development?
- What are the characteristics of these turning points?
- What is the relationship between the movements of FDI turning points and the development of China's FDI theory and practice?
- And what kind of lessons can be drawn from these turning points for China's FDI participants and the rest of the world?

In this chapter, the main existing definitions of turning points will be reviewed, these being based on the three different existing criteria. The application of different criteria to each turning point means that each is classified differently. That does not mean the criteria are not "right" or "wrong", but simply that they are selected or decided according to different purposes or policy initiatives. Following this review, a definition of the term "turning point" will be suggested in the context of this dissertation and in line with its research aims. Finally, the turning points evaluated in detail in the next three chapters will be established according to the author's own definition.

4.2 Definition of the turning point

In the first part of this section, existing definitions of the turning point will be reviewed, which are extracted as examples from publications, and the author's comments on these definitions will be given.

In the second part of this section, the turning points that are defined and included in this dissertation will be established and explained.

4.2.1. Review of Existing Definitions

The turning points of China's FDI development have been defined by many researchers in one way or another. Different criteria create different definitions, which therefore lead to different classifications of the turning points. Three different criteria are identified by the author among the existing research in connection with defining the turning point. Examples of turning points (extracted from publications) according to these criteria are given and discussed as follows.

1. The turning point is defined in terms of the "important changes in China's specific foreign investment policies".

Two examples are given below. The first example is centred specifically on the foreign exchange policy; while the second example is concerned with the legal treatment of FDI in seven different FDI areas.

According to Roehrig (Example 1), two turning points can be seen from these three major phases of China's policy changes (1983 and 1986) in foreign exchange balancing towards foreign invested enterprises.

These two turning points can be described as:

i. From universal tough foreign exchange balance requirement to relieving particular joint ventures from this requirement (1983);

ii. From partially relieving foreign exchange balance problems to attempting overall resolution of the problem (1986).

Example 1

There are three major phases of legislation for foreign investment in the area of foreign exchange since 1979.

The "Provisional Regulations on Foreign-Exchange Control of the People's Republic of China" in the 1979 Joint Venture Law required all Sino-foreign joint ventures maintain a positive balance between foreign exchange expenditures and revenues. This has proved to be the biggest obstacle for many joint ventures, as they needed to import necessary inputs with hard currency, and paid hard currency as expatriate salaries and dividends to foreign shareholders. Therefore, the only possible option for the joint ventures to meet the requirement of balancing foreign exchange was to export the products they produced in China. Between 1979 - 83, this policy had become unpopular and impractical, as one of the major reasons for most foreign businesses to invest in China was to produce as well as to sell their products in local market.

An important policy change occurred in 1983, when the Chinese government issued the "Implementing Act for the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment" and the "Rules for the Implementation of Exchange Control Regulations". These new regulations eased the foreign exchange requirements by allowing joint ventures to sell their products to qualified domestic enterprises for foreign exchange, and giving local governments the power to lend money from their own foreign exchange reserves to import-substitution joint ventures. However, the new regulations didn't totally resolve the foreign exchange problem many joint ventures had faced, as they only provided a way for particular joint ventures which had to be recognised as import-substitution joint ventures – even these joint ventures were not guaranteed by domestic enterprises to provide the necessary markets for joint ventures' goods.

Further progress in balancing foreign exchange was made by the government in 1986 when the "Regulations on Foreign Currency Balance of Equity Joint Ventures" were announced. This new law allowed joint ventures to balance foreign exchange among themselves, that is, joint ventures which had foreign exchange reserves were allowed to sell foreign exchange to those which were in foreign exchange deficit, or the latter were allowed to buy foreign exchange from the former. This change led to the establishment of foreign exchange swap centre in Beijing, Shanghai, and other major cities in China, which became an important means for most foreign invested enterprises to obtain foreign exchange as they relied mainly on swap centres.

(*Source*: Roehrig, 1994).

Indeed, the issue of foreign exchange balance or the foreign exchange shortage is important, as it had been one of the most common problems experienced by many foreign invested enterprises and "inhibiting the rapid growth of FDI in China" (Chen and Raftery, 1994).

In addition, the important policy changes which led to the two turning points reflected the fact that:

i. The Chinese government and foreign investors differed in terms of their respective objectives of FDI activities in China. The government had been much worried about the foreign exchange balance as the country is a developing country, and badly needed hard currency to develop its economy by importing advanced technology and equipment; whereas the shortage of foreign exchange had been its long-term problem (Li, p.139).

On the other hand, however, the main purpose of many foreign investors, especially a manufacturing foreign invested venture, is to sell its industrial or consumer goods on the domestic Chinese market (Delfs, p.114).

ii. Improved or more relaxed legal measures were introduced and implemented had indicated that the foreign exchange problem and its negative effect on further FDI development in China was realised and understood by the government. The turning points, therefore, in this sense were good for both Chinese and foreign parties, and of course good for the further development of FDI in China as well.

It can be seen from below the Example 2 that the approach Wei adopted in the study is similar to the study shown in Example 1. That is, analysis of the seven tidal changes in legal treatment of FDI is focused on significant changes in China's specific foreign investment policies. Example 1 is centred on changes in one specific FDI policy area - foreign exchange policies; while Example 2 is concerned with seven different specific FDI policies, including the foreign exchange policy.

Example 2

There have been *seven tidal changes* in the legal treatment of FDI since 1978.

(1). Joint Ventures: From controlling to Regulating.

The Equity Joint Venture Law, as the country's first foreign investment legislation issued in 1980, is more like a series of political declarations allowing leeway in its implementation. All the activities of a joint venture must be governed by Chinese laws, relating to such items as the chair of the board, domestic distribution and termination. In other words, this new form of economic entity with a capitalist element would be dominated by socialist public ownership. Legislative developments occurred in the spring of 1990, when the National People's Congress adopted the Equity Joint Venture Law Amendment which, for the first time, allowed that the chair of the board of a joint venture could be elected from the foreign side. This marked the beginning of regulating FDI firms.

(2). Whole Foreign-Owned Subsidiaries (WFOS): From Regional Experimentation to National Promotion

China's adoption of WFOS was accompanied by the concern about the negative effects of this 100 per cent foreign economic participation, namely, the fear of a westernisation of China's economic structures, social values, political beliefs, and so forth. This concern effectively paved the way for the gradual adoption of this 100 per cent foreign ownership in China. The process, however, was painstaking and involved continuing administrative efforts, from the experimenting stage in the SEZs to a limited expansion in the fourteen coastal cities and finally, with relevant new laws and regulations in place, to national promotion.

(3). Regional Policies: From Coast-lining to Opening Inland

The architects of the Open Door policy committed themselves to fully utilise the geographic accessibility of the coastal region and its relatively more sophisticated technical and infrastructural receptiveness to foreign markets, capital, and technology. This would end its several-decade-long self-imposed isolation and, in the long term, to spread the benefits to the interior region, thereby closing the gap between that region and the coast.

(4). Tax Regime: From Initial Favours to Proliferating Encouragement and Rationalisation

The first phase came with the adoption of the Joint Venture Income Tax Law, Foreign Enterprise Income Tax Law, and their respective implementing rules. The initial tax favours were offered to attract more FDI. The second phase was marked by the adoption of the 1984 SEZs and Coastal Cities Tax Reduction and Exemption Regulations. The regulations recognised the existing tax incentives authorised to be given for FDI firms in the SEZs and further extended these incentives to the fourteen coastal cities. The Foreign Investment Enterprise and Foreign Enterprise Income Tax Law adopted in 1991 marked the beginning of the third phase of China's legislative development in the area of income tax as applied to FDI firms and other foreign business activities.

(5). Foreign Exchange Management: From Relief Qualifications to Greater Accommodation

The primary cause of the foreign exchange imbalance that haunted most FDI firms is the non-convertibility of the Chinese currency. Up to early 1986, the joint venture laws and regulations were ineffective in helping to generate foreign exchange. The relief offered by the government was limited, such as it allowed domestic sales of venture products that are most needed by domestic manufacturers or consumers, or have to be imported.

The growing confidence and accumulated experience in working with FDI operations for the first half of the decade, allowed more creative avenues to be proposed and implemented. The new options offered in the Foreign Exchange Balance Provisions and the Encouragement Provisions include: (a) domestic sales of sophisticated products; (b) reinvestment of RMB profits; (c) government assistance; (d) mortgage RMB on foreign exchange loans; (e) import substitutions; and (f) foreign exchange "swaps" at foreign exchange swap centre.

(6). Technology Transfer and Intellectual Property Protection: From Rudimentary Access to More Sophisticated Operation

The first change was that Chinese authorities gradually set up intellectual protection laws: the Trademark Law, the Patent Law, and the Copyright Law were promulgated in 1982, 1984, and 1990, respectively. This led to the establishment of China's own system in the intellectual property arena.

Another major change took place in 1992 when the Chinese government made a series of moves to bring its intellectual laws in line with international practices by acceding to a number of international conventions on intellectual property protection.

(7). Foreign Bank Operation: From Simple Presence to Operational Expansions

The first step the Chinese government took was the issue of the Foreign Financial Institutions Resident Office Procedures in 1983, which permitted foreign banks to establish representative offices in major Chinese cities.

The second step was taken in 1985 when the State Council adopted the SEZ Foreign Bank Regulations. These regulations allowed foreign banks to open new branches and to conduct basic retail banking business in the SEZs, following the Shanghai branches of two major Chinese banks officially authorised the four foreign bank branches to expand their business to include the lending of foreign currency at unrestricted interest rates and the acceptance of deposits in foreign currency with interest payable at rates of the Bank of China.

A further step was taken on September 8, 1990 when the People's Bank of China issued the Shanghai Foreign Financial Institution Measures. These measures, for the first time, allowed foreign banks to start their branching operations into a non-SEZ coastal city.

(Wei, 1994)

However, , the discussion of the turning point summaring in Example 1 is only a minor part of the book – "Foreign Joint Ventures in Contemporary China" – written by Roehrig. This kind of study looks just like a simple historic record, and does not provide any theoretical implications, although it may give an idea of what kind of turning point takes place in China' FDI history. The study Wei undertakes extracted in Example 2 has taken this issue much further, as (a) Wei's book is focused on turning points of China's FDI policies and the turning point has been discussed in detail, which is hardly seen from the existing research; and (b) this book looks at turning points from seven different FDI policy areas, which can therefore be asserted without doubt that Wei's work has provided a more comprehensive picture of the historical development of FDI in China, along with the important FDI policy changes between late 1978 and early 1990s. His work has also been useful for other researchers into FDI in China with a particular interest in the topic of these turning points.

Nevertheless, Wei only treats seven FDI areas as separate issues, and doesn't attempt to explore the relationships between the turning points in these different areas. It also has no intention of enquiring whether there are any more general or overall FDI policy changes which would affect these specific FDI policy changes in order to make a more comprehensive or a more systematic analysis – which could provide in-depth explanations of why these turning points take place, what the implications of them are, and how China's FDI development has been affected.

2. Turning points are defined mainly according to the important qualitative and quantitative changes of FDI, as a result of changes in FDI policies and important events.

Quantitative changes in FDI refer to how much more or less China attracts FDI after China's FDI policy changes in terms of the number of FDI projects, or the amount of foreign capital. Qualitative changes in FDI, on the other hand, refer to changes in the form of FDI (there are three common FDI forms: Joint Venture, Wholly Foreign-Owned Venture, and Joint Co-operative Venture), changes in the development of China's opening to FDI, and changes in the industrial areas to which foreign companies make their investment.

Analysis of quantitative and qualitative changes in FDI relating to China's FDI policy changes is an approach conducted by many researchers.

According to Lu (1997), China has experienced three stages of FDI:

(1) Start stage (1979 –86):

At this stage, FDI in China is limited and the average size of FDI projects is rather small. This is because China had just started to introduce FDI, the legal environment for FDI was poor, and foreign investors' main objective at this stage was to gain experience of doing business in China.

(2) Growth Stage (1987 – 91):

FDI developed at a good pace, and the amount of FDI was six times greater than the first stage. The main reasons for this change are: (a) the Chinese government speeded up the establishment of a legal framework for FDI, and issued a series of laws and regulations, including "the Provisions for the Encouragement of Foreign Investment", which offered many more incentives to FDI makers than ever before; (b) more of China's coastal regions are allowed to enjoy the government's special FDI policies, including Shanghai Pudong New Development Area; and (c) Infrastructure for FDI has been greatly improved after the government's massive investment, such as more high-quality roads and seaports being built up.

(3) Rapidly Developing Stage (1992 – 95):

In 1992 alone, the number of new FDI enterprises was more than the number over the previous thirteen years. In addition, in 1993, China attracted more FDI than any other developing country and became the world's second largest recipient of FDI (next only to the USA).

The reasons behind this tremendous FDI development include:

A) The tour of south China made by the then leader Deng Xiaoping in early 1992 boosted the country's confidence in the Open Door Policy and therefore gave a powerful boost to further development of FDI in China;

The government's decision during the Fourteenth National Congress of the Communist Party of China in October 1992 to change China's economic system from a planned economy to a market economy, which provided the Chinese with a new and modern concept to deal with international economic co-operation,

B) including China's FDI;

C) Many of China's inland and border cities are allowed to be open areas to FDI in 1992.

Example 3:

According to Lu (1997), China has experienced three stages of FDI:

(1) Start stage (1979 –86):

At this stage, FDI in China is limited and the average size of FDI projects is rather small. This is because China had just started to introduce FDI, the legal environment for FDI was poor, and foreign investors' main objective at this stage was to gain experience of doing business in China.

(2) Growth Stage (1987 – 91):

FDI developed at a good pace, and the amount of FDI was six times greater than the first stage. The main reasons for this change are: (a) the Chinese government speeded up the establishment of a legal framework for FDI, and issued a series of laws and regulations, including "the Provisions for the Encouragement of Foreign Investment", which offered many more incentives to FDI makers than ever before; (b) more of China's coastal regions are allowed to enjoy the government's special FDI policies, including Shanghai Pudong New Development Area; and (c) infrastructure for FDI has been greatly improved after the government's massive investment, such as more high-quality roads and seaports being built up.

(3) Rapidly Developing Stage (1992 – 95):

In 1992 alone, the number of new FDI enterprises was more than the number over the previous thirteen years. In addition, in 1993, China attracted more FDI than any other developing country and became the world's second largest recipient of FDI (next only to the USA).

The reasons behind this tremendous FDI development include: (a) the tour of south China made by the then leader Deng Xiaoping in early 1992 boosted the country's confidence in the Open Door Policy and therefore gave a powerful boost to further development of FDI in China; (b) the government's decision during the Fourteenth National Congress of the Communist Party of China in October 1992 to change China's economic system from a planned economy to a market economy, which provided the Chinese with a new and modern concept to deal with international economic co-operation, including China's FDI; and (c) many of China's inland and border cities are allowed to be open areas to FDI in 1992.

(Lu, 1999).

Two turning points appear in the above example.

The first one occurred between the start stage (1979-86) and the growth stage (1987-91). A criterion of defining this turning point by Lu is the important change of FDI in terms of its quantity. The reason behind this change – FDI moving from the initial stage towards growth stage – is thought by Lu to be improvements of the legal framework on FDI, notably, the Provisions for the Encouragement of Foreign Investment, which offered significant concessions over FDI makers. However, the question of why the government decided to issue the Provisions and of their importance remains unanswered.

Again, the quantitative criterion is applied to defining the second turning point – between the Growth Stage (1987–91) and the Rapidly Developing Stage (1992-95) – as China started to attract much more FDI in 1992. The major causes for the second turning point are claimed by Lu to be important political events (Deng Xiaoping's south China tour and China's adoption of a market economy system) and the further development of China's FDI policy (the government's decision to open up many of China's inland and border cities).

By applying a similar approach, Yongming Fan (1992) declares there have been four phases of China's FDI development (see Example 4):

Example 4

(1) Starting phase (1979 – 84):

The "JV Law" was the first ever legal document of China's introducing foreign investment, and marked China's Open Door policy. During this phase, China attracted a large number of foreign investment projects, including the establishment of 3,278 Chinese-foreign joint ventures, Chinese-foreign co-operative ventures and wholly foreign-owned ventures, with a total agreed foreign investment of USD8.99 billion, and actual foreign investment of USD3.46 billions. The rapid increase in introducing foreign investment resulted mainly from some of the Chinese leadership's belief that any of China's economic problems can be resolved once foreign investment is introduced.

(2) Adjustment Phase (1985 – 86):

China's policy of "stimulating economy" led to foreign investors swarming into the country, especially in 1985 when 3,069 foreign investment projects were approved, with an agreed amount of USD5.53 billion. However, problems relating to investment environment, including poor infrastructure and.a serious lack of foreign exchange , etc, resulted in complaints from many foreign investors. To cool down the economy, the government introduced a new economic policy of "retrenchment and adjustment" for the year 1986 and 1987. This policy led to a downturn of the country's economy, as well as FDI in 1986. The number of new foreign investment projects and the agreed amount of foreign investment were down 51.25 per cent and 51.21 per cent respectively.

The sudden boom and bust of FDI and dramatic criticism from foreign investors urged the Chinese leadership to have a serious review of China's FDI policy against the foreign investment problems. As a result, "the Provisions for the Encouragement of Foreign Investment" were announced, aimed at encouraging foreign investors to actively involve in China's priority projects and areas. "The Provisions" marked new stage of FDI development in China - the FDI policy-oriented stage, as, for the first time, the government attempted to guide FDI via its FDI policies.

(3) Development Phase (1987 – June 1989):

From 1987, the "second boom" of FDI in China occurred. Some 2,233 new FDI projects were approved, with agreed amounts of USD3.788 billion, which was double that of 1986. In 1988 and 1989, new FDI projects went up 5,945 and 5,779 respectively; accordingly, the agreed amount increased to USD5.297 billion and USD6 billion respectively. This is because foreign investors' confidence was renewed after "the 1986 Provisions", and was strengthened after the promulgation of the "Laws on Foreign Invested Enterprises" and "Laws on Chinese-foreign Co-operative Enterprises" in 1986 and in 1988 respectively. These two laws, for the first time, provided overall legal protection to the wholly-foreign owned enterprises and Chinese-foreign co-operative enterprises although these enterprises had come to existence in 1979.

(4) Tortuous Phase (June 1989 – June 1991):

The strong FDI growth was suddenly halted by China's "June 4^{th}" incident in 1989. After this incident, the western countries launched economic sanctions on China. This included withdrawing and cancelling loans to China and some economic cooperation projects. With regard to FDI, Western companies' representative offices closed down one after another. Some western investors withdrew from their existing investment projects. In addition, foreign businesses' confidence was further hit by China's economic retrenchment policy starting late 1989.

Every effort was made by the Chinese government in the hope that FDI could be revived: (a) the government insisted that China's Open Door policy would remain unchanged; (b) the "JV Law" issued in 1979 was amended in 1990, giving foreign partners more control over the management and operation issues; (c) special financial arrangements were made by the central government to foreign invested enterprises to minimise the negative effect from the country's retrenchment policy; and (d) opening up Shanghai Pudong as a new development area, allowing this area to enjoy some most preferential policies as to attract foreign investment to the promising zone.

Consequently, the negative political effect of "June 4^{th}" event was minimised, and FDI development had taken a turn for the better.

From Example 4, it appears that the same approach is adopted as Example 3 - classification of China's FDI's turning points is based on the shifts of China's FDI related policies and important political events, in terms of FDI's quantitative and qualitative changes. Example 4 shows there have been three turning pints relating to the dramatic increase or decrease in FDI inflows to China. The first turning point is between the Starting Phase and the Adjustment Phase, when FDI went downwards caused by the government's overheated economic policy. The second turning point is from the Adjustment Phase to the Development Phase, when FDI underwent the "second boom" as a result of a set of new FDI policies being issued. FDI suffered a serious setback, which marked the third turning point between the Development Phase and Tortuous Phase and resulted from the "June 4th", famous political incident.

It is without doubt that, by using quantitative and qualitative criterion to determine the turning point of China's FDI, research such as Examples 3 and 4 would be useful to provide information on how and why China' FDI has been up and down. However, for the study on the relationship between the turning point and FDI policy issues, the turning points classified in Examples 3 and 4 are not always connected with Chinese FDI policy change. For example, the "June 4th" political event did not indicate that China intended to change its FDI policy. Likewise, to a great extent, Deng Xiaoping's south China tour was aimed at reconfirming China's Open Door policy to the outside world after the "June 4th" incident, as well as China's FDI policy, again, it didn't imply any change in China's related policies.

3. **Turning points are determined by the important FDI policy changes, which have more general, overall, and longer-term impact on China's FDI further development, or lead to fundamental change in all China's FDI environment.**

According to this criterion, the following turning points are explored:

(1) Allowing or permitting FDI into China marks an important turning point of China's FDI development.

As Ho (1984) claims, the Open Door policy adopted in December 1978 is the "historic turning point", as, for the first time, capitalist investment was allowed.

More specifically, Pomfret (1991) recognises that "direct foreign investment (DFI) was permitted by the July 1979 Law on Joint Ventures", this Law is believed by Fan (in Example 4) to "mark the China's open door policy".

Indeed, this dramatic shift clearly indicated that China no longer stuck to its previous inward development strategy, notably its self-reliant strategy. This historical change has been generally agreed as China's fundamental policy change, which makes western FDI possible to locate in China.

(2) Encouraging FDI, Instead of Permitting FDI

As many researchers agree, the insurance of "the Provisions for Encouragement of Foreign Investment (also known as "the 22 Articles")" in October 1986 marks another important turning point. As Pomfret (1991) states, the provisions "indicated for the first time, that China wished to promote rather than simply permit FDI", in other words, China's FDI had moved from Permitting FDI to Promoting FDI. Fan (1992) regards "the significance of the Provisions as equal to the Joint Venture Law, as it marked another new stage of FDI development of China – moving from the stage of establishing FDI basic policy environment to the FDI policy oriented stage".

This positive change of the overall strategy and attitude of the Chinese government in FDI was clearly shown in "the 22 Articles" and their implementing regulations: to foreign invested ventures, the swap of foreign exchange for RMB was allowed, tax and other incentives were offered, greater management autonomy and decentralised decision-making about joint venture approvals were given (Pomfret, 1991). A detailed discussion about this turning point will be carried out in Chapter 6.

(3) Managing FDI Strictly According to China's Priority Projects, Industries and Regions, Rather Than Simply Stimulating FDI

Since 1995, the Chinese authority has made some strategic changes in FDI policies, and issued several sets of new policies.

On June 7, 1995, the government promulgated "*Interim Provisions on Guiding Foreign Investment Direction*" and "*Catalogue for the Guidance of Foreign Investment Industries*", which classify FDI projects into four different categories: encouraged, permitted, restricted, and prohibited. From April 1996, China started to withdraw some of the existing preferential policies to FDI new comers, and planned to gradually replace most of these policies by "the National Treatment" to all FDI makers.

These significant changes indicated that the government, for the first time, decided to strictly direct the FDI based upon their priority projects, industries, and regions, and started to consider treating FDI according to international practice, such as the government's intention to apply "the National Treatment" to foreign invested ventures.

This new and fundamental FDI policy change is seen by Richard Brecher (1995) as an important turning point "as Beijing shifts from investment promotion to investment management" (p.15).

4.2.2. Turning Points Are Included In This Dissertation

It can be seen from the above discussion that the turning points of China's FDI development can be identified and classified in different ways based on different criteria. Three different criteria reviewed above generate three different classifications of turning points of China FDI:

(1) The turning point is defined in terms of the important changes in China's specific foreign investment policies;

(2) The turning point is defined mainly according to the important qualitative and quantitative changes of FDI, as a result of changes in FDI policies and important events;

(3) The turning point is determined by the important FDI policy changes, which have more general, overall, and longer-term impact on China's FDI further development, or lead to fundamental change in all China's FDI environment.

Since this dissertation attempts to look at turning points which are derived from overall and fundamental changes in China's FDI policies and which have general and longer-term impact on China's FDI further development, therefore the third approach from the above three approaches is apparently qualified to fulfil this study.

Having adopted this criterion, the author of this dissertation has identified the above three turning points generated by the third criterion (page 16 – 17), and now defines them as follows:

(1) From the "Self-reliant" to Permitting Western FDI (late 1978): Evaluation of the First Turning Point;

(2) From Permitting FDI to Promoting FDI (October 1986): Evaluation of the Second Turning Point;

(3) From FDI Promotion to FDI Management (June 1995): Evaluation of the Third Turning Point.

It is worth pointing out that each of the above three turning points is equally important in the sense that they all have changed general direction of China's FDI history. In addition, because these three turning points are equally important, and they represent respectively a turning point in a different period of time, looking at all three turning points together – the shift from one turning point to the next, would provide an overall, general, and consistent picture of China's FDI development from 1978 until 1990s, and give answers as to how and why the turning points take place, and what the impacts of these turning points on the further development of China's FDI are .

Moreover, this study will also seek the relationship between the movement of the turning points and the development of China's FDI theory and practice, as Chinese government's understanding of and interpreting FDI could be a key to the development of FDI in China.

The detailed analysis of three turning points will be respectively in Chapter 5 (the first turning point), Chapter 6 (the second turning point), and chapter 7 (the third turning point).

CHAPTER 5

From "Self-reliance" to Permitting Western FDI (1978-1986):

An Evaluation of the First Period of China's FDI Development

5.1 Introduction

As discussed in Chapter 2, FDI existed in China as early as the 1950s, though these investments were not made by Western companies but by the governments of the Soviet Union and Poland. It was "not until 1978, with the declaration of the open policy, did China's dealing with the West firmly move into the ascendancy, and only then were Western companies officially welcomed to invest directly in the Chinese economy" (Shapiro, *et al.*, 1991, p.12).

During the Maoist period from 1949 to 1978, China followed a policy of "self-reliance", partially because it was isolated by the West for political reasons, and partially it feared, by allowing the West to get involved in its socialist construction, loss of its sovereignty and loss of the state control over the country's development path (Pearson, 1991). This policy was followed even more strictly after China's split with the Soviet Union in the late 1950s. As a result, only exports were allowed in exchange for planned necessary imports, while international loans and investment were shunned by China (Pomfret, 1991). During that period, the Chinese prided themselves on being a country with neither internal nor external debts. This was in fact a reflection of the policy of autarky. Especially during the "Cultural Revolution", things were pushed to such extremes that the use of foreign investment was actually labelled as worshipping things foreign and fawning on foreigners - characteristics of the comprador bourgeois ideology (Liu and Liang, 1987).

China's open door policy was initiated in 1975, when then Premier Zhou Enlai suggested China's "four modernisations" in industry, agriculture, science and technology, and military. Later Hua Guofeng criticised the "closed door" policy of the Gang of Four when he came to power (1976-1978) after the Cultural Revolution, and proposed to import western technology. In a single year between 1977-78, China signed as much as USD7.8 billion of technology transfer agreements from western countries, which was well beyond its repayment ability in hard currency (Fan, 1992).

Hua's proposal was so ambitious that it led to a number of the technology transfer programmes being withdrawn, and his proposal was soon replaced by Deng Xiaoping's "open door" policy. The policy was announced in December 1978, at the Third Plenary Session of the 11^{th} Central Committee of the Chinese Communist Party, and was even referred to by the Chinese themselves as a "historical turning point" (Ho and Huenemann, 1984, p2), since this change had important political and theoretical implications, as well as having noticeable implications in China's economic policy and legal system.

Politically, the announcement of the open policy was a result of Deng Xiaoping's retention of power, who managed to remove the Gang of Four from their state and Party posts in the late 1976, then consolidated the power of reformists (Delfs, 1986). In addition, it was made clear at the Party's Plenary Session that the adoption of economic reforms and open door policy would become China's long-term and essential policy, rather than a temporary measure (Hu, 1989).

Theoretically, Deng Xiaoping created a famous theory termed "Socialism with Chinese Characteristics" (Liu, Li and Tian, 1993, p.142), after his long "pursuing an alternative model of socialism" (Delfs, 1986, p.19), in order to replace unsuccessful Soviet models of development.

The open door policy plays a key part in implementing Deng's new development model of "Socialism with Chinese Characteristics" (Fang and Xu, 1995, p.26), whilst the use of foreign direct investment is a major motivation and the most dramatic manifestation of China's open door policy (Roehrig, 1994; Kueh, 1992). This was because the Chinese leadership recognised the importance of FDI in contributing to the success of its open door policy and to the economic development of the country:

> Using foreign funds and attracting foreign businessmen to launch joint ventures, co-operative enterprises or wholly foreign-owned ones is a major component of our open policy. It is also an important means to make up for the shortage of domestic funds, enhance our capacity to earn foreign exchange through export and raise China's technological and managerial levels (Qi, 1998).

China's isolation from the rest of the world during the period 1949-1978 had led the country to serious difficulties in developing itself without any external assistance. In terms of the industrial sector, only 20 per cent was post-1960's technology, 20-25 per cent was serviceable but backward, while 55-60 per cent had to be replaced (Shapiro, *et al*, 1991). Its managerial skills remained poor, and its access to international markets was very limited. China's open door policy makers realised that all these required immediate attention if the country was going to be able to fulfil its goals of broad modernisation, and "to bring about in less than 20 years what it has taken 200 years for the industrial West to achieve" (Chalfont, 1986, p. 8). They also realised that FDI in China could facilitate domestic technological growth and the development of managerial abilities. This, in turn, would foster higher domestic standards of living and increase Chinese national security, through the provision of access to modern management methods, advanced production techniques, and industrial know-how. In addition, the Chinese government saw FDI as a way to make optimal use of its limited foreign exchange resources by encouraging foreign invested ventures that would promote import substitution, export promotion, and resource exploitation - without having to spend its scarce foreign exchange.

The implications of China's economic policy and legal system derived from China's "historic turning point" of opening its door are also significant, since

(1) China, for the first time, "was prepared to accept ... not just technology, but investment as well, from the developed countries of the capitalist world", and "the new 'Law of the People of the Republic of China on Joint Ventures' using Chinese and Foreign Investment" was promulgated on 8 July 1979, which "thereby took a major symbolic step toward confirming and implementing the open door policy" (Ho and Huenemann, 1984, p. 2).

(2) China's determination to establish Special Economic Zones (SEZs) in Shenzhen and Zhuhai in Guangdong province, and Shantou and Xiamen in Fujiang province was a pioneering undertaking, as far as socialist countries were concerned (Fang and Xu, 1995). In these selected areas, special economic policies were given and a special economic system was allowed, in order to test out the open door policy and to set successful examples for the rest of China. SEZs' success later not only stimulated China's further opening up, but also attracted other developing countries to follow up the model,

including Egypt and a number of former Soviet Union countries. Recently, even Japan has expressed their interest in this model (Hu, 2002).

China's open door policy was indeed a landmark shift, turning the country from the period of "self-reliance" to the era of "allowing Western FDI". However, many theoretical and practical questions relating to western FDI remained unanswered, as the Chinese knew little about what FDI was, and they "started virtually from zero in forming the legislative and legal framework..." (Shapiro, Behrman, Fischer and Fowell, 1991, p.123). In other words, since FDI was a totally new area for the Chinese to work in, they had no option other than "learning it while doing it", this led to a striking feature of FDI development in the country: practising first, study and establishing policy environment later; or studying on FDI and making FDI policy followed the FDI practice.

In addition, how the Chinese side worked together with their western partners in a FDI project would become a wait-and-see issue, since China was isolated from western nations for such a long time, it did take time for both of them to get familiar with each other.

Two major measures were taken by the government in order to resolve problems they were facing while introducing FDI. Firstly, western FDI theories were allowed to be introduced to the country. As a result, translated FDI related books, articles of introduction to Western FDI - written by both western and Chinese scholars - were seen in Chinese bookstores, and university students had the opportunity to study on a new course of Western Business, which included worldwide recognised western FDI theories. This, as discussed in Chapter 2, formed the first stage of the development of China's FDI theory. In the meantime, however, all Chinese were reminded by the government that China was building up socialism with Chinese characteristics, whilst Western FDI was used only for this purpose.

Secondly, the government was fully aware that they lacked the knowledge and experience of dealing with western FDI, they therefore realistically decided, to begin with, to allow the form of equity joint ventures to be set up in the country. They believed this form of FDI was commonly used in the world, it therefore would be easier for western investors and Chinese people to follow. Thus, in the year following China's open door policy, the government promulgated the Chinese equity joint venture law. Interestingly, this form of equity joint venture did not develop as well as the government expected. Instead, two other forms of FDI – non-equity joint ventures (also known as contractual joint ventures [CJVs]), and wholly foreign owned enterprises (WFOEs) – emerged in China in the absence of related laws. The WFOEs were initially confined to SEZs and were small in number, although the law on WFOES was not available until 1986 when this form of FDI became permitted to fourteen open coastal cities; while the form of CJVs, compared with equity joint ventures, soon became a more popular form to attract western FDI in the early years of China's open door policy, though the law on CJVs was published as late as 1988.

The problems of China's understanding western FDI and its poor policy environment generated the slow FDI growth during 1979-86, and serious dissatisfaction of foreign investors caused by the controversial issue of balancing foreign exchange led to a FDI dramatic fall between 1985-86. The Chinese took astonishing efforts to resolve these problems in October 1986 by announcing an important new FDI policy, namely the "22 Provisions", which, for the first time, were aimed at encouraging western FDI, instead of simply allowing it. This, therefore, marked the second turning point of China's FDI development.

The second section of this chapter examines how western FDI was treated in China - in terms of the government approach, attitude and policy – and why it was treated as such. The actual development of FDI will also be considered with regard to its pattern and features, and the reasons for its type and direction of development will be reviewed.

In the third section, a general evaluation of China's use of FDI will be given, in terms of whether or not China had been successful in the introduction of western FDI in the 1978 and 1986 period; and the reasons for the sudden FDI "boom" and its disappointing "bust" in 1985-86 will be explained. This will be followed by a summary of the major problems related to how China viewed and dealt with FDI and foreign investors, it being these problems which blocked the way for its FDI further development in the country. Special attention will also be paid to the issue of balancing foreign exchange, as this became a central problem and served as a fuse that urged the Chinese government to take action to resolve its major problems and which finally led to another dramatic change in China's FDI policy, and led to a new historical turning point in China's FDI development.

5.2. Evaluation of the First Period

5.2.1. Permission and Control: a special combination of China's approach towards FDI

As a socialist country, China's opening of its doors to the west was an astonishing shift, especially when other socialist countries - such as the Soviet Union, East European countries and the communist countries of south-east Asia - still held the door closed to the west until the late 1980s. What remained for China to answer, though, was the precise path it would take in its move to being an open economy and to welcoming Western FDI in China.

It should be noted that the open door did not mean China would give up its control over Western business activities in the country. On the contrary, the open policy makers did not reject the view that FDI had potential negative effects. Nevertheless, they believed that China could "selectively absorb the good things and boycott the bad things from abroad" (Pearson, 1991).

The Chinese government thus adopted an approach which combined a bold permission of FDI, but with a careful control over it. This approach induced the following determinations:

(1) *the model of the "four dragons (Singapore, Hong Kong, Korea, and Taiwan)" - to use FDI to speed up economic growth, as well as to maintain political stability - was followed;*

(2) *export promotion and technology transfer were seen as two main objectives of using FDI;*

(3) *new legislation was passed both to stimulate FDI in China and to strictly control its influence;*

(4) *"minding the stones under the water while crossing the river" - a gradual opening door pattern was designed.*

(1) The Success of the "Four Dragons" and China's Determination to Introduce FDI

China was trying to benefit from the experience of other developing countries, notably the "four dragons" - Singapore, Hong Kong, Taiwan, and South Korea - the Newly Industrialising countries and regions of South-eastern Asia, where FDI has played a significant role in promoting exports and technology transfer and which thereby has helped the economy to meet international standards (Pomfret, 1991).

The government felt a deep regret that the country had missed good opportunities for development, especially the one that occurred in the 1960s, because the country had been influenced by ultra-left thought (Fang and Xu, 1995). In the 1960s, the western developed countries were restructuring their industries, which was generated by their dramatic development of high-tech industries. As a result of this, some labour-intensive manufacturing industries and less advanced technology were relocated to some developing countries. The "four dragons" did not miss the chance to attract these relocated Western industries and transferred technology to their countries and regions. This led to a boom in their economic development in the late 1960s (Liu, Li and Tian, 1993). Now world-wide industrial restructuring was emerging again following "the second petroleum crises" in 1979, while China was conducting its open policy, and the view was that China could not afford to miss it again.

China wanted to follow the experience of the four dragons; each of them had sought to contain the impact of foreign investors on their economy, as well as to encourage some degree of nationalism to consolidate their desired economic growth and political stability. In addition, each of the four had close cultural and historical ties to China, resulting in a competitive as well as collaborative relationship. Despite the previous isolation of China, it had witnessed these successes and had felt their competitive pressures as it opened into the world market in the late 1970s. Moreover, the four managed to exploit their low-cost labour and in turn, provide very competitive products for the world market. Low-cost labour was also one of the major comparative advantages that China held, and export promotion was a key objective other than technology transfer via FDI.

Although China had much in common with the four dragons, the journey of China's introduction of FDI to its country has not been smooth due to differences in its political and economic systems from that of the four dragons.

(2) *Export Promotion and Technology Transfers: two major objectives of China's use of FDI*

China's declared aims of attracting FDI were for export-oriented projects and technology transfers.

The scarcity of foreign exchange was always a Chinese major concern as a result of its previous isolation. Therefore, foreign exchange earnings were seen as a major goal by the Chinese government in order to finance its priority programme (Kueh, 1992). Secondly, China regarded the Brazilian debt crises in the 1970s as a good lesson for its dealing with foreign investment, and concluded that the Brazilian model of import substitution inevitably led to its severe foreign exchange deficit, and China should not let it happen (Fan, 1992; and Liu, Li and Tian, 1993). Thirdly, the sudden rise of the four dragons greatly encouraged China to favour their model - using foreign investment as a major means of promoting export and earning foreign exchange (Roehrig, 1994).

In addition to export promotion, another purpose of China's use of FDI was to attract Western technology.

In the early 1980s, China's then Premier Zhao Ziyang enunciated the Chinese government's belief that modernisation depended largely on the country's ability to develop high technology rapidly: "In order to realise modernisation, reinvigorate the economy, and quadruple the total industrial and agricultural output value, we must rely on the progress of science and technology" (*People's Daily*, 19 August 1983, p.5). Technology development was expected to improve the quality of labour and management; to increase levels of production and labour productivity; and to improve product quality. Consequently, competitiveness on the international market would increase and exports could be promoted.

Simply speaking, China's master plan wished to develop exportable products from Chinese materials and labour by using Western facilities, technology, and managerial expertise. In turn, once exporting is expanded by using advanced technology, technology transfers can then be paid for by exporting. In doing so, technology transfers and exporting can promote each other, and FDI in China would be running in a good circle.

On the other hand, however, what the foreign investors desired to obtain by investing in China was access to a potentially massive domestic Chinese market (Walker and Flanagan, 1987). “With 22 per cent of the world’s population in China, we cannot afford not to be there”, said the chief executive officer of a major international company (Shapiro, *et al.*, 1991, p.17). This objective apparently was against the Chinese objective of export promotion. These two different positions thus led to conflicts between foreign investors and Chinese FDI participants, which however had been gradually eased by their compromise over time.

With regard to technology transfer via FDI, the Chinese had been disappointed that technological levels of many of the ventures were unsophisticated, contributing little to China’s modernisation programme (Shapiro, *et al.*, 1991).

What caused this?

One of the major reasons of foreign investors operating in low-tech activities in China was that the Chinese new law on JVs carried idiosyncratic restrictions on foreign partner operation and their behaviour, as Western capitalists were viewed with suspicion. As a result of this, many foreign investors simply sought quick returns on investment by using low technology and cheap Chinese labour before they were more confident in China’s investment environment (Pomfret, 1991).

In addition, as already noted, the Chinese, in theory, seemed to understand that the technology transferred from Western countries to developing countries was declining or less advanced as a result of western countries’ industrial restructuring, and China expected to take advantage of the opportunity of western industrial restructuring.

In reality, the government still wished to “acquire high technology and... the ability to export high quality goods” (Walker and Flanagan, 1987, p.45). This contradiction led to uncertainty in China’s FDI policy on technology transfer. It is a fact that China has introduced some more advanced technology via FDI since late 1979, which may be in line with its policy of import substitution. However, the majority of FDI ventures had for the most part involved products “at the very end of the relevant product cycle” (Kueh, 1992, p.657), although these products have been internationally well-known, embodying appropriate technological standards. Moreover, many foreign companies do not wish to “arm” China with advanced technology, equipment, and know-how which could be used by China some day against them in the global competition. This is why Japan, in the early year stages of China’s open door policy, was reluctant to transfer technology to China; instead many more of its investments in China were in the form of financing arrangements (Shapiro, Behrman, Fischer, and Powell, 1991).

(3) Welcome, but Under China's Control: The new law on joint ventures

It would be a mistake to interpret the open door policy as one where China had to rely on Western advanced countries, so as to achieve its modernisation goals. As mentioned previously, the strategy set by the Chinese government of utilising Western FDI was to take advantage of its positive effects - modern technology, managerial skills, and so forth - which would speed up China's modernisation drive; but in the meantime, to minimise its negative effects - such as capitalist ideas, and western influence - which would be harmful to the Chinese people. Based on this strategy, joint venture (JV) was selected as a first means to introduce FDI as it provided the possibility for the Chinese to gain the control, and the law on joint ventures was designed more of less in a Chinese way - welcoming FDI, but under China's control.

On the one hand, the Chinese government strongly favoured the form of joint venture because it believed that foreign companies were familiar with this form from their investment in other countries, and would therefore be willing to invest in China under similar terms. The government also believed that, as part owners of joint ventures, foreign investors would be more committed to their success and hence would be more willing to supply ventures with advanced technology and management skills (Pearson, 1991).

On the other hand, because the JV involves local participation, the government then hoped to use the host country's advantage to gain substantial control over the operation of the JV.

"*The Law on Joint Ventures Using Chinese and Foreign Investment*" was adopted on 1 July 1979 at the Second Session of the Fifth National People's Congress and promulgated on 8 July. The publication of the JV law had indicated the Chinese government's firm commitment to its FDI policy, as well as showing that China recognised and opened itself to western ways of doing business. In addition to its officially welcoming and permitting FDI, the JV law also protected the resources that foreigners invested in JVs and their rights to dispose of their property and to remit their share of the after-tax profits and other funds abroad (Ho and Huenemann, 1984).

However, some problems arose because the law was too simple, and therefore too vague; but there were other problems too.

Firstly, before 1979, China did not have a company law, a contract law or a commercial law, it would have been extremely complicated to create the legal framework for the JVs on the basis of China's primitive legal system. Instead of drafting a detailed and comprehensive law, China chose to produce a JV law of only fifteen broadly worded articles but left the detailed rules and regulations to future legal pronouncements. However, great efforts were made in drafting of the law: the China State Planning Commission headed a drafting team, who had reviewed a large number of related legal documentation existing in more than thirty other countries, and visited some of these countries to learn their experience (Liu, 1993).

Secondly, China desired to remain as flexible as possible in an area where it had no experience. In other words, it was a way the government used to protect itself, as it was the Chinese authority, not the foreign investors, who was in a position to retain "the power of amendment" of the Law.

Other problems occurred because JV legislation was too simple. For example, the Law did not give the criteria that China used to judge investment applications nor did it give much guidance to potential investors as to the type of JVs preferred or the type of information they needed to submit in support of their applications, which led to uncertainty in the approval process (Ho and Huenemann, 1984).

In addition, confusion appeared about the foreign ownership. According to Article 4 of the JV Law, "The proportion of the investment contributed by the foreign joint venture(s) shall generally not be less than 25 per cent of the registered capital of a joint venture".

Does no maximum amount of foreign ownership imply that 100 per cent of foreign-owned enterprises are permitted in China?

The fact that eighteen wholly foreign financed enterprises existed in Guangdong Special Economic Zones ha answered "yes" to the question. However, this raised another question of why the enterprises entirely funded by foreigners should be regarded as a joint venture in the absence of Chinese partner.

It is very important to notice that the JV Law had reflected strongly the Chinese desire to maintain their control over the ventures in one way or another.

Firstly, in order that the proposed JVs were under the entire control of the Chinese central government, the JV Law required that "the joint venture agreement, contract and articles of association signed by the parties to the venture shall be submitted to the Foreign Investment Commission of the People's Republic of China, and the Commission shall, within three months, decide whether to approve or disapprove them" (Article 3).

The central government's bureaucracy and cautious attitude towards JV project applications led to a long and complicated procedure for approvals. Chinese provincial governments had the authority to approve the FDI projects only two years later, but their authority to give approval was generally subject to no more than USD3 million of FDI value which was set by the central government until 1983 when the central government started to gradually soften its strict restriction over the amount of FDI projects the local governments can approve (Hu and Ji, 1994, p.36).

Secondly, the Law put the Chinese participants in a dominant position by gaining control over ownership of equity in the venture. In most JVs outside of China, control over decision-making is directly tied to the division of ownership between partners, namely, the partner with majority ownership has the majority of votes on the board of directors. In order to retain control, host governments in both planned and market economies commonly restrict the percentage equity held by foreigners to 49 per cent or less, particularly to the ventures in raw materials, utilities, and other strategic industries (Pearson, 1991).

Interestingly, China's JV Law broke with this common host country preference for majority equity by allowing the foreign partners to contribute 25 per cent or more of their investment to a JV, but did not specify a maximum limit on foreign ownership, therefore offering the possibility of majority foreign ownership of a joint venture. However, when the Law was in operation, it did not seem to follow this theory, as the Chinese government was clear in its preference for Chinese majority or fifty-fifty ownership, for the "comfort of control" over management (Pearson, 1991, p.165). To reflect this preference, many more JVs with Chinese majority or equal ownership were approved and established than foreign majority in the early years of the Law (Beanish and Spiess, 1993).

There were some careful considerations behind the Law which did not restrict the percentage of foreign ownership. Firstly, the government wished to make sure the new Chinese law would make the country attractive enough to foreign investment in China.

Secondly, the government hoped to have some flexibility to deal with different cases. Some foreign participants were allowed to hold a majority share because they were in a strong position or preferred to do so. For example, foreigners who invested large amounts of capital in projects with low profits could be granted by the government the right to hold majority ownership, or when the projects were involved advanced technology (Pearson, 1991). In general, however, JVs with Chinese majority ownership would be much more easy to be approved.

In addition to its preference for Chinese majority ownership in the JV, the government also found a way to strengthen the Chinese dominance in the JV by requiring that "a joint venture shall have a board of directors.... The board of directors shall have a chairman, whose office shall be assumed by the Chinese joint venture(s)..." (Article 6). The board of directors were designated as the highest authority in the JV, which was in a position "to discuss and decide all major problems" of the venture, ranging from "expansion projects, proposals for production and operating activities, the budget,... the termination of business,..", to "the appointment or employment of the president, the vice president(s)..." (Article 6).

In order to show China's fairness to foreigners somewhat, the Law did not restrict foreigners to being the president (or the general manager) who was in charge of day-to-day management. However, since the board chair had to be Chinese, who is the number one of a JV, and Chinese partners held a majority or equal position on most boards, the JV was therefore firmly controlled by Chinese hands. This stipulation also provided the possibility for the Chinese to dominate JVs with a foreign majority stake, because the Chairman of the board is Chinese, who is the most important person in the JV. In other words, foreign majority ownership in the Chinese JV under this Law did not necessarily mean that foreigner(s) were in a stronger position in a JV.

In addition, the Chinese had instituted a safeguard - "shadow management" (Roehrig, 1994, p.39) - against foreign domination at management level. The shadow management system was initiated by the Chinese side, who again, attempted to present equality of the Chinese policy, as it usually provided for a Chinese deputy for each management position in the JV. Under this system, the Chinese side comfortably achieved two of their major goals.

The first goal was that the Chinese could watch and learn how foreign managers coped with JV issues with "advanced methods", while they were working together as close colleagues; the second was that the deputy title did not prevent the Chinese from playing a key role in the managerial areas of the JV, as "managerial decisions must generally be based on agreement between the expatriate manager and his deputy".

(4) Crossing the River by Minding the Stones under the Water: a careful designed opening pattern

Once the open door policy was determined and announced, and the new law on the JV was promulgated, the next move for the Chinese leadership would be to put FDI from theory to practice in China. In order to find a safe way in which Western FDI can be fully used, and at the same time the Western negative influence can be minimised, an approach combining "activeness" and "caution" was adopted (Wang, 1995), which in China is called "crossing the river by minding the stones under the water". Under the guidance of this approach, China's door was opened very narrowly in the early years of its open policy.

Along the lines of the successful free economic zones in Taiwan, South Korea, the Philippines and other Asian countries, together with the consideration of creating an economic environment conducive to FDI inflows with an experimental manner, a small border township in Guangdong province of South China - Shenzhen was selected as the China's first "Export Zone" by the China State Council in January 1979. Within the following two years, three more - Zhuhai and Shantou (Guangdong province), and Xiamen (Fujian Province) - were established. These zones were renamed as Special Economic Zones (SEZs) in July 1981 in order to reflect the broader scope of their business activities (Qi, 1998).

An interesting question is why these four zones were selected as China's SEZs. Two major explanations are the most relevant to the question. The first explanation is that these zones are much more easily controlled by the Chinese government. All of these zones are located in the periphery of China, far away from major Chinese urban areas, so as to prevent the transmission of negative characteristics that the Chinese government expected to accompany western investment.

Shenzhen, the largest of the SEZs, is a typical example. It was physically cordoned off from the rest of Guangdong by a fifty-three-mile long patrolled high fence, which constituted a second border to control the flow of people and materials between the SEZ and the rest of China. The government also relied on control of the Hong Kong border to prevent smuggling of electronic goods, pornographic materials, and other "corrosive materials" from Hong Kong, and to prevent Chinese citizens from leaving Shenzhen for Hong Kong. More generally, the government tried to suppress activities it considered immoral, criminal, or otherwise anti-socialist, such as gambling and prostitution (Pearson, 1991). Offenders were punished harshly to provide examples for others. In addition, the zones cover only very limited areas in terms of China's vast land. As a largest SEZ, Shenzhen only covered an area of 327.5 square kilometres. Although there was a site extension of SEZs in 1984, the other three SEZs remained small : Zhuhai SEZ was extended from 6.7 kilometres (1980) to 15.16 kilometres, Shantou SEZ was enlarged from 1.6 kilometres (1980) to 52.6 kilometres, and Xiamen SEZ expanded from 2.5 kilometres (1980) to 131 kilometres (Fang and Xu, 1995).

Therefore, all of the SEZs were seen as a laboratory where the open policy was tested. As the Chinese decision-makers planned, once SEZs were successful, their experience would be useful for the further opening of China's doors; if not, the price the government could pay would be very little, which would not cause a disaster for the open policy, but would provide some lessons for the leadership to draw from, so as to adjust and better the open policy (Liu, 1994).

The second explanation was that the SEZs were the areas in which the open policy would be more likely to be successfully tried out. The government believed that, because of their special circumstances, Guangdong and Fujian provinces - where these four SEZs were located - could take full advantage of the open door policy.

Firstly, historically both provinces were more open than many other part of China to foreign businesses, and large numbers of Overseas Chinese have roots in the two regions.

Secondly, both are close to Hong Kong, and Guangdong has had a long-term special relationship with Hong Kong. Shenzhen was designed as a gateway to Hong Kong, and Zhuhai was considered as a special link to Macao, as the former borders on the new territories of Hong Kong, and the latter is next to Macao. As for Xiamen SEZ in Fujian, it is close to Taiwan which is situated on the other side of Taiwan Channel, and has a great potential to develop its relationship with Taiwan along with the improvement of the political atmosphere between Beijing and Taiwan.

Thirdly, most Overseas Chinese have much in common with Guangdong and Fujiian people. For example, they speak either Guangdong or Fujian dialect, and have a common cultural tradition. These advantages facilitate communication and thus help reduce the transaction costs of investing in China and the costs of transferring technology and skills to the country.

Finally, there were also political reasons for the government in favour of Guangdong and Fujian. As Hong Kong, Macao and Taiwan were regarded by the Mainland Chinese as being run under the capitalist system, the Chinese government hoped to demonstrate that capitalism and socialism can co-exist, even if only in a few restricted SEZs (Ho and Huenemann, 1984, p.51). A success of the co-existence would help China in later years to take over Hong Kong and Macao more smoothly, and negotiate the reunification of China with the Taiwan Administration, as the Chinese government claimed that it wished Hong Kong, as well as Macao and Taiwan continue to function under their existing economic system after reunification of China. This was called by Deng Xiaoping "one country, two systems" (New Star Press, 1991).

Thus, these special circumstances of Guangdong and Fujian helped SEZs tap an extremely important source of capital and skills, namely the Overseas Chinese communities in Southeast Asia.

Of the Overseas Chinese communities, the nearest and the most attractive is Hong Kong. China had been eagerly to learn from Hong Kong's economic success and was hoping to gain access to its capital, its managerial skills and international marketing networks.

With regard to the nature of the SEZs, some Chinese defined the SEZ as "an area... [where] controls are relaxed as compared with inland China for the purpose of promoting economic co-operation by all proper means with foreign businessmen, Overseas Chinese, as well as Hong Kong, and Macao compatriots" (Ho and Huenemann, 1984, p. 49). This definition implies that the Chinese central government would give more authority to the SEZs in order to promote the SEZs' international economic relation, and also to specify the relationhip between SEZs and Hong Kong and Macao.

A clearer and more official definition of the SEZ was given later, when the following was written:

"A special economic zone, or fully called 'specially-opened economic zone', means that a sovereign state or a region, in order to reach a special goal for its internal and external activities, can select a zone in which a special economic management system is practised and special economic policies are given" (Ma, 1993, pp.125-126).

This definition, politically, claims that the SEZs are under the full control of the Chinese government, as the government did not expect to develop them as modern "foreign concessions", or treaty ports (Chen, 1989, pp.32-3).

Economically, it reveals two things which make the SEZs special: one is a special economic management system; the other is special economic policies, which suggests that there is nothing special in the political sense. Therefore, the government repeatedly pointed out that the SEZs were still the sovereign territory of the Chinese government, and that the SEZ governments must follow the policy and the party centre, and that the SEZs were governed by the Chinese laws (Hu, 1989, p21; Li, 1995).

Indeed, special economic treatments were given to the SEZs by the government, and they were significantly different from those that existed in other parts of China. What the "special" really means was specified by the then Chinese vice premier Gu Mu in April 1984 (Zhang and He, 1995, p.94):

> The "special" in the SEZs, means that special economic policies and the special economic management system are adopted in the SEZs.
>
> These included:
>
> (1) The economic development in the SEZs relies primarily on receiving and utilising FDI, and products made in there are mainly for the purpose of exporting. The economy in the SEZs is a combined economy, that is, the SEZs' economy is under the leadership of the national socialist economy, while Sino-foreign joint ventures, Sino-foreign co-operative ventures, and wholly foreign owned enterprises play a major role in the SEZs.
>
> (2) Market forces play a prominent role in the economic activities in the SEZs.
>
> (3) Foreign investors in the SEZs receive special preferential treatment in taxation and convenience in entrance to and leaving China.

(4) The administrative system adopted in the SEZs is different from the inland China, and allows the SEZs to have a greater authority.

All these policies were intended to make the SEZs different from the rest of China, so as to increase the SEZs' attractiveness for foreign companies. This was so "special' because other parts of China at that time were governed by the centrally-planned economy system until 1992, and only state-owned enterprise were allowed to play a dominating role. In addition, decentralisation offered the SEZs the authority at the provincial level somewhat, as they can "operate their enterprises independently in the special economic zones", and review and approve investment projects.

For example, Shenzhen can authorise FDI projects without the approval of higher authorities, as levels of capital investment - some USD17 million for heavy industry, USD10 million for light industry, and USD33 million for non-industrial projects such as hotels - are considerably higher than commonly permitted to local authorities (Shapiro, Behrman, Fischer and Powell, 1991). This was designed to let foreign investors face less red tape and bureaucracy in the SEZ than other parts of China. Other measures of decentralisation for the SEZs included the retention of foreign exchange, and deciding how to use funds to improve their infrastructure.

Furthermore, all SEZs were permitted to offer incentives above and beyond national investment incentives.

The most important of these was that net earnings of enterprises in the SEZs were taxed at a flat rate of 15 per cent, as compared to 33 per cent for JVs in other parts of China. Also, there was no remittance tax on after-tax profits remitted abroad. "Machinery, spare parts, raw materials, vehicles and other means of production for the enterprises in the SEZs are exempted from import duties", and the duties on necessary consumer goods for use in SEZs may be lowered or exempted depending on "the merits of each case". To encourage the use of Chinese products, domestic machinery and raw materials are available to enterprises in the SEZs at a lower export prices, but they must be paid with hard currency (Ho and Huenemann, 1984, p. 50).

As a sign of China's early year's open policy, SEZs were growing quickly. The injection of large sums of investment for basic infrastructure in Shenzhen between 1979 and 1986, had developed it from a small township surrounded by the rural landscape to the largest economic zone of its type in the world (Shapiro, Behrman, Fischer and Powell, 1991, p. 63). The emergence of Shenzhen SEZ was described as "a modern city built up overnight" (Hu, 1989, p. 27). Economic growth was also fast in the SEZs. Shenzhen's annual average growth rate of GDP was around 50 per cent during the period of 1979-86. "Shenzhen speed", and "Shenzhen efficiency" became government's slogans to encourage Chinese people, especially those outside the SEZs, to build up China's modernisation more quickly and more efficiently. Standards of living were improved greatly for residents in these zones, which had attracted a great number of Chinese people (skilled and unskilled workers) to cross the Shenzhen boarder and seek opportunities in the zones.

Of the skilled workers, those who came from Shanghai may be the most active group, as there were so many Shanghai people working in Shekou (industrial area of Shenzhen SEZ), that the Shanghai dialect had become one of the most important local languages. "A couple of years after the establishment of Zhuhai SEZ, local people no longer leave Zhuhai for Macao illegally by crossing the bay", said a Zhuhai local official, pointing to the bay between Zhuhai and Macao - during a research visit made to China as part of this study. As a pioneer for receiving foreign investment, the SEZs had attracted more amounts of FDI than any other part of China during the period of 1979 - 86 (see Table 5.1).

It should be noted that the figures during the period of 1979-1983 are absent because only the SEZs were opened for FDI at the time and there was therefore nothing else existing to compare with the SEZs until 1984 when fourteen coastal port cities were allowed to be opened for FDI.

In general, it can be seen from the Table 5.1 that FDI attracted to the SEZs accounted for an important part of China's total in terms of the number of projects agreed, as well as the amount of capital agreed and the actually realised amount of capital. However, it is important to note that the agreed amount of capital appeared to remain on a sharp downward trend, which implies that more and more FDI makers were seeking opportunities in newly opened areas, thus the SEZs were facing a big challenge from them.

Table 5.1 **FDI in SEZs and Its Percentage in China (in US$ 10,000)**

	1984			1985			1986		
	Agreement No.	Agreement	Actually Amount	Agreement No.	Agreement	Actually Amount	Agreement No.	Agree ment	Actually Amount
China Total	1,856	265,100	125,800	3,073	593,100	166,100	1,498	283,400	187,400
SEZs Total	511	80,022	34,268	454	110,257	27,868	285	31,868	43,571
Percentage of SEZs in China Total (%)	27.53	30.19	27.24	14.77	18.59	16.70	19.03	11.24	23.25
Shenzhen	331	53,289	18,437	253	76,322	17,651	190	22,716	36,080
Zhuhai	70	9,705	11,000	71	6,020	2,181	45	5,191	3,298
Shantou	24	2,061	787	23	1,303	732	16	1,202	800
Xiamen	86	14,967	4,044	107	26,612	7,304	34	2,759	3,393
Percentage of Shenzhen in SEZ total (%)	64.77	66.5	53.80	55.73	69.22	63.34	66.67	71.28	82.81

(*Sources* : 1. China Statistical Yearbook, 1992;
2. China Foreign Economic Statistics, 1979 – 1991)

The growth of SEZs was accompanied by some disappointments.

The USD1.5 billion (agreed amount) and USD720 million (actually used) in FDI in Shenzhen was a considerable amount. However, the amount spent on infrastructure in Shenzhen by the Chinese government only accounted for little more than half of the dollars (in terms of agreed amount of FDI), which was not as much as local officials expected. In addition, only a small proportion (10 per cent in 1984) of the manufacturing enterprises established in Shenzhen was classified as high-tech. The definition of high-tech at that time was exactly as a self-critical Shenzhen official said, "If a [foreign] manufacturer made a product just a little better than we could, we considered it to be high technology" (Pearson, 1991, p.158).

It was estimated that only around 10 per cent of the manufacturing sectors in Shenzhen in 1984 was seen as high-tech, whilst the majority of the manufacturing ventures in Shenzhen were "essentially rather crude, labour-intensive ventures that produced such products as cheap radios, knitwear, and plastic followers" (Shapiro, *et al.*, 1991, p.66). The Chinese government felt disappointed about this unexpectedly poor result, but some local people viewed it in a different way. For example, Li Guofu, President of the Shenzhen Industrial and Trading Centre, commented "We are naive if we think this industrial desert can go hi-tech in just a few years" (Shapiro, Behrman, Fischer and Powell, 1991, p. 66).

Moreover, total exports from Shenzhen were only 20 per cent of the zone's industrial output in 1984, and far short of the government's target of 60 per cent by 1980. Shenzhen's imports usually outweighed exports by a substantial margin (by five to one in 1983, for example). While the overall contributions of the SEZs to national foreign currency reserves started out relatively small, they apparently became a net drain on reserves in the mid-1980s, when foreign exchange deficits in the zones ranged as high as USD542 million (Pearson, 1991).

Finally, national control over the entrance and spread of western "decadent" values and goods was not as effective as the Chinese leaders had expected. In fact, unhealthy capitalist elements more commonly started to exist in the SEZs than in inland China, especially in Shenzhen. Illegal trading of smuggled goods (most were electronic goods and cigarettes), corruption, beggaring and prostitution had become an undesired phenomenon in these zones, which was severely criticised by the older cardres in the zones and Chinese conservative leaders. Younger Shenzhen officials and managers took it less seriously, however. They argued privately that the Chinese people would be able to learn for themselves what is right and wrong. One official stated that it was more important to pay attention to China's' economic development than to unhealthy tendencies (Lin, 1987).

What caused these problems? One answer says that the problems resulted from the combination of pressure for quick results and the incentives arising from decentralisation of authority hindering the capacity of SEZs to fulfil their original development goals (Pearson, 1991). It is true that the SEZs had faced considerable pressure from the government that had intended to make these zones a successful example for the whole of China to utilise FDI, and from the Chinese people in other parts of the country who had been seriously learning from the SEZs experience of fast economic development via FDI, and eagerly expecting the open door policy to reach their regions soon. The question is why this pressure would put the SEZs in a dilemma even though the SEZs were in the meantime given incentives of decentralisation of authority.

It is evident that because of the fundamental difficulties the SEZs had, quick results were therefore unlikely to be achieved in the zones. Firstly, as already noted, labour is cheap in the SEZs by Western standards, but is more expensive than elsewhere in China, which is a disadvantage compared to many other regions of the country to attract FDI. Secondly, the labour in the zones impose significant limitations, as the majority of factory employees were previously rural-based labour, and technical and skilled workers were very difficult to find locally. Last but not least, because the SEZs have no established industrial base, enterprises that depend on a network of suppliers are less likely to be attracted to locate there. This is a major shortfall in the development of the SEZs.

Despite the problems with the four SEZs, these zones were still considered by the Chinese leadership to be successful examples. The much faster rate of growth in SEZs than the rest of the country had brought the hope for the leadership to develop the country further by opening up its door more widely. On the other hand, the government faced pressure from both China's major cites and foreign investors for further opening-up, as these cities anxiously wished to benefit from the open policy and demonstrate their huge potential to take advantage of FDI. Foreign investors were more interested in China's vast market and some areas with better investment environment, such as better infrastructure, better local talent, and better industrial base. With regard to the western negative influences derived from their investment, the government realised it was inevitable, butt it was not a reason to withdraw the open policy, as the principle the government followed was to "resist external negative elements", but not to "resist foreign investment" (Fan, 1991).

Two measures were taken. One was to strengthen education, so as to build material civilisation and spiritual civilisation spontaneously in the SEZs. The second measure was to more effectively control the SEZs, such as more firmly punishing the offenders, and upgrading the staffing of the second border, and initiating audits of enterprise finances to detect smuggling (Tang, 1988).

The status of a good example for testing the open policy was officially approved by Deng Xiaoping when he inspected Shenzhen, Zhuhai and Xiamen in early 1984 "The fact of experience and development of Shenzhen have shown that our policy of setting up SEZs has been right", "Zhuhai Special Economic Zone is excellent", and "Making Special Economic Zones faster, and better" (Qi, 1998, p.17).

More importantly, Deng's speech in Beijing a month after his tour in the SEZs indicated that China would launch a new policy of open policy, as he states, "We must make it clear that our purpose of establishing SEZs and adopting open policy is not to withdraw them, but to develop them further" (Zhang and He, 1995, p.89). As a result, the government decided in May 1984 to open fourteen coastal port cities for foreign investment.

These coastal open cities (COCs) were Beihai (Guangxi province), Zhanjiang (Guangdong), Guangzhou (capital of Guangdong), Fuzhou (capital of Fujian), Wenzhou and Ningbo (Zhejiang province), Shanghai, Nantong and Lianyungang (Jiangsu province), Qingdao and Yantai (Shandong province), Tianjin, Qinghuangdao (Hebei province), and Dailian (Laoning province).

All of these newly-opened cities were offered incentives similar to those in the SEZs, but less preferential, as these areas were not considered as special economic zones. For example, income tax of enterprises in COCs was 33 per cent (15 per cent in the SEZs).

The authority of approving FDI projects varied from city to city. Shanghai and Tianjin municipal authorities were allowed to approve investment up to USD30 million; Dalian and Guangzhou, USD10 million; and the others were limited to approvals of USD5 million. In addition, each COC was allowed to establish an Economic and Technical Development Zone (ETDT) outside the city, where income tax rates of 15 per cent were offered and the 10 per cent profit remittance tax was also waived (Shapiro, Behrman, Fischer, and Powell, 1991).

Unlike Shenzhen and Zhuhai, where there are second border controls to prevent unhealthy tendencies from spreading to other parts of the country, COCs were unlikely to be controlled in this way, as they covered huge areas of the country. The central government therefore used a slightly different way to control the COCs by offering them less favoured policies to make them less relaxed than the SEZs. However, this led to a struggle between Central Government control over COCs and the COC government's strong desire for more incentives and greater decision-making authority. In addition, regional conflicts derived from unbalanced regional development had become more serious, especially in the later years of the open policy. Consequently, a new open strategy or pattern was formulated in October 1987, when the 13th

National Congress of the Chinese Communist Party was held, which was described as a "gradual expanding open pattern", from "SEZs - COCS - CEOZS - Inland" (Liu, 1994), or from "South - North, East - West, Coast areas to inland areas" (see Table 5.2 for the details of China's open events).

Table 5.2 Major Events of Geographical Opening up of China to Foreign investment

Year	Status of Opening	Geographical Location
1979-80	4 Special Economic Zones (SEZs)	Shenzhen, Zhuhai, Shantou, and Xiamen
1984	14 Coastal Open Cities (COCs)	Beihai, Zhanjiang, Guangzhou, Fuzhou, Wenzhou, Ningpo, Shanghai, Nantong,Lianyungang, Qingdao, Yantai, Tianjin, Qinghuangdao, and Dalian
1985	3 Coastal Economic Development Open Zones (CEDOZs)	Changjiang (the Yangzi River) Delta, Zhujiang (the Pearl River) Delta, and Xiamen, Zhangzhou and Quanzhou Delta [in Fujian province]
1985-91	14 Economic and Technological Development Zones (ETDZs)	Outside the cities of fourteen COCs, but Wenzhou and Lianyungang are excluded, and Shanghai has three ETDZs (Minxin, Hongqiao, and Caohejing)
1988	Hainan SEZ	The whole Hainan province
1990	Shanghai Pudong	The east bank of the Huangpu River in Shanghai, New Zone covering an area of 350 square kilometers
1990-92	13 Free Trade Areas (a small district with closed access facilities)	Waigaoqiao (Shanghai), Tianjin Port, Dalian, Shatoujiao and Futian (Shenzhen), Guangzhou, Zhangjiagang (Jiangsu), Haikou (Hainan), Qingdao (Shangdong), Ningbo (Zhejiang), Fuzhou (Fujiang), Xiangyu (Xiamen), and Shantou (Guangdong)
1990	Taiwanese Investment Zones of Fujian	(1)Xinglin and Haichang of Xiamen SEZ; (2)Fuzhou Mawei ETDZ
1991	13 Open Border Cities (OBCs)	Huichun (Jilin Province), Heihe and Suifenhe (Heilongjiang Province), Manzhouli and Erenhot (Inner Mongolia Autonomous Region), Tacheng, Bole and Yining (Xingjiang Uygur Autonomous Region), Hekou, Wanding and Ruili (Yunnan Province), and Pingxiang and Dongxing (Guangxi Zhuang Autonomous Region)
1991	5 Cities along the Changjiang (Yangzi River)	Chongqing (Sichuan province), Yueyang (Hunan province), Wuhan (Hubei province), Jiujiang (Jiangxi province), and Wuhu (Anhui province)
1991	11 Capitals of Inland and Autonomous Regions (treatment equivalent to COCs)	Taiyuan (Shanxi province), Hefei (Anhui province), Yinchuan (Ningxia Hui Autonomous Region), and so on.
1991	27 High and New Technology Development Zones	Shanghai Caohejing, Guangzhou Tianhe, and so on.
1992	Hainan Yangpu Econo- mic development Zone	Yangpu Port

(*Sources*: 1. China Economic Development Trends; 2. China Handbook, 1993).

5.2.2. Characteristics of FDI in China between 1979 and 1986

(1). Slow inflows of FDI into China

A. Trend in FDI growth

The Table 5.3 below illustrates that, during the period 1979-86, the growth of both agreed and actually used value of FDI was rather high except in 1986, as there was no western FDI in existence before the introduction of the open door policy. In terms of size of the country, however, the amount of FDI inflows seemed to be very small, and thus the pace of FDI was in reality slow. In addition, the speed with which China introduced FDI was uneven during the whole of the above period. That is, the growth of FDI inflows between 1984-85 was relatively quicker than that in previous years, especially in 1985 (in terms of agreed value of FDI inflows) when China's "first boom" in FDI inflows occurred.

Table 5.3 China's Utilisation of FDI (in USD 100 million)

	Number of agreement	Value of agreement	Actually used value	Used value as a % of agreement value *
1979-82	922	46.08	11.66	25.30
1983	470	17.32	6.36	36.72
1984	1,856	26.51	12.58	47.45
1985	3,037	59.32	16.61	28.00
1986	1,498	28.34	18.75	66.16
Total	7,783	177.57	65.96	37.15

(*Source*: China Foreign Economic Statistics [1979-91], published by China Statistical Information & Consultancy Service Centre, 1992;

* The "Used value as a percentage of agreement value" is calculated by the author of this dissertation)

The boom, however, was followed by a FDI bust in 1986 (especially in terms of agreed value of FDI inflows). Therefore, these growth trends suggested that the inflows of FDI can be sub-divided into three different periods:

- 1979-83, when FDI rose from almost zero 1979 to USD1.732 billion in 1983);
- 1984-85, when FDI increased dramatically, reaching a peak in 1979-86 period);
- 1985 - 86, when FDI was sharply down.

Moreover, the realisation of the FDI value as a percentage of agreement value was poor, as the average FDI realisation was only 37.5 per cent, a little more than one third, although the annual FDI realised value seemed to be up year by year except for 1985.

B. Explanation for the above results of FDI in China

Factors causing the growing features of FDI in the above period are various. It was generally agreed, however, that China's legal environment had contributed significantly to the FDI growing features.

According to Wang (1995), Pearson (1991), and Roehrig (1994), there have been three major phases of legislation since China opened up to the world from the late 1978, marked by the years 1979 (when the Joint Venture Law was issued), 1983 (when the Implementation of the Regulations of the Joint Venture Law was announced), and 1986 (when "The 22 Articles" were promulgated); and the trends in the flow of FDI are closely related to these phases in the regulatory environment. It is interesting to consider how the development of the Chinese legal system affected FDI in the three different phases (the discussion of the third phrase - as it relates to the second turning point - will be covered in the following chapter).

As noted earlier, in July 1979, a few months after China's determination of the open door policy, the Chinese government moved quickly in taking its first step towards undertaking FDI legislation by issuing the Law of the People's Republic of Joint Ventures using Chinese and Foreign Investment. The law allowed western companies to make investment directly in the country, and guaranteed foreign investors' property and dividend rights. It was the first formal statement of commitment to foreign investment by the Chinese government, and established the principles and procedures for investment. The Law therefore marked the first regulatory phase (1979 - late 1983).

Very soon after the promulgation of the Law, foreign business representatives thronged to China to investigate the potentially lucrative situation. Some foreign investors did take advantage of the opportunities offered by the Government. As can be seen in the table of Chapter 5, by the end of 1983, 1,392 projects (all FDI forms) had been approved with an aggregate value of USD6.34 billion pledged investment, of which, equity joint venture was 190, with the whole pledged value of USD362 million, accounting for only 13.65 per cent of the total number of projects, and 5.8 per cent of the total pledged FDI value (the trends of different FDI forms - equity joint ventures [DJVs], non-equity joint ventures or contractual joint ventures [CJVs], and wholly foreign owned enterprises [WFOEs] will be discussed separately in Section 5 of this chapter).

One of the major reasons why there was such limited flow of FDI to China was the broadness and vagueness of the EJVL, which had only fifteen short and general articles, and far short of guiding both Chinese and foreign partners in crucial legal and operational matters (Pearson, 1991, p.71). Although, before the announcement of Implementation of the Regulations of the Joint Venture Law in 1983, there were several regulations concerning some practical issues of FDI activities, ranging from taxation to labour management, and these legal rules more or less helped clarify the EJVL, however, the foreign investors still felt that the regulatory environment was quite restrictive, or not attractive (Liu, 1993, p. 866).

For example, the income tax law announced in 1980 offered 33 percent of income tax to joint ventures located outside of SEZs (15 per cent of income tax offered in SEZs), which was not generous enough in comparison with some other Asian countries (see Table 5.4 below).

The Table 5.4 shows that the income tax rate of Chinese joint ventures is about average - lower than that in Malaysia, the Philippines, and Singapore, but higher than South Korea and Taiwan, and about the same as that in Thailand. In addition, a rough comparison of the length of tax holiday suggests that Chinese incentives were less generous than these were available in other parts of Asia, as the tax holiday is the most important tax incentive for foreign investors to operate in a high-risk environment such as China and thus they are anxious to recover their investments in as a short period of time as possible (Ho and Huenemann, 1984).

Table 5.4. Effective Tax Rates On Profits And Number Of Years Of Tax Holiday In Selected Asian Economies, 1981

	Effective tax Rate on profits(a)	Tax holiday (number of years)
China	33% (b)	3 (c) (exemption – 1 year, reduction – 2 years)
Malaysia	44.5%	2 – 5 (d)
Pholippines	35%	none
Republic of Korea	25%	8 (exemption – 5 years, reduction – 3 years)
Taiwan	maximum effective rate not to exceed 22%- 25% (depending on industry)	5 (or the use of accelerated depreciation)
Singapore	40%	15 (exemption – 5 years, reduction – 10 years)
Thailand	29.5%	13 (exemption – 8 years, reduction – 5 years)

(1. *Source*: China's Open Door Policy – The Quest for Foreign Technology and Capital, published by University of British Columbia Press, Vancouver, 1984

2. *Notes*:

a. Assuming an industrial joint venture with a total investment of USD5 million and a 20 per cent pre-tax rate of return on investment;

b. 30 per cent if local surtax is excluded;

c. If the joint venture is located in an underdeveloped region or is engaged in a low profit industry, such as farming and forestry, a tax reduction of 15 per cent to 30 per cent for ten years beyond the original three may be granted;

d. The precise period depends on the size of the investment and the number of workers employed. Exemption may be extended to ten years if the enterprise produces a priority product, meets the local content requirement, or is located in a "development area").

In addition to being offered less attractive tax incentives, foreign investors were also discouraged by China's bureaucracy such as long and complicated FDI project application and approval; and by the uncertainty of policies, such as China's cancellation of large importing contracts for its ambitious domestic construction plans, notably the Baoshan Steel Plant invested by Japanese companies (Pearson, 1991). As a result, only a few "intrepid' or "foolhardy" foreign investors decided to establish their businesses in China (Pomfret, 1991) and to "test" its investment environment (Liu, 1993).

By 1983, the Chinese Government had recognised that the legal framework during 1979-82 did not provide sufficient incentives to foreign investors, and had to be improved if China wished to attract more FDI. Thus, in May 1983, at a national meeting concerning FDI, the State Council called for more open and more comprehensive policies and regulations towards FDI, which were reflected in the detailed and long-awaited "Implementation of the Regulations of the Joint Venture Law" (*IRJVL*) in September 1983 (Liu, 1993, p. 865).

The *IRJVL* contained sixteen chapters with one hundred and eighteen articles, ranging widely from JV establishment, management durations to taxation and foreign exchange control, thereby making some important issues much clearer. All of these matters were raised by foreign investors and their advisors as areas of concern (Kemp, 1987, p46). It also provided some additional incentives to JVs, such as the rules governing the exemption of import duties, and the consolidated industrial and commercial tax (CICT) on goods imported by JVs were liberalised marginally. The new regulations also relaxed the rule on the amount of income foreign workers of JVs may remit home. Now, foreign staff may request permission to remit abroad all, instead of previously only 50 per cent of their income after living expenses. Taking account of the revised income tax law of May 1983, which offered JVs the exemption of income tax in the first two profit-making years, and income tax reduction by one-half in the third, fourth, and fifth profitable years (the original provision provided only a one-year tax exemption plus a two-year 50 per cent reduction in income tax), China's tax incentive for foreign investment moved closer to that available in other parts of Asia (again, see Table 5.4).

From the viewpoint of the foreign businessman, the most interesting - and, potentially the most significant - change was China's announcement that it planned to relax its insistence that each JV must export at least enough to satisfy its own foreign exchange needs (Ho and Huenemann, 1984). The *RIJVL*, for the first time, provided the possibility for some JVs to sell their products mainly on the Chinese market, if the products were urgently needed or were import substitutes (Article 61), although the RIJVL was not designed primarily to liberalise China's investment environment, but to clarify it so as to relieve the doubts of many existing and potential investors.

Nevertheless, the additional tax incentives and the improved prospect of selling to the domestic market did make China more attractive for foreign investors. For this reason, the RIJVL initiated a second regulatory phase (late 1983 - late 1986).

In addition, the Government also made further efforts to attract western companies by promulgating the new patent law in March 1984, by opening the fourteen coast cities a month later, and by signing investment protection treaties with a number of western countries. As a result of these changes, many contracts were signed, and the growth rate of used and pledged investment went up sharply in 1984-85, which led to the first boom of FDI in China (see Table 5.3).

However, the short-lived FDI boom was soon replaced by a sudden bust in 1986, for the following reasons. Firstly, China was again faced with growing competition for investment within Asia throughout the 1980s, which threatened to offer more favourable locations to investors seeking a source of low-wage labour.

Secondly, China's greatly expanded imports in 1985 and 1986 caused a serious cut in domestic spending of foreign exchange, which affected JVs immediately, as fewer domestic buyers could pay for JV goods in foreign currency. Added to existing difficulties JVs were facing in exporting their products, the forced reduction of domestic sources of foreign exchange made it very difficult for them to earn the foreign exchange they needed to both import materials and, eventually, repatriate profits. Finally, after the optimistic expectations of previous years, foreign investors were disappointed by the high cost, price gouging, unproductive labour, and excessive government bureaucracy (Pearson, 1991).

(2). Regional concentration of FDI distribution

Foreign invested ventures were concentrated geographically in the coastal region, especially in the SEZs, which was one of the two striking characteristics of China's FDI. This primarily reflected the fact that within these areas, the economic benefits and preferences were provided by the laws and regulations of the Government (Brown, 1993).

Taking advantage of China's special policies and their geographical location, SEZs introduced the largest share of FDI, accounting for 52.2 per cent in China's total in 1979-83, but was sharply down in 1986, accounting for only 28 per cent. By contrast, FDI in the fourteen coastal cities increased from 16.1 per cent in 1979-83 to 26.1 per cent in 1986, which was very close to the level of the SEZs (Casson and Zheng, 1991). This dramatic change in geographical distribution of FDI over the period mainly resulted from the extension of preferential treatment to these areas. The further opening of the fourteen coastal cities reflected the view of some economists that the SEZs had relatively little to offer investors, and should therefore be de-emphasised in favour of the country's northern areas (The SEZs of Guangdong and Fujian are located in southern China, therefore, other parts of China are usually seen as northern areas of China.). Administratively, however, Shanghai is regarded as being in the east part of China, Beijing and Tianjin as in north part and Liaoning in the North East.

In addition, it was arguable that if it was worth building up the basic infrastructure in the SEZs in order to facilitate foreign investment, which proved to be more expensive than the foreign investment in other old cities. Cities such as Shanghai, Tianjin and Dalian already had well established infrastructure available, which only needed to be modernised. "The marginal cost per foreign investment dollar is therefore lower in these cities than in the SEZs" (Kemp, 1987, p. 58).

Furthermore, the government desired to promote FDI with modern technology, which is one of the major considerations of the open policy apart from export promotion. Since a great number of export-oriented projects already existed in SEZs, which were characterised as small and low-technology, it became very necessary to open the fourteen coastal cities for preferential foreign investment, as in those cities, both the existing physical infrastructure and the skills endowment were more conducive to the absorption of higher-technology production, and these cities were therefore more likely to attract high-tech FDI projects.

It is interesting to note that, on the one hand, as has been mentioned, SEZs were in the dominant position to introduce FDI, and later the fourteen coastal cities emerged to share the dominance. On the other hand, a particular open area was also dominated by a particular investor/country to make the investment.

For example, companies from Hong Kong and Macao and South East Asian countries chose to invest in one of the SEZs rather than in one of the older city areas, as they could fully use the comparative advantages that the SEZs had, namely their proximity to Hong Kong and Macao, and South East Asia; a common language, culture, and tradition; a joint heavy dependence on imported raw materials as the Zones are a long way from most of China's natural resources and suppliers of many raw materials; and their relatively cheap labour forces.

In addition, these investors viewed China as an export processing zone, in order to take advantage of its cheap labour, and favourable tax conditions, then to sell back into the region. Most of them only required basic skills from their work force, and imported raw materials or semi-manufactured goods from abroad for processing or assembling. All products were exported once they were finished. They therefore did not require an established infrastructure connecting the production processes with other parts of China. Their main concerns lay in quality port facilities and transport between the port and the production cite. Consequently, SEZs particularly suited overseas Chinese and Hong Kong investors, as about 90 per cent of foreign investors in the SEZs were overseas Chinese and almost 80 per cent were from Hong Kong (Kemp, 1987).

Investment in the north of China was much influenced by Japanese companies. In Dalian, for instance, at the end of 1984, all but one of the representative offices of foreign business had been set up by Japanese firms, and the majority of JVs had involved Japanese investors. This is in part because the north of China is not far from Japan, and historically had much more influence than other parts of China by the Japanese during the period of Japanese occupation.

Shanghai was somewhat different. Its previous emergence as a financial and industrial centre in the Far East had much to do with the influence from the US and the UK and other European countries. The determination to open up Shanghai as one of the fourteen coastal cities immediately attracted many foreign investors, especially those from America and Europe, whose investments were largely involved in technology-intensive and capital-intensive projects. Shanghai Volkswagen, Pilkington and Foxboro were established in Shanghai, as Shanghai was able to provide necessary support to these ventures, such as more technically skilled labour, better links with inland provinces, and a more developed infrastructure for the supply of locally available raw materials, and a stronger industrial base which provide both local suppliers of components and a market for finished products.

Investors in Shanghai were therefore able to become more fully integrated into the Chinese economy and its markets than investors in the SEZs. Also, part of their product could be sold into the domestic market, although, in most cases, some must also be exported. As a result, coastal areas of south China attracted more FDI than the north, whereas in the north coastal cities received a better quality of FDI than the south.

Undoubtedly, the SEZs and open coastal areas benefited a lot from the regional emphasis of China's FDI policy to develop themselves. However, this development strategy was in spite of the fact that most of the Chinese mineral and natural resources are distributed in inland areas, especially in the north-western part of the country, and that there were a good number of industrial bases already existing in these regions which were built up before the open door policy for the purpose of narrowing the gap of the economic development between coastal areas and inland regions. The uneven economic development of these two different regions would worsen if the Government placed emphasis only on certain preferred regions rather than giving priority to more industrial development areas (this issue will be discussed in more detail in Chapter 7).

(3). Majority of FDI from Hong Kong/Macao and overseas Chinese investors

Up until 1986, most of the FDI into China came from Hong Kong and Macao, and South Eastern Asian countries. FDI from South-eastern Asian countries was described by a Japanese scholar as "overseas Chinese investing to mainland China" (Fan, 1992, p. 57), as most investors from these countries were ethnic Chinese. More notably, almost all of FDI in Guangdong was made by Hong Kong/Macao companies (from 100 per cent of FDI in Guangdong in 1979 to 87 per cent in 1986). It is therefore fair to say that in the early years of China's open door policy, the door of Guangdong was primarily opened to Hong Kong and Macao (Hou, 1993). Accordingly, China's FDI was dominated by overseas Chinese from Hong Kong and Macao and South-eastern Asian countries, with little FDI coming from Western countries. Therefore, China's opening-up had yet to reach a world level, only a regional level (Fan, 1992).

Table 5.5. Source of FDI Commitments in China, 1979 – 1985

Amount: USD1 million

Country/Region	Amount	Per cent of Total
Hong Kong	10628.96	63.8
United States	2177.01	13.1
Japan	1628.63	9.8
Great Britain	378.30	2.3
France	262.50	1.6
Sweden	202.40	1.2
Singapore	192.50	1.2
West Germany	162.10	1.0
Italy	137.40	0.8
Australia	105.20	0.6
Others	765.46	4.6

(*Source*: US Joint Ventures in China: A Progress Report, National Council for U.S. China Trade, 1986, p.186.)

As mentioned earlier, Hong Kong and Macao were the largest and most frequent foreign investors in China, especially in Guangdong, because they have some well-known advantages in dealing with China due to shared languages and culture, and proximity to Guangdong. More importantly, however, it was because joint production by both Hong Kong and Macao and China/Guangdong were mutually suitable.

Most manufacturing firms in Hong Kong and Macao, in most cases, used small-scale and labour-intensive technology and production facilities, and were oriented to take advantage of cheap labour to produce goods for export. A chronic shortage of cheap labour in Hong Kong and Macao made their companies have no hesitation in crossing the border to Mainland China/Guangdong, where wage rates were far lower than in Hong Kong and Macao and many other Asian countries.

From China's point of view, Hong Kong and Macao-backed ventures met with government objectives of export promotion, despite the fact that the Chinese government was not completely happy with the low level, small-scale of Hong Kong and Macao investments. In addition, Hong Kong and Macao invested projects continued to be the most important portion of FDI in China, although the share of FDI from the US, Japan, and Western Europe gradually increased over the period.

As a neighbouring country of China, Japan was one of the world's largest foreign investors, and its relationship with China seemed to be strengthened with its signing of the Sino-Japanese Treaty of Peace and Friendship in 1978. As shown in Table 5.5, however, only a tiny portion of its investment went to China. The Chinese government remained disappointed not only with the amount of Japanese FDI in China, but also with the nature of its investment. "Small" (small-scale) and "low" (low-technology) were the primary nature of Japanese FDI in China (Pan, 1991).

In the early years of China's open door, the average value of total Japanese FDI projects in China was less than USD2 million, lower than the average value of its projects in the world total. In 1984, only four out of the fifty-nine FDI projects in China with a value exceeding USD10 million were invested by the Japanese (Fan, 1992). The Japanese were not willing to invest advanced technology in China, partially because, as noted earlier, they feared that the Chinese would become their strong competitor in Asia. Partially , according to Kojimas' FDI theory discussed in Chapter 2, because the Japanese believed they could benefit more by investing less-advanced technology in other countries especially Asian countries where the low technology was more efficient and labour costs were relatively low.

In addition, Japan's reluctance to make large direct investment in China was also explained by themselves for several reasons, such as China's poor infrastructure and an uncertain supply of raw materials. More importantly, as the Japanese in general favoured the investment mode of the joint venture, many of them were not satisfied about being unable to run their enterprises "along the lines agreed to in joint venture contracts", because the Chinese local authorities and venture's Chinese partners had dominated influence in joint ventures, and run them in their own way (Shapiro, *et al.,* 1991, p. 78).

According to the US-China Business Council (1987), US businesses tended to be more interested than others in investing in higher technology, capital-intensive, and larger-scale FDI projects. Some US large world transnational corporations were also involved in FDI in China, such as American Motors (Beijing Jeep), and Foxboro (Shanghai). Although the

United States was ranked second in terms of FDI into China, the Chinese government would still have expected FDI from the US to have risen more significantly as, up to 1985, China had received only 4 per cent of total US direct investment overseas. For their part, US investors were unlikely to make major investments of capital and technology unless China was able to relax its strict requirements on foreign invested ventures such as requirements of foreign exchange balance, production exportation.

As shown in Table 5.5, European direct investment in China was more modest than Japan and US. However, the government was rather happy with a number of ventures which had been capital-intensive, involving quite sophisticated levels of technology, such as Shanghai Volkswagen Auto Factory, and Shanghai Pilkington. Lack of contacts (of overseas Chinese) in European countries may be the reason why European direct investment was relatively small (Fan, 1992).

(4). More FDI in service sectors than in manufacturing sectors.

The concentration of FDI projects on service sectors was another striking feature.

According to the data from Year Book of Chinese Foreign Economy and Trade (1986-90), between 1979 and 1984, only 54 per cent of the contracts and 30 per cent of the foreign capital pledged in foreign invested ventures involved productive projects. During the same period, direct investment in service areas made by Hong Kong and Macao, and Japan accounted for 89 per cent, and 59 per cent of their total FDI in China respectively. Of projects in service sectors, the major composition was hotels and tourism-related projects. In 1986, FDI in service sectors reached as high as 60.9 per cent in China's total FDI value, while manufacturing sectors decreased dramatically to 27.7 per cent.

Yet the large proportion of FDI in manufacturing sectors was into labour-intensive, low technology, and export-oriented projects. As noted previously, the majority of manufacturing projects from Hong Kong and Macao was to use cheap labour and make such products as toys, clothing, shoes, foodstuff, and bags, and electric clocks and watches for export. Some large ventures were formed in the electronic and electrical industry, such as the Hitachi-Fuzhou Television Joint Venture in Fujian province. Both the Japanese and American investors had heavy commitments to making electronic and electrical goods and small appliances, reflecting a trend among investors from Japan, the US and other countries towards shifting their least price-competitive manufacturing to low-wage areas. This phenomenon was described as "a logical extension of consumer electronics exports that started pouring into China in the early 1980's" (Seo, 1993, p. 129).

The manufacturing sector of FDI being biased towards the low-technology projects, especially FDI being concentrated on the service sector was not in line with the government's initial objectives of transferring advanced technology via FDI; the sectoral distribution of FDI in China was very important as it was "crucial to the modernisation of the country" (Pearson, 199, p. 87).

A major factor contributing to China's dissatisfaction with the performance of sectoral distribution of FDI was that China lacked the detailed policy to implement its objectives towards priority sectors.

For example, the Implementation of Joint Venture Law did not put emphasis on the government's priority industries, instead, it provided opportunities for foreign investors to enter six major industries, as can be seen below, which covered most sectors of China's existing industrial areas :

- energy exploitation, building materials, chemicals, metallurgy;
- manufacturing of machinery, instruments and apparatus, sea oil prospecting and exploration;
- electricals, computing industry, manufacturing of telecommunications;
- light industry, textiles, food processing, pharmaceutical, packing industry;
- agriculture, animal husbandry, breeding;
- tourism and services.

Leaving such a wide range of sectors for foreign investors may reflect the hesitation of China's position towards FDI:

Firstly, the government needed to ensure that FDI would come to China, rather than by over-emphasising the priority sectors which may lead too little FDI to accommodate in the country (Fan, 1992). On the other hand, due to China's principle of closing its domestic market for foreign investors, and China's relatively cheap labour forces, it was a logical result that the majority of FDI projects were low-tech, labour-intensive, and export-oriented.

In terms of a large number of hotels and tourism-related projects in service sectors, it seemed to be necessary to build up a number of international standard hotels and office buildings for foreign investors to live and work, as existing facilities were far less likely to meet the increasingly high demand following the rapid growth of international business in China.

In addition, in the early years of the open door policy, foreign investors remained worried about the certainty of China's policy environment, and Chinese local governments and partners eagerly expected FDI to be successful, therefore, with quick returns, straightforward management and low-risk became the major concerns for both foreigners and the Chinese to involve FDI sectors and projects (Duan and Yang, 1993), while hotels and tourism-related projects met these concerns very well.

Moreover, investment in these projects made it easy to balance foreign exchange, as these international standard facilities were used mainly by foreign businessmen and foreign travelers, who were required to pay using foreign exchange rather than the local Chinese currency.

However, the attractiveness of investment in hotels led to over-expansion in the middle of 1980s. In the meantime, modern technology projects with high risk, low-return, and large-scale investment had not been paid enough attention by foreign investors (Li, 1990).

(5) The dominant form of FDI was contractual Ventures (CVs), rather than equity joint ventures (EJVs).

As noted in Chapter 2, equity joint ventures (EJVs), contractual joint ventures (also known as co-operative ventures [CJVs]), wholly foreign owned enterprises (WFOEs), and joint exploration have been recognised as the four major types of FDI in China.

Of these, EJVs, CJVs, and WFOEs (since 1986) have played a major role in China's FDI in terms of the number of ventures, the value of their investment, and their sectoral distribution. Joint exploration has only narrowed its role in exploring offshore oil and is less significant in terms of the total number of ventures (less than 1 per cent). Therefore, study and discussion of China's FDI usually gives little attention to the form of joint exploration (Pearson, 1991; Shapiro, *et al.*, 1991), and this study makes no exception.

It can be seen from Table 5.6 that, among the three forms of EJVs, CJVs and WFOEs, EJVs were the first to be introduced to China. JVs Law was passed soon after JVs came into existence in 1979. In the following year, CJVs and WFOEs followed.

In addition, CJVs had caught up with EJVs and become the dominant form from 1980 until 1985, in terms of both the number of contracts approved and amount of foreign capital pledged. Moreover, WFOEs grew very slow especially by the number of enterprises approved in the same period.

Table 5. 6. Foreign Investment Actually Used by Form (1979 – 1986)

Unit: USD100 million

Form	1979-1982	1983	1984	1985	1986
EJVs	0.98	0.74	2.55	5.82	8.05
CJVs	5.32	2.27	4.65	5.85	7.94
WFOEs	0.40	0.43	0.15	0.13	0.16

(*Source*: *China Foreign Economic Statistics*, China Statistical Information & Consultancy Services Centre, Beijing, 1992).

There is no doubt that EJVs were the form most preferred by the Chinese government who published JVs law shortly after its announcement of the open door policy.

This form is believed by the government to be the most likely way of introducing advanced western technology and equipment, and management know-know, because the foreign partners share the profits and risks proportionately according to their equity stake, and they therefore have to make a firm commitment to the ventures in order to succeed. However, EJVs did not become as a dominant form of FDI as the Chinese authority expected, but grew well behind the CJVs in the initial years.

For Chinese FDI participants, the initial slow growth of EJVs derived from two major reasons. Firstly, they knew little about EJVs, although the JV Law established the first legal framework regarding FDI, it took time for them to learn how to follow the law. Secondly, Chinese partners were very eager to have quick results after setting up a joint venture, whilst the majority of foreign investors were Hong Kong companies, which also sought a quick return from their investment. Consequently, CJVs were the more popular investment vehicle for both Chinese and foreign partners (Liu, 1993), as the set up of CJVs was based on negotiation, and much easier than the set up of EJVs. Foreign investors preferred to wait for improvements in China's investment climate before making any serious commitments. They therefore favoured CJVs over EJVs .

However, some western investors - especially the Americans - had strongly favoured the EJVs over the CJVs and not found the CVs as attractive as had the Southeastern Asian investors, because they thought it was uneconomic to set up CJVs which were short-term (usually 1-5 years) by spending so much time on difficult partner search, negotiations, and approval process. By contrast, Southeastern Asian investors were likely to be more adept at or more patient in doing so as they have "advantages in know-how, patience, flexibility, and proximity to China" (Shapiro, *et al.*, 1991, p. 57).

Because most FDI projects came from Hong Kong investors and other Asian investors who were in favour of CJVs, these were the dominant form of FDI in China in the early years following the introduction of FDI. The following points may explain why CJVs were the predominant type of FDI in China until 1985. Firstly, it is an arrangement that permits the participants to work together for a short period of time to become better acquainted before entering into a more permanent relationship such as the EJVs if they wished. This obviously suited the majority of foreign investors who invested in China in a very careful manner in the early 1980s.

Secondly, this form is extremely flexible and adaptable. It can therefore be used for a wide variety of projects - everything from small manufacturing operations to large property development projects.

Thirdly, they were quicker to establish than EJVs because they were restricted by fewer legal requirements and therefore were easier to negotiate.

Fourthly, this arrangement does not necessarily require Chinese partners to participate in the venture with investment of cash. Instead, they can contribute existing property or factory facilities and site to the venture. For foreign partners, this investment form provided them with the opportunity to have a quicker return on their investment, as the contract would allow them to have more profits than their proportion of investment.

Finally, until 1986, CJVs had tax advantages over EJVs. In particular they were not required to set aside a portion of their funds as registered capital, interest on which was not a tax-deductible expense even if the sum was raised through borrowing. As a consequence, the CJV became the most favoured form of FDI until 1985 as it was suitable for most initial foreign investors, particularly for those from Hong Kong, who preferred to establish a short-term, quick return and project-related venture.

The majority of this type of enterprise was located in Guangdong province. Many of them were restaurants, hotels and taxi services. Outstanding examples in this respect were the White Swan Hotel in Guangzhou, the Lido Hotel in Beijing, and the China Scientific and the Technological Exchange Centre in Hainan Island (Liu and Liang, 1987).

With regard to WFOEs, these were initially not encouraged by the Chinese government as this form of FDI was seen to be beyond government direct control. In contrast, a major reason for foreign investors to set up WFOEs was to retain entire control so that they could make sure, as an affiliate, that its local activities were in line with its parent's worldwide strategy (Shapiro, Behrman, Fischer and Powell, 1991). In addition, the protection of commercial secrets and a lack of working capital from local potential partners were also other reasons for foreign companies to adopt this structure (Beamish and Spiess, 1993). However, WFOEs were only allowed to be established in SEZs from 1980 until 1984. During this period, only forty eight WFOEs were approved. Following China's further opening of the fourteen coastal cities in 1984, WFOEs began to be permitted outside the SEZs. It was not until 1986 that the government changed its cautious attitude over this form of FDI because of a significant decrease of FDI over the year (Casson and Zheng, 1991).

5.3. A General Assessment and Problems of China's Use of FDI During 1979-86

Following the above discussion of China's FDI during the period of 1979-86, it is now necessary to assess if China's use of FDI had been a success.

It is also necessary to generalise and discuss some key common problems which negatively affected the further development of FDI in the country. Some of these problems were so serious that a call for a big change in Chinese policy was demanded.

5.31. General Assessment of FDI during 1978 - 1986

It is true that the development of FDI in China during the first period was accompanied by some disappointments. These included: neither a great number of nor high level of FDI projects were introduced; the investment environment and, especially, the policy environment was poor; and in spite of the open door policy, many doors still remained closed. However, if the following factors are taken into account, China's FDI in its initial stage can still be seen as a success.

(1) The determination of China's use of FDI means China changed itself qualitatively, although the quantitative impact had been relatively modest.

In terms of the absolute amount of FDI that China had absorbed, it was not insignificant. Between 1980-85, for example, China was the fifth largest recipient of FDI among all developing countries, accounted for 5.8 per cent of the world total, and followed Brazil, Mexico, Singapore, and Malaysia (Pearson, 1991); the World Bank estimated net FDI in China during 1981-86 at USD1.4 billion, second only to Spain as a net FDI recipient, and well above other Asian countries (Pomfret, 1991).

However, when compared to the size of China's economy, the amount of FDI introduced was relatively small.

For example, FDI accounted for only one per cent of China's GDP in 1985, which was a fraction of the amount contributed by the foreign sector in 1979 to other large developing countries such as Indonesia (11 per cent), Brazil (7 per cent), and Mexico (5 per cent), and was well behind Brazil in 1985 (12 per cent) (Pearson, 1991; Pomfret, 1991).

In terms of the level of technology transferred via FDI, as already noted, most FDI projects did not contain sophisticated technology, and were concentrated on the service sector (hotels and restaurants) and on comparatively low technology sectors. These disappointments were derived partially from China's complete lack of experience in dealing with FDI, which made China very cautious towards its introduction; and partially resulted from the careful response of foreign investors to China's open door policy, as they wished to test the water through some form of limited arrangement before committing substantial capital and technology and management know-how (Pomfret, 1991).

Nevertheless, it should be noted that the open door policy fundamentally altered China's approach to the utilisation of Western investment and technology (Ho and Huennemann, 1987), which was regarded by both Western countries and China itself as "the second great revolution" after the first revolution of 1949 when the new China was born (Nee, 1986, p.101). The invitation of FDI to China was indeed a significant political change in the sense that China denied its previous political position. Bearing this quality change in mind, a "quantity" outcome of FDI to China becomes less important in the initial stage of China's open door policy.

Firstly, the open door policy changed the Chinese thoroughly in their ideology. For example, at the beginning of the1980s, there was a serious debate in the Shanghai local press regarding a Japanese product advertisement placed on the top of a city centre hotel, where it was initially a political slogan of "Long live Chairman Mao"! Some local people were very confused as this advertisement reminded them of the time when Western powers occupied Shanghai in the 1930s, and they wrote to the local papers asking what was going on and why. In contrast, other people wrote articles to support the open door policy.

The argument lasted for several days. In the end, the local government made an official explanation which calmed down this radical sentiment (the government explained the situation by emphasizing that China's present open door policy was totally different from the previous "foreign concessions", as under the Open Door policy, China did not lose its full status of a sovereign country).

In later years, more and more Shanghai people were eager to work in foreign invested companies, and even left Shanghai to find jobs in Shenzhen where it was at that time much more open than Shanghai (traditionally, Shanghai people preferred to stay in Shanghai to work and live).

Within a few years of China opening-up, some western aspects of ideology had been introduced and accepted by Shenzhen people. For example, two slogans, "time is money", and "efficiency is life", were commonly used in the construction of the Shenzhen Special Economic Zone. A few years later, these two slogans were widely recognised in many other parts of China, and became widely used for encouraging the Chinese people to speed up the country's modernisation process.

Secondly, FDI, for the first time, brought the opportunity for the Chinese to learn western technology and management skills by working together with foreign partners, which would improve significantly the quality of Chinese personnel in terms of both modern knowledge and technology. As a result of this, these talents would be able to play an important role in China in catching up with western economies.

Thirdly, the existence of foreign invested companies in China provided immediate examples for China's economic reforms. In addition to FDI, economic reforms were also a major aim of China's open door policy. Allowing China's SEZs to follow the law of the market economy reflected the impact of western companies running in the country. In the later years of China's reforms more changes occurred. These included the removal of the "iron rice bowl", and "dual pricing systems", which were more or less influenced by the approach western companies adopted.

(2) The investment environment, especially the legal environment, was consistently improved, although China had a long way to go to establish a sound environment for FDI.

As previously mentioned, these had been hardly any legal formation existing in China when the country opened its doors to the outside world. It is therefore understandable that it was not easy for the country to build up its comprehensive legal environment in a short period of time, since everything was new to the government, and there was a "leaning curve", within the new type of foreign invested firms, as well as in implementing a new policy, which involved a historical change (Pomfret, 1991, p. 127).

It is a fact that, generally speaking, the government had shown its willingness to establish a regulatory base for FDI.

For example, only a few months after the country declared its intention to undertake the open door policy, the Law on FJVs was published. Between 1979-86 the government issued several hundred relevant regulations, covering a wide range of commercial activities such as advertising, commerce and domestic trade, economic contracts, trade marks and patents, etc.

(Kemp, 1987). Of these regulations, nearly one hundred were foreign investment-related laws and regulations, which was "a noticeable event in a country that had forsaken legal procedures during the Cultural Revolution..." (Plasschaert, 1993, p. 103).

In addition, the Chinese authorities made an effort to make laws and regulations in accordance with common international practice. In order to draw up EJV law, the government had sought advice from a wide variety of foreign sources including academia and practising lawyers, businessmen, and foreign government agents (Kemp, 1987). Also, China had been open to criticism of its new laws and regulations, then gave response to the concerns of foreign investors by supplementing improved editions or promulgating new laws and regulations (Beamish and Spiess, 1993).

Moreover, in the early years of its open door policy, China's FDI policy was by no means as attractive as that of its Asian neighbouring countries. However, compared with the policies applied to local companies, these policies were seen as "special treatments" in the sense that local enterprises were not allowed to enjoy them. In terms of taxation, foreign invested companies enjoyed lower rates of income tax than Chinese companies.

Furthermore, foreign invested ventures were granted full power of decision-making and were allowed more flexibility in terms of the way they operated. These policies were not available for Chinese state-owned enterprises. For instance, a foreign-funded company had the power to make its own plan, and had the right to conclude economic contracts with corporations and enterprises at home and abroad. It was also entitled to open accounts with the Bank of China or other banks approved by the Bank of China, where it could deposit or draw money freely and could also apply for loans. It could raise funds for its own use from foreign banks (Liu and Liang, 1987).

It is fair to say, therefore, that the Chinese policy and attitude towards FDI was becoming increasingly more favourable over the period of 1979-86, which in general led to a steady growth of FDI inflows into the country.

(3) An important foundation was established for the open door policy, although the door was yet to be opened widely.

As noted earlier, China conducted a cautious approach to its opening-up to the world economy, and the open policy began with a very strict regional emphasis. Thus, only four small SEZs were approved to become open areas in early 1980s. Therefore, the door was only "ajar" (Ho and Huenemann, 1987, p.174), or was only "cracked a little way" (Soe, 1993, p. 113).

However, the initiative and development of these four SEZs attracted great attention thoughout the country, in particular from China's major cities such as Shanghai, Guangzhou, Tianjin and Beijing, and so on. Government officials, company managers and scholars of these cities made visits to SEZs and learned experience from the open zones. More importantly, the success of the SEZs set a good example which led to a further opening-up of China's fourteen coastal cities including Shanghai, Guangzhou, Tianjin and Dalian.

All of these cities, as compared with SEZs, contained some of China's most advanced infrastructural and industrial facilities, had better access to supplies of raw materials, a greater supply of skilled labour and experienced management, and were generally more productive (Pearson, 1991; Kemp, 1987).

In addition to their existing advantages, these coastal cities held a dominant position in that they collectively:

- produced about one-quarter of China's gross value of industrial output;
- generated one-quarter of its taxes and profits;
- provided two-fifths of its exports;
- had productivity levels two-thirds above the national average; and
- handled one-fifth of all China's freight and virtually all of its cargo.

(Shapiro, *et al.*, 1991).

It is important to note that the opening-up of China's fourteen coastal cities had significant implications. Firstly, it indicated that China had become confident about its open-door policy as it believed the policy had been successful in SEZs. Secondly, allowing fourteen further coastal cities to be open areas implied that the government wished to ensure further success as these cities were historically "open" cities and therefore in a better position than other areas of China to attract and take advantage of foreign investment. The initial opening of SEZs was more or less designed by China as a "laboratory" to test whether and how western investment could be introduced into the country while under socialist principles. Thirdly, as these fourteen coastal cities were so important to China's economic development that their opening suggested that China had made a very serious decision towards western countries, and its "open policy" was unlikely to be changed. From this point of view, the opening of China was not a temporary or short-term measure, but a strategic long-term policy.

5.32. Major Problems of China's Using FDI in the 1978 – 86 Period

The preceding section comes to a generally positive conclusion towards FDI development in China in 1979-1986 period, finding that the opened door of China would not be closed again, and that the main issue for China would be whether or not the country could manage to attract FDI from the West. It also concludes that China has acted successfully (Qing, 1998, p.13), although this was characterised by the small amount of FDI introduced.

With regard to why there was little inflow of FDI to China in the initial years of the open policy, it is generally agreed that the following are the main contributing factors: poor infrastructure, lack of legal framework, and fears and worries western investors had to make direct investment in the country (Ho and Huenemann, 1984; Lu, 1997, p.146; Qing, 1998). However, little attention is paid to the factors such as how western FDI is interpreted and treated in the country and why, as this would much more significantly determine the fate of FDI in China.

As noted in Chapter 2, and in the Introduction Section of this chapter, as far as western FDI is concerned, it was China that took the initiative to "allow" or "welcome" it. This is one of striking features of China's inward FDI. It is logical to argue, therefore, that how FDI was viewed, interpreted, treated, and developed depended, to a great extent on the Government's attitudes, approach, and related policies. It was also mentioned in Chapter 2 that China made it clear that the country was building up "the socialism with Chinese characteristics", which meant that all foreign invested enterprises would exist in a totally different environment, and that FDI would be treated in a Chinese way. It should be noted, however, that the Chinese leadership did realise that FDI was new to them and that they would need to "learn from practice, learn from books, and learn from experience and lessons of others" (Lin, 1993, p. 35). This led to western publications and books about FDI being introduced to the country, while at the same time Chinese universities were permitted to launch a new course of western business, including FDI. However, once western FDI was put into practice in the country, it was used, treated, and explained in a different way.

It is Chinese understanding of western FDI that decided their attitudes and approach towards western FDI and investors, and these attitudes and approach turned to affect the making of FDI policy, in the end, FDI policy induces FDI performance. In the first period of China's FDI development, many major problems were mainly derived from the Chinese way of dealing with western FDI. More specifically, as Pomfret (1991) recognised, some of the most serious problems were "policy induced" (p. 23). The existence and development of these problems led to limited FDI inflow to China between 1979 and 1986, and finally led to the well-known foreign exchange crisis which marked the end of the first period of China's FDI development, and urged China to improve its FDI climate.

(1) Problems associated with Chinese approaches and attitudes towards western FDI:

A. Undertaking the new policy of open door, but still maintaining the old policy of "self-reliance".

It appears that China's announcement of the open door policy did not mean that the country would give up its "long-held socialist principle..." (Seo, 1993, p. 111). Instead, Chinese leaders and official scholars repeatedly insisted "self-reliance" policy was still important for China. As Deng Xiaoping declared, "...self-reliance, used to be in the past, and is at present, and will be in the future, our foothold...", and he then proceeded to issue the following warning to the West: "no foreign country should ever expect China to be their dependency, and to accept something which may be harmful to our country's interests" (Deng, 1984, p. 3). This declaration therefore politically decided the nature of the relationship between the policy of self-reliance and the open door policy, including the use of western FDI, namely that of relying mainly on our own efforts, while making external assistance subsidiary, otherwise China will suffer (Fang and Xu, 1995; Ji, 1999).

One of the important reasons behind this position, as Pearson recognises (1991), was that the Chinese leadership believed western FDI "would lead to a number of negative results..."; they doubted "China's ability to capture its share of the economic benefits generated by foreign investment..."; and they also feared "loss of political independence" (p. 3). However, there is still a difference between the self-reliance policy period and the early years of the open door policy: the former totally rejected western FDI, while the latter accepted it but "did not reject the view that FDI had potential negative effects…" and they would need to "selectively absorb the good things and boycott the bad things from abroad" (p. 3).

Now that it had been decided that external assistance would play a minor role in the open policy, how could significant western FDI be expected to flow into China? This approach really means, as Seo (1993, p. 113) concludes, that China's "open door is not really open - it is only cracked a little way…", which, therefore, "will undoubtedly hinder their economic progress in years to come" (Seo, 1993, p. 113).

B. Accepting FDI, but still worrying about the capitalist influence

It was believed in China, that the introduction of western FDI was accompanied by several negative effects, notably bourgeois decadent ideology and life style (Ji, 1999). When signs of wealth and prosperity appeared in the opened coastal areas of China that were earlier to open to the outside world, condemnation of "capitalisation" was voiced widely in the country (Chen, 1989, p. 1). In order to protect China from the capitalist influence, Deng Xiaoping claims, in the process of the open policy, the country must "keep a cool head, firmly resist the corrosive influence of bourgeois ideology, and never allow the spread of bourgeois life style" (19xx, p372). As mentioned in the above section of this chapter, Shenzhen Special Economic Zone - China's most open area at the time - was also guided by this strict attitude. As Tang explained (1988), "Shenzhen is a Special ***Economic*** Zone, but not a Special ***Political*** Zone" (p. 362).

This attitude - accepting FDI while worrying about its negative influence - led the government to adopt the policy which would not only attract western investors, but would also control their negative effects. This was the so-called "getting rid of dirty things, but not the whole foreign investment" (Tang, 1988, p. 363). This attitude had been reflected in a number of China's FDI policies, notably the Chinese-foreigner equity joint ventures' law, as discussed in Section 2 of this chapter.

Foreign businessmen therefore felt uneasy as they believed that "the open door policy is the direct result of political changes in China and is closely tied to Deng Xiaoping and his supporters…" (Ho and Huenemann, 1984, p.178). As China was regarded by the west as a country with a high political risk for international business according to their "deep impression of China's past political turbulence" (p.178), and its politically-oriented attitude and policies led them to doubt, "how long the door will remain open and whether future political shifts will adversely affect the profitability of international economic co-operation in China..." (p.178).These concerns inevitably resulted in hesitancy of foreign companies to make their investment cautiously, and consequently caused the slow development of FDI in China.

C. Willing to follow the international practice, but still doing things largely in the Chinese way

The Chinese government realised the importance of following international practice in order to successfully deal with western FDI. Deng Xiaoping urged the Chinese to establish a favourable investment environment for foreigners, and let their business be profitable (Fang and Xu, 1995).

As a starting point of accommodating western FDI in China, the government tried very hard to learn western experience when formulating their first legal document, namely the equity joint venture law (Liu, 1993). However, Chinese domestic aspects were clearly included in the law, notably the chairman of the joint venture board had to be Chinese regardless of the percentage of the participation of the foreign party, which obviously did not reflect the principle of international practice.

In addition, the way joint ventures and foreign investors were treated was also problematic, in spite of the existence of the law. For example, the law did not say joint ventures had to export their products but, rather, that joint ventures were "encouraged" to make products for export. In practice, non-exportable ventures were hardly to be approved by the governments. Also, the law did not block the way for foreign parties to become majority shareholders, but in reality, joint ventures with a foreign majority were unlikely to be granted.

Another problem relates to the joint venture's legal status. In many western countries, foreign invested companies can apply the host country's company law in the same manner as domestic companies. In China, foreign invested companies had to follow the law on Chinese-foreign joint ventures, since there was no company law available in the country. In fact, however, joint ventures were deemed by the Government to be "a Chinese corporate body", "whose operational activities..." should be therefore "subject to the guidance, inspection and supervision of relevant Chinese authorities" (Liu and Liang, 1987, p.515). In other words, joint ventures were actually denied as "foreign enterprises", and they had to follow Chinese laws. This position of the Chinese government over joint ventures was stricter than many other countries, even other socialist countries, as foreign sides of joint ventures in these countries had a choice between enforcing their contracts based on either the host country's laws or the non-host country's laws (Pearson, 1991). This paved the way for the government to entirely control joint ventures in the country.

Interestingly, at local level, joint ventures and other foreign invested enterprises had suffered from time to time just because they were regarded as "foreign enterprises" by Chinese local authorities. A typical example is the price charged over foreign invested firms: prices set by local governments for foreign companies' various business activities were much higher than those of Chinese domestic companies, as foreign companies and investors were thought to be rich. This unfair treatment seriously dampened the enthusiasm of foreign investors investing in China (Tang, 1988).

China's willingness to follow the international law, while acting greatly in its own way is seen by Li (1990) as the key cause of many other problems, "before China manages to establish an investment environment based on international practice, significant growth in FDI is impossible" (p. 3).

D. Taking advantage of western FDI, but minimising the possibility of being used by western investors

In theory, China repeatedly and officially emphasised that "mutual benefits" were one of their principles for doing business with their foreign counterparts. In reality, however, it behaved differently.

It is understandable that the Chinese government should have selected the introduction of advanced technology and encouraging export as the two main goals of western FDI. This was because the country badly needed western technology in order to catch up with the developed countries and to realise its modernisation. It was believed that FDI could offer technology directly and indirectly: directly, in the form of advanced machinery, equipment and other advanced knowledge, which would become a part of foreign investors' commitment to set up foreign invested companies in China; and indirectly, export via foreign invested firms could earn foreign exchange for China, with which China could import advanced technology.

However, this was only one-sided planning, as the Government did not think further then to ask: what did the foreign investor come to China for? According to Kemp (1987), foreign investors were motivated by three different objectives: market-related objectives, production-related objectives, and objectives related to special incentives.

Most foreign companies investing in China had market-related objectives, because they saw China as a massive market, and aimed at gaining an access to this market in the long term (Kemp, 1987; Shapiro, *et al.*, 1991). However, their attempts to enter the Chinese domestic market were blocked by two measures set by the Government. One measure was aimed at encouraging foreign invested companies mainly to export their products. The second measure was concerned with foreign exchange – foreign invested companies were required to maintain the balance of their foreign exchange, which had proved a very tough requirement and caused a serious crisis between the foreign investors and the Chinese government in 1985-86 (this crisis will be discussed separately below). This led to a dramatic change in Chinese FDI policy, and marked a beginning of the second period of China's FDI development.

Restricting foreign investors by these two measures, on the one hand, reflected the fact that China was worried about loss of its home market to foreign invested companies, as Chinese industries were backward and non-competitive. On the other hand, it showed the Government's lack of a basic understanding of what foreign investors came to China for. As noted in Chapter 2, one important advantage of FDI over international trade is that FDI provides the opportunity for foreign investors to produce and sell their products locally. In addition, foreign investors recognised comparative advantage as the essential economic principle, and they believed it was fair for them to provide their capital and know-how in exchange for China's market; "China's policies, however, are clearly designed to provide maximum benefit for China with little or no consideration for trading partners or foreign investors" (Seo, 1993, p.114).

Labour intensive foreign companies were mainly motivated by production related factors of China. They were attracted by China's cheap labour force, and by the low cost of land use and other production factors. As indicated in the above section, the Chinese government displayed their disappointment with these firms, as they basically manufactured low technology products like toys, clothing and electronic watches for export, most of which came from Hong Kong and Macao.

The main motivation of the third group of foreign investors was to take advantage of special tax incentives which China offered. The nature of these companies was similar to the foreign investors who were motivated by the low production costs, most of them being Hong Kong and Macao companies, and who were located in China's SEZs and other areas of Guangdong province, and were engaged in labour intensive and low technology industrial activities, including hotels.

The Chinese one-sided policy inevitably led to its failure to achieve both the promoting of technology transfer and of FDI-led exports. The latter two groups of foreign investors were not particularly welcomed by the Government because they did not meet one of the Chinese goals, namely that of introducing high technology. However, they did meet another of China's goal – exporting. In addition, service industry enterprises such as hotels were not on the Chinese priority list, but they had no problem in maintaining their foreign exchange balance as the Chinese policy required.

(2) The foreign exchange crisis and its impact on China's FDI development

As shown in the previous section, there was a FDI boom in the late 1984 and 1985, followed by a bust in the late 1985 and 1986. China's overall economic policies and the economic situation these policies generated were the main causes for the boom and the bust. The foreign exchange balancing problem - many foreign invested companies, especially some large joint ventures such as Beijing Jeep, had long suffered – developed so seriously that it had become the centre of the problem, with complaints from foreign investors about China's FDI environment policy being heard widely in China and reported by the press in their home countries, and as a result of which some foreign governments became involved in dealing with this issue.

From 1984, China speeded up the pace of its economic reforms, which led to credit inflation and to a dramatic increase in the capital investment in fixed assets. In the meantime, a large amount of foreign loans started coming into the country from western governments and international financial organisaions. All these misled foreign investors who overestimated China's market potential and the ability to pay back the foreign exchange (Fan, 1992). In addition, there was a sign of China's reaffirmation of its open door policy (demonstrated by the further opening up of fourteen coastal cities in April 1984), and of the improvement in the foreign investment climate (exemplified by signing investment protection treaties with a number of western countries in the late 1984). All these led to a sudden boost in the confidence on the part of foreign businessmen towards investing in China: (a) Some small foreign invested projects were switched to the form of an equity joint venture as it was believed to be a more stable and a longer term selection; (b) some big multinational enterprises started to make serious commitments by expanding their investment; and (c). Many more newcomers "rushed to make a deal before they missed the boat" (Pomfret, 1991, p.54). As a result, a FDI boom occurred in 1985, when 3,073 FDI projects were approved with a pledged amount of USD5.932 billion. As a consequence, the rate of growth increased sharply in 1985 over 1984 (66 per cent and 124 per cent respectively).

The overheating of the economy caused a shortage of raw materials, electricity, and working capital, and caused many industrial enterprises to cut production. In addition, China's widening trend of its international trade deficit in 1985 led it to impose stricter regulations on foreign exchange allocation in the same year. In 1986, a more restrictive import and export licensing system, and strict controls on bank credits and loans to foreign invested companies were implemented.

China's reversed economic situation and its policy adjustments immediately had a negative impact on FDI growth. In 1986, only 1,498 FDI projects were approved with pledged investment of USD2.834 billion, both of the figures were down 48 per cent over 1985. Dissatisfaction of foreign investors with Chinese FDI policy - in particular its foreign exchange rule - was expressed widely and became a central issue in China. The case of Beijing Jeep, an American Motors (AMC) joint venture in China was a most publicized relating to the foreign exchange issue at the time.

Case of Beijing Jeep

The agreement of a joint venture, approved in June 1983, was for a USD51 million project, 32 percent US-owned and 68 per cent Chinese, to produce Jeeps and Jeep engines in an existing Chinese factory. The foreign partner, American Motors (AMC), contributed USD8 million in cash and USD8 million in technology to update the Beijing plant. The joint venture could become operational quickly because the factory was in place and it was successful in maintaining output levels of the Chinese BJ212 with a much-reduced labour force. However the plans to produce a jointly-designed Jeep and to export over a quarter of the joint venture's output were wildly over-optimistic and the joint venture ran into problems from the start. The design project broke down amidst mutual suspicion, and in October 1984 the Chinese partner started to have difficulty in finding adequate quality domestic components. In addition, production problems within the plant soon revealed that the export targets were unrealistic. Although these problems were endemic to the Chinese economy of the early 1980s, AMC was also widely criticized for believing it could produce an export-quality Jeep in China with an outlay of only USD8 million. In mid-1985, Beijing loaned the joint venture USD8.5 million and AMC provided an extra USD6 million for a new assembly line and production of Cherokee Jeeps in September 1985.

The infusion of cash did not, however, soothe the joint venture's troubled relationship. AMC's additional purchasers would pay in FECs (foreign exchange currencies), but it soon became apparent that they would not, in part because the need to import components subject to high potential buyers simply did not have foreign exchange allocations. When the American president of Beijing Jeep discovered the joint venture had not even been paid in RMB for recent sales, he decided to go public with the joint venture's problems and this led to a showdown in March 1986 when AMC allegedly threatened to pull out of China. The threat was averted by Central Government's agreeing to pay USD2 million for already assembled Jeeps, and more importantly guaranteeing payment in foreign exchange for 12,500 Cherokee kits over the next four years plus convertibility of RMB earnings. Nevertheless, the joint venture's production problems continued as output was well below its 1986 target of 4,000 Cherokee Jeeps and exports remained a distant prospect.

(*Source*: Richard Pomfret, "Investing in China – Ten Years of the Open Door Policy", pp. 48-9, published in 1991 by Harvester Wheatsheaf).

The problems of China's FDI policy and investment environment were also paid serious attention by western governments. In May 1986, in a news conference in Beijing, the

American Treasury Secretary criticised the fact that "foreign investors are facing serious problems, including increased costs, shortage of foreign exchange, and unstable tax systems". A month later, a German association of machinery and electronic industries warned their members to be especially cautious when investing in China (Fan, 1992). The US-Chinese Business Council communicated with their Chinese counterpart, explicitly calling for certain policy changes in China, as they believed "it would be needed if China wished to induce more investment" (Pearson, 1991, p. 74).

The Chinese government was under great pressure. A positive approach was adopted and significant action was taken. The central government arranged a number of serious meetings to review its policies and the current situation, and was "open to criticism of its new laws, and in response to the foreign concerns of foreign investors the State Council issued '22 provisions'". This policy change had turned a new page in the history of FDI in China.

CHAPTER 6

From Permitting Western FDI to Promoting It *(1986 – 1995)*:

An Evaluation of the Second Period of China's FDI Development

6.1 Introduction

As discussed in the previous chapter, after a long period of "self-reliance" policy, in order to promote China's modernisation, the government decided to replace it with a new policy – the open door policy. This new determination paved the way for western FDI first ever to get into the country. However, the decision makers gradually realised that their approach towards the western FDI – welcoming it but strictly controlling it – was not effective, as not as much FDI as the government expected materialised, and there were serious complaints about tight control over their investment from the existing FDI makers. The announcement of the "22 Articles" in October 1986 marked a new period of China's FDI development: from Permitting western FDI to Promoting it (Pomfret, 1991).

This chapter will evaluate how China's FDI was promoted after the government introduced a number of more positive policies; and it will also discuss the problems due to incompletion and misuse of the government FDI policies. It will, to begin with, review the effectiveness of the "22 Articles"; and then look at the impact of other new and more positive FDI policies, which include the issue of the Law on Wholly Foreign Owned Enterprises in April 1986, and the Law on Sino-Foreign Contractual Joint Ventures in April 1988, and the revised Law on Sino-Foreign Equity Joint Ventures in April 1990. The further development of China's opening pattern will be analysed, which is followed by looking at several important political events that help accelerate China's FDI to the fastest growth pace.

This chapter will also consider a number of facts, in order to draw an overall picture of China' FDI in terms of FDI inflows, regional and industrial distribution of FDI, sources of investing countries/regions, and form of FDI. Last, but not least, this chapter will discuss important problems: the problem of the central government's favourable policies over FDI being misinterpreted and misused by local governments, problems of poor technology transfer via FDI, problems of serious imbalance of FDI distribution in China's different regions and industries, and more importantly, the FDI quality being largely ignored following the FDI booming since 1992.

This chapter concludes that the development of these problems lead to the Chinese leadership finally deciding to change the FDI policies dramatically in the hope that FDI Quality and quantity can be well balanced. Consequently, China's FDI development moves into a new stage: from Promoting FDI to Managing FDI.

6.2 The 1986 Provisions Leads China to a New FDI Development Era

6.2.1. The Effectiveness of the "22 Articles" of the 1986 Provisions

As mentioned in the last chapter, the 1986 Provisions was an important response to the fall in FDI after overheating of the China's economy in 1985, when severe balance of payment problems occurred. A number of large Joint Ventures (JVS) that mainly sold products locally had serious foreign exchange difficulties that were all well publicised (Leung, 1990). Complaints of individual Foreign Invested Enterprises (FIEs), and western organisations, such as the US-China Business Council, were well noticed by the Chinese government.

The government was increasingly aware that, in order to reach their target – raising the quality and quantity of FDI - foreign investors must be ensured that the problems they faced needed to be resolved quickly and that the Chinese investment environment needed to be improved (Li & Li, 1999). To tackle these problems and to revive and promote FDI, a series of positive actions were taken by the government. Firstly, in order to promote more FDI to China, the government issued "the Law on Wholly Foreign Owned Enterprises" in April 1986. For the first time, it legally allowed this kind of venture to run in a socialist country (Fu, 2000). Secondly, in July 1986, the central government published the Notices for Further Improvements in the Conditions for the Operation of FIEs, and urged the local governments to take action to improve operations conditions for FIEs (Ji, 1986). Thirdly, in 1986, the State Council set up a leadership team to deal with foreign investment. This team was headed by a vice premier, to decide FDI related measures and policies, and to coordinate and resolve important FDI issues across the country. Later, several major FDI recipient province cities of China established the local Foreign Investment Office to help foreign investors sort out their FDI related problems (Ji, 1989).

However, among the number of attempts made to improve FDI environment, the particularly important one was the 1986 Provisions (together with its implementational details published several months later), as, for the first time, foreign investors were provided with comprehensive legal documentation. They felt that the documentation ensured the protection of their interests, and the provision of privileged operating conditions, and that all of their major concerns were dealt with and removed (Fang, 1995).

One of the striking features of the 1986 Provisions is they went much further than the 1983 regulations, in terms of offering incentives towards two kinds of FIEs that introduced advanced technologies and that were export oriented (Li and Li, 1999).

The main reasons for giving more special treatment to the above two types of FIEs were that the government still wished to stick to its objectives on introduction of FDI – improving the country's technology and exporting, and the government was not happy with the FDI performance in these two main areas. For example, there was a big national debate about the development direction of SEZs during the end of 1985 and early 1986. Some claimed that SEZs were supposed to give a good example to the rest of the country, in terms of focusing on high-tech and export oriented FDI projects. The fact is, however, FDI in SEZs was going a different way, as the majority of FDI was from Hong Kong, with low technological level, and many of the products made there were sold to the inland China (Fan, 1992).

As a response to this, the Chinese State Council, in February 1986, set up a meeting on SEZs, which reconfirmed the government initial objectives for SEZs: SEZs should stick to internationally outwards development policy, and play an example role in introducing foreign advanced technologies, management skills and opening to the outside world. The debate and the government reconfirmation had great impact on China's FDI policy adjustment and change, and led to more favourable policies being given to technologically advanced and export-oriented FIEs (Fan, 1992). This was regarded as a well balanced policy for the government to follow, as the government not only gave a positive response to the foreign concerns, but also satisfied its own goals (Pearson, 1991).

The main difference between the 1986 Provisions and previously existing government policies was that more open policies and more special preferences were now focused on export-oriented and technologically advanced FIEs (Wang, 1995). These two types of FIEs that were located in other part of China would enjoy tax deduction from 30 per cent to 15 per cent, the same as those in SEZs. In addition, their tax holiday and deducted tax rate could be extended (Fan, 1992).

More JVs in these two categories were growing quickly in a number of municipalities and open cities, such as Guangzhou, Shanghai, Tianjin, Beijing and Dalian (F Li and J Li, 1999). These new incentives also promoted large companies to invest in China with relatively high technologies. For example, American Wang-An IT Co. Ltd established a JV with Shanghai Computer Development Company, which was called Shanghai-WangAn and produced super-mini PCs of VS series that represented the technology of the 1980s. Japanese Gu-He Electronics Co. Ltd set up a JV with Xi'an Cable Manufacturer called Xi-Gu Optics-Fibre & Optics Cable Co. Ltd, annual production capacity reached 20,000 kilometer of optics fibre and 2,000 kilometer of optics cable (Fan, 1992).

The 1986 Provisions also improved overall investment environment for all FIEs as below:

A. JVs parties were allowed to decide the duration of the establishments, depending on the necessity and the nature of the projects, rather than being fixed between 10 and 30 years by the previous policies.
B. Foreign exchange centres were set up that enabled the FIEs to swap foreign exchange for RMB (Ren-Min-Bi, meaning People's Currency, which is the name of Chinese currency), to keep the balance of their foreign exchange (Ji, 1989).
C. Central government gave more local governments the power to approve a large amount of FDI projects, such as the municipal government of Shanghai, Beijing and Tianjin were allowed to approve the FDI project with a maximum amount of under USD30 million, under USD10 million for Dalian City and USD5 million for other local authorities (Fan, 1992).

D. The favourable treatment was provided to JVs, including international trade privileges, in particular the greater freedom to import and export on their own accounts and to retain foreign exchange earnings, and equal terms as the China stated-owned enterprises to gain access to water, electricity, transport, and RMB loans.
E. FIEs were permitted to make decisions regardless of the state plans (e.g., they had freedom to hire senior managers, determine employment of their employees and decide the level of salary) (Pomfret, 1991).

The 1986 Provisions were the response to "all problems about which, investors had complained loudly. Many of the provincial and local versions of these provisions went even further than the central regulations to induce investment to meet the concerns of investors" (Pearson, 1991, p. 76).

After the promulgation of the 1986 Provisions, Chinese local governments made every effort to improve quality and efficiency of their services, many different government agencies worked together very closely to approve FDI projects in order to simplify the application procedure and shorten the application time. Government officers in charge of FDI were required to attend a training programme so as to obtain professional knowledge of FDI and deal with their work more efficiently and more effectively. The Chairman of Sino-Japanese Fu-Wan Toys Co. Ltd claimed that Chinese government attempts to improve investment environment "has brought in promising future", and "has boosted my confidence in investing in China" (Ji, 1989, p. 123).

The 1986 Provisions now enabled all FIEs to balance foreign exchange by establishing foreign exchange centres where FIEs with foreign exchange surplus and FIEs with foreign exchange deficits met and negotiated, they either bought or sold their foreign exchange. Such swap centres, beginning with cities of Shenzhen and Shanghai, were quickly spread across the country – about 90 swap centres were set up by year 1990 (Fu, 2000).

A survey report showed that balancing foreign exchange used to be the "most thorny issue" facing many FIEs; now it was no longer a serious problem. In the case of Fujian province, FIEs that became able to maintain a favourable foreign exchange were increasing fast, from 21.5 per cent in 1985, to 73.3 per cent in 1988. In the country as a whole, the general situation of FIEs with a favourable balance of payment was improving from 1988 (see Table 6.1. below):

Table 6.1 *Foreign Exchange Balance of FIEs (1987 – 95)*

Year	Balance (US$ million)
1987	-0.1
1988	4.1
1989	11.4
1990	10.1
1991	16.5
1992	24.2
1993	60.6
1994	31.2
1995	49.2

(Source: Fu, 2000).

The new means of balancing foreign exchange changed the foreign exchange situation of famous Beijing Jeep that was in serious foreign exchange difficulty before the promulgation of the 1986 Provisions. The company first ever made profits in thousands of USD since its establishment in China in 1984. The chairman of the company expressed, "I am full of confidence in doing business in China" (Ji, 1989, p. 124).

The promulgation of the 1986 Provisions resulted in the recovery of FDI and record level being reached in 1987 (Pomfret, 1991). The pledged investment in JVs rose 85 per cent (41 per cent for utilised) in 1987 over 1986, and a further increase 59 per cent (23 per cent for utilised) in 1988 over 1987. The strong growth of FDI remained sustained in the first half of 1989 (pledged FDI rose 44.2 per cent, and utilised FDI rose 21.5 over the same period of 1988), even the government took tough retrenchment measures to slow down its economy. The FDI growing pace was affected when Tiananmen incident happened in June 1989 (Li and Li, 1999).

Like the JVs Law in 1979 that marked the beginning of the first turning point of Chinese FDI development, the 1986 Provisions marked the beginning of another turning point of China FDI development as the country started to positively promote FDI by offering additional incentives in order to remove the difficulties and concerns the foreign investors faced and by improving overall investment environment (Fan, 1992). The provisions were also "the key turning point in establishing joint ventures as equal as Chinese enterprises" (Shapiro, *et al*, 1991, p. 126).

6.2.2. Setting Up Essential FDI Law Systems and Improving Terms of These Laws

During 1986 and 1995, laws and regulations on FIEs – Equity Joint Ventures (EJVs), Contractual Joint Ventures (CJVs), and Wholly Foreign Owned Enterprises (WFOEs) – were either improved by the terms of the laws, such as the Law on EJVs; or were finally in place, such as the promulgation of the Law on WFOEs and the Law on CJVs.

Law on WFOEs

It is interesting that WFOEs existed in China since early 1980 in the absence of the Law on this kind of venture. Six years later, in April 1986, the Law on WFOEs finally became available, as the government was urged to improve the legal environment, and to encourage more FDI projects and WEOEs to come (Casson and Zheng, 1991).

The Law on WFOEs gave the registered ventures a "legal status" (International Business, p. 78), and was "an institutional breakthrough" in China's FDI legal system, as the country became the first socialist country to regulate a law allowing western capitalist companies to set up their subsidiaries on its territory where state-owned enterprises are dominate (Fu, 2000).

Some 120 WFOEs had existed by the end of 1985, of which 104 were situated in the SEZs, and the rest of them were in Shanghai, Beijing, Guangzhou and Changsha respectively (Fu, 2000). The WFOEs Law did not push up the new number of WFOEs significantly and immediately, but the number of WFOEs did go up in 1987 when 183 WFOEs were approved, and more significantly in 1988 when 410 WFOEs were approved (Pomfret, 1991).

Several factors contributed to the slow increase in WFOEs number. Firstly, the WFOEs Implementation Act for Law on WFOEs was not available until October 1990 – four years after the WFOEs Law was passed, which resulted in some potential foreign companies adopting a wait-and-see approach. Secondly, unlike JVs, WFOEs had restrictions on investing in certain sectors. They were forbidden to operate in the areas of media, retail and wholesale, telecommunications; and were restricted in the areas of public utilities, transportation, real estate, trusts and leasing. Thirdly, WFOEs faced discrimination in the tax payment. For example, they were required to pay higher taxes than JVs: the enterprise income tax for WFOEs was based on a progressive rate, ranging from 20 per cent on income at RMB 250, 000 to 40 per cent on income over RMB1 million. A local tax surcharge was also applied, which brought a total rate to a maximum of 50 per cent. The total rate therefore was 10 per cent higher than JVs that were charged a total rate of 40 per cent (30 per cent as enterprise income tax, plus 10 per cent of a local tax surcharge) (Fu, 2000).

The tax discrimination provided an explanation of why WFOEs only accounted for a relatively small proportion of China's whole FDI. Two new policies turned round the situation. One was the promulgation of the Implementation Act for Law on WFOEs in October 1990, which gave detailed legal guidance for WFOEs' operations, and the other was the Foreign Investment Enterprise and Foreign Enterprise Income Tax Law became effective in 1991, which unified the Foreign Investment Enterprise Income Tax Law and the Foreign Enterprise Income Tax Law, and treated all forms of FDI equally (Lin, 1994).

Table 6.2 **Agreement of China's FDI by Form**

USD 100 Millions

	1979-82	1983	1984	1985	1986	1987	1988
EJVs	1.27	1.88	10.67	20.30	13.75	19.50	31.34
CJVs	27.27	5.03	14.84	34.96	13.58	12.83	16.24
WFOEs	3.32	0.40	1.00	0.46	0.20	4.71	4.81
	1989	1990	1991	1992	1993	1994	1995
EJVs	26.59	27.04	60.80	299.73	544.23	401.94	397.41
CJVs	10.83	12.54	21.38	136.45	253.84	203.01	178.25
WFOEs	16.54	24.44	36.67	160.86	291.34	219.49	336.58

(*Source*: 1. China Foreign Economic Statistics (1979 – 1991), Published by China Statistical Information & Consultancy Services Centre, Beijing, 1992 ;

2. China Foreign Economic Statistical Yearbook (1994), Published by China Statistical Publishing House, Beijing, 1995.

3. J, Xing, (1998, p.153): A Study on Foreign Invested Enterprises in China, Published by China Construction Materials Industry Press, Beijing).

Law on Contractual Joint Ventures

The law on CJVs was not issued until 16, April 1988, after nearly 10 years of CJVs operation. In the early years of China's open door policy, unlike WFOEs, which only received limited FDI, CJVs, together with EJVs were two main vehicles for China to introduce FDI. Among all FDI forms, however, CJVs received more FDI than any other form of FDI (Fan, 1991).

Unlike EJVs that were directed by EJVs Law, CJVs were mainly based on a contract agreed and signed by Chinese and foreign partners concerned. At the same time, some existing laws were consulted by the CJV. For operational issues, CJVs followed EJVs Law; for financial issues, the Chinese side and foreign sides were taxed separately – the foreign party was taxed by Income Tax Law of Foreign Enterprises, while the Chinese party was taxed by the laws applied to China's domestic enterprises, either taxed from its profits, or from its income (Yao, 1989).

Since CJVs is non-equity partnership, their key issues were discussed and finalised in a contract. This kind of joint venture therefore enjoyed great flexibility in the following aspects:

- Proportion of contribution and return on investment by either partner was not seriously valued and calculated. It is then possible for the foreign party to take more profits and to recover their capital contributions before termination of the venture. For the Chinese party, they would obtain the whole ownership of the venture after the termination of the venture.

This form of FDI particularly suited investment projects of short term, small and medium size, and low technology (Lin, 1987).

- Flexibility of management structure. CJVs could be managed by both foreign and Chinese parties, or by either the foreign party or the Chinese party, or a third party agreed by the venture.

With the above flexibility, JVs successfully became the FDI form that attracted more FDI than other FDI forms in China until 1986. However, a majority of CJVs were made by Hong Kong and overseas Chinese, and their investments were usually small-medium size, short-term, and labour-intensive. Many western investors adopted a wait-and-see approach in the absence of the legal framework for CJVs, and some of them made a small amount of investment in order to test out or have their presence in the market (Lin, 1987).

Logically, CJVs were focused on certain FDI projects, such as hotel, house and office building construction, and hotel and factory management, as these projects tended to be short-term, labour-intensive, and small and medium size of investment (Brown, 1993; Yao, 1989). In order to attract more FDI from western investors who preferred the law governing the venture (Beamish and Spiess, 1993), and to promote export-oriented and high-tech FDI projects, the government believed the time had come to regulate the Law on CJVs after several years of lessons learning from running such a venture (Wang, 1995). The Law on

CJVs was passed on 16 April 1988, which paved the way for more FDI to be attracted, although further development of FDI did not occur until September 1995 when Implemental Details of Law on CJVs was published (Zhao, 2001).

Amendment of EJVs Law in April 1990

As mentioned earlier, as one of the key signs of China's opening to the outside world, the government passed the Law on EJVs on 8 July, 1979, which is the first ever legal document concerning FDI in China, and laid a legal foundation for the foreign investor in investing in the country (Fan, 1992).

However, until 1988, both the project number and value of FDI in the form of EJVs were much fewer than CJVs that were run in the absence of the related legal framework. According to Hu and Ji (1994), causes of the relatively slow growth of EJVs include:

- As far as the Chinese partner is concerned, they were not used to being restricted by the law, instead, they preferred a simple, flexible and quick way to do business with the foreign partner. The CJV was the form of FDI they preferred, to the form of the EJV.

- For most foreign investors, they were not sure whether or not the Chinese investment environment would be stable. Since they required much stricter commitment from the EJVs than the CJVs, they therefore preferred the CJV that enabled them to have less commitment and quick return on their investment.

- Some articles of the Law on EJVs were not in line with international practice, but full of Chinese characteristics. For example, the Chairman of the board of an EJV had to be Chinese, regardless of the percentage of the ownership the foreign partner had in the EJV. This was because the Chinese wanted to make sure the venture, to a large extent, was in their control. The duration set for an EJV was between 15 and 30 years, regardless of the nature of the FDI project, as the government did not wish the foreign investor to be involved in its economy for too long.

In April 1990, the Chinese government decided to amend the Law on EJVs, as one of the efforts to revive China's FDI, due to the fact that China's FDI suffered a setback – FDI boom in 1987-88 was replaced by a sudden drop due to the "June 4" Tiananmen Square Incident, which resulted in Western company's withdrawal of substantial existing FDI from China, and cancellation of new FDI projects (Fan, 1992).

The amended Law on EJVs had made three major changes:

A. The requirement that the chairman of the board of an EJV had to be Chinese was changed to being "decided by mutual agreement of foreign and Chinese investors or by election of the board members";
B. The requirement that the duration of the venture had to be up to 30 years was changed to being decided based upon the venture's strategic planning; and
C. The government made it clear that the venture would not be nationalised. In the event that this happened, compensation would be given.

(Fan, 1992)

These changes were welcomed by foreign investors, as all these changes were just something they had long expected. The amendment of the Law was also served as a good sign from the government for foreign investors, meaning that to promote western FDI in China was a longer term policy of the country, rather than a short-term strategy. Consequently, the policy amendments helped to accelerate FDI to China (Zhao, 2001).

As noted already, from 1979 when China published its first law concerning FDI – the Law on EJVs, until 1995 when the country promulgated the Implement Details of the Law on EJVs, China in the end had all essential legal documents available to govern the FDI activities of the country. Therefore it can be concluded that China's Laws have been successful in the promotion of FDI, which was witnessed by the fact that through 1994, China had approved some 206,000 foreign investment projects which together employ over 14 million people and accounted for approximately 29 per cent of China's exports (Xing, 1998).

6.2.3. China's Further Opening Up and the Completion of an Overall Opening Pattern

As discussed in Chapter 5, China adopted a gradual and cautious open-up approach since it decided to follow its open door policy in late 1978.

As a first step in 1979, the government allowed limited area to be opened up on an experimental basis. To this end, two small border towns in Guangdong province were chosen – Shenzhen (next to Hong Kong), and Zhuhai (next to Macao) – as Special Economic Zones (SEZs), as western successful economic experience can be easily introduced from or through Hong Kong to Shenzhen, and from or through Macao to Zhuhai (Yao, 1989). SEZs were offered special policies by Chinese central government, including favourable tax rates for foreign investors (such as 15 per cent income tax, much lower than the tax rate applied in the rest of the country), and special administrative power for local authorities to deal with FDI activities (such as local governments being allowed to approve FDI projects, which was different from the other part of the country, where all governments had to follow the central government's instructions and decisions). Later, SEZs was extended by including Shantou city in Guangdong province, and Xiamen city in Fujian province (Hu and Ji, 1994).

In 1984, 14 Coastal Open Cities (COCs) – Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai - were selected to open to FDI, and partially enjoyed the policies offered to SEZs (such as favourable 15 per cent of income tax rate was offered). In 1985, three Coastal Economic Development Areas (CEDA) were established. They are Yangtzi River Delta Area, Zhujiang Delta Area, and Xia-Zhang-Quan Delta Area, in which a 15 per cent income tax rate was applied (Yao, 1989).

From 1984, Economic and Technological Development Zones (ETDZs) started to be set up within 12 COCs, except Wenzhou and Lianyungong city. Within ETDZs, FIEs were offered the same income tax rate as those in CEDAs (Investment in China, 1993). In 1988, Hainan Island was separated from Guangdong province, and at the same time, became a new province as well as the largest SEZ in China, as the whole island was given the special policy from the central government. In 1990, Pudong, East bank of Shanghai River Huangpu, was decided by the government to be a new development area, in which a set of more favourable policies were offered. From 1991, a number of border cities and capital cities of inland areas were approved to be opened up to foreign investment (Liu, 1994).

China started opening up to the outside world as early as late 1978; however, during the second period of China's FDI development between 1986 and 1995, the pace, width, and depth of China's opening up reached a much higher level, which finally shaped the overall opening pattern as follows (Liu, 1994): Opening up from the south (Guangdong/Fujian) to the east (Shanghai/Tianjing/Liaoning), from the east to the west (such as Guangxi), or from the coastal regions to the inland areas (Hu and Ji, 1994). As the main open events before 1986 were already reviewed in the previous chapter, this chapter will discuss two major events between 1986 and 1995. One of them is the opening up of the whole Hainan province as the largest SEZ in China in 1988, and the other is developing Pudong in Shanghai by offering it more flexible and favourable policies than other SEZs (Liu, 1994).

Whole Hainan Province being opened up as the largest SEZ of China

Hainan is the second largest island of China, and its size (33,920 square kilometres) is very near Taiwan (35,774.6 square kilometers) that is the China's first largest island. This island was part of Guangdong province until April 1988 when the Chinese central government decided to separate it from Guangdong and give it a provincial status in order to offer it more and higher level support, as Hainan had long been one of most underdeveloped regions of the country (Mai, 1993).

In fact, Hainan has a number of strengths that suggests it has great potential to become a more developed place. Firstly, Hainan is famous for its rich natural resources in petroleum and natural gas, tropical plants, and sea products, etc. Secondly, Hainan is also called "Eastern Hawaii", or "the Pearl of South Sea", as it is full of extremely beautiful sceneries, it is therefore one of the most attractive tourist destinations in the world (Yao, 1989).

The decision of the Chinese government making Hainan another SEZ was based on the following considerations:

A. First four SEZs' successful experience in developing themselves by attracting foreign investment encouraged the decision maker to use the same way to develop Hainan (Liu, 1994).

A. In the view that Hainan was so underdeveloped that the government believed the more effective way to improve its economy and catch up other more developed areas of China in the shortest possible time was to offer more special policies than existing SEZs'. By doing this, Hainan's advantages of abundant natural resources could be quickly and possibly explored (Yao 1989).
B. Asia and Pacific region was then "the Growth Pole" of the world economy, while Hainan was ideally situated in the centre of this region. This means Hainan was facing a unique development opportunity, as well as a big challenge (Mai, 1993).

Consequently, on 13, April, 1988, the Chinese leadership made two important decisions:

A. The decision of setting up Hainan province; and
B. The decision of establishing the whole island as a special economic zone (Yao, 1989).

In order to speed up the economic development of Hainan, more special policies than those given to existing SEZs were offered to Hainan, which included:

- Premier rate of 15 per cent of income tax for both foreign invested and local invested enterprises (in four existing SEZs, 15 per cent of income tax was only applied to foreign investors).
- Unlike other areas of the country, the right to run exports and imports was authorised by the central government. Hainan was allowed to approve the exports and imports programme by itself (Liu, 1994).

On 1 August, 1988, Hainan government passed "Act of Hainan People Government's Implementing the State Council's No. 26 Document, Speeding Up Hainan's Economic Development and Construction. This Act provided detailed policies and measures that were more special than those available in four existing SEZs. Both foreign and local investors responded positively to these policies by taking action in Hainan.

More special and flexible policies of the Act included:

- In addition to being allowed to invest in infrastructure, agriculture, industry and tourism, foreign investors were also allowed to operate domestic and foreign trading, and retailing and wholesaling, which foreign investors were not allowed to get involved with in any other area of China until the 1990s.

- Encouraging foreign and domestic investors to contract, lease and buy local state-owned or collectively owned enterprises, which were not permitted anywhere else in the country until the 1990s.
- Encouraging foreign investors to contract one area and to develop this area comprehensively. That is, the Hainan government provided an area (up to 100 square kilometres) where the transportation system was good, and natural resources were abundant. This kind of area was fully contracted by the foreign investor who was asked to pay a very low cost for using the land. This kind of area can be developed differently as an economic area, such as economic development zone, or free trade zone, or free port, or export zone, or science park (Yao, 1989).

Hainan, as the largest SEZ, grew strongly in the initial five years. By the end of 1992, it attracted 3,393 foreign companies from 34 countries, with USD3.41 billion of contract value, and USD 868 million of realised value. In addition, 14 development areas were set up based on "developing the whole area" module, including Haikou Bonded Area, Sanya Yalona Bay Tourist and Holiday Resort Area, and Yang-Pu Economic Development Zone (Mai, 1993).

Shanghai Pudong New Area being established and opened up for Foreign Investment

In June 1990, the Chinese government made a big decision: establishing and opening up Shanghai's Pudong New Area. The significance of this opening up was made clear as the government stated, "this is an important strategic plan aiming at strengthening China's ongoing reforms and pushing further the open policy", therefore "this is a vital issue for the whole nation, which must be done successfully" (Qi, 1998, p. 94).

1. Pudong New Area was given more special policies than existing Special Economic Zones (SEZs)

(1) Pudong is situated in the east side of Shanghai Huang-Pu River, and at the south-western tip of the Estuary of the Yangtze River. Pudong New Area is a triangle-shaped area close to

Shanghai city centre at Puxi - in the west side of Huang-Pu River. The New Area has a designed area of 518 square kilometres and population of 1.3 million people (*Investment in China,* 1993).

Developing and opening up Pudong New Area was seen by the government as China's key open event for the 1990s, following the success in opening up of four SEZs and 14 coastal cities in the 1980s. The aim of opening Pudong was to promote the development of cities along the Yangtze River, hence to form China's overall open pattern – opening the whole country, both the North and the South, and both the coastal region and the Yangtze River area (Fan, 1992).

Shanghai is an internationally well-known city, and used to be the largest world trade centre and financial centre of Asia as early as in the 1930s. Having long been restricted by the Chinese traditional policies and systems, Shanghai's development pace had been slow. However, Shanghai's strategic location, and high level of technological and economic capability, were still seen by the Chinese leadership as a "trump card". In March 1990, then Chinese leader Deng Xiaoping claimed, developing Shanghai was a shortcut to develop the whole nation. He regretted that the decision of developing Pudong was delayed, but he hoped Pudong could catch up by starting their development at a high level (Qi, 1998).

Consequently, the special policies being offered to Pudong New Area not only included those that were in use in SEZs, but also included some new policies that were not available for anywhere in China (Investment in China, 1993). These new policies gave Pudong New Area the permission to:

- get foreign investors to involve in retail, finance and insurance sectors.

- issue A Share and B Share by Shanghai Stock Exchange.

- set up China's first bonded area – Wai-Gao-Qiao Bonded Area. Within the Area, Chinese and foreign trade agencies were allowed to be established, and they were free of import and export tariff, and of a trading license. In addition, there was no restriction on use and transaction of foreign currencies. Moreover, Shanghai municipal government was given greater power to approve inward foreign investment and international trading projects (Liu, 1994).

(2) Pudong New Area was proposed to act as a "dragon-head" - to lead the further development of Shanghai and the whole of China (Hu and Ji, 1994).

In October 1992, two years after the opening up of Pudong, Jiang Zemin, then General Party's Secretary of China, reaffirmed the goal of developing and opening up of Pudong – let Pudong play a role like the dragon-head, leading the way of opening up cities along the Yangtze River and taking the economic development of Yangtze River area on to the fast track, and promoting Shanghai to become one of the world economic, financial and trade centre in the shortest possible time (Investment in China, 1993).

The whole Yangtze River area – Pudong/Shanghai being a centre of this area – is situated in a central part of China's coastal line, and is the end of the Yangtze golden waterway. This area has a group of China's largest ports, and has one third of China's total population. The total value of output of industry and agriculture in that area accounted for almost half of that in China's total. Therefore, to a large extent, the opening up and development of the Yangtze River area led by Pudong/Shanghai, had led the whole country to be opened up, or had helped to shape the overall open pattern – opening from the south to the north, from the east to the west, from the coastal area to the inland area (Hu and Ji, 1994).

2. Pudong's achievements up to 1997

After seven years of open policies since 1990, Pudong New Area had grown very strongly and made steady and great progress in introducing foreign investment (Qi, 1998):

(1) Achievements in foreign investment:

- Strong growth in foreign investment. Every year, foreign investment was growing, especially in the more recent years when the annual growth rate reached around 33 per cent.

- Large scale of foreign investment projects were introduced to Pudong. For example, Shanghai General Motors – a car-making joint venture between Shanghai Automobile Co.

and American GM invested USD157 million. Huahong – NEC, a joint enterprise between China and Japan invested USD120, to produce microelectronic products.

- Pudong had become an important destination for FDI. Up to 1997, 85 transnational enterprises (TNEs) that were on the list of the world's 500 largest enterprises invested 138 projects in Pudong, which involved 63 countries/regions, including Hong Kong, Japan, the US, Taiwan, Singapore, Canada, the UK and Australia. 4,918 projects were invested with the total value of USD 623.836 billion.

- Foreign invested projects had moved towards high level sectors and new sectors. For instance, world famous TNEs like Intel, HP, and Bell invested high-tech projects in Pudong New Area. Up to 1997, around 50 per cent of foreign invested projects in Pudong New Area were High-Tech. Meanwhile, foreign invested projects were shifted from traditional services sectors (such as office building, hotels, restaurants, entertainment centres) to new sectors, including finance, international trade, retailing and wholesaling, real estate management, design, investment and technology consulting firms, and other services sectors.

(2) Four function zones of Pudong New Area had been developed to a high level

Pudong New Area is featured with four function zones: Lu-Jia-Zui Financial and Trading Zone, Jin-Qiao Export Processing Zone, Wai-Gao-Qiao Bonded Area, and Zhang-Jiang High-Tech Park. Each of these four function zones has a different focus of attracting foreign investment, and was successfully developed to a high and international level. The Table 6.3 below highlights these four function zones about their main features and development/achievements in foreign investments based on the data up to 1997.

Pudong New Area's development and opening up also followed the strategy of "collectively developing with Puxi". That is, Pudong's development would be backed up by Puxi's strong economic, technological, and talent resources. On the other hand, Puxi's further development would be benefited by learning Pudong's experience of developing and opening up (liu, 1994).

Table 6.3 Main Features and Achievements of Four Function Zones in Pudong New Area

Zone	Feature	Development/Achievement
Lu-Jia-Zui Financial & Trading Zone	1. China's only zone as such; 2. situated at the east bank of Huangpu River, close to the west side of the River where it is part of Shanghai city centre, and a number of big Chinese banks are well-established; 3. occupying an area of 28 square kilometre; 4. aim of the zone is, together with Puxi – the other side of the River, to be developed as an international financial and trade centre	1. the Zone had been established and shaped as the "Golden Triangle" by 189 modern high buildings around that were set up by foreign and Chinese investors.; 2. These modern buildings were used by companies from over 60 countries as business offices, ranging from trading companies, financial firms, regional headquarters, and business centres, etc.
Jin-Qiao Export-Processing Zone	1. China's only such zone; 2. Four major functions: export-processing, trading operations, business services, and people's living; 3. Aim of the Zone: establish an export-processing system based on the combination of middle level of export-oriented strategy and high level of import-substitution strategy.	1. 302 projects were invested, of which, 164 were foreign invested, involving 18 countries/regions; 2. Majority of world large TNEs located in Pudong was in this Zone; of which, 21 TNEs were listed on the "Fortune" of 1996, including GM, Coca-cola, Mitsubishi, Hitachi, Sharp, Ricoh, Siemens, Bell, International Digital (UK), and Philips, etc.
Wai-Gao-Qiao Bonded Area	1. China's first and largest such zone; 2. Established on the basis of international standard of "Free Trade Zone"; 3. Businesses conducted in the Zone ranged from entrepot trade, export-processing, storage, to port and financing services.	3,100 investment projected made, with total value of US$ 3.8033 billion; of which, 2,059 projects were foreign invested, with total value of US$ 2.864 billion
Zhang-Jiang High-Tech Park	1. Key areas for research & development included: modern medicine science, microelectronics, and IT. 2. In terms of IT, priority was given to Networking, software, and digital communications projects.	1. World biological medicine giant Roche Group set up 6 branches in the park; 2. Motorola set up a software area within the Zone.

(*Source*: Yuan Qi, *20 Years of China's Open Policy*, 1998, Zhongzhou Ancient Literature Press, Zhengzhou City, China).

Pudong New Area was emerging strongly to be a modern downtown in Shanghai and China (Qi, 1998):

- Its GDP was increased from 7 per cent in the 1980s to around 10 per cent in the 1990s. Pudong New Area is 1/12 of Shanghai's total size, and its population accounted for 1/10 of Shanghai's total. However, in Shanghai's total in 1997, Pudong's GDP accounted for 1/6, gross industrial output accounted for 1/5, exports accounted for 1/4, and inward foreign investment accounted for 1/3.

- In addition, Pudong's astonishing development made itself a new and very important connecting point between Shanghai and the rest of China, and between China and the rest of the world. In fact, in July 1992, two years after opening up of Pudong, China's State Council decided to open five cities along the Yangtze River, which were Chongqing (formerly a city of Sichuan province, granted the status of municipality in 1997 by the central government), Yueyang (Hunan province), Jiujiang (Jiangxi province), and Wuhu (Anhui province). These cities were offered to enjoy the Open Coastal Policies. At the same time, 15 further cities were opened to enjoy the same policies, which included 4 boarder cities and 11 capital cities in China's inland areas.

Pudong New Area was growing strongly, and leading the way for further development of the Yangtze Valley area, and the rest of China. Pudong was also leading the whole country to open to the outside world and helping to get China's overall opening pattern finalised (Wang, *et. al,* 1995).

6.3. Three Important Political Events and Three Years of FDI Boom Between 1992 – 94

As discussed early in this chapter, China's FDI had moved into a new development era – from the period of *Permitting Western FDI to the period of Promoting It* in 1986 when the government promulgated "22 Articles" to encourage FDI. However, "June 4" Tianmen political incident in 1989 brought in a big question mark on the Chinese leadership: whether or not the country would continue its open policy, since FDI was dropped after the incident. The government's positive efforts to revive FDI and the recovery of FDI proved China's consistency of moving on its already chosen direction. Foreign investor's confidence was restored soon after the political statement was made by Deng Xiaoping – then Chinese political leader – on his south China tour in early 1992, and the declaration of the adoption of a market economy by the 14th National Congress of Chinese Communist Party in October 1992. These above two events not only successfully clarified the Chinese government position over the open door policy and removed worries, doubts and concerns of foreign investors, but also led China's door to be opened much more widely (more geographical locations were granted to open to foreign investment, which led to the overall open pattern of China being established) and much more deeply (various business sectors were allowed to open to foreign investment). This new open situation led to a dramatic FDI boom for three years between 1992 and 1994.

6.3.1. "June 4" Tiananmen Event in 1989 and Its Impact on China's FDI Development

China's FDI saw a surge for thirty months during the period between January 1987 and June 1989, after the government started to promote FDI 1986 by issuing "22 Articles" in October 1986; both the number of agreements signed and the value of these agreements were raised sharply. The number of FDI projects signed had gone up by 400 percent, and the value of these projects had increased by 67 percent, compared with the figure in January 1987 (Seo, 1993).

However, the "June 4" Tiananmen Incident caused significant destruction of the above achievements (Li and Li, 1999), and FDI further development was largely affected (Fan, 1992).

"June 4" Tianmen Event and Its Causes

"June 4" Tianmen Event was seen as "the massive student movement" (Li and Li, 1992, p. 65), which began with "a full social crisis in May 1989" (Soe, 1993, p.119). The demonstration of Chinese students and civilians in Tianmen Square of Beijing city centre eventually led to a crackdown by the military forces on June 4, 1989.

This event started with economic difficulties. Inflation, which began in 1985 when the index of urban cost-of-living rose by 11.9, reached a very high level in late 1988, when the cost-of-living index in the city increased 30 points over 1987. The serious economic situation led the whole country to economic chaos: people rushed to the bank withdrawing their money and panicked to do the shopping. The central government responded by announcing anti-inflationary policies in September 1988, aiming at slowing down the economy. Several measures of economic retrenchment were taken, including tightening Renminbi (Chinese currency) credit, taking a toll on existing joint ventures. These policies led to severe economic difficulties in the early of 1989 (Soe, 1993).

In addition, along with China's opening up to the outside world, the Chinese people were being greatly influenced by western ideas, values, philosophy and culture that were blocked in the country before. Moreover, growing corruption and lack of social justice led to a strong desire of more democracy and political reform of the country (Li and Li, 1999).

Effects of "June 4" Tiananmen Event

Consequences of "June 4" Tiananmen Incident were various and enormous:

- Western countries, including United States, Japan, and Western European countries announced political and economic sanctions against China (Fan, 1992).

- Foreign loans were suspended. These included an eight-year loan from the world bank, amounting to USD8.5 billions (USD3.4 billions was interest free); the Japanese government decided to delay a new seven-year loan of USD5.8 millions in June 1989 (Soe, 1993).

- In terms of FDI, although the majority of existing foreign investors did stay in China, they either reduced production or delayed new investment. For example, both Peugeot SA and Pepsi-Cola Inc planned to expand their joint ventures in south China, but the "June 4" Tianmen Incident led them to postpone their new commitments; the five American companies that were included in Fortune-500 enterprises initially planned to invest as much as a total of

USD650 millions, but four of them finally decided to cancel their plans (Seo, 1993). Some foreign investors moved their investment away from China to Southeast Asian nations (J Li and F Li, 1999). Little new FDI was made in China after the "June 4" Tiananmen Incident, apart from a small number of FDI projects that were ready to be finalised at that time. The number of new FDI agreements signed and the value of these agreements in the second half of 1989 dropped 11.3 per cent and 11.4 per cent respectively, compared with the first half of the year (Fan, 1992).

Implications of the "June 4" Event

After the "June 4" Event took place, researchers gave different explanations about the implications of the event. Some believed that this event "signalled that China was reverting to the old system", and leading to "the foreign investors confidence in the economic restructuring of the new China rapidly wasted away" (p120, Seo, 1993). In addition, this event even "marked a new phase of China's open door policy", as "the top leader in China realised that a wide range of political, social and ideological issues associated with the open policy needed to be reassessed" (Li and Li, 1999, p. 64).

Some argued that the "June 4" Event .... "for a moment it seemed that China would close its doors to foreign investment. But that prospect did not materialise" (Fu, 2000, p. 50).

In fact, soon after the event, the Chinese government made a number of great efforts in order to minimise the damage, to renew the confidence of foreign investors, and to continue its open door policy (Fan, 1992; Fu, 2000).

Firstly, the State Planning Commission of China arranged 400 millions of Chinese RMB yuan to foreign invested enterprises. This served as emergency loans to support these enterprises' investment to the fixed capital, so that they could alleviate their severe financial difficulties derived from the retrenchment policy.

Secondly, in April 1990, the Joint Ventures Law was revised. The improved terms and conditions of the Law over foreign investors included: 1. The Chairperson of the board could now be elected, rather than having to be Chinese; 2. The duration of the venture became flexible, depending upon the strategic plans of the venture, rather than being fixed between 10 and 30 years; and 3. The venture was not to be nationalised by the local government, only if it became absolutely necessary, but full compensation would be paid (Fan, 1992).

More notably, the State Council, in October 1990, announced a big decision – to develop and open up Shanghai Pudong New Area (that has been discussed in detail in the early part of this chapter). This brave move was actually "lightened and encouraged" by Deng Xiaoping who made it very clear that "the country must be courageous and accomplish new things to show to the world that we are sticking to the open policy" (Fu, 2000, p. 51).

In the meantime, the situation was moving positively in China's way.

The government successfully restored the social and political order. In addition, for their own political and economic interests, Western governments started to play down the "June 4" Tianmen Incident and to re-establish their relationship with China in July 1990. For example, the Japanese government announced the release of its loan of 810 billions of Japanese yen; and a year later, in 1991, several major western leaders paid official visits to China, including Mr James Baker, the then American Secretary of State, Mr Miyazawa Morihiro, the then Japanese Prime Minister, Mr. John Major, the then British Prime Minister. These visits resulted in the removal of Sanctions they imposed on China, and their continuation of co-operation with China's economic reforms and open door policy. This later led the World Bank and Asian Development Bank to resume their loans and financial aids to China. Moreover, Western countries' attention was no longer focused on China, and actually their attention was shifted away to the issues of the collapse of the old political systems of Eastern European countries and former Soviet Unions, and the Gulf Crisis after Kuwait was invaded by Iraq (Fan, 1992).

As a result, economic recovery started to get underway, and the effects of the "June 4" Tianmen Event on China's FDI development receded. In 1990, FDI was gradually growing: approved new FDI contracts was 7,276 with a value of USD6.567 billion; actually used FDI in the same year was USD3.4 billion. Contract value and actually used value of FDI introduced to China increased 23 percent and 17 percent respectively, compared with the previous year. A further rise occurred in 1991 (up to August), new FDI programmes were

7,280, with agreed amounts of USD6.374 billions, and actually used amounts of USD2.321 billions, increased by 44 percent, 45 percent and 23 percent respectively over the same period of the previous year (Fan, 1992).

In conclusion, it is true that the Chinese government paid huge costs for the "June 4" Tianmen Crisis, which contributed to a fall in foreign investor's confidence in their investment in China. However, it cannot be ignored that it was the severe inflation before the "June 4" Incident that played a major part in leading China to social and political chaos, then to the "June 4" Incident. There was a misunderstanding from foreign investors over Chinese retrenchment policy that was adopted in September 1988, aiming at bringing down the inflation rate from 18.5 per cent in 1988 to 10 per cent in both 1989 and 1990. This policy involved cutting down the investment and money supply in order to slow down the economy, but instantly put foreign invested companies in financial difficulties. This was mistakenly thought by foreign investors as a sign of China's change in its open door policy, especially as the "June 4" Tianmen Incident happened to take place after the retrenchment policy became effective (Fan, 1992). The fact is that the Chinese government had made every effort to prove itself to be sticking to the open policy by taking a number of measures, including opening up Shanghai Pudong for foreign investment, making positive changes in the Joint Ventures Law by improving terms and conditions for foreign investors, etc. It is therefore fair to say that the Chinese government had no intention of changing its open door policy, and that the "June 4" Tianmen Incident cannot be regarded as a new phase or turning point in terms of China's FDI policy change. In addition, the "June 4" Tianmen Event proved itself to be a "short-lived" and unexpected incident, compared with the mainstream of China's open door policy and its FDI development (F Li and J Li, 1999).

6.3.2. Impact of Deng Xiaoping's South China Tour and The 14th National Congress of Chinese Communist Party on China's FDI Development

In 1992, two important political events took place in China. One was Deng Xiaoping's South China tour in early 1992; the other was the 14th National Congress of Chinese Communist Party that was held in October. Both events had significant impact on China's further FDI development.

Deng Xiaoping's South China Tour and the 14th National Congress of Chinese Communist Party

As discussed in Chapter 5, China made a historic change in late 1978 when western FDI was permitted to be introduced to the country. Since then China had received a growing number of FDI. However, many Chinese were still worried about the role FDI played in Chinese socialist construction. That is, since China was a socialist country, FDI could do harm to the Chinese economy, as it came from western capitalist countries. These worries and concerns affected the Chinese policy-makers who had adopted a very cautious approach to dealing with FDI activity, and this indeed led to a slow pace of FDI development in the country (Hu and Ji, 1994).

In addition, the sudden collapse of former Soviet Unions and Eastern European countries put big pressure on the Chinese leadership, who were concerned that China could be affected by the capitalist "peaceful evolution" from western countries, including the introduction of western FDI (Fu, 2000).

FDI in China therefore could not move forward quickly before these political and ideological beliefs were removed. Deng Xiaoping, then Chinese political leader, launched a political activity by visiting a number of cities in south China, including Wuchang (in Hubei province), SEZs of Shenzhen and Zhuhai, and Shanghai, in early 1992. He argued against these beliefs when he talked to local officials, "being afraid of the capitalist influence causes China's slow pace of reforms and opening to the outside world. He claimed that the criterion to distinguish the socialist from the capitalist should be: 1. whether or not the socialist productivity can be developed; 2. whether or not the overall national power of the socialist country can be strengthened; and , 3. whether or not the living standards of Chinese people can be improved" (Ji, 1998, p351).

Deng Xiaoping's remarks successfully clarified the confusion and doubt over the open door policy and the introduction of western FDI.

In his tour of south China, he also challenged the traditional definition of the socialist economic system. This system was interpreted as *a planned economy based on social ownership* in Third Plenary Session of the 12th Communist Party of China in 1984; in the 13th National Congress of the Chinese Communist Party, the system was developed as *a socialist commodity economy based on internal harmony between planning and market.* Deng Xiaoping pointed out, market could not simply be seen as equal to capitalism, as capitalism did make use of the planning in some way. Likewise, the planning could not be seen as equal to the socialism, and the socialism could also make use of the market (Li and Li, 1999).

Deng Xiaoping's idea on the relationship between the market and the planning had broken through the traditional socialist beliefs and laid a theoretical foundation for a fundamental change of the Chinese economic system. That is to say, in October 1992, the 14th National Congress of Chinese Communist Party announced to the world that the aim of China's reforms was to "establish ***a socialist market economy***" (p.73).

China's shift from the planned economy to the market economy led the country to move towards the way of the market economy. As a result, various market systems were being established, including the production materials market, the financial market, and the labour market, etc; these markets were really necessary for foreign invested companies to conduct their businesses in China (Hu and Ji, 1994). The market was playing a more important role in the country's economic development. For example, the planning proportion in the total national industrial output was going down to 6 per cent in 1994, from 70 per cent in 1979 (Li and Li, 1999).

Deng Xiaoping's remarks and ideas in the South China Tour in 1992 were regarded as "the Second Liberation of People's Thought", if the first one was to get the Chinese to accept the Western FDI in 1979. This new liberation immediately led various markets to be established, and the pace of economic reforms and activities of opening to the outside world to be accelerated. This finally led to three years of FDI boom in China between 1992 and 1994 (Ji, 1998).

6.3.3. Three Years of FDI Boom Between 1992 and 1994

China's economy and FDI successfully recovered from the "June 4" Tiananmen Incident after the country took effective action to overcome the economic and political difficulties and to stick to the open door policy. Deng Xiaoping's south China tour and the 14th National Congress of Chinese Communist Party in 1992 put the country on a fast gear to the development road, which finally brought China into a three-year FDI boom from 1992.

This boom had generated several historical records and created a number of important features of FDI development in China.

Historical Records of FDI Development in China

- In terms of China's introduction of all forms of foreign investment, foreign loans – one of the indirect foreign investment forms - had been a dominant form (accounting for 60 per cent of the total value of China's introduction of foreign investment) before 1992. Since 1992, however, the total value of actually used FDI, for the first time, has overtaken that of the indirect foreign investment, and become the dominant form of China's introduction of foreign investment (Ji, 1998).

- In 1993, China became the second largest FDI receipt country, next only to the United States (Xing, 1998). In other words, China was the largest FDI receipt country in terms of whole developing countries, and this position had stayed every year for 14 years since 1993 (Pang, 2003).

- In 1992 alone, the actually used value of FDI in China was equal to that actually used in previous three years from 1989 to 1991 (Ji, 1998); and the total number of agreements signed and the value of the agreements in 1992 were almost half of those in the previous 13 years from 1979 to 1991 (Hu and Ji, 1994).

- Total value of FDI agreements and actually used value of FDI for three years between 1992 and 1994 were 4.8 times and 3.1 times respectively more than some of those in the past

13 years from 1979 to 1991 (Li, 1995). Table 6.4 below lists the annual FDI figure in terms of the number of FDI project, agreed value and actually used value of FDI.

Table 6.4. Inward FDI in China from 1979 to 1994

Unit Price: USD100 millions

	1979-86	1987	1988	1989	1990	1991	1992	1993	1994	Total
No. of FDI Projects	7819	2233	5945	5779	7273	12978	48764	83437	47490	221718
Agreement Value	191.8	37.1	53.0	56.0	65.7	119.8	581.2	1114.4	814.1	3033.1
Actually Used Value	65.9	23.2	31.9	33.9	34.1	43.7	110.1	275.2	337.9	955.9

(*Source*: Li, "Principles of China's Utilisation of Foreign Investment", 1995)

Important Changes of FDI Development in China

In addition to the above historical records generated by the FDI boom between 1992 and 1994, the boom had also brought in several important features of FDI development in China.

- Growing number of FDI source of countries

From the 1980s until the early 1990s, major FDI players in China were from Hong Kong, Macao and Taiwan, and a few from other counties only played a minor role in China's FDI activity. From 1992, the number of countries and regions that invested in China rose sharply. Up to 1994, over 130 countries/regions invested in China. Notably, western countries started to invest in China seriously (Wang, *et al*, 1995). Take America and Japan for example. Not until 1992 did American FDI in China become significant. In 1992, its actually invested FDI value in China, for the first time, exceeded USD500 millions. And its actual FDI in the following year reached beyond USD2 billions. Before 1992, Japan was not enthusiastic to be involved in direct investment in China, and it invested a small scale of projects with low level of technology. Two factors affected the Japanese attitude towards their investment in China in the early 1990s: 1. China's stability of political and economic environment and consistence of following the open door policy; 2. Products made in China by American and European invested ventures started to compete strongly against Japanese products in the world market, which made Japan feel a threat. In 1993, the Japanese began their participation in China's FDI much more seriously. Some world electrical giant firms established their factories in the country, including Sony, Toshiba, and National, etc (Hu, 2003).

- Major Transnational Enterprises (TNEs) Pouring into China

Before 1992, little FDI was made by TNEs as China's FDI was gradually growing. Instead of involving themselves in FDI, the majority of TNEs in China set up their representative offices, selling their products and technology to the country. From these companies, China purchased a large number of consumer products and production facilities, including the whole set of a production line. For example, for the TV production line alone, China imported over 100 such lines (Ji, 1999).

According to a survey by Zhile Wang (1996) on 30 German and Japanese TNEs on Fortune-500 List, only two – Japanese Sanyo and German Volkswagen - of these 30 TNEs made significant FDI in China. Sanyo set up six enterprises in Shenzhen; and Volkswagen established two joint car ventures, one of which was in Shanghai, the other was in Changchun. All other 28 firms either took a wait-and-see approach, or invested a couple of small-sized projects. Not until 1992 did TNEs start to pour into China. Some of them that never invested in China before now actively took part in FDI there; some of them that previously had small amount of investment raised the number of FDI projects. Table 6.5 shows the sharp rise in 30 German and Japanese companies, in terms of the number of FDI projects in three years between 1992 and 1994, compared with the previous years.

Table 6.5. 30 Japanese and German TNEs Investing in China by Number of FDI Projects from 1980 to 1994

Year	No. of FDI Projects	Year	No. of FDI Projects
1980	0	1988	2
1981	1	1989	7
1982	0	1990	5
1983	1	1991	5
1984	5	1992	16
1985	4	1993	37
1986	1	1994	69
1987	4		

(*Source*: "Investment of Transnational Corporations", Zhile WANG, Economic Press of China, Beijing, 1996)

Up to 1994, over one hundred of the world's top TNEs invested in China. Among the American's 500 largest TNEs, 52 of them had FDI in China, involving over 80 projects with agreement value of USD3.6 billions, which accounted for around half of the total FDI value made by American investors in China. 15 out of 20 Japanese companies, which were the world largest 100 companies, invested in China, including National, Hitachi, Toshiba, Sanyo, NEC, Fujitsu, Mazda, and Toyota. 10 out of 15 German enterprises, which were included in the world's largest 100 manufacturers, had FDI projects in China, including Volkswagen, Siemens, Bayer, Basf, and Hester. This marked the first wave of TNEs' investing in China (Ji, 1999).

- More Sectors/Industries to open for FDI

FDI in the 1980s was mainly concentrated on manufacturing sectors, particularly in product processing sectors, and the tertiary industry (i.e., services industry) was restricted for FDI. For example, domestic commercial sectors (retails and wholesales), foreign trade, and advertising industry were forbidden for FDI (Wang, *et al.*, 1995).

Since 1992, more sectors and industries had been gradually opened up for FDI. Several sectors and industries that were previously forbidden for FDI were now allowed to introduce FDI on an experimental basis. For example, the new policy allowed: 1. foreign investors to operate retailing and wholesaling industries in the form of a joint venture or a wholly foreign owned enterprise; 2. foreign firms to run foreign trade in certain open regions; 3. foreign financial institutes to set up a bank with a Chinese partner, or on their own in coastal open cities. Sectors and industries that were previously restricted for FDI were now permitted to open further. These sectors and industries ranged from land development, real estate development and management (including regeneration of old urban areas), restaurants and hotel development and management, and information and consulting services (Hu and Ji, 1994).

- Moving towards the overall opening up of the whole country to the outside world. Before 1992, China's opening up was concentrated on coastal cities and regions where a number of cities were given favourable policies for FDI by the central government, which led to the majority of China's FDI being located there. This along the sea opening up strategy was adopted in the view that these coastal cities had location advantage - they were relatively developed areas with established infrastructure, educated labour forces, and experience of international business. This strategy proved to be successful in the sense that the country managed to receive a good number of FDI, which helped to upgrade the economy of these opened areas (Zhao, 2001).

However, on the other hand, this strategy did not help China's less developed inland areas to improve their economy, and therefore made the gap of their economic differences even larger (Peng, 2003). Soon after Deng Xiaoping's south China tour at the beginning of 1992, China's State Council took action to open up the inland areas of the country. This new opening up adopted a new strategy, which in fact puts these inland cities and areas in a similar position to coastal open cities, as now these two different kinds of locations were given the same favourable policies that were originally given to the coastal areas, and the divide between these two areas could be improved (Hu and Ji, 1994; Fu, 2000). See Table 6.6. for details of this opening up.

Table 6.6. New Opening Strategy for China's Inland Areas

Date	Areas	Policy
From 9th March to 30th July 1992	Opening Up Along the Border Cities: 13 border cities were opened up. They were Heihe City and Suifenhe City in Heilongjiang province, Huichun City in Jilin Province, and Manzhouli City and Erlianhaote City in Inner Mongolia Autonomous Region, Pingxiang and Dongxing in Guangxi Autonomous Region, Wanding, Ruili and Hekou in Yunnan Province, Yining, Bole and Taicheng in Xinjiang Autonomous Region	These border cities were given more power to operate border trade with neighbouring countries and deal with issues of foreign economic co-operation.
Beginning on 30th July 1992	Opening Up Along the (Yangtze) River: Chongqing City, Yueyang City, Wuhan City, Jiujiang City and Wuhu City – these 5 port cities along the Yangtze River were opened, and half year later on 18th February 1993, Huangshi - a further city along the River was opened.	These cities were offered the favourable policies that applied to Coastal Open Cities
As above	Opening Up Provincial Capital Cities: 18 capital cities of inland provinces were opened, including Hefei City (Anhui Province), Nanchang City (Jiangxi Province), Nanning City (Guangxi Zhuang Autonomous Region), Changsha City (Hunan Province), Zhengzhou City (Henan Province), Shijiazhuang City (Hebei Province), Taiyuan City (Shanxi Province), Huhehaote City (Inner Mongolia Autonomous Region), Xi'an City (Shaanxi Province), Changchun City (Jilin Province), Harbin City (Heilongjiang Province), Yinchuan City (Ningxia Autonomous Region), Lanzhou City (Gansu Province), Xining City (Qinghai Province), Mulumuqi City (Xinjiang Uygur Autonomous Region), Chengdu City (Sichuan Province), Kunming City (Yunnan Province), Guiyang (Guizhou Province).	Like the above port cities along the Yangtze River, all these capital cities enjoyed the special policies initially only given to the open coastal cities.
From 1992, after the first Bonded Area in Shanghai in 1990.	13 more bonded areas were established: These further 13 bonded zones were located in Futian and Shatoujiao (in Shenzhen City), Tianjin Port (in Tianjin City), Dalian City (in Liaoning Province), Guangzhou City (in Guangdong Province), Qingdao City (in Shandong Province), Zhangjiagang City (in Jiangsu Province), Ningbo City (in Zhejiang Province), Fuzhou City and Xiamen City (in Fujian Province), Shantou City (in Guangdong Province), Haikou City (in Hainan Province).	Enjoy same preferential policies as in Shanghai bonded area

(*Source:* Hu and Ji, 1994).

This new dramatic opening up also shaped China's open pattern – from south (coast) to north (coast), from coastal areas to inland areas. This finally led to the whole country opening up to the outside world (Hu and Ji, 1994).

6.4. Overall Assessment and Major Problems of China's FDI Development During 1986 – 1994

6.4.1. Overall Assessment

As discussed in the opening part of the chapter, "22 Articles" of the 1986 Provisions marked another turning point of China's FDI development – from permitting FDI to Promoting FDI. During the period of FDI promotion, the Chinese government comprehensively liberalised its foreign investment systems in order to encourage more FDI to be introduced to the country (Lardy, 1995). The liberation included taking effective measures to resolve the problem of foreign exchange balance for foreign invested enterprises, to improve operating conditions and provide more attractive incentives and greater authority for their management issues. Meanwhile, the government improved the legal system by making the Law for the wholly foreign owned enterprise (WFOE) in 1986 and the Law for the contractual joint ventures (CJV) in 1988, which meant, together with the law for the equity joint venture (EJV) being issued in 1979, that now all legal frameworks were being made available for these three major types of FDI in China. Moreover, in 1988, the government took a brave step to open up the whole Hainan Island as a special economic zone – China's fifth special economic zone by offering it full provincial status and separating it from Guangdong province (Qi, 1998).

The dramatic policy development brought the country a thirty-month FDI boom until 1989, when the "June 4" Tiananmen political incident occurred. This event led to severe worldwide political and economic sanctions over China, including withdrawal and suspension of FDI projects in the country. The Chinese government, however, made every effort to successfully turn the difficult situation by developing and opening up of the Shanghai Pudong New Area in 1990, and two years later in 1992 opening up the whole country for FDI, and changing the Chinese economic system from a planned economy to a market economy. These significant changes clearly indicated that the country was still well on the track of opening up. According to the Economist (21, May, 1994), to assess China's investment environment in terms of the political stability and the economic and investment potential of all nations, China's risky rating was improved to 25 in 1992 from 35 in 1989, and was regarded as a less risky country for foreign investment. China's stable investment environment and the market potential therefore greatly boosted foreign investors' confidence, and led China to a tremendous FDI surge for three years between 1992 and 1994.

The boom generated several historic records of China's FDI development: (a) since 1992, in terms of the value introduced to China, FDI has overtaken foreign loans, and become the most important form of China's introduction of foreign investment (Xing, 1998); (b) since 1993, China has constantly become the largest FDI receipt country of the developing countries, and the world's second largest FDI receipt country, next only to the USA (Xing, 1998); and (c) actually realised value of FDI in three years between 1992 and 1994 was 3.1 times more than the total value of FDI in the past 13 years from 1979 to 1991 (Li, *et al*, 1995).

According to Sun (1995), then Deputy Minister of China's Ministry of Foreign Trade and Economic Cooperation, the overall performance of FDI development in China was deemed by the government to be a success:

- FDI had played an important role in the fast growth of China's economy. For example, in 1994, FDI China received accounted for 13 per cent of the total amount of China's fixed investment (which was only 2.3 per cent in 1985) (Zhao, 2001). This made an important contribution of 11 percent to China's high economic growth rate.

- Western technology and products made by foreign invested enterprises in China had changed people's work and life style and lifted their living standards, especially advanced electronic products.

- Western FDI had also helped to train many Chinese entrepreneurs who learned the advanced and effective operations techniques and management skills from their foreign partners in a venture.

- Foreign invested enterprises provided an important job opportunity for the Chinese. By 1994, around 14 million Chinese people worked in foreign funded enterprises.

- Foreign invested firms contributed more and more revenue to China. In 1992, they contributed 10.7 billions of Chinese yuan, but the figure was increased to 20.6 billions in 1993, and 39 billions in 1994.

- Foreign funded companies had become a major player of China's exports. In 1994, their exports accounted for as much as 28.7 per cent of China's total exports, which is much higher than that in 1985 when it was only 1.1 per cent (Zhao, 2001).

6.4.2. Major Problems

As discussed above, Chinese continued positive approaches and policies over FDI between 1986 and 1994 did successfully attract a record number of FDI, and made the country one of the most important FDI receipt nations in the world.

On the other hand, however, the government, as well as researchers, started to have a thorough review of China's FDI development during 1986 and 1994, in order to identify some guidelines for the further development of its FDI (Pan, 1997).

It was generally agreed that the general picture of China's FDI development was still unbalanced, and some fundamental problems of China' FDI remained critical, notably, the quality of FDI was still unsatisfied, although the FDI quantity had reached the peak in the history of China's introducing FDI (Chen, 2004; Li P, 1995; Li L, 1995).

The unsatisfactory quality of FDI was regarded as a low level of FDI structure in terms of FDI's scale, industrial distribution and geographical distribution, source countries/regions of FDI, and type of the projects (Pan, 1997; Chen, 2004). These problems relating to FDI quality are discussed below.

Problems of FDI Quality

- Small scale of FDI: generally speaking, the advanced FDI projects usually came on a larger scale. For example, in the middle of 1990s, the average FDI scale by world major TNEs was around USD6 million, while the average scale of 70 per cent of China's FDI was under USD1 million, and the average scale of FDI projects made by 300 largest foreign invested enterprises in China was still under USD5 million. FDI projects that were over USD10 million only accounted for 4-5 per cent of China's total FDI projects (Chen, 2004).

- The Majority of FDI was from Hong Kong, Macao, and Taiwan

The Table 6.7 below shows that the majority of China's FDI came from Hong Kong, Macao and Taiwan, and actually used FDI from these regions accounted for 77.1 per cent of China's total FDI between 1979 and 1993.

Table 6.7. Source of China's FDI Investors (1979 – 1993)

Unit Price: USD100 million

Investors	**Agreed amount**	**Percentage in Total (%)**	**Actually Used Amount**	**Percentage in Total (%)**
HK & Macao	1472.7	68	385.1	68.2
Taiwan	184.3	8	50.1	8.9
USA	146.5	7	57.7	10.2
Japan	89.3	4	51.9	9.2
Others	276.3	13	19.7	3.5
Total	2169,1	100	564.5	100

(*Source*: Financial Times, 20, May, 1994).

China felt disappointed about the small percentage of FDI that came from developed nations – only 10.2 per cent from the USA, and 9.2 per cent from Japan, as FDI from these countries was seen as good quality and big scale (Pan, 1997).

By contrast, FDI from Hong Kong, Macao, and Taiwan was mainly small scale and low quality, such as the simple processing industry that made toys, leather products and textiles (Jia, 1997).

- Poor Industrial Structure

Table 6.8 shows that between 1979 – 1994, in terms of value, FDI in China was concentrated on the manufacture sectors, which accounted for 56 per cent of total value of FDI projects. Within these sectors, many FDI projects belonged to light industry, textile industry, and electronic and processing industry with low technology. Even for the electronic industry, 70 per cent of its FDI projects were labour-intensive. In the whole manufacturing sectors, one fourth of FDI projects were highly polluted and energy-inefficiently-consumed, which caused a serious environmental problem (Chen, 2004).

FDI projects belonging to the tertiary industry accounted for 39.5 per cent, but 78 per cent of which was labour-intensive and capital-intensive, such as real estate, hotel development, and tourism projects. FDI projects in the first industry only accounted for 4.5 per cent, but covered China's weak but priority areas of agriculture, and infrastructure (such as power, transportation, and communications (Pan, 1997).

Table 6.8. Industrial Distribution of China's FDI between 1979 - 94

Type of Industry	No. of Projects	Percentage in Total	Agreed Value	Percentage in Total
First Industry	13058	5.9	135.4	4.5
Secondary Industry	168749	76.1	1696.6	56.0
Tertiary Industry	39911	18.0	1198.1	39.5
Total	221718	100.0	3033.1	100.0

(*Source*: Pan, 1997)

- Unbalanced FDI Distribution of Geographical Locations

According to the custom of dividing different geographical locations of China, the whole country can be divided into three different regions: East Region, Central Region, and West Region. East Region covers cities and provinces along or near the coastal lines, including cities of Beijing, Tianjin, Shanghai, and provinces of Liaoning, Hebei, Shandong, Jiangsu, Zhejiang, Fujian, Guangdong, and Hainan. The Central Region covers inland China between the north east and central part of the country, including provinces of Heilongjiang, Jilin, Shanxi, Inner Mongolia Autonomous Region, Henan, Hubei, Hunan, Anhui, and Jiangxi. The West Region mainly covers border areas between the west and northwest part of China, including Xinjiang Uygur Autonomous Region, Tibet Autonomous Region, Gansu Province, Qinghai Province, Ningxia Hui Autonomous Region, Shaanxi Province, Sichuan Province, Chongqing City, Yunnan Province, and Guizhou Province (Chen, 2004).

Most of the East Region was more developed than the other two regions, therefore it was decided by the government to be the first opened up to the west in order to make sure FDI would be attracted. This open strategy proved to be rather successful as most of China's FDI was successfully introduced to that region, and foreign investors also preferred to take advantage of the convenience of the coastal location, established infrastructure and better quality labour forces of this region, as well as taking advantage of favourable policies being offered by the government (Xiao, 2002).

However, this open strategy inevitably led to a bigger gap of economic development between the East Region and the other two regions - Central Region and West Region. Even after the open policy was eventually extended to these two regions in 1992, and China therefore saw three years of FDI boom between 1992 and 1994, FDI was still largely concentrated on the East Region. For example, the overall ratio of China's FDI from 1979 to 1994 in three different regions is 79 per cent for the East Region, 16 percent for the Central Region, and 4.3 per cent for the West Region. In 1994 alone, four provinces and one city – provinces of Guangdong, Fujian, Jiangsu, Shandong, and Shanghai City within the East Region accounted for 64.7 per cent of national total value of actually used FDI. The government was very concerned about this big divide between Chinese different regions (Pan, 1997).

What causes the above unbalanced picture of China's FDI development – rapidly growing quantity, but low quality of FDI? Much of the research concluded that the major factor that contributed to the low quality of FDI in China was the pattern the government adopted to introduce FDI. That is, China attracted FDI mainly by using the preferential policies to foreign investors, and got these policies applied to the gradually opened locations and economic sectors (Xiao, 2002). In addition, the Chinese central government's preferential policies were misinterpreted and misused by Chinese local governments and by those who involved in FDI activity, including those located in the Central Region and the West Region of China to which the open policy was extended in 1992 (Lardy 1995; Yang, 1999).

Outcome of China's Preferential Policies on FDI Development

As stated early, the government's primary strategy to introduce FDI between 1979 and 1994 was to offer various preferential policies (see these policies in details from Table 6.7 below) to foreign investors, which were, in the early years of China's open door, only made available for Special Economic Zons (SEZs), Coastal Open Cities (COCs), and were finally extended to the whole country, following the open policy that was developed from the coast part of China to the rest of the country (Lardy, 1995; Xiao, 2002).

The preferential policies the Chinese government offered to foreign investors were mainly tax deductions and the tax break. For example, the ordinary corporate income tax for the foreign invested enterprise was 33 per cent (including 3 per cent of local tax), which was similar to the rate of many developing countries, but was much lower than the rate imposed on Chinese local enterprises. But for foreign invested enterprises located in SEZs, or involved projects with large scale and in China's priority industrial areas, lower tax rates of 24 per cent and 15 per cent were offered. In addition, foreign invested enterprises could enjoy a tax holiday for 2 years, followed by 50 per cent tax off for another three years (after the year they made profits), if they committed themselves to China for 10 years or longer, and involved in certain business areas. Some foreign enterprises were even offered the tax holiday for as long as five years, and another five years of 50 per cent tax off. Moreover, foreign invested enterprises also enjoyed tariff exemption for importing office facilities and production materials from abroad for their operation in China (See the Table 6.9 for China's preferential policies in more detail) (Xiao, 2002).

These preferential policies proved to be very practical and effective, as they played a vital role in introducing FDI into China in the initial years of its open policy, and in promoting the large and recorded number of FDI into the country since 1992 (Xing, 1998; Zhao, 2001). When China opened to the outside world, its leaders were aware the country did need to provide some incentives or to make some concessions to foreign investors, in view of the fact that the country had to make certain of success in bringing in western FDI as the country was still weak in its investment environment and could somehow be compensated by providing preferential policies (Xing, 1998). These offers were therefore seen as the cost for the country to pay for launching its open policy and learning from the west (Xing, 1998; Yang, 1999).

However, after three years of FDI boom between 1992 and 1994, the focus of attention to FDI – from both the Chinese government and researchers – was shifted from its quantity to its quality, as FDI quantity did not seem to be a major concern any more; while FDI quality turned out to be a disappointment (Pan, 1997).

The negative impact of the preferential policies on FDI development was seriously reviewed, especially for the three-year FDI boom period when these policies were over used and misused (Zhao, 2001):

- The preferential policies were misused by Chinese partners of the joint venture: In order to take advantage of these favourable policies, the Chinese partners – who were from Chinese state-owned or collectively owned firms – were desperate to find a foreign partner to form a joint venture. They therefore "generously" gave away a lot to the foreign partner. For example, they devalued the fixed capital they invested to the joint venture, and deducted the proportion of their equity in the venture so as to "encourage" the foreign partner to set up the venture with them. This led to the loss of the property owned by the state or by the local community. Another way was to overvalue the foreign partner invested assets that allowed them to gain more equity and therefore to share more profits in the future. This also led to the sacrifice of the state or the local community (Pan, 1997).

Table 6.9. List of China's Major Preferential Policies for FDI Makers

Favourable Corporate Income Tax	
Rate	**Application**
1. Ordinary Tax Rate: 33%	This rate is applied to all ordinary foreign invested enterprises (FEIS), which was about same as many other developing nations and regions, but lower than China's local enterprises.
2. Most Favourable Rate: 15%	(1) FIES located in SEZs; (2) Manufacture FIEs located in Economic and Technological Zones; (3) Hi-Tech and New-Tech Enterprises located in Hi-Tech & New-Tech Development Areas; (4) FIEs involving building up ports and yards; (5) FIEs investing over USD 10 millions and operating over 10 years; (6) Chinese governments approved tech-intensive and capital-intensive FDI projects; (7) FDI projects over USD 30 millions but with a long investment return period; (8) Energy and transportation FDI projects,
3. Medium Favourable Rate: 24%	(1) FIEs located in Coastal Economic Open Areas; (2) Manufature FIEs for Cities Along the River and Along the Border and Provincial Capital Cities; (3) FIEs located in National Tourism Zones
Tax Holiday and Tax Discount (Corporate Income Tax), and Tax Return	
4. Tax Holiday and Tax Discount	(1) "2 years of tax free, plus 3 years of half tax" - Manufacture FIEs operating for more than 10 years, beginning from the year of making profits, the first two years of tax free, followed by three years of 50 per cent tax off (FIEs with advanced technology were given three further years of half tax; FIEs having 75 per cent of products for exporting, half tax duration was allowed for extension); (2) "5 years of tax free, plus 5 years of half tax" – FIEs involving building ports and yards, with duration over 15 years; for FIEs involving industry of agriculture, forestry and animal husbandry, or located in under-developed areas, they were allowed to enjoy 10 – 30 percent of tax off after initial 10 years of tax concessions.
5. Tax Return	FIEs got 40 per cent of their paid corporate income tax returned if they reinvested by using their profits (no matter investing to the existing or new venture).
Favourable Tariff and Business Consolidated Tax	
6. Tax free for particular imports and exports	(1) Import tariff free and Business Consolidated tax free for production materials that were used to produce exports; (2) Business Consolidated tax free for exported products, except crude oil and ready-for-use oil; (3) Goods that was imported as part of foreign investment, including facilities, meters, etc, was free from tariff and consolidated tax.

(*Source*: A Study on FDI of Transnational Enterprises, 2002, Wuhan University Press, China).

- Recycled FDI: Many Chinese firms took advantage of the preferential policies by registering a company abroad, then recycling it back to China as their overseas fund that was "disguised as foreign investment". According to the World Bank, this recycled amount of "FDI" accounted for as much as 25 per cent of China's total FDI in 1992 (Lardy, 1995; Pan, 1997).

- Keep setting up new ventures: A foreign invested enterprise that was offered a tax free break for two years, followed by another three years of 50 per cent tax off. Before this treatment ended, they formed a new venture either by closing down the existing one or by transferring most of the funds from the existing venture, to start enjoying the tax holiday and discounted tax again. According to the author's interview record in 1997, a director of a shoe-making joint venture in Foshan City, Guangdong province, who admitted that they now had two ventures after the first one being founded five years ago, the second one was just established a few months ago with most funds transferred from the first one. Now the second one was happily enjoying the preferential policies, although the first one would soon disqualify to enjoy the policy. This was the strategy many foreign invested enterprises followed (Lin, 1997).

- Regional competition of offering better preferential policies to foreign investors: Beginning in 1992, the government extended its open policy from the East Region to the Central Region and the West Region, which made the preferential policies available to the whole country. This immediately led to a dramatic nation-wide race for FDI between less developed regions and more developed regions, and in particular, between less developed regions themselves. This race was out of control as the preferential policies were seriously misused (Kueh, 1992). In order to attract more FDI to their territory, many local governments offered much improved preferential policies to foreign investors, which was beyond the permission of provincial and central governments. For example, they offered foreign invested enterprises additional duration of tax holiday (additional 5 – 10 years after initial 5 years), and additional duration of discounted tax (additional 5 – 10 years of 50 per cent tax off, after initial 5 years). To the higher level of governments, sound quantity of FDI introduced by the local governments and their officials meant the better performance of their dealing with FDI (Chen, 2004). Strong enthusiasm for FDI from the central government and intense race for

FDI from the local governments made FDI very popular to the whole nation, as long as the investment was seen as foreign investment, such investment could receive superior treatment unconditionally, which put foreign investors in a position to bargain for a much better deal (Xing, 1998).

As a result of the preferential policies being misused and overused, and the nation-wide race for FDI, a number of serious problems were generated.

Problem 1: great loss of the government tax income. China's standard preferential policies already gave foreign invested enterprises special treatment at the cost of giving away much of its tax revenues. The policies being misused and overused led the government to lose much more of its income from the tax. (Yang, 1999).

Problem 2: all levels of local governments only aimed at introducing as many FDI projects as possible into their regions, and they were reluctant to follow their development strategy based on their local strengths. This led to many FDI projects being identical and repeatedly introduced (Chen, 2004).

Problem 3: The race for FDI led to many low quality and small scale FDI projects being introduced; in other words, the government had failed to attract good quality FDI they planned by offering foreign invested firms the preferential policies. The reason being, the preferential policies were only seen as unstable and short-term measures. For world leading companies such as transnational enterprises, they mainly paid attention to the overall investment environment of a host country (e.g. a host country's political and economic stability, quality of local labour forces and infrastructure, etc) when they planned to make FDI, as they followed a long-term investment strategy. Foreign firms involving hi-tech areas follow the same strategy of making FDI. This was why, under the preferential policies, mainly those foreign firms that were small scale, low-tech, and pursued quick return of their investment can be attracted, because they followed a short-term strategy (Pan, 1997).

In conclusion, China's introduction of FDI by relying on offering preferential policies to foreign investors inevitably generated the above problems. These problems logically formed an important feature for China's FDI as quantity-expended, rather than quality-oriented (Pan, 1997; Xing, 1998).

6.4.3. China's Move to Directing FDI and Withdrawing the Preferential Policies

After a three-year FDI boom between 1992 and 1994, which was accompanied by poor FDI quality due to misuse and overuse of the preferential policies, the central issue of China's FDI development was shifted from raising FDI quantity to improving FDI quality, and the existing role of the preferential policies on FDI development was seriously questioned (Xiao, 2002; Chen, 2004).

FDI researchers overwhelmingly agreed that it was the time for China to propose a new strategy to introduce FDI to replace the existing one – largely relying on the preferential policies, since the country already received large amounts of FDI, and since these preferential policies had failed to bring in good quality FDI to China (Xing, 1998; Yang, 1999).

Some claimed that more attention should now be given to the improvement of China's overall investment environment, such as: (a) removal of bureaucracy of local authorities, so as to deliver quality services for foreign investors; (b) making the government policy transparent, so as to help foreign investors to make a long-term strategy based on complete information available and full understanding of the Chinese government policy; and (c) improving infrastructure (especially for the central region and the west region), economic system (speeding up China's transformation from the planned economy to the market economy), and legal system (e.g. Contractual joint venture was running in the absence of implemental measures for the law on contractual joint venture, which was available in September 1995) (Pan, 1997).

Some argued that the preferential policies were still useful and effective, but the government needed to set strict condition for foreign invested enterprises to make use of them. These conditions should help to guide foreign investors to invest in China's priority regions (such as the central region and the west region), and in the priority industrial sectors (such as hi-tech sectors), and FDI projects that could improve the infrastructure (such as roads, ports and power station) (Xing, 1998).

Some pointed out that offering foreign investors the preferential policies was against the principle of "the National Treatment (foreign investors are treated as equally as local firms)", as doing this created a superior platform for foreign invested enterprises to compete against their local counterparts – Chinese local enterprises, which made the competition unfair for Chinese local firms. Local firms had to pay twice as much tax to the government, which made their life much harder. The preferential policies indeed provided the foreign investors a "Superior National Treatment" in this regard. Having had this special treatment, foreign invested enterprises were still not happy with their treatment relating to their operation aspects. For example, they had to pay higher price for purchase of local production materials and services, because of the dual price system (production materials were controlled by the government and two different prices for similar materials were set: local state-owned companies paid a lower price for the material, while the foreign invested enterprises had to pay a higher price for the same material). This price discrimination on foreign invested enterprises was also against the principle of "the National Treatment", which was known as "Inferior National Treatment" (Yang, 1999). However, in comparing the gains the foreign invested enterprises obtained from their superior treatment and the loss they received from inferior treatment, foreign invested enterprises actually gained more and lost less, and they were still in a better position to compete with Chinese local firms. To make the competition fair to both foreign invested enterprises and Chinese local enterprises, offering foreign invested enterprises "the National Treatment" seemed to be an ideal solution (Zhang, 1996).

To these important issues relating to China's FDI further development, the central government and its officials reacted very promptly. Li Langqing, then China's Vice Premier in charge of China's foreign economic activities urged the local governments to give up ways to attract FDI – relying on the preferential policies, and to replace them by introducing "the National Treatment", so that an equal operating environment can be created for both foreign and Chinese firms. He also urged the foreign investors to adjust their investment strategy in China, to change it from a low level short-term strategy to a long-term strategic partnership, and to invest their technology to gain China's market share (He, 1995).

Substantial action was taken by the central government. On June 20, 1995, then State Planning Commission, the State Economic & Trade Commission, and the Ministry of Foreign Economy, Trade & Cooperation jointly promulgated "Provisional Regulations Guiding Foreign Investment", and "Industrial Catalogue Guiding Foreign Investment". These two documents provided the foreign investors with guidelines and requirements when they planned to invest in China's certain industrial areas. To guide FDI, the Catalogue listed three different industrial areas with different policy treatment: FDI-encouraged industrial areas, FDI-restricted industrial areas, and FDI- forbidden industrial areas (these two documents and their impact on FDI will be discussed in detail in the next chapter). For the first time, the Chinese government comprehensively adopted a selective approach to FDI (Xiao, 2002).

Three months later, FDI, as a major issue, was discussed in the Fifth Plenary Session of 14th Central Party Committee, and two important principles were concluded by the Session, which was included in the published document by the Session:

1. Introducing FDI to China shall follow the principle of "positive, justified, and effective", which implied that the quality of FDI, not the quantity of FDI, would become the first priority for FDI further development in the country (Zhang, 1995).

2. The government would "gradually offer the National Treatment to foreign invested enterprises", which aimed at providing a fair competition environment for both foreign and Chinese firms, and also aimed at meeting the requirements of the World Trade Organisation (WTO) as China was making efforts to join WTO (Zhao, 2001).

As a first important step to move to the National Treatment, on December 28, 1995, the China State Council took a very bold action by announcing that from 1st April 1996, new foreign invested enterprises no longer enjoyed tariff free treatment for their importing of production facilities and production materials (Chen, 2004).

All the above significant FDI policy changes marked a new turning point of China's FDI development - from FDI promotion to FDI management (Brecher, 1995). Also, the approach the Chinese government adopted to make this historical policy change was different from the one in 1986. At that time, the government adopted a "reactive" approach, as it was forced to make an urgent and fundamental policy change, reacting to the foreign investors' complaints and severe situation of FDI further development. The significant policy change this time, however, was based on a "proactive" approach, as the government took the initiative to make this big decision, in the hope that FDI could play a better role in developing Chinese economy and helping the country to move towards internationalisation (Li and Li, 1999).

CHAPTER 7

From Promoting FDI to Managing FDI (1995 - 2000):

An Evaluation of the Third Period of China's FDI Development

7.1 Introduction

As discussed in the last chapter, since 1986, the Chinese government adopted a new approach – promoting FDI by issuing "22 Articles", so as to replace the approach of permitting FDI. As a result of this, China's inward FDI started to increase dramatically, especially after Deng Xiaoping's South China Tour in early 1992, when China saw a three year FDI boom between 1992 and 1994.

The government had mixed feelings for the sharp rise of FDI. On the one hand, the rise was seen as a sign of success in the government policy of promoting FDI; on the other hand, however, serious problems were explored, such as the central government policies on promoting FDI being misused or misinterpreted by the local governments that made every effort to attract FDI to their governed areas, which led to a large amount of low quality and disguised FDI being poured into the country.

In order to improve the quality of FDI and use FDI to promote China's priority industrial areas and sectors, on June 20, 1995, the State Planning Commission, the State Economic & Trade Commission, and the Ministry of Foreign Economy, Trade & Cooperation jointly promulgated "Provisional Regulations Guiding Foreign Investment", and "Industrial Catalogue Guiding Foreign Investment". These two documents provided the foreign investors with guidelines and requirements for them to invest in certain industrial areas of China.

Notably, the "Catalogue", for the first time, gives environmental issues the special consideration, as the Chinese government has growing awareness of: (a) China is paying higher cost to introduce some highly polluted industries via FDI, as a result of relocation of these industries by western countries (Wheeler, 2001); and (b) China's existing environmental problems are worsening along with large proportion of highly polluted FDI projects (e.g. 8 out of 10 most polluted cities in the world are located in China, and only 37 per cent of the surface water monitored meets the national standards and less than 20 per cent of municipal wastewater is treated) (Qin, 1999). Thus, the "Catalogue" requires all kinds of FDI projects to follow the principles of environmental protection: (a) for the *encouraged* projects, the Chinese government particularly welcomes those skills which can protect environment; (b) for *restricted* projects, the government is very strict to approve the those which may cause environmental problems; (c) for *forbidden* projects, the government disallows any projects which pollute the environment and damage natural resources; and (d) for *permitted* projects, the government requires the projects have no pollution or little pollution but with measures to deal with the pollution (Environmental Paper of China, p.3, 28, August 1999)..

Three months later, FDI, as one of the major agendas, was discussed in the Fifth Plenary Session of 14th Central Party Committee, and the Party Meeting announced that the government would "gradually offer the National Treatment to foreign invested enterprises", which aimed at providing a fair competition environment for both foreign and Chinese firms, and also aimed at meeting the requirements of the World Trade Organisation (WTO), as China was making efforts to join WTO (Zhao, 2001). As a first important step to move to the National Treatment, on December 28, 1995, the China State Council took a very bold action by announcing that, from 1st April 1996, new foreign invested enterprises would no longer enjoy the tariff free treatment for their importing of production facilities and production materials (Chen, 2004).

These significant policy changes marked the third turning point of China's FDI development – China no longer simply promoted FDI, but managed FDI by setting up a clear legal system. This system enabled the government to select FDI projects based on its longer-term national economic strategies, and to gradually open more industries and sectors, and to gradually bring an equal treatment for FDI based on international requirements from WTO.

It can be seen that the Chinese government adopted a different approach to make the policy change this time from the previous one. For the previous turning point – from permitting FDI to promoting FDI, the Chinese government was passive and not well prepared to make an emergent policy change, in order to overcome the severe difficulties the foreign investors underwent to take part in FDI in China, and to keep their confidence. However, this time, the government adopted a "proactive" approach, and took the initiative to make the big policy change, as they were well prepared, and they had clear aims to make such a change, that is, letting FDI play a better role in developing the Chinese economy and helping the country to benefit from the globalisation (Li and Li, 1999).

During the period of China's managing FDI since 1995, the government still found it hard to balance up between FDI quality and FDI quantity, the FDI distribution between east China and central and west China. The government was also frustrated with the difference between the expected outcome of FDI policy change and actual result of the policy shift. During this new period of managing FDI, serious national debates took place on the issues of the relationship between increasingly growing FDI and the strong emergence of large numbers of world top transnational enterprises in China and its impact on the development of Chinese national economy, etc. The government overcame the difficult period, moved on towards the direction it planned, which paved the way for the country to join the WTO in 2001, and to merge the tax law of foreign invested enterprises and the tax law of Chinese enterprises in 2007.

Overall, this chapter will review major policy changes and their impact or effectiveness on China's FDI further development. Specifically, after this section of the introduction, Section 2 will examine the effectiveness of "Provisional Regulations Guiding Foreign Investment", and "Industrial Catalogue Guiding Foreign Investment", as well as the effectiveness of the government policy change over the tariff free treatment for importing of production facilities and production materials. Section 3 will assess how the "national treatment" is interpreted and followed by the government over foreign investors, and China's FDI policy change in relation with joining WTO. Section 4 will discuss then hot and key theoretical and practical issues including the increasingly strong growth of transnational enterprises in China and its impact on development of Chinese national enterprises, and Section 5 will examine the imbalanced FDI development between the east part of China and the west and central part of China. Section 6 will summarise overall features and performance of FDI development during the new period.

7.2 Effectiveness of Changes of Chinese Policies

7.2.1. Issue of "Provisional Regulations Guiding Foreign Investment", and "Industrial Catalogue Guiding Foreign Investment"

As discussed in the last chapter, some major problems in relation to China's introduction of FDI were explored, especially during the period of 1992 – 1994, when the country saw a three years of FDI boom. These problems included : (a) China lacked a clear industrial development policy; (b) For FDI received, technologically advanced and export-oriented programmes only accounted for a small proportion; (c) A majority of FDI was processing projects, and mainly sold locally in China; (d) The estate development projects were growing too soon; and (e) the rapid rise of luxury entertainment projects (Wen, 1995).

In order to improve the FDI industrial structure, on 28 June, 1995, the State Planning Commission, the State Economic & Trade Commission, and the Ministry of Foreign Economy, Trade & Cooperation jointly promulgated "*Provisional Regulations Guiding Foreign Investment*", and "*Industrial Catalogue Guiding Foreign Investment*" (Chen, 2004). The Chinese government, for the first time, published these policies in the form of government regulations, which raised the policy transparency of the government, and improved the investment environment (Wang, 1996).

The "*Catalogue*" classified FDI projects into four different types: encouraged, permitted, restricted, and forbidden (permitted was not listed in the catalogue, which meant all projects that were not listed in the catalogue were restricted) (Chen, 2004). Encouraged industries for FDI were those China's major bottleneck industry, high-tech and new-tech industry and export-oriented industry. Restricted industries consider the relationship between the demand and supply of products of the industry and the development status of a Chinese national industry. An industry became restricted, when the supply of products was more than the demand, or an important national industry was growing but it was still in an infant stage. The forbidden industries included those that the country believed may harm the national security (such as arms industry) and social development (such as heavily polluted industry and sex industry, etc) (Zhao, 2001). Table 7.1 below provides detailed information about these three types of industries.

Table 7.1. Summary of Major Industries/Projects In the Catalogue

Type of Industry/Projects	Industries / Projects of the Type
Encouraged	(1) New-tech agriculture, transportation, important material industries; (2) High-tech, New-tech, Advanced tech, energy and material saving, New facilities and new materials that lack supply of locally; (3) Promoting demand of international market, upgrading product quality, developing new market, and promoting exports; (4) Resources regenerated, and pollution prevented tech and facilities; (5) Good use of labour force and resources in the Central and West parts of the country, as well as in line with the country's industrial policy; and (6) Other projects encouraged by laws and regulations of the country.
Restricted	(1) Technologies that already domestically develop or are being introduced externally, production capacity is sufficient domestically already against the market demand; (2) Introduced to the country at the experimental stage; (3) Exploring and developing of rare and precious metal resources; (4) Under the government planning; and (5) Restricted by the laws and regulations of the governments.
Forbidden	(1) Harming the national security and public interests; (2) Polluting environment, destroying natural resources, and harming human health; (3) Occupying substantial land, and bad for protecting and developing land resources, or harming military facility's safety and usage; (4) Using Chinese traditional and special skills; and (5) Forbidden by the laws and regulations of the country.

(*Source:* Chen, 2004).

The promulgation of the "*Provisional Regulations*" and the "*Catalogue*" is the milestone of China's FDI development – as it signaled that:

- China no longer relies on the preferential policies to promote FDI. Instead, the government would encourage FDI by improving the operating environment, gradually opening its domestic market, and lifting restrictions on FDI operating areas (Wang, 1996):

- The priority of China's FDI policy was shifted from the location-oriented to the industry-oriented, and;

- China would pay more attention to the quality effectiveness of FDI and guide FDI, in order that FDI introduced is in line with the country's macro adjustment and industrial policies (Yu, 1996).

According to Yi WU (1995), then Chinese vice premier, the promulgation of the "*Provisional Regulations*" and the "*Catalogue*" indicated that, instead of merely promoting FDI, China now started to manage FDI by directing it based on the country's industrial policies and macro-economic development planning. However, at the same time, China was gradually opening up more investment areas and industries, in order to meet the requirements to join WTO. For example, the "Catalogue" enlarged the inclusion of the encouraged type of FDI, some forbidden projects, now became restricted; some restricted projects, now became permitted. Many sectors, industries and projects were listed as encouraged for the first time, including wasteland, barren hills, hydro-junctions, local railways, city underground and light railways, roads, civil airports, nuclear power stations, new type of energy, ethylene, construction and operation of patrol and gas pipes, civil aircrafts, airplane engines, manufacture of civil satellites, micro-electronics, biological engineering, and consultancy of national economy and technological information. Some became restricted from the previously forbidden, including air-transportation, retail and wholesale, goods distribution, foreign trade, extraction and melting of precious non-metal mines, extraction of diamond and other gems (Wang, 1996).

China's policy change - managing FDI by making regulations and directing FDI into certain industries and sectors, hit the FDI growth immediately, especially for FDI from Hong Kong, Macau and Taiwan, the top FDI sources, who were losing momentum as the transfer of labour-intensive production to mainland China slowed down. The share of these three economies' cumulative FDI inflows had dropped from 72 per cent in 1993, to 63 per cent in

1995. A question was therefore raised as to "is China's FDI growth sustainable?" (China Economy & Trade, Spring, 1996).

The Chinese government moved on with opening up more areas for FDI, rather than taking care of concerns from investors of Hong Kong, Macau and Taiwan, as the government stuck to the strategic aim – meeting WTO's requirements in order to join it. In 1997, the revised "Catalogue" was published which saw many more areas and sectors opened up for FDI, ranging from China's strategic areas of transportation and logistics, telecommunications, and extracting and developing mineral products, to nationally important service sectors of banks, insurance, foreign trade, accounting firms, law firms, and retailing. Now, over 100 foreign banks from 38 countries established offices, and 25 foreign invested banks were permitted to operate the transaction of Chinese currency; foreign trading companies were set up on Chinese – foreign joint venture basis in Shanghai and Shenzhen, and foreign invested retailing stores were established in 11 Chinese cities. As a result, only very limited industries and sectors remained unopened to foreign investors, including the press industry, arsenal manufacture, broadcasting and film and video industry, Chinese traditional and special industry, etc (www.chinaacc.com, 2006-7-28).

7.2.2. Withdrawal of the Exemption of Tariff and Taxes on Imported Equipment and Raw Materials

On 18, December 1995, the State Council announced important policy changes to custom duties, that is, to withdraw preferential import tariff policies, including a notable withdrawal of the exemption of tariff and taxes on imported equipment and raw materials which were counted in the total capital of the foreign invested enterprise. This new policy would become effective from 1 April 1996, which meant any new established foreign invested company, would have to pay normal import tariff and related import taxes for their imported equipment and raw materials in the total amount of their investment in China. However, a foreign venture established before 1 April 1996, would still enjoy the exemption for one or two more years (Guangdong Grand Economy and Trade, 1997).

For this symbolic policy change, Sun Zhenyu, then Chinese deputy minister of Ministry of Foreign Economy & Trade explained with great confidence why the policy was changed and that this change would affect foreign investors:

- Tariff cut was the important requirement of China accession of WTO. China's withdrawal of the exemption of the tariff and import taxes would actually be accompanied by the significant cut of import tariff – cut of 30 per cent of 35.9 per cent of China's import tariff. Since the import tariff was dropped, the withdrawal of the exemption of the tariff and import taxes became reasonable:

- It was anticipated that the withdrawal would add some burden on foreign invested enterprises, but would be limited, as (a) the government gave a transfer period of 1 – 2 years for the existing foreign invested companies; and (b) the government would leave all other preferential policies unchanged, including corporate income tax of 24 per cent for coastal open cities, and 15 per cent for Special Economic Zones, and tax discount and tax holiday for three years and two years respectively still applied to FDI in agriculture, and hi-tech projects, etc.

- It was also anticipated that the change of the policy might bring concerns and doubt of foreign investors over the certainty of Chinese investment environment. However, it was believed that the tariff matter would not be served as a deciding factor, as the majority of foreign investors doing business in China were motivated by its huge market potential, rapid economic growth, and stable political environment (Sun, 1996).

It was unfortunate that the reality was different from the government's expectation. The withdrawal of the exemption of the tariff and import taxes indeed resulted in foreign investors' worries and concerns of certainty of Chinese FDI policy (Li, 1997).

Take Guangdong province alone as an example where there had been more FDI introduced than any other provinces of China. FDI introduction appeared to be growing in the early part of 1996 before the policy change, and to be dropping immediately right after the policy change. Foreign investors were very actively finalising the deal in the first four months of 1996, in order not to miss the last boat of the "preferential policy". The committed value of

FDI signed in the first four months was USD 9.034 billion, accounting for 51.8 per cent of the all agreements of the whole year. From May 1996 when the tariff exemption expired, fewer foreign investors were enthusiastic to commit themselves in China's FDI, the number of agreements signed dropped month by month. The average monthly value of the agreements signed in the eight months between May and December of 1996 was USD 1.052 billion, which was only 46.6 per cent of the monthly average value between January and April when the average monthly value of agreed FDI was USD 2.256 billion. Both the number of FDI agreements signed and the amount committed dropped, compared with the same figures of the previous year - year 1995. In the whole year of 1996, the number of FDI agreements signed was 5,955, down 36.3 per cent compared with year 1995; the value of new agreements in 1996 was USD17.446 billion, down 33.2 per cent over 1995. The realized value of FDI in 1996, however, was 14.9 up over the previous year (the realized amount was from the previous years of agreements. It would, however, be going down following fewer agreements signed (Guangdong Statistical Information, 1997).

The withdrawal of the exemption of the tariff for foreign invested enterprises' equipment and raw materials also severely hit the confidence of Japanese companies investing in China. In 1996, new agreements of FDI from Japan dropped 32.4 per cent over 1995, although the realized FDI value increased 18.4 per cent. According to a questionnaire survey conducted by Japan-China Investment Promoting Society in 1997, 47 per cent of Japanese enterprises claimed that China's policy change had an impact on their operating in the country (China's Foreign Investment, 1997).

Statistical Information published on 7, April 1997 by China State Statistical Bureau showed that both the number of newly committed FDI projects and its agreed amount dropped. The newly approved number of FDI projects was 24,556, with agreed amounts of USD73.28 billion, down 33.7 per cent and 19.7 per cent respectively over 1995. Following the withdrawal of the exemption of the tariff, both newly approved FDI agreements and agreed amount were going down. From April to December, the total number of newly approved agreements was 1771, down 38.3 per cent over the first quarter of 1996 in terms of its monthly average number; from April to December, average agreed monthly FDI amount was USD5.1 billion, down 44 per cent over the first quarter of 1996. As for the realized amount of FDI, it reached USD3.76 billion, increased 42.4 per cent over 1995 (see Table 7.2).

Table 7.2 China's FDI in 1996 (on monthly basis)

Unit: 100 million USD

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
No. of New approved FDI projects	2038 apprved	1655	4922	2141	1708	1598	1588	1666	1600	1461	1657	2522
Comparison of same period of previous year (%)	-19.3	-17.2	77.5	-19.0	-41.0	-49.2	-36.8	-40.0	-28.5	-29.0	-44.3	-70.2
Agreed Amount	71.5	59.3	142.6	79.6	51.7	51.6	28.9	43.5	45.4	41.0	47.3	70.4
Comparison of same period of previous year (%)	49.9	46.1	105.2	134.8	260	-35.4	-37.9	-26.6	-41.2	22.2	-54.4	-74.0
Actually used amount of FDI	22.3	23.0	34.0	30.7	42.7	50.3	17.4	41.2	27.5	38.9	39.6	49.7
Comparison of same period of previous year (%)	19.9	33.0	6.3	33.5	47.2	17.3	-45.3	36.0	11.0	19.2	30.4	-19.3

(*Source:* China's Statistical Information, April 1997).

China Statistical Information made it very clear that the main cause of FDI drop was the government withdrawal of exemption of the tariff. The drop of FDI in 1996 would affect the increase of FDI in the future (*China Statistical Information,* April, 1997).

The situation was getting worse in Guangdong in the first quarter of 1997 when both the newly committed amount of FDI and the realized amount of FDI dropped for the first time in the Guangdong history of FDI development (*Guangdong Statistical Information*, 7, July, 1997).

For the unexpected and negative impact of the policy change on FDI further development, Li Peng, then China's premier, admitted the obvious reality derived from the policy change, and defensively explained that the government had no intention to slow down the growth of FDI, but only tried to improve the FDI structure and guide FDI to the areas China gave priority. However, China would still provide some preferential policies for FDI projects such as high-tech and new-tech projects, and the projects which could compete against other products in the international market, etc. (Li, 1997).

Action was followed by the Central government:

- Chinese State Council announced in March 1997 that, the treatment of the exemption of the tariff was extended till the end of 1997 (*Foreign Investment in China,* September 1997).

- In December 1997, Jiang Zemin, then Chinese President, announced that China now decided to renew the policy that had just withdrawn, as long as FDI projects were in line with China's industrial policies, and would bring China new technology, etc. (*Foreign Investment in China,* December, 1997).

7.3. National Treatment, Preferential Policies, and China's Accession to WTO

As discussed in the previous chapter, China's preferential policies – lower corporate tax rates, discounted tax rates and tax holiday, etc - offered to foreign invested enterprises resulted in "Super National Treatment"; on the other hand, however, foreign investors received "Inferior National Treatment", as they were restricted to entering certain local market and industrial areas, and they were asked to pay much more for services charges and production materials than Chinese local enterprises. These contradictory policies were causing a growing clash with ongoing reforms and further opening up of the country, and were obstacles to China gaining accession to WTO (Guo, 2002).

To resolve this contradictory problem, in September 1995, the Chinese leadership announced an important strategic decision at the Fifth Plenary Session of 16th Congress of Communist

Party of China: the country would gradually adopt the policy of the national treatment towards foreign invested enterprise, so that an environment of equal treatment and equal competition could be established for all kinds of enterprises (China's Foreign Investment, November 1995).

Since then, China started to make every effort to progress towards the national treatment. The following were the major step-by-step strategies for realizing China's goal:

- Gradually withdrawing preferential tax policies for foreign invested companies. For example, to begin with, China already decided, from 1st April 1996, to withdraw the exemption of tariff and tax on the imported equipment and raw materials that were counted in the total capital of the foreign invested enterprises;

- To get foreign invested enterprises included in China's internal foreign exchange system for buying and selling foreign exchange;

- To let Special Economic Zones (SEZs) get ahead, practise the national treatment before it was extended to the whole country, and exercise open policies for services sectors (such as finance, tourism, trade, logistics, aviation) before these policies became available for the rest of China) (Zhao, 2001).

The national treatment is interpreted in China as a system that provides a foreigner with equal civil rights and obligations as a local citizen. The national treatment is applied to the FDI field, meaning the equal treatment for foreign investors as local partners (Chen, 1999).

To test out the national treatment, Shenzhen, the China's first special economic zone, was selected as the first city to practice the national treatment on an experimental basis. From 1st January 1997, Shenzhen offered the following policies to foreign invested enterprises based on local government document, "Notice of Gradually Providing the National Treatment for Shenzhen's Foreign Invested Enterprises and Foreigners":

Opening local market to foreign invested enterprises;

- Allowing foreign investors to run imports and exports;

- Entirely opening commercial sectors;

- Widening business scope for foreign invested financial institutions;

- Opening tourism sectors for foreign investors on an experimental basis;

- Allowing foreign investors to involve in cargos shipping sectors.

As an initial step, what Shenzhen offered the foreign invested enterprises were two new policies: one was the opportunity of selling their products in the Chinese domestic market, and the other was to unify the services charges Selling products in the Chinese market was a dream for many foreign investors. The opening up of the Chinese domestic market, would promote FDI to China, especially attracting large foreign companies, including transnational firms. Unifying services charges would make foreign investors feel they were equally treated, and also save them a lot of money, as they were charged much more than Chinese nationals in charges for travel, hotel, rental, hospital, water and electricity bills, etc. The Shenzhen government found the cut in the services charges made a win-win situation, as it boosted foreign investors' confidence and enthusiasm for doing business, although their income was reduced a great deal. This experience of Shenzhen will be useful to the rest of China in the future (Guangdong Grand Economy & Trade, February, 1997).

The above discussion was the issue of "inferior national treatment" of the "national treatment", about which the Chinese government was making corrections. Another side of the problem of "national treatment" is "super national treatment".

Since the government followed the open door policy in 1979, the foreign invested enterprises had enjoyed preferential tax rates, which were far lower than Chinese local enterprises had (Chinese local enterprises paid 55 per cent of corporate income tax, whistle ordinary foreign invested enterprises paid 33 per cent, those located in open coastal cities paid 24 per cent, and those located in special economic zones only paid 15 per cent).

After the reforms of the tax system in 1994, corporate income tax rate for both foreign enterprises and Chinese local enterprises became the same at 33 per cent, in other words, instead of bringing up the tax rate for foreign enterprises, the tax rate for local enterprises was cut down from 55 per cent to 33 per cent. It seemed now both foreign enterprises and local enterprises paid the same tax rate, therefore they seemed to be in an equal position to pay the tax. Remember, however, for some foreign invested enterprises, they only paid 24 per cent or 15 per cent of tax; in addition, some foreign invested enterprises enjoyed discounted tax for three years and a tax holiday for two years. Taking all these into account, the actual average rate foreign invested enterprises paid was only a little less than 10 per cent. Indeed the foreign invested enterprises were very much enjoying "super national treatment".

The effective way to resolve this unequal "super national treatment" is to unify the two separate corporate income tax laws – corporate income law on Chinese local enterprises and the corporate income tax law on foreign invested enterprises. The law made by the Chinese authority on foreign invested enterprises follows a generally favorable principle, that is, as long as it is a foreign invested firm, it is eligible to enjoy preferential corporate income tax rate. It now became necessary to change this preferential principle to an equal principle, following the development of China's establishing the market economy and open policy. In fact, it is very uncommon that the separate corporate income law was set up based on different investment source countries. Unifying these two different laws will put foreign invested enterprises and Chinese firms in an equal position in terms of income tax treatment, completely get rid of problems such as "recycled FDI", and "preferential policy competition" (which were discussed in the previous chapter), and avoid the clash with rules of the WTO. As for the way of attracting foreign investment, a special favorable principle should be applied. That is, to set up different corporate income tax rates based on certain priority locations and priority industries, rather than based on the investment source country. The government recently published "Catalogue" is a new way to direct and attract FDI (Wang, 2004).

It should be noted that on the way to the "national treatment" for foreign invested enterprises, a step by step strategy is important, in terms of satisfying WTO requirements, as

- China is transforming from a traditional planning economy to a market economy, and many economic and management regulations, rules, etc, still had elements of the planning economy, for instance, the enterprise in China is not yet an independent and equal body in the market. Therefore China's pace of moving towards the "national treatment" has to be the same as the pace of China's economic reforms and open door policy.

- Applying the "national treatment" requires the adjustment of China's national development objectives. China has committed itself to open up more services sectors, which inevitably leads to the adjustment of industrial policies of the country.

- Reviewing three situations when withdrawing preferential tax policies and the "super national treatment" over the foreign invested enterprises: (a) consider the demand China needed from foreign investment and the tax policy adopted by other neighbouring countries over foreign investors. Changing preferential policies in a rush would have a negative impact on FDI inflows into China. China's withdrawal of the exemption of the tariff of imported equipment and raw materials on foreign invested firms that seriously caused a dramatic drop of FDI inflows is a typical example; (b) It would be harmful if the government withdrew the preferential policies before they became invalid. Keeping government promise and maintaining stable policies are important to keep foreign investors' confidence; and (c) Changing preferential policies can be compensated by opening more areas, industries and sectors to foreign investors. This will balance the situations, and make a smooth journey for China to move towards the "national treatment" and joining WTO (Cai, 2006).

7.4. Threat or Opportunity?

- *A National Debate on Increasingly Growing Number of FDI and Transnational Enterprises in China*

Following strong growth of FDI in China, especially after a three-year FDI boom between 1992 and 1994, China's FDI moved into a fast growing track. Since 1992, China had consistently been the world's second largest FDI recipient country, next only to the US. In addition, since early 1990s, a growing number of giant transnational enterprises flocked to

China to commit themselves with big investment. Up to the end of 1996, around 200 of the magazine Fortune listed top 500 transnational enterprises invested in China (China' Foreign Investment, February, 1997).

Rapid growth of FDI and a great number of well-known transnational enterprises investing in China brought the country's badly needed capital and technology, but also "brought" doubts for some Chinese. These doubts included:

- Did China have too much FDI? This doubt was based on the fact that the Chinese market was occupied by more and more products made by foreign invested enterprises, ranging from cars, home electronic appliances, lifts, films, detergents, microcomputers, beers, medicines, tyres, to cosmetics and clothes.

- Would Chinese national industries be seriously affected? This worry was based on the fact that a growing number of Chinese famous and traditional brands were crumpled up, and replaced by "foreign" products.

These doubts or worries were developed so seriously that appeals were launched in the medium with slogans of restricting FDI, protecting Chinese market, protecting Chinese national industries, and protecting Chinese traditional brands, etc. (Ji, 1997).

To agree or disagree these points, Chinese researchers, specialists, and government officials concerned, actively involved in an argument focusing on: (1) whether or not FDI in China was overheated? And (2) whether or not FDI and transnational enterprises could not co-exist with Chinese enterprises?

Those who held a positive viewpoint argued:

(1) The scale of FDI in China is still not big enough:

Firstly, it is true that FDI in China has been growing rapidly, and the country has become the second largest FDI destination consistently for several years. However, since China is a big country with a large population, China's FDI introduced is still relatively low if counted based on per capita. Take 1995 as an example. FDI in China based on per person is USD31.5, it is USD53 in Thailand, USD110 in Peru, USD124 in Hungary, and over USD200 in Britain, America and France. Secondly, China's Ninth Five-Year-Plan (1996 – 2000) has planned to invest USD1,800 billion of fixed capital, USD240 billion is needed for five years based on the FDI proportion accounted for total value of fixed capital in 1995. USD48 billion of FDI is needed every year, USD10.5 more every year after 1995. Lastly, China has a large amount of personal bank saving (by November 1996, the amount reached around USD500 billion), but the large amount of personal saving cannot justify not introducing too much FDI, as (a) on one hand, there is a high amount of saving, but on the other hand, the amount of bank's loan to enterprises was even more than the saving amount. That means, there is no amount of savings left for the nationally planned investment; and (b) China's using FDI is not only for resolving the capital shortage, but also for introducing advanced technology, managerial expertise, international talents, new products and new market. Generally speaking, developed countries don't usually lack funds, but more world FDI takes place among the developed nations, the reason being that objective of FDI is the internationalization of production, rather than simply the capital movements (He, 1997).

(2) A win-win situation can be produced between the growth of development of FDI and transnational enterprises, and the development of Chinese national economy.

- *Foreign brand and Chinese brand:* Chinese brands cannot be guaranteed to take a dominant position when FDI and market economic system are introduced to the country. Take a look at drinks in the Japanese market: famous brands include Japanese own made tea – Wulong Tea, but also other foreign brands, such as black tea of British brand, and American Coca Cola. Even many Chinese brands have a big share of foreign markets, including various toys and clothes, etc. It is therefore fair that foreign brands should be accepted as long as they have market demand in the Chinese market or they are welcomed by Chinese consumers (Zhou, 1996).

During China's introduction of FDI, it is normal if foreign brands defeat Chinese local brands during fair competition. It is not right that foreign brands are blamed because of such defeat. In fact, Chinese enterprises can take advantage of foreign investment to strengthen and develop their brands. There have been many examples of this. The Huizhou TCL Co. Group set up a joint venture with foreign investors and generated TCL telephones, TCL colour televisions, and TCL mobile phones and TCL laptops, etc. Now TCL has become one of the top brands in the Chinese market. Qingdao Haier is another good example. This enterprise was a small local private factory, and was near to closing down due to financial difficulties (loss of almost USD200,000). After setting up a partnership with German Haier, Qingdao Haier grew very strongly. Now, Qingdao Haier is a world famous brand of many electronic products. Similar examples include Sino-foreign joint vestures of Chongqing-Qingling, Jianshe-Yamaha, Guangdong-Kelong, Shenzhen-Segem, and Jinan-Cowger (Zhu, 1997).

- *Growing investment in China of the transnational enterprise and the Chinese national industry.* Like rapid growth of FDI in China, which brings worries and concerns to the country, the strong growing investment in China by the transnational enterprises make some people worry about the development of the national economy and the safety of the Chinese economy, as it is believed that the transnational enterprise is extremely strong, and they are taking more and more market share of the Chinese market. According to a survey, sales of products made by foreign invested enterprises were only accounted as 7.9 per cent of the total sales of China. In terms of market share of some typical products made by transnational enterprises, washing powder and detergent accounted for 35 per cent, cosmetics accounted for 36 per cent, soap accounted for 40 per cent, beer accounted for 20 per cent, carbonic drinks accounted for 37 per cent, electronic products accounted for 10 per cent. It can then be seen that none of the transnational enterprise-made products dominated in the Chinese market. Also according to another survey involving 110 China based transnational enterprises, none of these enterprises have dominated the Chinese market (He, 1997). As for the issue of Chinese economic safety that may be affected by the transnational enterprise, this sounds over pessimistic. As a foreign invested enterprise, their capital investment only forms part of the elements of production; other elements, such as labour forces, and land, are controlled by the local authorities. In addition, foreign investors are enslaved by the local laws and regulations. Moreover, there are a large number of stated-owned enterprises that dominate China's key economic areas. Therefore, perhaps foreign investors, rather than local enterprises, have reasons to worry about the safety issue, as they are in a weaker position as they run business in a foreign land (Zhao,1997).

- *Rethinking of Chinese National economy and Foreign invested enterprises.* Foreign investment is private economy compared with Chinese public economy; it is foreign capital compared with the Chinese local one. The question now is if foreign investment can be deemed as part of Chinese national economy? Can a foreign invested enterprise be seen as a Chinese enterprise? (He, 1997). The traditional concept of the national economy originated after the Second World War, which is based on the fact that many developing nations obtained independent status from colony governing. This concept recognizes that the national economy is based on 100 per cent of local proportion of ownership. Following the deepening of the international division of labour, and increasing integration of global economy, this concept, however, has to be redefined. Generally speaking, a 100 per cent of the national economy no longer exists. Companies like Coca-Cola claims it is not an American company, but a global company with its headquarter in America. The bank giant HSBC emphasizes it is an international local bank. Foreign invested enterprises should therefore be regarded as Chinese enterprises, as they are registered and physically in China, governed and protected by Chinese regulations and laws, pay tax to the Chinese government and pay wages to Chinese employees (Gong, 1996).

It is true that there are some problems from transnational enterprises while doing business in China, such as transfer prices, trying to escape from local government supervision. However, if compared to problems with benefits generated by the transnational enterprise, the benefits outweigh the problems (Ji, 1996). It is also important to understand that to invest in China is a very big decision for the transnational enterprise, which often takes a few years to make. The Chinese should treasure this situation (Wang, 1996).

Major benefits the transnational enterprise brings China include: (a) they usually invest in high-tech and new-tech industries, which are exactly what the Chinese government mostly encourage. China's auto industry and electronic industry upgraded to a higher level is a good example of this (Zhou, 1996); (b) investment the transnational enterprise makes is large scale, pays special attention to scale of economy, and economic efficiency (Xia, 1995); and (c) The transnational enterprise follows the modern enterprise systems, which can help Chinese enterprise management and systems to move towards the new ones (He, 1996).

The debate in China in 1996 about the relationship between FDI, transnational enterprises, and Chinese national industry received the attention and active involvement of the Chinese officials. In June 1996, China's Society of Foreign Invested Enterprises organized a big "Symposium of Strategies of Utilizing Foreign Investment", and over 100 specialists and government officials submitted over 80 papers. These papers generally agreed that FDI and transnational enterprises investing in China can promote the further development of the Chinese national industry. Meanwhile, China's number one party's newspaper, People's Daily, published an article, entitled "Firmly Utilising Foreign Investment" (He, 1997).

This debate is also thought to be somehow a repeat of the one that occurred in early 1990s when FDI was doubted as an element of capitalism, and those who doubted FDI tried to deny China's reforms and introducing FDI (Ma, 1997). The debate ended up with the redefining of China's economic ownership structure, and the affirming of China's FDI. In September 1997, Jiang Zemin, the then party leader claimed at the 15th National Congress of Chinese Communist Party, "we shall have all-sided understanding of the public economy. The public economy is not only composed of state-owned and collectively-owned economy, but also composed of stated-owned and collectively-owned elements of a mixed ownership economy". The statement clearly affirmed that the foreign invested enterprise belongs to the mixed economy which is part of China's economic system, but not a foreign enterprise. Li Peng, then Chinese premier, pointed out during the Party's Congress, "Introducing foreign investment and developing the fixed ownership economy, will not affect the development of Chinese national industry, but promote the Chinese national economy to a higher level" (People's Daily, 14th September 1997).

7.5. Issue of Central and West Part of China

In the past 20 years of China's open door, the majority of FDI is located in the eastern coast regions, only a little is distributed in the central and west parts of the country. In 1980's, over 90 per cent of FDI was located in China's coastal areas. In 1990's, especially after Deng Xiaoping's south China tour, this divide was slightly improved. Up to 1994, 36,065 FDI project were approved in central and west regions, and actual used FDI was USD8.4 billion. In the year 1994 alone, 9,229 FDI projects were introduced, and actually used FDI is

USD4.29 billion. Compared with China's national total number of FDI projects and actually used FDI in central and west China only accounted for 16.3 per cent and 8.8 per cent respectively. The situation of introducing FDI in the west is even worse that that in central China: for example, in China's total, FDI in Ningxia accounted for 0.03 per cent, Xinjiang accounted for 0.16 per cent, Gansu accounted for 0.05 per cent, Guizhou accounted for 0.17 per cent, and Yunnan accounted for 0.21 per cent. In addition, the average scale of FDI introduced to the west and the central is not large, is only USD0.847 million, lower than the national average, which is USD 1.37 million. The reason for the small average scale of FDI is more FDI projects are labour-intensive, and less are involved in infrastructure, services industry and agriculture (Luo and Li, 1995).

The important cause for the divide between the east coastal area, and the west and central China in terms of the introduction of FDI, apart from the long-time backward economy, poor infrastructure and inconvenient transportation and communication, is the unbalanced FDI policies offered to these two different kinds of areas. That is, the FDI policies for the east part of China, is clearly better than that of west and central China: (a) In terms of investment industry, the coastal area has permission to introduce FDI into bank, insurance, retailing, etc, but the central and west China does not have that policy; (b) In terms of approval right of FDI projects, local governments of coastal regions have the authority to approve an FDI project with the value up to USD300 billion; while local governments in the central and west China are only allowed to approve the FDI projects with a maximum value of USD100 billion; and (c) In terms of preferential tax rates for foreign invested enterprises, Special economic zones and economic and technological development zones enjoy 15 per cent of corporate income tax, coastal open cities and zones enjoy 24 per cent; while only capital cities of provinces in the central and west area enjoy 24 per cent of corporate income tax rate, tax rate for all other areas is 33 per cent (Zhao and Sun, 1996).

Since China was opened to the outside world, its annual economic growth rate on average has been around 9 per cent. To maintain this economic development pace, the key is to improve the supply of power and energy, and upgrade the infrastructure and other bottleneck industries. The central and west part of China is a very important supply base of power, energy, and raw materials. Logically, the underdevelopment of the central and west area will largely affect the rapid, healthy and sustainable growth of China's economy (Qian, 1996).

Central and west China has been backward for a long time. However, they have important resources potential, all kinds of industrial foundations, unique agricultural and livestock farming, low labour forces, and large market. Since China's open door and economic reforms, big changes have taken place. For example, the set up of the important railway network between Beijing and Jiulong (in Hong Kong), which go through many parts of the central and west regions, and hydraulic power network of Yangtze Gorges will greatly improve the infrastructure of this region. In terms of introducing FDI, the growth pace is fast, but because of low starting point, the proportion of FDI in China's total is still little. It is very encouraging that the Chinese government is well aware of the importance of stimulating the development of this part of China. A set of preferential policies are offered to this region, which include:

- Priority is given when the central government provides the government loans and makes financial arrangements to this region, especially for the projects of resources development and infrastructure construction.

- FDI projects of resources processing and labour-intensiveness will be directed to this region.

- Providing the region with the more flexible industrial and sectoral catalogue, to encourage more FDI to move to that area. FDI projects that can take advantage of local labour forces and resources will be particularly encouraged. In addition, for some restricted FDI projects in other part of China, after government approval, they may become encouraged FDI projects in the central and west region.

- Giving local government the authority to approve the FDI project with a value of up to USD30 billion, instead of USD10 billion before.

- The foreign invested enterprise in this region is now allowed to enjoy same corporate income tax rate – 24 per cent - as the coastal open cities.

- Products made in foreign invested enterprises in the region are allowed to mainly sell locally, regardless of ratio of exporting products and selling products in the local market, and regardless of balance of foreign exchange (Gan, 1996).

The government's new policies for the central and west China produced an effective outcome. Some of China's national priority projects attracted many foreign investments, such as Xinjiang Tarim oil-gas field, Sanxi oil-gas field, Gansu oil-gas field, and ningxia oil-gas field, Qinghai Lijiaxia hydropower station, etc (www.cbwchina.com, 25/05/07). To strengthen the policy stability, the government proposed a long-term strategy, that is, to gradually minimize the divide between south China and central and west China, and to develop all regional economy in a balanced way. Indeed, minimizing the gap of introducing FDI between these two regions will help to minimize the gap of economic development between these two regions too (Ma, 1996).

The new policy produced positive impact on FDI growth in central and west China. Up to 2000, the proportion of actually used FDI in this region in the China's total goes up to 14 per cent, from 8.8 per cent in 1994 (Jiang, 2002). See Table 7.3 below for details.

Table 7.3. FDI of Accumulative Total Divided by China's Regions in 2000

Unit: USD100 million

Region	No. of Projects	% in China's Total	Committed Value	% in China's Total	Actually Used Value	% in China's Total
East	292,561	80.40	5,835.73	86.31	2,988.72	85.80
Central	44,580	12.25	516.49	7.64	305.92	8.78
West	26,744	7.35	408.76	6.05	188.82	5.42

(*Source*: Jiang, 2002).

7.6. *Overall Picture of China's FDI during 1996 – 2000*

7.6.1. FDI Inflows

During 1996 and 2000, the growth of China's FDI was chiefly affected by two factors: (1) significant changes in China's FDI policy; and (2) the 1997 Asian Financial Crisis.

(1) Significant Changes in China's FDI Policy:

- The promulgation of "Provisional Regulations" and "the Catalogue" in June 1995 encouraged more FDI to be made in China's neck-bottle industries such as infrastructure, energy, and transportation. Around 15 per cent more FDI was attracted to these fields in 1996 over 1995 (Pang, 2003). In addition, technological projects such as electronic and machinery projects rose 11 per cent in 1996 over 1995. On the other hand, the government restricted real estate projects dropped quite significantly in terms of its percentage in FDI total, from 25 per cent in 1995 to 17 per cent in 1996, (Zhao, 2001).
- With the government withdrawal of the exemption of tariff and taxes on imported equipment and raw materials in April 1996, the confidence of many foreign investors was hit. Many of them, especially those who were from Hong Kong, Macao, and Taiwan started to relocate their investment in South-Eastern Asian countries. New agreed FDI projects were down significantly in 1996, which negatively affected FDI sustainable development in China (Chen, 2004).

(2) The 1997 Asian Financial Crisis led to the slowing of China's FDI growth. As a result of this crisis, some Korean invested firms in China were closed down, some Japanese enterprises withdrew their investment from China, and many investors from South-Eastern Asia and Hong Kong either withdrew their existing FDI projects or decided not to invest in China for the time being. During that time, the American economy happened to see a downturn, which hit American enthusiasm for the investing in China. This resulted in, for the first time, negative growth of actually used FDI in China in 1999 (See Table 7.3. for details).

Table 7.4. China Actually Used FDI between 1979 and 2000

Unit: USD100 million

Year	Actually Used FDI		FDI / GDP %
	Value	Growth (%)	
1979-82	11.7	-	0.1
1983	6.4	-	0.2
1984	12.6	97.8	0.3
1985	16.6	32.0	0.6
1986	18.7	12.8	0.7
1987	23.1	3.1	0.7
1988	31.9	38.0	0.8
1989	33.9	6.2	1.0
1990	34.9	2.8	1.0
1991	43.7	25.2	0.9
1992	110.1	152.1	2.4
1993	275.2	150.0	4.6
1994	337.7	22.7	6.1
1995	375.2	11.1	5.3
1996	417.3	11.2	5.1
1997	452.6	8.5	5.0
1998	454.6	0.5	4.7
1999	404.0	-11.1	4.1
2000	477.7	0.9	3.8

(*Source*: Zhao, 2001).

It can be seen from the Table 7.3 that a decrease in FDI growth rate occurred from 1997 until 1999. However, the government was still happy to see the quality of FDI being improved. For example, world large TNEs were actively involved in China's FDI. Up until 2000, over 400

TNEs which were on the Fortune list as the world largest 500 TNEs involved FDI in China. In addition, during 1996 – 2000, the amount of FDI China had introduced was still regarded as significant: the country had absorbed over USD210 billion of FDI, annual average FDI was over USD20 billion. Compared with the rest of the world, China was consistently the second largest FDI recipient, next only to the US (Yang, 2001).

7.6.2. The Development of FDI Form and FDI Pattern

(1) FDI Form: As mentioned in Chapter 2, among the three major FDI forms in China, CJVs were the most popular one from 1979 until 1986 when EJVs overtook their position. However, in the period 1996 – 2000, WOFEs were growing so strongly in the country that they became the number one FDI form – they started from as little as 1 per cent, and developed to 47.61 per cent in 2000, in terms of the amount introduced by all three major FDI forms (Pang, 2003).

(2) FDI Pattern: Between 1979 and 1997, 70 per cent of FDI China had received was regarded as "Greenfield Investment" (i.e. Chinese and foreign parties establish a new venture). The reason for this was China's strengths of attracting FDI were mainly cheap labour force, natural resources, and preferential policies. These strengths were fading in late 1990s, due to the intense competition for FDI from other developing countries. Meanwhile, as a new FDI pattern, international merge and acquisition was growing very strongly and became a primary pattern of FDI. China therefore attempted to develop this FDI pattern in China in order to promote its inward FDI. Two methods were followed to employ this pattern: one is to let foreign partners take over the venture by purchasing the stock shares from Chinese partners, and the other is to let foreign investors buy the whole Chinese enterprise in one go. This new pattern of FDI started well in China, for instance, in 1999, 60 per cent of China's FDI was introduced through this channel. The further development of this pattern was resisted by China's pre-matured investment environment. The relevant legal systems was not in place and China's capital market were not entirely open for foreign investment related business (Jiang, 2001).

7.6.3. FDI Policy Changes in 2000 and Their Effectiveness

Year 2000 became an important year for China's FDI development as the government was aware that special efforts were needed in order to make FDI growth in the country sustainable, as well as to further meet the requirements of WTO, aiming at gaining membership in 2001.

As a result, the government amended two major FDI laws, one was Laws on Wholly Foreign Owned Enterprises (WFOEs), and the other was the Law on Contract Joint Ventures (CJVs). Some important articles in the Laws which were not in line of international practice were amended: (a) eliminating the requirement for both WFOEs and CJVs to keep their foreign exchange balancing, therefore, ending the long-lasting headache for foreign investors; (b) replacing compulsory domestic procurement of raw materials with optional purchase by WFOEs and CJVs; and (c) replacing the government's *requirements* of export performance and advanced technology with the government's *encouragement* of exporting and use of advanced technology (Chen, 2004).

In addition, more industries and areas were opened up for FDI: (a) allowing foreign invested enterprises to set up separate firms in the country; (b) allowing investors to involve their investment in the area of medical treatment; (c) allowing foreign investors to get involved in the cinema industry, including establishing and operating the cinema; (d) allowing foreign investors to invest in railway transportation; and (e) allowing foreign investors to operate telecommunication related businesses (Pang, 2003).

Moreover, further and more serious action was taken to promote the development of west China, which included: (a) the Chinese State Council set up an office to lead the all development issues in the west part of China; and (b) a series of preferential policies were made available to further encourage FDI in that region.

Consequently, committed FDI projects in 2000 rose sharply by 47 per cent over 1999, which indicated that stronger FDI growth was on the way from 2000 (Zhao, 2001).

After long pursuing membership of WTO, China's dream became true in December 2001. This big move would lead to three major changes in terms of China's FDI related policies: (a) China's regions and industrial areas would shift from limited open to much more open; (b) China's open policy based on an experimentally-oriented approach would be shifted to a proactive approach; and (c) China's carefully and self-controlled opening would be shifted to a mutually opened environment among the WTO member countries. This inevitably led to FDI move to a new development stage (Jin, 2001).

CHAPTER 8

Conclusion and Recommendations

8.1. Conclusion

As discussed in previous chapters of this thesis, the impact of the fundamental changes in China's FDI related policy on the development of western inward FDI in China is explored, the root cause for these fundamental changes is examined, and China's approach to FDI and the world generally accepted FDI approaches is compared and discussed. On a whole, western FDI is treated differently in China, because FDI is seen in the country with the Marxist approach – a negative political approach associated with social political systems and class relations, together with Chinese characteristics – a positive approach to western FDI in the view that FDI from capitalist countries is useful but needs to be controlled under socialism. China's approach and its evolution to western FDI leads FDI development in the country to undergo three periods between late 1978 and 2000, in terms of overall Chinese government policy changes and their impact on China's FDI development.

The first period begins in late 1978 when China announced its open door policy – welcoming western inward FDI to enter the country. This marked the first turning point – a historical policy shift from the "self-reliance" strategy to permitting western FDI. The second period started in October 1986, when the government dramatically changed its approach to FDI by promulgating the "22 Articles". For the first time, China started to promote FDI, rather than permitting FDI. The passing of "Interim Provisions on Guiding Foreign Investment Direction", and "Catalogue for the Guidance of Foreign Investment Industries" in 1995 marked the beginning of the third period, as the government started to manage FDI, instead of simply promoting it. In addition, since 1995, the growing concern has been given by the Chinese government about environmental issues such as air pollution and water pollution, as many highly polluted FDI projects introduced to China are worsening already seriously damaged environment in the country. The severe problem costs China heavily in terms of the sustainable growth in its economy. To deal with the problem, the government issued the

"Catalogue" to encourage environmentally-protected FDI projects and restrict polluted FDI projects.

These three different periods have brought out a number of features of China's FDI development:

(1) From the perspective of change in the number of FDI projects and the amount of FDI.

In the first period, FDI was growing very slowly, as China saw western FDI being developed from nothing to a small number of projects and to the small amount. The second period, however, there have been increasingly growing number of FDI pouring into the country, including many large transnational enterprises (TNEs). FDI has climbed up sharply from a small number of projects and small amount to a great number and as China consistently became from 1993 the second largest FDI destination of the world. The third period indicated that China started to give its first priority to the quality of FDI while still hoping the quantity of FDI remaining large.

(2) From the perspective of change of FDI form

There are three main forms of FDI in China: equity joint ventures (EJVs), contractual Joint Ventures (CJVs), and wholly-foreign- owned enterprises (WFOEs). During the first period, the FDI form of CJVs has been the dominant one, although EJVs are the first FDI form regulated by the EJVs Law. This is because both Chinese party and Foreign party wanted to test out the FDI environment in China. For the Chinese side, since they lacked funds and experience, but were eager to participant in FDI, CJVs, as a flexible FDI form, were the suitable one for them. For the foreign side, since they were not confident enough to make serious and longer-term investment commitment to China, the FDI form of CIVs provided them with the opportunity of small size, and short-term commitment and quick return of their investment. In terms of WFOEs, this form was restricted in the limited geographical area of China, such as special economic zones (SEZs) in initial years of China's open door policy, as the government thought it was hard to control it because of its 100 per cent of foreign ownership. From 1986, in the second period, CJVs were overtaken by EJVs, as foreign investors gained experience, as well as confidence in operating in China. Meanwhile, some disadvantages of CJVs were explored including conflicts between the Chinese party and the foreign party due to lack of a legal framework, although the Law on CJVs became available in 1988, but without detailed implementing measures until 1992 when these measures were in place. As for WFOEs, they started to grow at a fast pace from 1986 when the Law on WFOEs was published, which has made a new record – as China became the first socialist country to regulate a law to officially introduce western WFOEs. In the third period beginning in 1995, EJVs have strengthened their leading position in 1992 when EJVs Law was amended based on international practice, which made foreign investors feel more confident and comfortable to operate their production in China. WFOEs continued to grow ever stronger than before, since this form is believed to be the more effective FDI vehicle to bring to China a large amount of FDI, as well as the most advanced technology for China, which are the government's top priority targets. By contrast, the form of CJVs is fading, as this form was thought to primarily introduce low technology and small amounts of FDI projects, which was no longer encouraged by the government as before.

(3) From the perspective of change in the government's approach to control over FDI

In the first period between late 1978 and 1986, the location, the form of FDI, the industrial area, the operation of the ventures, etc, were tightly controlled by the Chinese government, more notably, among the three forms of FDI, only EJVs had the law available to follow, FDI activities of other FDI forms chiefly followed the Chinese relevant laws, which enabled the government to control FDI in a Chinese way.

In the second period, the government's willingness to regulate the relevant laws and legal framework for FDI was increased. As a result of this, the Law on WFOEs, and the Law on CJVs were passed in 1986 and 1988 respectively, aiming at promoting FDI. In the third period between 1995 and 2000, the government followed a combined approach to control FDI. On the one hand, the government started to direct FDI to their priority industries and regions in light with their national economic development strategy and national interests; on the other, it started to formulate and follow "the National Treatment", in order to meet the requirements of international organisations, such as WTO.

(4) From the perspective of change in approach to creating the turning points

For the first turning point – from "self-reliance" to permitting FDI in late 1978, the Chinese government was well prepared to make it happen, as the government had clear aims and objectives beforehand. That is, to bring to China the western advanced technology, capital, managerial expertise, etc, via FDI, in order to promote Chinese economy, and eventually to promote its modernisation. The approach the government adopted is clearly proactive, but is also defensive in terms of taking cautious measures to prevent China being affected by capitalist elements of western FDI.

As for the second turning point – from permitting FDI to promoting it in October 1986, the Chinese government was facing severe difficulties, notably the foreign exchange crisis prior to the turning point. These special circumstances have put the government under extreme pressure. They would have to find a way to overcome the unexpected problems. This led the government to adopt a reactive, or a passive approach. The "22 Articles" are issued, as part of prompt action to boost the confidence of foreign investors, which in turn results in the door of China being opened much more widely.

With regard to the period of the third turning point from 1995, China has successfully attracted a large amount of FDI and FDI has started to play a major role in Chinese economy. At that time, the government follows two new strategies. Internally, China is proposing a more efficient and effective way to develop its economy and make its high economic growth rate sustainable. To this end, the government makes efforts to balance up FDI between its quantity and quality. As a result, the "Interim Provisions on Guiding Foreign Investment Direction", and "Catalogue for Guidance of Foreign Investment Industries" were promulgated to improve FDI quality by directing FDI to China's priority industrial areas and making FDI more effective to promote Chinese economy. Externally, China is seeking the membership of the WTO, moving its economy towards the international economic system. For this reason, the government is prepared to follow "the National Treatment" for foreign investors, to replace the "Super National Treatment" and "Inferior National Treatment". This eventually led China to be a member of the WTO. The above policy changes, beginning in 1995, have shown that the government this time took the initiative to make these changes happen, which therefore clearly indicated that a proactive approach is employed by the government.

The shift of the approach from one to another implies that China's FDI has gradually moved from a low level to a high level: (a) China has growing awareness of the importance of FDI to its economic development; (b) the development of FDI in China has made its open door policy more open.

In terms of the development of China's FDI concept, as discussed in Chapter 2, this concept has undergone three stages along with the three turning points of China's FDI development in practice. These three stages of China's FDI concept are: concept introduction, concept creation, and concept development. It is important to notice that the evolution of the concept of China's FDI, is largely influenced by how western FDI is seen by the Chinese government. At the beginning of China's introduction of western FDI, the government adopted a traditional and typical Marxist approach – analysis of social system and class relations. Western FDI is believed to carry western harmful elements which may have a negative influence in China's socialist construction. This approach decides how FDI is treated in the country: FDI is permitted, but is also strictly controlled under China's socialist system, in terms of limited location, industrial fields, and restricted FDI forms, etc. This approach has not been changed until early 1992, when the then Chinese top leader Deng Xiaoping interpreted FDI in a new way - instead of making analysis of class relations and social systems, judging FDI by considering: (a) whether or not the socialist productivity can be developed; (b) whether or not the overall national power of the socialist country can be strengthened; and (c) whether or not the living standards of Chinese people can be improved.

This new approach has suggested that western FDI has been useful in developing Chinese economy, and therefore FDI in China should be promoted. This positive approach immediately stimulates FDI in China. However, since this approach did not challenge the Chinese traditional approach – Marxist approach directly, the Chinese are still unclear about FDI status in the Chinese economic system, therefore their attitudes towards FDI are still associated with class relationships, and some questions still remained doubtful, such as the class nature of the western FDI, as well as the relationship between western

FDI and the Chinese socialist system. These questions were raised again in 1996 when serious concerns arose in China about the increasingly strong growth of FDI, especially the dramatic emerging of the transnational enterprises (TNEs) in China, and concerns about China's loss of its national market and the national economy safety. This led to a national debate about the relationship between western FDI and TNEs, and the Chinese national industry.

The debate is concluded by the Chinese leadership with a new approach to FDI at the 15th National Congress of Chinese Communist Party in September 1997: the foreign invested enterprise in China is no longer seen as a foreign firm, but a part of China's economy. Thus their growth will not affect the development of Chinese national industry, instead, will promote the Chinese national economy to a higher level.

This new approach moves much further than all previous approaches, and indicated very clearly that the analysis of class relations and social structure and systems on FDI is no longer relevant, and that the only remaining issue for western FDI in China is now how to develop FDI in China based on China's economic development strategies, rather than controlling it for the political reason.

8.2. Recommendations

Since December 2001, China has become a member of the WTO as a result of many years of pursuing. This marks one of the most important events since China's opening up to western FDI in 1979. Being a WTO member country, China started its journey to get its national economic system connected with the international economic system. To this end, the Chinese government took action to review its laws and regulations relating to its foreign economic issues: legal documentation which was in line with WTO requirements was abolished; and a new legal framework in line with WTO rules was being established.

This change suggests that: (a) the period of China's opening up has shifted from the government policy-oriented to the period of the system-directed (Jiang, 2002); and (b)

China's development of its economy, including introducing FDI, would have to follow international practice (Pang, 2003).

Accordingly, this change will also lead to a significant change of China's FDI, in terms of its theory, as well as its practice.

As for the theory of China's FDI, China has created a new approach of "peacefully rising", aiming at connecting China with the world economic system which is dominated by western capitalist countries, and making China an important part of the world production chain (China has already been very successful in this regard). Consequently, this inevitably puts a full stop to China's traditional approach of dealing with FDI: making significant policy changes based on the willingness of the government. This leads the key issues of China's FDI to be shifted to how China's FDI is developed in line with international practice, including WTO's requirements.

In terms of the practice of China's FDI, China is gradually opening up more industrial areas, especially services industries. In addition, China is revising its legal framework to reach to international standards, for example, the Law on equity joint ventures (EJVs) was revised again in 2002 based on international practice. Moreover, China is taking serious action to realise "the National Treatment" for foreign invested enterprises, to replace the "Super National Treatment" and "Inferior National Treatment". In March 2007, the National People's Congress of China passed a historical document: the Tax Law on Chinese Enterprises. This Law, for the first time, treats foreign invested firms the same as Chinese enterprises in terms of corporate tax rate (25 per cent applied to both of them. Previously two different laws with different rates applied, and foreign invested firms enjoyed low tax rate and tax discount and tax holiday). This change has finally taken away the preferential tax policy, and created an equal operating environment for both Chinese and foreign firms.

In short, China's FDI of post-WTO will be developed differently, in terms of its approach to western FDI, and the form of FDI, and its position in the world economy. All these changes will generate a lot of issues relating to China's FDI in a new era. In addition, from early 2000s, China started to strongly involve in outward FDI, which will also bring out a new research subject.

8.3. Possible Further Research

As discussed above, unlike the previous three periods of China's FDI development, the government can now no longer as effectively as before control inward FDI by adopting its Marxist approach. Instead, China will increasingly have to follow international practice, or the requirements from various world organisations.

FDI development in China in the new era inevitably creates a number of interesting and meaningful topics for further research, which may include the following:

- China's new approach to FDI after 2000: from December 2001 when China became a member of WTO, China started to view its western inward FDI in a more positive way, by stating that western FDI to China is inevitable and important to China. In practice, the government makes enormous efforts and commitments to following requirements of world oganisation, such as WTO, and seriously and comprehensively improving its legal system. This leads China's politically oriented approach to western FDI to system-directed approach. Now the question is, what are the implications of China's new approach to western FDI.
- The motives or determinants of China's involvement in outward FDI: since 2000, China started to strongly get involved in outward FDI. As a developing country, as well as a socialist country, why does China emerge as an outward FDI maker; is it for political reasons, or for economic reasons, or both. Is there any relationship between China's inward FDI and outward FDI, if yes, what are they;
- In FDI development history in China, there have been a number of important political and economic events, which have tremendous influence in changing the direction of FDI development in the country. This kind of events may be called turning points. Research focusing on these turning points will help produce in-depth knowledge and understanding of how FDI is developed in China, and why it is developed in this way.
- The relationship between the increasing inflows in China's inward FDI and the growing environmental problems, such as air pollution and water pollution. Can China manage these problems, is China's economic and FDI development sustainable with severe environmental problems.

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