THE DEVELOPMENT OF FOREIGN DIRECT INVESTMENT IN A RAPIDLY GROWING ECONOMY: THE CASE OF CHINA AS OF 1979

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Thanks for my old graduate classmates for their invaluable friendship and encouragement.

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ABBREVIATIONS

ADB	Asia Development Bank
ASEAN	Association of Southeast Asian Nations
CCP	China Communist Party
CJV	Contractual Joint Venture
EJV	Equity Joint Venture
EU	European Union
FDI	Foreign Direct Investment
GDP	General Domestic Production
HKSAR	Hong Kong Special Administrative Region
JDV	Joint Development Venture
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
NIE	New Industrialized Economy
OECD	Organization for Economic Cooperation and Development
SEZ	Special Economic Zone
UNCTAD	United Nations Conference of Trade and Development
WFO	Wholly Foreign Owned
WTO	World Trade Organization

ABSTRACT

THE DEVELOPMENT OF FOREIGN DIRECT INVESTMENT IN A RAPIDLY GROWING ECONOMY: THE CASE OF CHINA AS OF 1979

The contribution of Foreign Direct Investment to the economic development is very disputed in the developed and developing countries. In the developed countries, the outflow of capital to the new emerging markets made some problems such as the loss of labor-intensive jobs caused by the flood-in of imports of light industrial products from the developing countries. On the other hand, the inflow of foreign direct investment in the South also bore different fruits, in Latin American countries, the problems of foreign debt led to the painful structural adjustment, the outflow of national resources to the developed countries and the destruction of natural environment. In Africa and Caribbean, FDI is a synonym of neo-colonist of foreign control. Amazingly, FDI in the East Asian Countries achieved great success comparing to the experience of the other developing countries. In recent years, China became the largest FDI recipient after the United States in the world, China's economy has achieved great progress since 1979 when China started reform and opening up of its economy to the outside world. Foreign Direct Investment, particularly those from the overseas Chinese sources through Hong Kong and Macao played an important role in China's economic catch-up. In this thesis, the author analyzes the development and characters of FDI in China over last two decades, with special attention on the role of Hong Kong's investment in China, which has always made a lion's share of the total FDI since 1979. This study finds that FDI is one of the leading powers behind China's rapid economic growth in last two decades. The affinity of culture and language between Mainland China and Hong Kong facilitated the inflow of FDI. In the new millennium, China is determined to rise as an advanced industrial country. FDI will continue to play a crucial role in China's catch-up effort.

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CHAPTER ONE

INTRODUCTION

1.1 Questions of the Study

Since reform and open-up policy was finally made by Deng at the Third Assembly of the Party's Eleventh Conference in December, 1978, China's GDP has grown at an average annual rate of 9.8 percent; imports and exports have grown at an average annual rate of 15.6 percent. Consequently, by 1997, China had become the seventh largest economy in GDP, the tenth largest nation in terms of trading, and the second largest recipient of Foreign Direct Investment (FDI) after the United States since 1993 (see tables 1.1 and 1.2). Enterprises with foreign investment accounted for 0.1 percent of total exports in 1981, 12.6 percent in 1990, and 41 percent in 1997.[1] FDI has become one of principal factors in China's amazing economic achievement over the last

[1] *People's Daily*, China, Beijing, October 7, 1998. China Profile, AE&A Consulting Ltd. http://www.aeagroup.com/china.htm

two decades. As the World Bank remarked in a recent report, China achieved in just one generation what took several centuries for some developed countries.[2]

Table 1.1 FDI Inflow in Major Countries/Regions (Based on Balance of Payments)

(Unit: US$ million, %)

	1990	1991	1992	1993	1994	Change form prior year (%)	1995	Change from prior years(%)
Asia	17,579	19,742	24,267	43,758	50,865	16.2	61,829	21.6
China	3,487	4,366	11,156	27,515	33,787	22.8	37,736	11.7
S.Korea	788	1,180	727	588	809	37.6	1,776	119.5
Taiwan pr	1,330	1,271	879	917	1,375	49.9	1,559	13.4
Singapore	5,575	4,887	2,204	4,686	5,480	16.9	6,912	26.1
Thailand	2,444	2,014	2,113	1,804	1,366	-24.3	2,068	51.4
Malaysia	2,332	3,999	5,183	5,006	4,348	-13.1	5,800	33.4
Indonesia	1,093	1,482	1,777	2,004	2,109	5.2	4,500	113.4
Japan	1,760	1,300	2,760	130	920	607.7	-2	-
Australia	6,482	4,037	5,038	3,008	4,708	56.5	13,710	191.2
Latin America	5,964	8,807	9,708	9,972	16,420	64.7	14,836	-9.6
NAFTA	58,324	29,492	26,490	52,396	68,031	29.8	77,979	14.6
US	47,920	22,010	17,580	43,010	49,760	15.7	60,230	21.0
Canada	7,855	2,740	4,517	4,997	7,266	46.1	10,786	47.8
EU	97,885	78,725	83,727	79,939	69,574	-13.0	110,929	59.4
WORLD	230,625	191,942	186,926	232,706	247,386	6.3	317,432	28.3
Developed countries	169,777	114,001	114,002	129,302	132,758	2.7	203,168	53.0
Developing Countries	33,735	41,324	50,376	73,135	87,024	19.0	99,670	14.5

Source: FDI Inflows in Major Countries/Regions. http://www.jetro.go.jp/whitepaper/invest97/to7.htm
1. "EU" indicates 14 states excluding Luxembourg.
2. "Asia" only includes China, South Korea, Taiwan province of China, Singapore, Thailand, Malaysia, Philippines, and Indonesia.
5. "Latin America" includes only Mexico, Brazil, Argentina, and Chile.
6. "NAFTA" indicates U.S., Canada, and Mexico.

How, did China, sticking to "building a socialist market economy with Chinese characteristics", make such great accomplishment in

2 *China 2020: Development Challenges in the New Century.* p.2. the World Bank, September 1997.

harnessing FDI to its economic development? What are the secrets for China's successful integration into the world economy? What can be the lessons for other developing countries to utilize FDI for their economic development? China's eye-catching FDI development deserves closer study.

Table 1.2 Countries with greatest FDI inflow (US$ billion)

Ranking	1993		1994		1995	
1st	US	43.0	US	49.8	US	60.2
2nd	China	27.5	China	33.8	China	37.7
3rd	France	20.8	France	16.6	Britain	32.2
4th	Britain	15.5	Mexico	11.0	France	23.7
5th	Belgium	10.8	Britain	10.3	Sweden	14.3

Source: Ministry of Foreign Trade & Economic Cooperation (MOFTEC), *Almanac of China's Foreign Economic and Trade Yearbook, 1995/96;*

After a long period of closed, self-reliant, and import substituting form of development since 1949, a centrally planned economy moved towards stagnation, the stifling of people's creativity and activity, and the "rust belt" phenomenon of state-run enterprises. While many East Asian economies experimented with an outwardly oriented form of development as of the late 1950s, it took China another 20 years to resolve its internal debate over the role that the international market should play in the domestic economy. During these decades, other Asian economies such as Taiwan and South Korea accelerated the growth of their domestic economies and the foreign trade sectors, improved economic efficiency and fostered technical transfer. Not until the late 1970s did China begin to mirror these actions by promoting economic integration with the world market through the establishing of four Special Economic Zones and thirteen coastal open cities to attract FDI and accelerate exports, along with protection for specific industrial sectors.

Given the outside impact of outward development models in the East Asian NIEs, China started to reform its social, economic, and legal structure and implemented a series of policies from 1979 to attract FDI. This marked a turning point in China's development strategy. With the aim of attracting overseas Chinese investment, China firstly established Special Economic Zones in the south coast next to Hong Kong and across the strait of Taiwan, which have long cultural affinity and tradition to invest in their ancestral homeland. Some 60 to 70 percent of "foreign" direct investment in China has always come from Hong Kong[3], the economic capital of overseas Chinese where most of their investment is registered, as well as Taiwan, an island of 80 percent Fujian descent and 20 percent of inhabitants from other different Mainland provinces[4].

The strategy formulated by Deng Xiaoping for first opening the southeast coastal region, attracting overseas Chinese investment to it, and

[3] Murray Weldenbaum and Samuel Hughes, the Bamboo Network, How Expatriate Chinese Entrepreneurs Are Creating A New Economic Superpower in Asia. Martin Kessler Books, 1996, p.65.

turning it into the leading force of the economic reform and open policies was quite effective. Without it, China's rapid economic growth would not have begun.

Until recently, the leading investors in China have been overseas Chinese in Hong Kong, Taiwan, and other Southeast Asian countries. In 1994, total utilized FDI in China amounted to US$33.9 billion, of which Hong Kong's share came to US$ 20.3 billion, or 60 percent. Overseas Chinese in Southeast Asia were also major investors. FDI from the US reached only 3 billion, 7.4 percent of the total (see Charts 1.3 and 1.4).

Chart 1.3

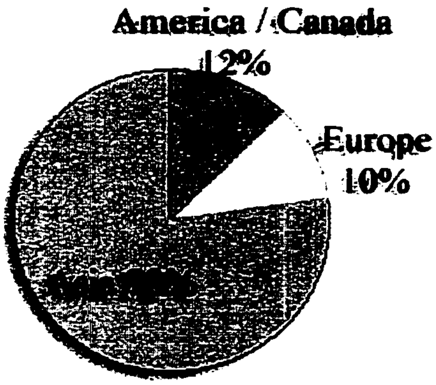
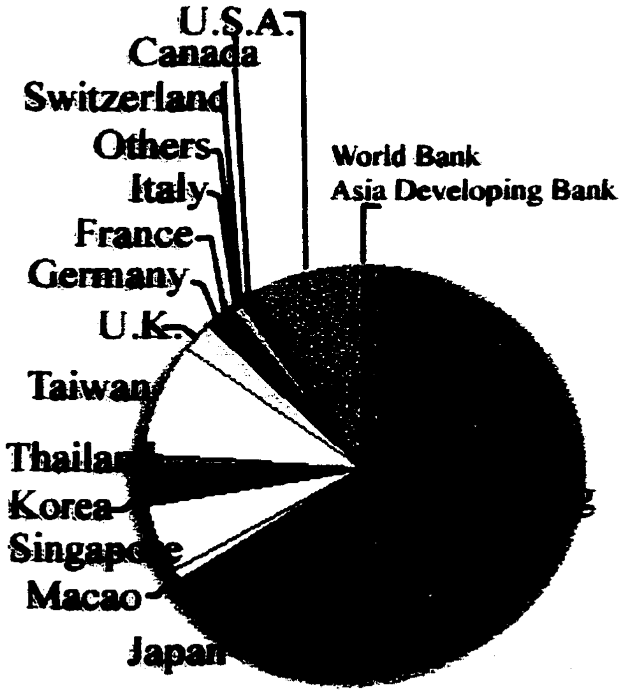


Chart 1.4 Sources of FDI in China 1994



Sources: Infopower Taiwan. http://www.infopower.com.tw/trend/taiwan/invest-1c.htm

[4] Cohen, Marc J. *Taiwan at the Crossroads*. Washington, DC: Asia Resource Center, 1988, p. 51.

After the rapid economic growth over the last two decades, China has moved towards a huge real market which will attract more and more technology and skill intensive FDI from the big multinational enterprises of the United States, Japan, and the EU.

1.2 Thesis Statement

In this thesis I argue that China's outward-oriented development strategy based on international trade and Foreign Direct Investment has been an important element in the economic success of China. This has been coupled with the reform of domestic economic development strategies; trade and FDI liberalization; and export promotion. FDI originated from overseas Chinese societies of Hong Kong and Taiwan accounted for 60 percent and 8 percent respectively. The business connections between Mainland China and overseas Chinese in Asia have been directing a substantial amount of investment to their ancestral homeland in the southeast coast of China (see Charts 1.3 and 1.4). Given critical importance of FDI in transferring technology know-how, management expertise, and improving efficiency of production, and its intricate link with trade flow and foreign exchange demands, FDI, especially those from Overseas Chinese sources is and will be an increasingly important catalyst in modernizing and developing the Chinese economy.

The debate in scholarly circles over the various factors responsible for the success of East Asian economies is extensive. Neoclassical economists explain the success of these countries as the result of an open market and export-oriented development strategy pursued by the governments in this region. However, it is difficult to fully support the neoclassical ideology in that the government and many other factors played very important roles in the economic development of East Asia. In this context, the economic success in East Asia has bred anew type of analysis based on what can be called a statistic paradigm. Contrary to the neoclassic approach which attributed the economic "miracle" to free markets with limited government interference and liberalization of a foreign trade and the investment regime, the statistic paradigm emphasizes the role of the state. This author will argue that these two theories actually complement the weakness of each other's argument. A hybrid development model --- the "Export-propelled Market Economy under an Authoritarian Bureaucratic State Paradigm" could provide the theoretical means for an argument of what the prime facilitator of economic development in East Asia (the Four Little Dragons and ASEAN-4), as well as China.

This study is based on and advance this argument: Development economists have neglected another important element behind the East Asia's especially China's remarkable development--- overseas Chinese investment in China and its subsequent business network as a means of financing China's economic growth.

The thesis of this study is that this has been a critical element of China's spectacular rate of rapid growth. The role of foreign investment is contentious. From the perspective of Chinese planners, there is the suspicion that not all foreign investment is equally beneficial, whether from the standpoint of promoting rapid growth or of promoting welfare. The suspicion of Chinese planners is historically founded. In the late nineteenth and early twentieth centuries foreign investors "scrambled" for concessions to construct railways, develop mineral resources, open manufacturing plants, and foster the production of commercial agricultural crops. The contribution of these Western investments to Chinese growth remains under dispute.

Traditional neo-classical theory allows for only a fairly narrow range of forces. The Organization for Economic Cooperation and Development (OECD) program of globalization and opening of markets, for instance, assumes that all foreign investment is equally beneficial, and that investors do not differ in any essential way[5]. Many observers, however, believe that economic factors other than those typically included in neoclassical analysis critically affect investment decisions, and other suggest that cultural affinity play a role as well. On the one hand, transaction costs internal to the firm---costs of contracting and enforcement, costs of acquiring and using information, costs for monitoring work within the firm, and costs for maintaining quality control---all vary from firm to firm and may be higher in a foreign environment. On the other hand, from the perspective of foreign investors, there has been a suspicion that those who benefit most from investment in China are those who are culturally closer to China. If cultural factors do play a role, then potential investors who are culturally more "distant' will need to adopt strategies to overcome their disadvantage.

[5] Donald J. Johnston, Secretary-General of the OECD, *"A New Global Age"*, OECD Observer, August/September, 1997,p.4.

In the economic area, the success of the overseas Chinese is largely due to their industriousness, self-reliance, risk-taking attitude, and the practice of setting up broad business network. The significance of the overseas Chinese presence in East Asia and China's economic development cannot be denied. In 1994, the total asset of the 500 largest public companies in Asian controlled by overseas Chinese exceeded US$500 billion (see table 1.5). The World Bank estimates that the combined economic output of the overseas Chinese was US$ 400 billion in 1991, an impressive sum for 50 million people (Weidenbaum, and Hughes, 1996:25). Since Deng Xiaoping launched the economic open door policy in 1978, Overseas Chinese from Hong Kong and Taiwan have invested more than US$50 billion in their ancestral land, representing over 70 percent of all foreign investment (Ibid, 27).

In last 30 years, Asia's Four Dragons achieved fantastic growth, three of them (Hong Kong, Taiwan, Singapore) are Chinese societies. As indicated this author argues that overseas Chinese investment through their trans-boundaries business connections is an important element in China's remarkable economic development. Chinese economic and cultural transnationalism can be regarded as part of the stimulus behind the current globalism which is a broad topic that needs to be explored in depth and invoke large amount of time and strength, thus falling beyond the scope of this graduate thesis. In this study, I concentrate on the development of China's FDI strategy, the features of FDI in China and impact of the investment from Hong Kong to the economic development of China, especially in south China, in its phase of openness since 1979.

Table 1.5 Economic Strength of Overseas Chinese Enterprises in Southeast Asia. (US$ Billion). 1994

Location	Number of Companies	Market Capitalization	Total Assets
Hong Kong	123	US$155	US$173
Taiwan Province	159	111	89
Malaysia	83	55	49
Singapore	52	42	92
Thailand	39	35	95
Indonesia	36	20	33
Philippines	8	6	8
Total	500	424	539

Source: Friedrich, Wu and Sin Yue Duk, *"Overseas China, Inc."*, the International Economy, Jan./Feb. 1995, pp.33-35.

1.3 Research Methodology

The methodology of the thesis is to collect and analyze first and second-hand data, including those official statistics of Chinese government, international organization such as the World Bank, the IMF, the UNCTAD, and the WTO, the data from the current newspapers, and the accessible Internet containing rich resources and update events of

FDI. However, there are a lot of contradicting data and ideas provided by existing academic schools. Thus in the judgement of the author who came from China, was born in 1960s, experienced the unprecedented political and economic transformation that occurred in China in 1980s and early 1990s, remains the ability in analyzing and evaluating the available data and their interpretation. Due to the lack of materials on the family enterprises across East Asia, this study concentrates on the broad economic and socio-cultural aspects of overseas investment in Mainland China.

1.4 Structure of the Thesis

The focus of this thesis is on two questions: 1.How FDI flourishes in China's opening and reform era; 2. How Overseas Chinese investment, especially from Hong Kong and Taiwan, promoted China's economic development. With reference to these questions, I argue that overseas Chinese investment, encouraged by the convenience of a common background and the same written language, played a very important role in China's reform and opening efforts.

Chapter one gives the background of the study and puts forward the questions, the present academic arguments of the success of the economic development in East Asian countries, the methodology applied to the study and the arrangement of the thesis. Chapter two reviews the literature of the theories of FDI and practical implications of FDI in the world economy, East Asia development and the case of China's recent performance of FDI. Chapter three gives a historic review of FDI in China since late Qing Dynasty up to the present open and reform era. This author finds that the attraction of FDI through open policy is aimed to the investment from overseas Chinese sources of Hong Kong, Taiwan and other East Asian parts. Chapter four examines the FDI in China with the respects of the FDI's features, distribution, and structure in the industrial sectors and compares the FDI from developed industrialized countries and those from Hong Kong and other Asian countries and regions. Compared with Hong Kong and Taiwan investment in China, FDI from the US, Japan and EU are minor, which is affected by geographic, industrial structural and cultural factors. Chapter five explores investment from Hong Kong, which made a lion's share in China's total FDI inflow over the last two decade. The impact of Hong Kong investment in China especially inGuangdong province is examined here. In chapter six some conclusions are made here and lessons of China's FDI for other developing countries are also presented.

CHAPTER TWO

THE ROLE OF FOREIGN DIRECT INVESTMENT IN ECONOMIC DEVELOPMENT

2.1 FOREIGN DIRECT INVETMENT IN THEORY

In this chapter, this author discusses the theoretical literature while the focus is on the practical experience with FDI and its impact on global and East Asia regional levels and, in terms of China, at the national level.

2.1.1 Definition of FDI

It is important to note the criterion used in distinguishing between FDI and portfolio and other types of foreign investment. WTO (1996b) indicates that "Foreign direct investment (FDI) occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset. The management dimension is what distinguishes FDI from portfolio investment in foreign stocks, bonds and other financial instruments".

In the short term, FDI is the acquisition of a controlling interest in a foreign firm or affiliate (branch, subsidiary, etc.). A firm that has at least one foreign affiliate is a multinational corporation (or multinational enterprise). Not too long ago, most multinational corporations, the bearers of FDI, were big, but increasingly small and medium-sized enterprises are engaging in FDI.[6]

2.1.2 Theoretical Approaches to the Determinants of FDI

Trade theory tells us little or nothing about the nationality of the owners of the facilities that generate exports. All that matters in trade theory is the country in which the facilities are located. And here the issue is foreign investment theory directly addresses the question of ownership, a quest of perquisites, related restrictions, or regulations, and the economic impact on the capital and technology deployed on the bases of FDI.

What determines whether a firm decides to establish production facilities abroad rather than export its product or license overseas entrepreneurs to invest abroad, primarily is lower labor costs. At least this is so in theory. However, although differences in labor costs may sometimes help influence firms' decisions to locate abroad, this is definitely not the whole story. As suggested by the FDI data prescribed in the chapter one, the bulk of FDI still goes to the advanced countries, in

[6] Most of the foreign-invested enterprises in China are small, according to the statistics from MOFTEC. The average size of foeign funded investment before 1992 is US$1.55 million. (See Chapter 4 of this paper. P53-55).

particular the United States, where wages are high relative to those in developing countries.

Economists have long recognized that at least initially there will normally be extra costs involved for a firm investing in a foreign country where it is not familiar with local markets and institutions.[7] At a theoretical level, economic analysis offers five main explanatory approaches that attempt to show why, despite these disadvantages, firms may still wish to invest abroad. These approaches focus on different aspects, namely:

1. Ownership advantages: (Hymer, 1960) Such advantages are thought to arise from economies of scale with respect to intangible assets such as skilled management capacity or organizational know-how which may also be exploited to even greater advantage by investing abroad. The existence of ownership advantages is a form of "market imperfection", i.e. departure from the assumptions of (1) perfect competition; (2) no barriers to trade; (3) no transaction cost, transportation costs, taxes, etc. Ownership advantages arise because products are not standardized and information of not freely available. Ownership advantages create barriers to entry for competitors.

Why do ownership advantages prompt FDI? Hereby a firm does not want to share its ownership advantages. It is best off if it can exploit them itself. Thus, for example, a firm that has exclusive knowledge of a technology will want to do its own production for a foreign market rather than licensing the technology to another firm, which has every incentive to then steal the idea.

2. Internalization advantages (Buckley and Casson, 1976)

Some investment is motivated by the desire to minimize uncertainty by putting two firms under common control. This is most easily seen by considering the impact of vertical integration of FDI. An example could be of a firm that acquires control of a supplier: an aluminum smelter buys an aluminum mining firm, or as when a computer manufacturer buys a semiconductor maker, and in so doing removes uncertainty about the availability and price of supplies. Similarly, a firm that invests in a customer removes uncertainty about the demand for its product.

3. Oligopolistic behavior

An oligopoly is a market structure with a small number of firms. The key feature is that the number is so small that each firm bases its decisions on what its competitors are doing or are expected to do. This is

9 In addition to these higher initial costs, there are extra risks involved in investing abroad, for which

different than the market structure what we might term "perfect competition", in which there is such a large number of firms that no one firm can affect the market and hence there is no need to pay attention to competitors' decisions.

When FDI is motivated by the actions or probable actions of competitors, this is oligopolistic behavior. For example, a firm might seek to invest abroad because its competitors are investing abroad. Alternatively, the firm may view foreign investment as a way to pre-empt its competitors' moves into a foreign market.

The recent upsurge in FDI in the world economy is possibly explained in terms of global factors, such as liberalization in both the developed and developing countries, in this regard, there has been, among other developments, the creation of a single European Market, and the North American Free Trade Agreement. Throughout developing world over the past decade and a half, there has been increasing liberalization of trade and finance.[8] Together with slower world economic growth, this has led to much greater competitive pressure among multinationals as well as greater opportunities to reaplocational

investors require a higher rate of return than that for domestic investment.

[8] In Africa and Latin America, in many cases, these were ushered in through the structural adjustment policies introduced to deal with the debt crisis.

advantages. The greater competition and cost cutting has, in turn, led to attempts to re-establish market power through strategic alliances among multinationals, joint ventures and collaboration over R&D.

4. Inherent locational advantages (Vernon, 1966)

A locational advantage is a factor that pulls a firm to invest in a particular location. In contrast, one could view the previous three factors (firm-specific advantages, internalization and oligopolistic behavior) as push factors. An inherent locational advantage refers to some natural feature of the particular foreign location, which could be related to geography. For example, the foreign investment could be motivated by a desire to minimize transportation costs or a desire to be close to customers so as to minimize distribution and service costs. Being close to customers could be motivated by a desire to minimize transportation costs or a desire to be close to customers so as to minimize distribution and service costs. Being close to customers could also facilitate adaptation of the product or service to local market conditions and consumer preferences (localization). Access to resources provides another set of inherent locational advantages. The draw for investors in these advantages could be low-cost labor, skilled labor, R&D facilities, cheap energy, mineral resources, etc.

5.Policy-driven Locational advantages

Policy-driven locational advantages are created by government policies which either push or pull firms into foreign investments. Trade barriers for example, can be a powerful push factor. Much of the Japanese investment in automobile manufacturing in the US can be explained in such terms through actual or potential barriers by voluntary export restraints and the threat of U.S. trade remedy laws.

Government inducements to attract foreign investments create a pull factor. Many government units offer incentives such as tax breaks, infrastructure investments, and subsidized land and utility costs in an effort to attract foreign investors. Governments also serve as information providers, and try to match potential investors with specific locations or local firms. An example is provided by China's establishment of Special Economic Zone and Development Zones with special policies to attract FDI. Host country policies regarding FDI can be rather schizophrenic, with the national government imposing restrictions (e.g. for national security reasons) and local governments providing incentives (in order to attract jobs and tax revenue).

Dunning (1981) proposed an integration of the various theories in what he called an "eclectic approach". He listed three key elements of direct investment: (1) The firm must possess ownership advantages over other firms, i.e., firm-specific assets; (2) The firm must find it beneficial to utilize these advantages directly instead of selling or leasing them ("internalization" advantages); and (3) There must be a profit advantage that can be exploited by combining these advantages with at least one factor input abroad so that local production dominates exporting to the host market ("locational" advantages).

2.2 FDI IN PRACTICE

2.2.1 Overview of World Development of FDI

During the last 15 years, there has been a huge six-fold increase in FDI flows in the world economy, reflecting a trend towards greater integration of world's economies. Total FDI inflows to all countries rose from an average of US$ 50 billion a year in the period 1981-1985 to an average of US$ 155 billion between 1990-1992, to US$ 208 billion in 1993, and to US$ 315 billion in 1995 (UNCTAD 1994, UNCTAD 1995a, UNCTAD 1996a, UNCTAD, 1997b).

FDI inflows into developing countries rose four-fold from US$ 19.6 billion to US$ 84.4 billion over the period 1981-1994. This figure rises to almost five-fold on the basis of data for 1995 (US$ 96 billion) and to over six-fold on the basis of inflows of US$ 129 billion for 1996 (UNCTAD 1995a).

UNCTAD (1997b) provides data showing that global FDI inflows rose by 10 percent in 1996 to US$ 349 billion. It is noted that although the growth rate of overall FDI fell significantly in 1996 compared to 1995 when total inflows rose by roughly 25 percent, the inflows nevertheless have increased every year since 1992. However, because inflows into developed countries were virtually stagnant in 1996 compared with 1995, most of the growth took place in developing countries. These countries recorded an increase in inflows of nearly a third in 1996 compared with 1995. Overall in 1996, 37 percent of FDI inflows went to the developing countries; just over 3 percent to former Soviet Union and East European transitional economies, and the remainder --- just less than 60 percent --- to the developed countries (UNCTAD 1997b).

2.2.2 Regional and country concentration of inflows

The main developing countries that were recipients of FDI inflows were in Asia, and followed by Latin America. Africa received only 1.4 percent of total FDI inflows in 1994 (UNCTAD 1996a). Within this broad pattern there is a very high degree of country variation and concentration of inflows, with ten developing countries of China, Mexico, Malaysia, Singapore, Brazil, Indonesia, Argentina, Chile, Bermuda, and Thailand accounting for 77 percent of the total of such inflows in 1995 (Ibid)[9]. China has been by far the largest single developing country recipient of FDI in recent years as enlisted in table 2.1.

Table 2.1 Average annual inflows of FDI to the 10 largest recipients among developing countries (US$ millions)

Host	1984-89	Host	1993	Host	1994
Mexico	2436	China	27515	China	37500
China	2282	Argentina	6395	Mexico	6984
Singapore	2239	Singapore	5016	Malaysia	5800
Hong Kong	1422	Malaysia	5006	Singapore	5302
Brazil	1416	Mexico	4389	Brazil	4859
Bermuda	1144	Bermuda	2960	Indonesia	4500
Egypt	1085	Indonesia	204	Argentina	3900
Saudi Arabia	1084	Thailand	1726	Chile	3021
Malaysia	798	Hong Kong	1667	Bermuda	2900
Taiwan pro.	691	Saudi Arabia	1369	Thailand	2300
Share of top ten in total flows to developing countries %	66%		79%		77%

Source: UNCTAD (1996a) *World Investment Report, 1996.*

2.2.3 Costs and Benefits of FDI

As noted before, the academic literature on FDI fully recognizes that from the point of view of host countries there are both important benefits and significant costs associated with FDI. Possible benefits

[9] The appearance of Bermuda among the top ten developing country recipients of FDI flows points to some of the difficulties with FDI statistics.

include the transfer of technology to individual firms and technological spill-over to the wider economy; increased productive efficiency due to competition from multinational subsidiaries; improvement in the quality of the factors of production including management in other firms and not just the host firm; benefits to the balance of payments through the inflow of investment funds; increases in exports; increases in savings and investment, and hence faster growth of output and employment. Consumers may benefit both from lower prices of goods and the introduction of new or better quality goods.

Among the acknowledged costs are the possible negative effects on the balance of payments; discouragement of the development of technological know-how by the local firms; the possible detriment of the growth of domestic producers and the national economy; diminishing of the tax revenues going to host governments; environmental and natural resources costs; the risk of facilitating hegemony by the dominant US and other western cultures, rather than providing a window on a multicultural world; the deterioration of national sovereignty.[10]

[10] To the extent that an open FDI regime is accompanied by a relatively open regime with respect to portfolio capital (which is the case in many countries), a country makes itself vulnerable to decisions by outside investors. Regardless of the underlying economic fundamentals, they may withdraw their funds, which may, in turn, lead to financial instability and discourage both domestic and foreign investment to the detriment of the national economy, as shown in the present Asian Crisis occurred in July 1997.

2.2.4 The Experience of East Asian Countries of FDI Inflow: A Selective Approach to FDI

On the positive side, there is a considerable literature, which argues that the characteristics of FDI inflows into Asian developing countries from other developing countries, particularly from Japan, are more conducive to development than are FDI inflows elsewhere from other industrial countries (UNCTAD 1996b). The basic assumption here is that the East and South-East Asian countries have been following a "flying geese pattern of development" in which FDI plays a central role.[11] As Japan and subsequently other Asian NIEs become more industrialized and their real wages rise, they shift their more labor intensive and technologically less sophisticated production to their less developed neighbors where real wages are much lower. FDI is thus connected with a dynamic division of labor in a growing regional economy. The recent upsurge of FDI in China from overseas Chinese societies of Hong Kong and Taiwan is thought to be a similar kind of development model of FDI in East Asia. At this point, it is instructive to

[11] For the classic statement of the "*flying geese*" thesis, see Kojima's collected papers, 1996. See also Ozawa, 1996.

examine the case of East Asian economic development model whose success has been attributed by some influential economists to their high degree of integration into the world economy and their openness to FDI (Chang 1996, Eatwell 1997, Calvo and Reinhart 1996).

In the East Asian Economies, governments have imposed important restrictions on the entry of FDI and on the degree of ownership. FDI was usually channeled into industries supplying critical intermediate inputs of complex technology or labor intensive export industries generating foreign exchange and jobs, while it was prohibited in the consumer durable industry supplying the domestic markets. Moreover, the governments in East Asian countries tried to encourage joint ventures, preferably under local majority ownership, in an attempt to facilitate technology transfer and the development of managerial skills (Lall, 1995:135-154).

Although there are very different degree of dependence on the FDI among economies in East Asia with Taiwan and South Korea employing limited FDI and China, Malaysia, and Singapore more receptive to and dependant on FDI, they all operated to a greater or less degree a selective policy in line with national priorities.[12]

2.2.5 FDI in China: Theoretical and Realistic Implications

While these theories reviewed above are useful in characterizing FDI dominated by large multinationals and occurring between the United States and Europe, China's recent FDI experience suggests that economic theories of FDI are inadequate with regard to their application to intra-Asia FDI flows. In fact, it might also seem to be somewhat artificial. A major share of FDI in China is small scale, and the largest investors in China are from Hong Kong and Taiwan. The ownership advantages that most small investors into China appear to possess is knowledge of retail and wholesale markets in advanced countries for specific products. In turn, these markets cannot be seen as standard transactions markets, but as markets in which individual firms with reputations for delivery and flexible production repeatedly negotiate unique, nonstandardized contracts. An example would be garment markets in which styles and

[12] For a discussion of FDI in South Korea over a longer period, see Chang, 1996. Chang, Ha-Jong (1996) *Globalization, Transnational Corporation, and Economic Development*, paper presented at the Economic Policy institute (EPI) Conference on " *Globalization and Progressive Economic Policy*", Washington, DC. Rasiah, Rajah (1996) "*Globalization and Liberalization in East and Southeast Asia: implications for growth, inequality and poverty*" in UNCTAD, *Globalization and Liberalization: Effects of International Economic Relations on Poverty*, UNCTAD, Geneva.

manufacturing inputs change from year-to-year and season-to-season. Another example would be toys and shoe-making where design changes occur annually (Hsing Y.H.,1998:12).

The basic machinery in these industries --- plasticmoulding, wood working machines, light stamping machines --- are not technologically advanced (Pomfret, 1991:10). In fact, the overwhelming mode of investment into southern China has been the physical transfer of used, in many cases fully depreciated, machines (Xu, 1991: 15-16). It would have indeed been artificial for these investors to consider seriouslyDunning's second alternative --- that of leasing or licensing these advantages. The actual ownership (or firm-specific) advantages that business operations in these markets can consider "leasing" or "licensing" is their access to retailers in developed country markets or original equipment manufacturers (OEMs) and their reputation as reliable and timely suppliers. If they were to lease out these advantages, the firm buying their output might as well contract with another supplier. The relationship between many of these businessmen and the market they supply can be extremely intimate and mimics much of the subcontracting systems so often observed in Japanese industries. In the case of toys or garment production where there are constant changes in product design, the normal cycle is for the supplier, using its existing plant, to initially produce a few samples based on a potential buyer's specification. Via such experimentation the supplier ascertains the method and the cost of production. The second stage is to negotiate prices and delivery schedules, while the supplier reconfigures his operation to meet the demand.

In any case, the accent on the trade and investment linkages of recent Asian capital especially those from Hong Kong flows brings up front the "gains from trade" role that FDI plays. The wide-ranging opening policies undertaken by China, creating a situation in which costs of production diverge significantly just across the border from Hong Kong, have created a situation where investment of the trade-oriented type dominates. Current theoretical approaches that emphasize the "internalization" of markets within multinational firms are not inconsistent with understanding FDI flows into China, but leave the impression of using a pile driver to crack a macadamia nut. In short, in the China case, multinational firms are often very small, some as small as individuals. They hold a personal reputation or a company reputation as a firm-specific asset; use a network, often lacking legal basis, to source a low cost input (labor); make small capital investments; and specialize in delivering timely, uniform quality output to Western markets.

In this context, the recent investment flows into China provide excellent examples of the overseas Chinese from Asia investment contractual business framework which Westerners like to call "informal" because of either the lack of or the unreliability of supporting documents that describe key aspects of the contract.

Hong Kong/Macao continue to be the largest investors in China, particularly in Guangdong province. The rapid increase and important role in FDI from countries or regions with large overseas Chinese community is noteworthy. In fact, a great deal of FDI in China flows through Hong Kong in partnership of the multinationals from developed countries, who form joint ventures with Hong Kong firms due to their "competitive advantage" in investing in China (Kwok, 1992:23).

CHAPTER THREE

FDI IN CHINA: A HISTORIC PERSPECTIVE

In China, three approaches towards FDI can be broadly identified: prior to 1949 FDI was largely imposed on China; between 1949 and 1979 China excluded Multinational Corporations; and since 1979 open policy has welcomed FDI.

3.1 FDI prior to 1949: Semi-colonization

Historically, FDI was largely imposed on China, beginning in 1715 when the British East India Company established a branch office in Guangzhou in order to explore trade opportunities (Wu 1958, forthcoming). However, foreign firms were severely limited by the policies of the Qing government, which in 1751 closed most of its ports to foreigners. Only Guangzhou remained open and in 1836 contained about 55 foreign businesses, mainly involved in opium and silver (Ramer,1933). The subsequent expansion of foreign involvement in China's economy combined business and political control and was often supported by military intervention. Thus, the Opium Wars of the 1840s and 1850s forced the Qing government to cede Hong Kong Island and to open several treaty ports including Shanghai, Guangzhou, Fuzhou, Xiame and Ningbo. Over the next decades, the imperial powers acquired navigation rights for use of China's inland rivers and ports and long term land leasing rights that made it possible to establish foreign concessions in treaty ports, speculate in real estate markets and dominate internal trade (Wu, 1958: 33). After the conflicts of the 1890s (Sino-Japanese War, the Boxer Rebellion and subsequent Eight Imperialist Power Invasion War[13]), foreign powers obtained rights to operate factories, mines and to construct railways in China, and Taiwan was ceded to Japan. The Qing government also received loans which were mortgaged on custom taxes and salt (production and distribution) taxes, a major source of government income since AD700. To further solidify foreign control over China's financial resources, foreign banks were established, probably beginning in 1848 with a branch of the British Eastern Bank in Shanghai, which became the centre for foreign banks and the control of foreign investment (Wu 1958: 36).

[13] Allied army formed by Britain, Germany, France, Russia, Japan, Austria-Hungary Empire, the US, and Italy.

In the twentieth century, foreign investment in China gathered momentum and by 1913 amounted to US$15 billion, Russia, Britain and Germany accounting for a combined total of 72.5 percent. Foreign investment reached US$35 billion in 1936 and a peak of US$91 billion in 1941 before declining sharply during the 1940s. During this period, the sources of foreign investment in China changed substantially. While Britain remained important, after the First World War, Russian investment in China disappeared while that of Germany declined substantially. In contrast, Japanese investment in China grew rapidly, especially after the Japanese invasion of Northeast China in 1930s and, by 1941 Japan accounted for 74.5 percent of China's foreign investment. In 1948, foreign investment in China was back at 1920s levels and the US was the dominant donor economy, with Britain second (Wu 1958: 45).

Assessments of the effects of foreign investment in China's economy prior to 1949 are mixed. For the pre-1900 period, Chang's, (1963), conclusion that the treaty ports and associated foreign investments had a positive trickle-down influence on China's development is questioned by Murphy, (1974), who claims that the treaty ports had little interaction with inland areas. In the first half of the twentieth century, the impact of FDI on China's modernization also appears limited. Foreign investment in the crucial manufacturing and mining sectors never exceeded 20 percent of total investment until 1936 while banking and finance remained unusually high (Wu, 1958: 55-60). Foreign investment was also geographically concentrated in Shanghai and Northeast China[14] and, for the most part, was in the form of wholly owned subsidiaries. Joint ventures that did exist were typically managed by foreigners. Finally, a large share of foreign investment (about 60 percent of the total in 1914) was provided by China itself in the form of war reparations paid by China to foreign powers. By the 1940s, if FDI generated benefits, these were not noticeably related to the creation of national industrialization within China.

3.2 1949-1979: Closure to FDI

In 1949, the new Chinese government accepted Lenin's view that the export of capital is a central mechanism of imperialism. However, Lenin argued that in the early stages of communism foreign capital is important for development as a source of advanced technology: "it is impossible for socialist countries to survive without interactions with the (capitalist)

[14]. Namely Manchuria, Called by Japanese and the West. Northeast China or Dong Bei in Chinese.

world. Under the current condition, we should link our fate with our relationships with capitalism" (Lenin 1959: 303).

On achieving power, China's communist government appeared ready to accept Lenin's advice. Thus, in 1949 at the Second Session of the Seventh Plenary Meeting of the Central Committee of the Chinese Communist Party, Mao Zedong noted that: "We have at first to do business with socialist and democratic countries. We also need to do business with capitalist countries." (Mao, 1949: 268). This latter statement, however, was soon overwhelmed by the implications of the Cold War and by Stalin's theory of two paralleled capitalist and socialist markets, which stressed internal integration among socialist countries for mutual economic development. This theory argued that the capitalist market was inherently weak and that socialist countries should not interact with the capitalist world.

After the founding of the People's Republic, China emphasized the Soviet dominated socialist bloc in order to develop industry and modernization. The Korean War and the related US trade embargo on China entrenched China's international activity to within the socialist bloc, in practice mainly with the Soviet Union and Poland (Wei, 1989:

317-18). In the 1950s, China received low interest loans from the Soviet Union and, with Soviet technical assistance, built 149 large industrial projects (Li, 1997: 70-71). China took full control of the Soviet joint ventures in 1954. Soviet assistance came to an abrupt stop in 1960 when the relations with Soviet Union deteriorated over ideological conflicts. Subsequently, China began actively soliciting assistance form the Western countries. During 196-1968 it imported over 80 technological items and industrial projects (52 percent of which were "turnkey" or complete projects) from Japan, Britain, France, West Germany, Sweden, Italy, and Austria. These were valued at over US$100 million, and were financed by export credits and deferred-payment systems of the exporting countries (Li, 1997:71). The Cultural Revolution abruptly ended this activity of the importation of foreign technology. Globally isolated, China debated its economic strategy in terms of the concept of self-reliance (Ziligensheng) which originated from the guerilla war fought by the communists in south China jungle in the 1930s and 1940. Self-reliance became interpreted to mean that, first, localities should strive for self-sufficiency in agriculture and industry and, secondly, at national level, China should rely on its own resources for economic development.

3.3 1979 to the Present: A Period of Transition

By the early 1970S, China's technological weakness was apparent in comparison with its East Asian neighbors. The failure of modernization led to mounting internal criticisms and, after the purge of the extreme leftist Gang of Four in October 1976, increasing political emphasis was placed on "readjustment and reform" (Ho S. and Huenemann R., 1984: 56).

China's repudiation of the closed door policy and its intentions to more fully embrace FDI as a vehicle to obtain advanced technology and assistance in achieving objectives of modernization soon became part of national economic strategy. In particular, this new emphasis was explicitly recognized by the formal inclusion in 1977 of the Four Modernizations[15] within the Chinese Constitution, and in the Ten-year Plan (1976-85) announced by the First Session of the Fifth National People's Congress in 1978 (Li, 1997: 72-3). The subsequent measures to facilitate the entry of FDI followed directly from this plan. While controversy over the use of foreign capital continued, in 1978 China

[15] To realize modernization of agriculture, industry, science and technology, and military by the end of this century.

agreed to further loans and in 1979 the government introduced Reform and Open policies --- a series of steps to facilitate FDI in China.

The open policy is rooted in China's selfacknowledged weakness. As Deng, stated: "China's power in science and technology was weak. From a macro viewpoint, China was behind the developed countries for twenty or thirty years in science and technology" (Deng, 1985: 117). For Deng Xiaoping (Deng 1989: 105), the policy of openness was essential for accessing FDI, not simply as a source of jobs, but to provide learning about advanced technology and to speed up the rate of modernization.

China's open policy to FDI should not be mistaken for laissez faire. Rather, the open policy was conceived as a regulatory strategy which seeks to control as well as stimulate FDI and its positive effects. This strategy is overtly geographical. Thus, in the original formulation of the open policy, FDI was limited to the four SEZs of Shenzhen, Zhuhai, Xiamen and Shantou that China had originally designated for FDI from overseas Chinese sources. In 1984 and 1985, the spatial restrictions on FDI were broadened to include 14 cities. The designated area strategy is intimately related to aspirations to facilitate the flow of overseas Chinese capital with the proximity of the special and open areas to Hong Kong, Macao and Taiwan.

China's open policy to attract FDI is to absorb technology and stimulate export-oriented development in the coastal regions, in this context, the role of overseas Chinese investment, as exemplified by the Hong Kong connections is extremely important in China's last two decade economic development and warrant further study.

CHAPTER FOUR

THE DEVELOPMENT OF FDI IN CHINA IN ITS OPEN ERA

4.1 AN OVERVIEW OF FDI IN CHINA

4.1.1 Motives of China's Open-door Policy

At the Third Plenum of the Eleventh National Party's Conference held in December 1978, China adopted an 'open door' policy that opened its economy to foreign investment. This was a major shift from it past policy of self-reliance that resulted in stagnation and closing of its economy to the outside world. During the last twenty-year period, 1979-1998, China made great strides in its domestic economic development and foreign trade relations by establishing five Special Economic Zones (SEZs) --- which include Shenzhen, Zhuhai, Shantou, Xiamen, and Hainan; fourteen open-trade coastal cities, Pudong of New Shanghai Area, and economic development zones across the country (Grub and Lin, 1995:18). They are designed as target areas for attracting FDI.

In its quest for economic modernization, China has suffered from two severe bottlenecks: lack of savings for capital formation and foreign exchange constraints. Consequently, China has sought an inflow of foreign capital to increase its capital formation, and it has attracted export-oriented industries to the country to increase its foreign exchange earnings, thereby alleviating the two constraints. In addition, foreign investment has facilitated the transfer of technology know-how and management skill, both badly needed by China in its modernization drive. These are the main objectives behind China's open door policy.

4.1.2 Types and Structures of FDI in China

According to the classification used in China, utilization of foreign capital takes the following three forms:

(1) Foreign loans by foreign governments and international development agencies such as World Bank and Asian Development Bank (ADB);

(2) Foreign Direct Investment (FDI), which includes equity joint ventures (EJVs), contractual joint ventures (CJVs), wholly foreign-owned enterprises (WFOs), and joint development ventures (JDVs), which relate mainly to oil exploration; and

(3) Other foreign investment, which includes compensation trade,export processing, and international leasing. An EJV, commonly called as a Sino-foreign joint venture, is a limited company jointly funded through equity by two or more investors. It has the status of a legal person, and

the investing companies share profits or losses in proportion to their respective equity shares.

A WFO is a branch founded by a foreign firm, or it can be an independent enterprise formed by a foreign company or a group of individuals outside China. A CJV is a loose form of enterprise where Chinese and foreign partners cooperate in operations and management as prescribed in the contract. The Chinese side often provides land, natural resources, labor, local equipment, or facilities, but does not contribute equity funds. The foreign partners often provide funds, technology, major new equipment, and materials. Under a CJV, profits or losses are split according to a ratio agreed upon beforehand. Finally, a JDV is a joint investment by Chinese and foreign interests that is limited primarily to exploration of offshore oil resources. Output, once produced, is divided between both sides according to contract terms.

Table4.1 FDI in China 1994, Average Value per Project (US$ Million)

	Number of Projects	*Contracted Value*	*Average US$ per Project*
EJV	12,268	31,876	2.52
CJV	2,849	14,297	5.02
WFO	9,062	26,810	2.96
JDV	17	293	--
Total	24,556	73,276	2.98

Source: MOFTEC, *Almanac of China's Foreign Economic Relations and Trade. 1996.*

Table 4.2 Utilization of FDI, 1979-1994 (100 Million U.S. Dollars)

Contractual	Number of Projects	Value
1979-1989	21,776	337.56
1990	7,273	65.96
1991	12,978	119.77
1992	48,764	581.24
1993	83,437	1,114.36
1994	47,549	826.80
Realized	Number of Projects	Value
1979-1989	-	154.95
1990	-	34.87
1991	-	43.66
1992	-	110.07
1993	-	275.15
1994	-	337.67

Source: China Statistical Yearbook (various years) zhong gou tong ji nian jian.

4.1.3 FDI in China 1979-94

Table 4.1 and 4.2 show the utilization of FDI from 1979 to 1994. During this period, total contractual or pledged FDI totaled US$ 228.4 billion, while total realized value of FDI was US$ 66 billion. During the early years, the FDI followed a zigzag path. It grew slowly in the initial years but suffered a drastic decline in 1986 due to a deterioration of the investment climate. When the Chinese government started to take serious action to rectify the situation, FDI began to gradually recover until the outbreak of the pro-democracy movement in the summer of 1989. After the Tiananmen Incident of June 4th, 1989, China was sanctioned by a number of Western countries. In addition, an economic entrenchment program initiated in 1988 to curb high inflation rates had an adverse effect on FDI in 1989. According to the data published by the Ministry of Foreign Economic Relations and Trade, the pledged FDI projects had declined from 5,945 in 1988 to 5,779 in 1989, representing a negative growth rate of –2.8 percent. Total commitments in 1989, recorded only a moderate growth of 6.1 percent as compared to 1988, and the number of EJVs and CJVs declined by 6.4 percent and 27.3 percent, respectively.[16]

In the second half of 1990, FDI in China began to recover as Western countries gradually normalized their relations with China, in particular after the lifting of economic sanctions by France, which had initially adopted a tough stance against China's crackdown on the pro-democracy movement. FDI flocked back to China after a cooling-off period, and FDI continued to increase in 1991. The high growth rates in 1992, and 1993, were partially due to the huge investments in real estate from Overseas Chinese. Certainly the optimism of FDI in China was spurred by Deng Xiaoping's visit to the south coastal SEZs in January 1992, when he argued for more rapid development of the open door policy. It was also helped by the adoption of the so-called "socialist market economy" doctrine at the 14th China Communist Party (CCP)

[16] Calculated from MOFETC, *Almanac of China's Foreign Economic Relations and Trade*, 1989/98 and 1990/91.

Congress held in October 1992. According to a report by Xihua News Agency, total commitments of FDI to China during the fist nine months of 1992 had far surpassed those of Indonesia, Malaysia, and Thailand, three of the booming Southeast Asian countries which compete with China for FDI.[17]

The relative shares of various forms of FDI have changed over the years in China. As presented in Table 4.3 in the first few years of opening to the outside world, China's utilization of foreign funds was realized mainly through contractual joint ventures, joint oil development ventures, and "compensation trade and export processing ventures." Together, these accounted for 82 percent of FDI during 1979-1984 (Hiraiwa, 1992: 11). EJVs and WFOs were relatively unimportant during that period. CJVs and "compensation trade and export processing ventures" in particular were generally smaller in scale and of low-skill labor-intensive industries which were located mainly in four SEZs and Pearl River Delta area of Guangdong Province. A majority of the foreign investors took advantage of low wages and cheap land prices in China. In addition, the forms of CJVs and export processing ventures were quite flexible and usually required no cash outlay by Chinese partners.

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[17] *People's Daily*, October 14 1992.

As shown in table 4.3, EJVs have become increasing important since 1985. The number of WFOs also surged after 1987 whereas CJVs and "other investment ventures" were declined. The increase of WFOs was due mainly to three factors.

Table 4.3 Percentage Shares of Various Forms of Foreign-Invested Enterprises to Total FDI, 1979-1993 (Contractual Values) ..

Year	EJV	CJV	WFO	JDV	Other* Investment	Total FDI Value in US$ 100 million
1979-84	13.4	45.6	4.6	23.5	12.9	103.3 (100%)
1985	32.1	55.2	0.7	5.7	6.3	63.3
1986	41.3	40.8	0.6	2.4	14.9	33.3
1987	45.2	29.7	10.9	0.01	14.1	43.2
1988	50.6	26.2	7.8	1.0	14.4	61.9
1989	42.3	17.2	26.3	3.2	11.0	62.9
1990	38.7	17.9	35.0	2.8	5.6	69.9
1991	49.0	17.2	29.5	0.7	3.6	124.2
1992	49.6	22.6	26.7	0.07	1.1	587.3
1993	49.3	22.8	27.2	0.3	0.4	1,119.7

Note: * includes compensation trade, export processing, and international leasing.
Source: *Almanac of China's Foreign Economic Relations and Trade* (various years).

First, there was a huge surge of FDI from Taiwan in the late 1980s. Taiwan investors usually are inclined to control their own companies rather than to cooperate with partners. Second, considerable costs and time involved in the coordination of technology and management deemed essential in EJVs and CJVs was avoided by establishing WFOs. Third, there was greater acceptance by the Chinese government of WFOs, which are export-oriented and bring into China much needed foreign-exchange earnings.[18] It is worth noting that many EJVs and WFOs have been established by well-known multinationals and conglomerates from all over the world. China has been quite successful in attracting large-scale, high-tech foreign enterprises to invest in the country in recent years.

4.2 DETERMINENTS OF ENTRY MODES, TRANSACTION COSTS, AND CULTLURAL DISTANCE

Entry modes are the ways or legal forms in which foreign investors enter the intended host country. In terms of property rights, entry mode is the ownership structure of a foreign subsidiary.

What determines the choice between a WFO and an EJV by a foreign investor? In the past two decades, transaction cost theory has been broadly employed to explain foreign investors' international investment activities, including their choice of entry model.[19] They argue that transaction costs are major tend to choose an entry mode that minimizes transaction costs.

Cultural distance is a further important factor determining the entry modes of foreign investors into the host country's market. It refers to the

[18] China— Growth From Foreign Direct Investment. http://pacificrim.bx.com/articles/1~3chinafdi.htm
[19] Oliver Williamson (1979), Mark Casson (1985), Alan M. Rugman (1985).

difference in social culture between the home and host countries. It is often argued within the transaction cost framework that the greater the cultural distance, the lower the degree of equity participation for which a foreign investor should aim (Hu and Chen, 1993:149-60). This can be attributed to two factors associated with cultural distance. First, cultural distance creates enormous information needs, hence high information costs for intending foreign investors. This is because in a dissimilar cultural environment foreign investors have little knowledge of local markets and business practices, and they find it difficult to transfer home technologies and management skills to an unknown operating environment. Second, operating in a foreign culture at a distance increases business uncertainty and unpredictability. These disadvantages can be avoided by forming joint ventures with local firms.

In terms of cultural distance, foreign investment in China can be classified into three groups. The investors from Hong Kong and Taiwan are the first group, the investors from other East Asian countries are the second, and "Western" investors are the third. Hong Kong and Taiwan investors are Chinese and share the same culture with people in China. In contrast to true "foreign" investors, these Chinese investors have advantages both in language, cultural traits, and ethnic links, and in access to Chinese society. These advantages allow them to enter into China market easily, with less reliance on local firms. Therefore, investors in this group are expected to be less dependent on local firms for management and market information. In many cases it is unnecessary for them to form EJVs with local firms to reduce transaction costs associated with an unfamiliar operation environment (Sun, 1998 forthcoming). Owing to this close cultural ties between Hong Kong, Taiwan and Mainland China, investors from the first group have a lower inclination to set up EJVs in China than other groups of investors. For instance, during the period from 1987 to 1992, the proportion of the FDI in EJVs to the total FDI by Hong Kong is 47 percent on average, compared to 52 percent for Japan, 59 percent for Singapore, 68 percent for the US, and 84 percent for the EU[20]. This indicates that the greater the cultural distance from China, the higher the propensity for investors to use EJV as the main entry mode. Cultural difference appears to be the main reason for Western investors to take joint venture as the principle entry mode into China's market and the less percentage of FDI in China comparing to that of Hong Kong and Taiwan.

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[20] MOFTEC, PRC, *Annual Statistical Report on the Utilization of Foreign Capital*, Beijing 1987-91. MOFTEC, PRC, 1993, *Statistical Panorama of Foreign Investment Enterprise in China*. Beijing.

4.3 MAJOR INVESTORS

4.3.1 Hong Kong Investment in Mainland China

By 1995, investors from over 80 countries or areas had invested in China. Although these large numbers of countries have made direct investments in China, the primary sources of FDI have been highly concentrated among several large investors. Hong Kong has been the largest investor area taking up over 60 percent of total FDI during 1979-1995. The cumulative value of pledged FDI by Hong Kong was US $ 237.7 billion.[21] It should be stressed that part of the investment flow from Hong Kong originated in Southeast Asia. Some Overseas Chinese and Taiwan businessmen invested in the mainland through subsidiaries registered in Hong Kong to avoid scrutiny from their home governments (Sung, 1995:19). Investing in China by wealthy overseas Chinese businessmen is politically sensitive in some Southeast Asian countries such as Indonesia, which broke diplomatic relationship with China after the Indonesia Communist Party was linked to the coup d'etat in 1965. The two countries reestablished diplomatic ties only in 1992. Since then, the Indonesian government has adopted a more positive attitude toward

[21] *China News Digest*, Canada based Chinese News Group. December 1996. China Profile.Internet Connection.

its ethnic-Chinese citizens regarding investments in China (Weidenbaum, and Hughes, 1996: 27-9). In Taiwan, investors were legally prohibited from investing in China prior to 1990, although Taiwanese businessmen found ways to circumvent government restraints by registering ventures through Hong Kong. The rule was relaxed in 1990 to allow Taiwanese firms to invest in the Mainland through proper registration with the Taiwan authority (Burstein, and Deijzer, 1998: 107). Consequently, future accounting for FDI through Hong Kong will be more accurate, but data on investment flow for previous years coming from Hong Kong include Taiwan and other Southeast Asian countries.

Moreover, there are some China-funded firms in Hong Kong that have established joint ventures with other domestic Chinese firms. The bogus joint ventures were established to take advantage of the preferential treatment given to joint ventures. Clearly the existence of the "recycled investment" overstates the flow of FDI from Hong Kong (Chakwin, and Hamid, 1997: 221-22). However, its magnitude is unknown, as China has published no official data.

Table 4.4 Sources of FDI in China 1979-1996 (Contracted Value in US$ Billion)

Location	*Number of Projects*	*Accumulated FDI Value*
Hong Kong	168,346	270.01
Taiwan province	35,033	34.60
Japan	15,002	26.39
US	22,248	35.18
Singapore	6,697	23.61
South Korea	8,117	11.02
Germany	1,800	11.93
Britain	1,503	5.41
Canada	3,169	4.51
Australia	2,687	3.89
Others	19,218	42.83
Total	283,820	469.38

Source: *Foreign Investment in China*. China Economic News, 1997. http://www.uschina.org.

In the initial stage of the open door policy, Hong Kong investment was dominated by assembly and processing projects. Most of the joint ventures established by Hong Kong firms were small in capital sizeand concentrated in labor-intensive manufacturing sectors. From 1983 to 1992, average capital size of Hong Kong FDI projects was US$ 1.12 million. As Hong Kong investment partially shifted to some large infrastructure projects, its average capital size increased to US$1.46 million in 1992 and US$1.78 million for the 1993-95 period (see table 4.4).

One of the primary driving forces for Hong Kong investment in China are the structural transformation form labor-intensive industries to technology-industries in Hong Kong and China's increasing openness. Because of the rapid growth of labor costs in Hong Kong since the later

1970s, labor-intensive manufacturing industries have lost their traditional competitiveness. Another driving force is the geographical, cultural and language affinity between Hong Kong and Guangdong province. These has spurred the transfer of labor-intensive export industries from Hong Kong to southern China, where geographic and cultural proximaties to Hong Kong facilitate investment activities.By 1996, nearly 80 percent of Hong Kong's manufacturing industry had been moved across the border to the Pearl River Delta.[22]

4.3.2 Taiwan Investment in Mainland China

Taiwan ranks second only to Hong Kong in FDI's flow in China, although it is a relatively recent entrant into China' market. By the end of 1995, the pledged FDI by Taiwan in China amounted to US $30 billion, accounting for 7.7 percent of the total pledged FDI. The United States is the third largest investor, accounting for 7.2 percent of the total pledged FDI. It is followed by Japan with 5.2 percent, Singapore with 4.4 percent, and Britain with 2.3 percent (table 4.5)

[22] Hong Kong-China Key Facts. http//www.hong kong. Org/htm

Table 4.5 MAJOR INVESTING COUNTRIES IN CHINA 1983-1995

Countries	*Number of Projects*	*Contracted FDI Value (US$ Billion)*	*Share Percentage %*	*Average Size (US$ Million)*	*Realized FDI Value (US$ Billion)*
Hong Kong	156,818	237.74	60.86	1.52	79.73
Taiwan pro	31,473	30.00	7.68	0.95	11.43
US	19,708	28.00	7.17	1.42	10.73
Japan	13,252	20.43	5.23	1.54	10.28
Singapore	5,888	17.27	4.42	2.93	3.91
South Korea	6,222	6.77	1.73	1.09	2.26
Britain	1,469	9.07	2.32	6.17	2.18
Germany	1,243	4.25	1.10	3.42	1.18
Canada	2,738	3.94	1.01	1.44	0.73
Australia	2,319	3.33	0.85	1.44	0.74
Other	17,134	33.00	8.45	1.93	9.50
Total	258,264	393.80	100.82	1.51	132.67

SOURCES: Calculated from data in People's Republic of China (PRC), Ministry of Foreign Trade and Economic Cooperation (MOFTEC), *Almanac of China's Foreign Economic Relations and Trade (Beijing:* Zhong Guo Shie Hui Ban Shi, annual, 1984-1994) (hereafter MOFTEC, Almanac); PRC, State Statistical Bureau (SSB), Statistical Materials on China's Commerce and Foreign Economic Relations; SSB, *China Foreign Economic Statistical Yearbook*, 1996 (hereafter SSB, Foreign Economic Statistical Yearbook).
FDI. Foreign Direct Investment. Contracted FDI refers to the value of projects proposed and approved; Realized FDI refers to the value of investment actually undertaken as of the given date.

Taiwanese investment in China was officially prohibited by the Taiwan authority before 1987. Since the promulgation by the Chinese government of the Regulations on Encouragement of Investment by compatriots from Taiwan in 1988, Taiwan's investment on the Mainland has grown dramatically. Pledged FDI by Taiwanese firms increased from US$520 million in 1988 to US$9,965 million in 1993, and realized FDI from US$222 million to US$3,139 million (Chung, and Cai, 1993:18).

Taiwanese investment projects in China are centered in labor-intensive and export manufacturing industries such as electronic and electrical appliances, plastic and rubber products, bicycles, food processing and beverage, footwear and toys, textiles, garments, and small service industries. Accordingly, the average size of Taiwanese projects is smaller than the average size of all FDI projects (Table 4.5). Taiwan's investment is largely located in Guangdong, Fujian, and Jiangsu provinces, directly across the strait.

The principal reasons for the rapid growth of Taiwanese investment in China are similar to those driving Hong Kong investment, namely, the rise in labor costs and industrial transformation from labor-intensive to capital and technology intensive production. This has forced Taiwanese and Hong Kong manufacturers to shift labor-intensive production to regions where labor costs are lower labor cost in Mainland. China have been estimated to be only one-third of those in Taiwan. Hong Kong and Taiwanese investments in China are largely oriented to exports. In addition, geographic proximity and similarities in regional Chinese culture and common dialect promote Hong Kong investment in Guangdong and Taiwanese investment in Fujian. These issues will be discussed in detail later.

4.3.3 Overseas Chinese of Southeast Asia Investment in China

Investment by Southeast Asian countries has also grown rapidly. Singapore resembles Hong Kong in being an urban enclave whose labor costs have risen dramatically, but differs from Hong Kong in that Singapore projects are above-average size and have been guided into industrial parks in Suzhou and Wuxi in Yangtze Delta of Jiangsu Province developed by the Singapore government. The investors from Malaysia, Thailand, and Indonesia are mainly Overseas Chinese businessmen. Their investments share some common features with Hong Kong and Taiwan investments, notably the small size of their investment projects and preference for close cultural connections. However, they also have distinguishing features to wit: (1) Overseas Chinese investors in Southeast Asia are motivated not so much by China's low labor costs and abundant land, which are already available in their own countries, but rather by China's expanding consumer demand. (2) Their investment flows mainly into China's primary industries and infrastructure construction. (3) These entrepreneurs tend to locate their projects in their ancestral towns and provinces, and as their ancestral origins were scattered widely in China, these Overseas Chinese investors advance into towns or provinces often ignored by other foreign investors. (4) Overseas Chinese are reputedly cash rich and debt free, and therefore able to commit to long-term investment, rather than seeking the quicker profits to be had from export processing (Weidenbaum, and Hughes:25-30).

4.3.4 The US and Other Western Countries' Investment in China

The patterns of investment by the United States and other Western countries differ from those of Hong Kong, Taiwan, and Southeast Asian countries. There are four aspects of these differences: (1) Investment by these advanced industrialized countries is largely in capital and technology intensive industries, and is generally of high technology content. Accordingly, the sizes of investment projects undertaken by these industrialized countries are generally larger than those made by Asian emerging investors. For instance, the average size of British and German investment projects is US$6.2 million and 3.4 million respectively during the 1983-95 period (see Table 4.5). (2) Most United States and European investment projects are aimed at China's domestic market. China's economic reforms, trade liberalization and increasing openness, and rapidly rising personal incomes are important reasons for these investments. Access to China's huge consumer population is the principal motivation for many multinational corporations from the United States and other industrialized countries. This is to some extent different from the incentives for Hong Kong and Taiwan investments, which are largely oriented towards exports using cheap labor. (3) Rather than primarily locating investment projects in theSEZs or other coastal areas, many American and European companies prefer to put their projects in major industrial and commercial centers such as Beijing, Shanghai, Tianjin, Guangzhou, Wuhan, and Shenyang. For example, during the period 1979 to 1989 only 47 percent of U.S. EJVs were located in the coastal region, much lower than Hong Kong's 67 percent.[23] (4) The duration of the U.S. joint ventures is longer. According to a database (2,491 equity joint ventures) prepared by the U.S.-China Business Council, the average duration of US EJVs is 15 years.[24]

4.3.5 Japanese Investment in China

At the end of December 1997, some 16,295 contracts for investment by Japan in China had been concluded for a total value of

[23] U.S.-China Business Council, *Special Report on U.S. Investment in China, 1990.* Washington, DC: China Business Forum, 1990.

[24] Ibid.

US$30.4 billion, with the actual amount invested reaching US$18.7 billion (Shinichiro, 1998: 10). Recent Japanese investment in China has the following characteristics. (1) Although early Japanese investment in China was intended to take advantage of low Chinese labor costs, more recently there is a growing movement toward securing a basis from which to target the rapidly expanding Chinese market for domestic sales. Also, investment in the manufacturing industry account for 85 percent of the total, a marked contrast with investment by overseas Chinese, which is concentrated on real estate and labor intensive industries.[25] (2) The influx of large manufacturers has led parts manufacturers to follow, which has in turn brought in materials manufacturers, such that broad categories of industry from the upper and lower reaches of the industrial stream have moved into China. (3) Supporting industries are also increasingly moving into China to supply molds, materials for molds, distribution services, printed packaging materials, and wrapping materials. (4) With the expansion of domestic sales within China, Japanese firms tend to be increasingly locating their operating bases around such areas, where economic concentration is high, as the Eastern

[25] Japanese investment in China is very disputed. For over a long period of time, Japan fell behind other industrialized countries to investment in China, which was perceived as fear of China's rise as a competitor explained by some Chinese scholars. However, in recent years Japan invested heavily on the mainland China partly due to the stable and healthy political and economic development there.

region centered around Shanghai, as well as the Northern district, which is the greater capital region including Beijing andTianjin (see table 4.7). (5) With increasingly pronounced multi-sector development on the part of large business firms, many are moving to establish holding companies. The sense is that these firms are eager to become deeply involved in the Chinese market. (6) Some Japanese big corporations have just started bold investments in such fields as automobiles, semi-conductors, and telecommunications, even though these same industries had previously been negative for large scale investments.

Compared to Japanese firms, European and American companies have been much quicker in seeing China less as a source of labor and more as a huge market of 1.2 billion people. These companies have consistently planed huge projects aimed at supporting the Chinese market (including petrochemicals, automobiles, foodstuffs, communications equipment, film, and the like). In particular, the appearance of leaders with strong practical experience and will to reform, such as premier Zhu, Rongji, and the steadiness of China in the midst of recent economic disorder in other Asian countries have both helped to boost confidence in the nation further. At the conference on introducing foreign investments held at the end of last year, China resolved to step up efforts to attract

Western multinationals, which do not shy away from major investment and technology transfer. Western firms are therefore expected to speed up their advance into China.[26] Compared to Hong Kong and Taiwan investment, the impact of investments from all these aforementioned countries on Chinese development is in fact minor (see table 4.4, 4.5).

4.4 REGIONAL DISTRIBUTION OF FDI IN CHINA

An important characteristic of FDI in China is its concentration in the coastal region. Table 4.6 compares pledged and realized FDI in the 1980s with the 1990s. In the 1990s, FDI gradually spread over the vast inland regions, resulting in a small increase in the share of FDI in the central and western regions. The overall pattern of the regional distribution of FDI, however, remained virtually the same as in the 1980s. During the period 1979 to 1989, 92.2 percent of total pledged FDI in China was located in the coastal region, and despite the huge increase in the totaling the first half of the 1990s, this proportion declined only slightly, to 87.3 percent. The proportion that flowed into the twoinland regions (the central and western regions) was very small.The increase of

[26] There are large sources of Foreign Direct Investment in China from the US and other industrialized countries. Among them to name a few: PC21 Taking Your Business to China. http//www.pc21. Global

Info Network, China Investment Statistics. China Profile. http//www.aeagroup.com

FDI in the inland regions was concentrated in the central region, whose share of the total FDI doubled from 4.5 percent in the 1979-89 period to 7.6 percent in the 1990-95 period, whereas the share of the western region declined from 4.6 percent to 3.5 percent (see Table 4.6). Realized FDI has the same distribution pattern; 90.2 percent of realized FDI flowed into the coastal region in the 1980s, and 87.3 percent in the first half of the 1990s, while the central and western regions together received a mere 8.6 percent and 11.4 percent in the two periods respectively. Although the share of the central region in total FDI displays an increasing trend over time, it is almost offset by the decline in the western region's share. This indicates that the regionalspread of FDI from the coastal region to the inland regions are making only slow progress.

Within the coastal region, Guangdong province is the largest recipient of FDI. It cumulatively received FDI of US$ 39.2 billion from 1983 to 1995, accounting for 35 percent of the total realized FDI in China. Jiangsu province is the second after Guangdong in receiving foreign investment, accounting for 11.7 percent of the total realized FDI. Fujian province, the second largest FDI recipient before 1994, is now in the third position with 11 percent. This is followed by Shanghai 8.2

percent, Shangdong province 6.8 percent, Liaoning province 4.5 percent, Beijing 3.4 percent, and Zhejiang province 3.3 percent (see table 4.6).

There are two basic reasons for the imbalance of the regional distribution of FDI in China. (1) The open door policy has been oriented to the coastal region since 1979. The Chinese government initiated the open door policy by establishing four SEZs, where special policies favorable to foreign investors were implemented. In 1984, the government opened 14 coastal cities and granted them policies similar to those of the SEZs. Since then there has been a significant shift in FDI from the SEZs to other open coastal areas. In 1986, the Chinese government extended the "open zone" to the "three deltas" including the Pearl River Delta, the Minnan Delta (the south part of Fujian), and the Yangtze River Delta. In 1988, Hainan Island become the fifth SEZ. In the early 1990s, Pudong New Area in east of Shanghai became a new focus of foreign investment, with support by government preferential policies (Zweig, 1995: 253-74). In recent years, although the central government has encouraged inland provinces to open up to foreign investment, and many more preferential policies are also applied to central and western regions, the regional distribution of FDI is still concentrated in the coastal provinces (table4.6). (2) The coastal region has advantages over the inland regions in economic conditions and investment environment. According to international production theory, location-specific factors account for a particular pattern of locational distribution of foreign investment. It is a common feature in most developing countries that the extent of the spatial diffusion of foreign investment is limited and most of these investments concentrate in major economic centers or more developed regions. This is because economic and social infrastructures in major economic centers are more developed than in other regions. In terms of transaction cost theory, the advanced facilities help the investors to reduce information and relevant costs by improving the efficiency of production and marketing. In the Chinese case, the coastal region and major economic centers like Beijing, Shanghai, Guangzhou, and Tianjin are more developed in their industrial facilities, education, and communication systems than are the inland regions. Traditionally, the coastal region was more developed than the inland regions in economic structure, industrial infrastructure, public utilities, convenient geographic location for transportation of export and import, plus most of the Overseas Chinese originate from these areas. In the past two decades, the coast-oriented opening policy and economic development have further improved the investment environment of the coastal region. As a result, the gap between the coast and the inland in economic conditions and investment environment has widened. Thus, the concentration of FDI in the coastal region associated with better physical and social infrastructures and liberalized economic conditions.

Table4.6 DISTRIBUTION OF CONTRACTED AND REALIZED FDI IN CHINA 1979-1995 (US$ Millions)

	Contracted FDI				Realized FDI			
Location	1979-89 VALUE	1979-89 %	1990-95 VALUE	1990-95 %	1983-89 VALUE	1983-89 %	1990-95 VALUE	1990-95 %
Coastal								
Guangdong	15,119	52.3	108,233	30.1	5,141	44.6	34,069	29.2
Fujian	2,219	7.9	36,414	10.1	757	6.5	12,798	11.0
Jiangsu	748	2.6	39,254	10.9	324	2.8	13,597	11.7
Zhejiang	466	1.6	13,193	3.7	160	1.3	3,814	3.3
Shanghai	2,654	9.2	30,279	8.4	944	8.1	9,572	8.2
Shangdong	682	2.4	21,755	6.0	646	5.6	7,931	6.8
Hebei	345	1.2	7,225	2.0	72	0.6	1,645	1.4
Beijing	1,847	6.4	15,823	4.4	1,256	10.9	3,991	3.4
Tianjing	479	1.7	11,147	3.1	287	2.4	3,352	2.9
Liaoning	927	3.2	15,335	4.3	379	3.2	5,231	4.5
Guangxi	524	1.8	7,250	2.0	202	1.7	2,592	2.2
Hainan	548	1.9	10,982	3.1	292	2.5	3,208	2.7
Total	***26,558***	***92.2***	***316,890***	***88.1***	***10,460***	***90.2***	***101,790***	***87.3***
Central								
Heilongjiang	198	0.9	3,159	0.9	97	0.8	1,129	1.0
Jilin	75	0.3	2,813	0.8	16	0.1	989	0.8
Shanxi	36	0.2	1,150	0.3	18	0.1	244	0.2
Henan	265	1.1	4,309	1.2	126	1.0	1,267	1.1
Hubei	171	0.7	5,595	1.6	78	0.6	2,043	1.8
Hunan	105	0.5	3,653	1.0	58	0.5	1,412	1.2
Jiangxi	99	0.4	2,515	0.7	37	0.3	884	0.8
Anhui	51	0.2	3,100	0.9	29	0.2	1,184	1.0
Nei Mon	38	0.2	724	0.2	12	0.1	193	0.2
Total	***1,038***	***4.5***	***27,018***	***7.6***	***471***	***3.7***	***9,355***	***8.1***
Western								
Shaanxi	1,007	3.5	2,290	0.6	344	2.9	916	0.8
Other	136	0.5	3,127	0.9	116	1.0	849	0.7
Total	***1,321***	***4.6***	***12,458***	***3.5***	***584***	***4.9***	***3,916***	***3.3***
Grand Total	**28,917**	**101.3**	**356,366**	**99.2**	**11,515**	**98.8**	**115,061**	**98.7**

SOURCES: MOFTEC, Almanac, 1984-1994; SSB, *Foreign Economic Statistical Yearbook, 1996.*

Notes: Percentage may not total 100 percent due to rounding. Method: percentage columns are FDI in each province or region/the total FDI in China.
"Other" provinces in the western region include *Xinjiang, Ningxia, Gansu, Qinghai, Yunnan, and Guizhou.*
"The grand total" refers to the total FDI registered in all regions; it does not include FDI introduced by government ministries. Pledge value of the latter was US$6,610 million, and realized value was US$6,538 million in the 1983-95 period.

Apart from the general features of regional distribution of FDI, the major foreign investors concentrate in the Southeast coastal region with 41.7 percent of Hong Kong's investment in Guangdong province alone and 10.9 percent in Fujian over the period from 1987 to 1993. Other investors show different spatial patterns. As tables 4.6 and 4.7 show, Taiwan investment concentrates in Fujian, with 19.1 percent followed by Jiangsu 18 percent, Guangdong 13.6 percent, and Shandong 8.2 percent. U.S. investment spreads more widely, with a focus on the major coastal provinces or cities such as Jiangsu 16 percent, Guangdong 13 percent, Shanghai 11.1 percent, Shandong 11.1 percent, Beijing 10 percent, Liaoning 6.2 percent, and Tianjin 5.6 percent. In contrast with the United States, but similar to Hong Kong and Taiwan, Japanese investors also have a regional focus. They choose Liaoning in the Northeast Region and other east industrial provinces and cities as their favored locations. 17 percent of Japanese investment is in Liaoning, followed by Jiangsu 13.8 percent, Shanghai 12 percent, Guangdong 11.2 percent, and Beijing 7 percent.

The spatial patterns of these countries' investments can be explained by variations in geocultural links, the technological nature of investment projects and motivation for investment. Geographic and cultural proximity are the major reasons for Hong Kong investment in Guangdong, where the local people share the same dialect, Cantonese, and have close ethnic links with Chinese in Hong Kong. Similarly, Taiwan and Fujian province not only are geographically adjacent to each other, but also speak the same dialect of Minnan. In comparison to American and European investment, Hong Kong and Taiwan investors are taking advantage of the abundant supply of cheap labor in China to produce goods for export markets. This investment strategy requires short distances from production sites to seaports for exports, which is an additional important reason for the concentration of Hong Kong and Taiwan investments in Guangdong and Fujian provinces.

Table4.7 REGIONAL DISTRIBUTION OF FDI IN CHINA BY COUNTRY/REGION, 1987-1993, PLEDGED VALUE (US$ Millions)

	Hong Kong		***Taiwan***		***Japan***		***US***	
	Value	***%***	***Value***	***%***	***Value***	***%***	***Value***	***%***
Coastal								
Guangdong	56,597	41.7	2,432	13.6	769	11.2	1,495	13.0
Fujian	14,784	10.9	3,419	19.1	243	3.5	396	3.4
Jiangsu	10,665	7.9	3,266	18.0	943	13.8	1,850	16.0
Zhejiang	4,936	3.6	923	5.1	177	2.6	439	3.8
Shanghai	7,006	5.2	921	5.1	816	12.0	1,296	11.1

Shangdong	6,621	4.9	1,461	8.2	609	8.9	1,287	11.1
Hebei	2,025	1.5	306	1.7	430	6.3	299	2.6
Beijing	5,392	4.0	775	4.3	481	7.0	1,110	10.0
Tianjing	1,932	1.4	416	2.3	272	4.0	638	5.6
Liaoning	3,721	2.7	504	2.8	1,181	17.0	717	6.2
Guangxi	4,222	3.1	428	2.4	86	1.3	199	1.7
Hainan	4,736	3.5	761	4.2	278	4.1	462	4.9
Total	***122,637***	***90.4***	***15,612***	***86.8***	***6,285***	***91.7***	***10,188***	***88.5***
Central								
Heilongjiang	1,099	0.8	178	1.0	25	0.4	125	1.1
Jilin	667	0.5	99	0.5	66	1.0	139	1.2
Shanxi	513	0.4	75	0.4	15	0.2	65	0.6
Henan	788	0.6	286	1.6	77	1.1	121	1.1
Hubei	2,376	1.7	404	2.3	54	0.8	129	1.1
Hunan	1,213	0.9	214	1.2	21	0.3	66	0.5
Jiangxi	1,233	0.9	169	0.9	18	0.3	62	0.5
Anhui	907	0.7	128	0.7	17	0.3	147	1.3
Nei Mon	341	0.3	59	0.3	16	0.2	74	0.6
Total	***9,137***	***6.8***	***1,612***	***8.9***	***309***	***4.6***	***928***	***8.0***
Western								
Shaanxi	1,267	0.9	155	0.9	72	1.1	98	0.9
Sichuan	1,065	0.8	231	1.3	45	0.6	100	0.9
Other	1,457	1.1	269	1.5	44	0.6	166	1.4
Total	***3,789***	***2.8***	***655***	***3.7***	***161***	***2.3***	***364***	***3.2***
Grand Total	**135,563**	**100.0**	**17,879**	**99.4**	**6,775**	**98.6**	**11,480**	**99.7**

Sources: SSB, Foreign Economic Statistic Yearbook, 1979-1991 and 1994.
Note: Percentage may not total 100 percent due to rounding.
Taiwan investment is for the period from 1989 to 1993.
Other provinces in the western region include: Xinjiang, Ningxia, Gansu, Qinghai, Yunnan, Guizhou.

Unlike Asian investors, U.S. and other Western investors do not have geographic proximity or close cultural ties with particular regions in China. Therefore, the regional distribution of their investment is not significantly affected by geographic and cultural factors. Rather, the regional distribution of their investments is affected primarily by industrial and technological factors and market orientation. In contrast to the labor-intensive and export-oriented investment of Hong Kong and Taiwan, American and European investments are largely in technologically advanced industries, using capital and technology intensive production methods. This requires a suitably developed industrial base and relevant linkage industries. In the case of China, large cities, especially those in the coastal region such as Beijing, Shanghai, Guangzhou, Tianjin, and Nanjing, are relatively more advanced in industrial structure and technology, and therefore fit the requirements of American and European investment in technological conditions and industrial linkages. In terms of investment motivations, American investments target China's domestic market. For example, over 95 percent of the output of Beijing Jeep (jointly produced with Cherokee) (Mann, 1986: 101-32), and of Motorola's mobile phones are sold in China's domestic market.[27] Making investment in highly populated large cities can effectively facilitate investors' marketing strategies and promote their sales in the domestic market, as it is relatively easy to access local consumers. This is an important reason for the concentration of American investment in large coastal cities and provinces.

[27] See Motorola investment in PRC at Motorola's Global Community. http.//www.global motorola. com

4.5 INDUSTRIAL COMPOSITION OF FDI IN CHINA

In the last decade, FDI has been concentrated in the industrial sector and real estate and public services. As shown in the table 4.8 below, the cumulative contracted FDI in the industrial sector reached US$277,196 million during the period 1979-1996, accounting for 57 percent of the total contracted FDI in China. The real estate and hotel sector is second only to the industrial sector, with contracted FDI of US$ 127, 597 million, 29 percent of total contracted FDI. This is followed by commerce, catering and storage industry (3.7 percent); the building industry (2.8 percent), the transportation, communications, post and telecommunications sector (2.5 percent); and the agricultural sector (1.8 percent).

Over the last two decades, the sectorial composition of FDI has changed dramatically. These changes were contingent on China's economic conditions, industrial policies, andinvestment environment in each individual sector.

Table 4.8 Industrial Sector Composition of FDI in China 1979-1996 (US$ Million)

Sectors	*No. of Projects*	*Contracted Value*	*Average Value Per Project*	*Percentage of FDI (%)*
Industrial	208,339	277,196	1.33	57
Real Estate& Hotel	28,432	127,597	4.49	29
Commerce Catering & Storage	14,351	17,599	1.23	3.7

Construction	7,842	13,001	1.21	2.7
Communications, Transportation, postage & Telecommunication	6,296	11,758	1.66	2.5
Agriculture	7,104	8,598	1.87	1.8
Insurance & Finance	55	795	14.45	0.16
Others	11,401	12,832	1.23	2.7
Total	*283,820*	*469,376*	*1.65*	*99.56*

Source: MOFTEC, Almanac, 1979-1997; SSB: Foreign Economic Statistical Yearbook.1997

Note:*Industrial sector in China includes manufacturing, mining, and power and water supply.

In the early stage of the open door policy, FDI was concentrated on oil exploration, hotels, tourism, and assembling and processing. China's Ten-Year Plan for industrial investment announced by then Chairman Hua Guofeng in 1978 included the construction of 10 new oil and gas fields to supply domestic energy needs and produce foreign exchange, a central pillar of the entire Four Modernization Campaign(Cheng, 1980:90). Since 1984, government policy has changed, and FDI has diversified its sectorial composition. The industrial sector has become increasingly important as a recipient of FDI, whereas the share of FDI in oil exploration declined sharply owing to the decrease in oil prices in international markets and an unfruitful exploration experience. At the same time, FDI in real estate, retained its share, 36.2 percent on average annually from 1983 to 1987. In 1996 contracted FDI in this sector accounted for 57.1 percent of total contracted FDI in China (table 4.9).

The primary focus of the large proportion of FDI in this sector was investment in real estate (especially hotels), tourism, and associated services that the government hoped would earn foreign exchange. Furthermore, in this early period China could not physically accommodate manufacturing investment projects owing to poor infrastructure and also the lack of a well-defined set of regulations governing entry into the domestic market.

After 1987, the Chinese government made great efforts to change the sectorial structure of foreign investment. On the one hand, the government began to discourage investment in tourism and real estate in favor of high-technology and export-oriented manufacturing investment by using different tax rates and approval control. On the other hand, it loosened the restrictions on foreign investors' access to the domestic market and on the requirement for foreign exchange balance in joint ventures. As a result, FDI in the industrial sector increased sharply, to over 80 percent in 1990 and 1991. At the same time FDI in commerce, real estate, and service decreased from 35.8 percent in 1983-85 period to 7.4 percent in 1990 and 14.0 percent in 1991 (see table 3.9).

Table 4.9 Percentage of Sectorial Composition of Contracted FDI in China 1983-1993 (%)

	1983-85	*1986-89*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*
Industry	29.5	64.4	84.4	80.3	56.2	45.9	53.1	67.5
Real Estate	29.7	23.7	6.9	12.6	31.1	39.3	29.9	19.5
Construction	1.8	1.7	2.7	1.1	3.2	3.5	2.9	2.1
Commerce	6.1	1.5	0.5	1.4	2.7	4.1	4.7	3.8
Agriculture	2.0	2.3	0.2	0.2	1.2	1.1	1.9	1.4

Source: MOFTEC, *Almanac*, 1984-94; SSB: *Foreign Economic Statistical Yearbook, 1996.*

In 1992, Deng Xiaoping made the famous South Talk for more openness and constructing a 'Socialist Market Economy', China has entered into a new stage of economic development. The more open economic environment and high economic growth stimulated a new surge of FDI in China. A remarkable feature of this new boom was a sharp increase in investment in real estate while the share value of FDI in the industry sector declined compared with the later 1980s. The contracted value of FDI in real estate projects accounted for one-third of the total contracted FDI value in the 1992-1994 period (table 4.9). The big jump of FDI in real estate can be attributed mainly to the "real estate fever" that was associated with the "housing reform" program prevailing in major cities across the country. This program, an attempt to commercialize housing allocation through the introduction of the market mechanism, provides an alluring profit perspective for both domestic and foreign investors since demand for housing is very strong.

This situation changed in 1995, which saw a sharp increase in FDI in the industrial sector in contrast to a decrease in FDI in real estate. This shift is largely owing to the stagnant condition of China's real estate market, as the 'real estate rush' in the previous years had resulted in an oversupply of expensive houses and apartments compared to the market demand for housing at an affordable price levels.

Within the industrial sector, FDI has also experienced some changes over the past two decades. According to the definition used in Chinese official statistics, the "industry" sector consists of manufacturing, mining, and power generating and water supply. Within the industrial sector, manufacturing is the core industry. In the manufacturing sector, light labor-intensive industries such as textiles, clothing, toys, footwear, food and beverage, bicycles, and other consumer goods. This group of industries are the major fields in which foreign companies invested. They accounted for over 60 percent of total contracted FDI during the period from 1984 to 1992 (table 4.9, 4.10).

The share of capital and technology intensive industries in total FDI was smaller. This group of industries includes the chemical, machinery, electrical and electronics, transport equipment, and precision instrument industries. They collectively accounted for about 30 percent of total FDI in the industrial sector during the period 1984 to 1992. Of this group, the electronics industry played a leading role in using FDI. It was second only to the textile industry as the largest recipient of FDI. Following the electronics industry are electrical products, machinery, chemical, and transport equipment industries. About 15 percent of the total FDI in the industrial sector flowed into these four industries. The remaining industries are oil exploration and processing; coal mining and processing; metal mining, smelting, and processing; and power generating and water supply --- all mainly resource-based industries in which FDI has remained stagnant since 1984 (table 4.9, 4.10).

Table 4.10 FDI Composition within the Industrial Sectors (US$ Million)

Industry	*1984*	*%*	*1989*	*%*	*1991*	*%*	*1992*	*%*
Textile	70	*10*	*312*	*6.7*	*857*	*8.9*	*2,733*	*8.4*
Chemical	54	7.7	186	4.0	500	5.2	1,590	4.9
Machinery	168	24	234	5.8	638	6.6	1,353	4.1
Transport Equipment	0	0	40	0.9	145	1.5	588	1.8
Electrical	-	-	*245*	*5.3*	*554*	*5.8*	*1,472*	*4.5*
Electronics	64	9.1	258	5.5	767	8.0	2,354	7.2
Precision Instrument	0	0	11	0.2	83	0.9	245	0.7
Oil Exploration	13	1.9	204	4.3	92	1.0	46	0.1
Other Industries	333	47	3,090	66	5,957	63	21,095	65

Source: MOFTEC, *Foreign Capital, 1985-1992.*
Notes: Percentages may not add to 100 due to rounding.
The category "other industries" is extremely heterogeneous. It includes 'light' manufacturing industries such as clothing, toys, footwear, foodstuff, beverages, clocks, furniture, bicycles, plastic products, tobacco, and small metal products, as well as printing. However the category also includes the 'heavy' industries of metal smelting and processing in addition to power generating and water supply.

4.6 CONCLUSION

This Chapter presents a comparative analysis of the characteristics of FDI in China, emphasizing the differences among major investors. Based on systematic analysis of the detailed government statistical information, it is found that the pattern of FDI varies from one country to another, depending on investors' socialcultural links with the host country, the comparative advantages of their home countries, technological nature of investment projects, and investment motivations. In terms of regional distribution of investment, geocultural factors and market-orientations of investment are major determinants of investment locations. Geographic proximity and cultural and ethnic ties account both for the concentration of Hong Kong investment in Guangdong, Taiwan investment in Fujian, and Japanese investment in Northeast China, and also for the dispersion of overseas Chinese investment. Hong Kong and Taiwan investment in Guangdong, Fujian, and other coastal areas also serves their investment purposes, continuing their production of exports by using China's abundant and cheap labor resources. Export-orientation requires the locations of these investments to be close to main seaports in order to reducing transportation costs. By comparison, US, and European investments use relatively advance technologies and mainly target Chinese domestic markets. This requires that their investment be located in major cities and industrial centers, where a large population and better developed industrial facilities are more suitable from both production and marketing perspectives.

The industrial composition of FDI in China varies from one country to another according to the investing country's comparative advantages and investment motivation. I suggest that although their investments span a wide spectrum of business fields, Hong Kong and Taiwan investments are largely concentrated on labor intensive manufacturing industries as a result of the changing structure of their own domestic industrial bases. In Contrast, Japan, American and European investments focus on capital and technology intensive industries using relatively advanced production techniques. The development of FDI in China in the past decades demonstrate that once an economy has become relatively "open" government policy can play an important role in guiding foreign investment, but it cannot completely determine its structure and apparently has little influence on its size. A related point is the observation that as Hong Kong investment increases, the economic integration between Hong Kong and Mainland China advances rapidly. Hong Kong investment has been a driving force of development in southern China. The return of Hong Kong to the motherland took place on July 1st, 1997 did not affect the pattern of Hong Kong investment. On the contrary, it seems that Hong Kong will play an even more important role in China's economic transition, given the fact that the two territories had cooperated successfully before and after the founding of the Special Administrative Region.

The findings give little support to over emphasized, single-factor theories of foreign investment. First, FDI in China is not predominantly Western and Japanese, but Hong Kong and Taiwanese. The findings are broadly consistent with multifactor approaches, such as the main propositions of Dunning's "eclectic" theory of specific factors leading to advantages for certain types of firms in certain environments and geographic distance, largely determine investment locations. The investing country's industrial structure, comparative advantage, and social and cultural affinity also effectively influence the flow-in of FDI and composition.

CHAPTER FIVE

THE IMPACT OF HONG KONG INVESTMENT AND THE ECONOMIC INTEGRATION IN SOUTH CHINA

This chapter examines the present and future role of Hong Kong investment in Mainland China. But, first the author present his empirical impressions of the impact of the open policy to FDI on the rapid development of South China.

Before Deng Xiaoping made his famous South Trip Talk in 1992, I had been to Guangzhou, capital of Guangdong province and Shenzhen, the most successful SEZ next to Hong Kong, several times. I was impressed by the energy and prosperity in Linnan Region (South of Nanlin Mountain, namely Guangdong).[29] In the spring of 1993, when I went to the China Export Commodities Fair in Guangzhou, I was so shocked by the development there that I could not imagine anywhere in this world had experienced such an economic leap in such a short period of time. The slogan on the large plates in the yard of the Export Fair reads: Guangdong will be the fifth Little Dragon by the year 2000. Yes, Guangdong has developed at an unimaginable annual average growth

[29] Guangdong or Linnan, is comparable to Malaysia or Britain in area with 240,000 square kilometers, similar size of population as Thailand of 60 million inhabitants.

rate of 19-22 percent since 1978 (China Profile). The social and economic development level of this province is equivalent to that of New Zealand today.[30] Before 1978, Guangdong's economic and social development was below the average level of the whole country. For national security reason, the central government channeled most of its capital to the north and central part of China, while Guangdong and Fujian 'Frontier' received little investment from the central government (Sung, 1995: 225). Guangdong's 'great leap' is the direct result of Deng's strategic open policy, Guangdong and Fujian benefited most from the twenty years' economic reform and China's effort to integrate into the capitalist world market. South China's first rise brought up the whole country's progress. It is the overseas Chinese, half of them originating from these two maritime provinces, who made South China's rapid growth possible. The ubiquitous Hong Kong and overseas Chinese business operations and the pop culture of Hong Kong and Taiwan in China were the most obvious testament. Nearly 80 percent of our clients in the Export Fair were from Hong Kong and many of them could speak Cantonese, Mandarin and English. Hong Kong becomes a nexus to link the whole world with China through a complex business and financial

[30] China News Digest, 16 September, 1998. Internet China News.

network. Hong Kong entrepreneurs' nimble fitness and sharp business acumen are the best practical 'MBA training courses' for Mainland China's counterparts.

From the start of open-up in 1978 to 1996, Hong Kong's investment in China has accumulated nearly 60 percent of the total FDI of 229.1 billion (Li, C. 1998: 29). Guangdong received the lion's share of those investment from Hong Kong (Sung, 1996: 225). This chapter examines the role of this investment in China. Before analyzing of Hong Kong, the nature of FDI from East Asia, especially those from Asian NIEs (Hong Kong, Taiwan, and Singapore) will be reviewed. What are the impacts of overseas Chinese investment on China's economic development, the transition to a market-oriented economy, and its increasing integration into the world economy? Most of the investment from Overseas Chinese went through Hong Kong to avert domestic scrutiny and political sensitivity. Guangdong province received the greatest share of Hong Kong's investment. In this context, the relation and interaction between Hong Kong and Guangdong are explored, with special attention to Hong Kong's role in South China's economic development.

5.1 Overseas Chinese in East Asian NIEs Investment in China

Asian NIEs share some common characteristics. These rapidly growing economies rely heavily on labor-added value in their production. In the industrialization process, labor is constantly upgraded in skills and quality through training and education. Culturally, these East Asian Confucian societies emphasize human resource development in general, higher education in particular.

Over the years, production and management technology has steadily deepened to the extent that product quality is improved, products increasingly become more sophisticated, and market prices for products rise. Industry has expanded in all sectors including heavy industries. Industrial development is so successful in absorbing rural labors that there is a shortage of low-skilled labor in those economies.

As the Asian NIEs develop, the need for investment market due to the over-accumulation of capital and for alternate sources of manual labor to offset domestic shortages has forced them to decentralize their production to less-developed Asian countries. When the open policy for foreign investment was adopted under China's economic reform, Asian NIEs found a receptive partner in China as a location for offshore production (Kwok, 1992 forthcoming). As Guangdong has culturally, linguistically and historically linked with Hong Kong, the overseas Chinese transnational business network quickly embraced South China as a new member.

5.2 The Impact of Hong Kong Investment in Mainland China

After 1978, China gradually opened its doors to international production and business, with Guangdong designated as the province for such experimentation. China's open-door policy came at a time when Hong Kong's export production had reached a point where Hong Kong was seeking to expand its production to offshore territories. China in general and Guangdong in particular provided the production advantages which had been steadily incorporating Hong Kong into so-called "Great China Economic Entity".[31] China offered the geographic advantages of proximity and convenient transportation, as well as the cultural advantages of an identical language and family ties. Most of the people living in Hong Kong came from the Mainland's Guangdong province, thus a common language and cultural background made the economic integration a quite natural process. Hong Kong seized the opportunity, becoming the first and remaining the largest investor in Mainland. Form

1979 to 1996, nearly 60 percent of utilized FDI in China came from Hong Kong, while in Guangdong, 64 percent of utilized FDI came from Hong Kong. The combined direct investments of the US and Japan reached only 15 percent of the total.[32] Hong Kong relocated 80 percent of its manufacturing industries to the neighboring Guangdong, employing nearly 4 million labor in Guangdong's 7 million manufacturing jobs, while Hong Kong upgrade to a world class city with financial service industries account for 80% of its total GDP.[33]

Table 5.1 Cumulative FDI in China and Guangdong Province (US$ million)

1979-1990 FDI	National Total	To Guangdong	From HK	From HK to Guangdong
Contracted	45,245	20,332	26,480	15,208
Percentage	100	44.9	58.5	33.6
Realized	22,219	8,132	12,888	5,180
Percentage	100	36.6	58.0	23.3

Source: Sung, Yun-wing, the Economic Integration of Hong Kong with China in the 1990s.

[31] Sung, Yun-wing. "*Patterns of Economic Interdependence in the Natural Territory.*" Paper in Southern China, Hong Kong, and Taiwan, Evolution of A Substantial Economy. Ed. Jane Khanna. 1995. The Center for Strategic and International Studies. Washington, D.C. p 14.
[32] MOFETC, *Almanac of China's Foreign Economic Relations and Trade*, various issues, Beijing.
[33] Sally Stewart, "*Return of The Prodigals: the Overseas Chinese and Southern China's Economic Boom*". Paper *in* Southern China, Hong Kong, and Taiwan, Evolution of a Subregional Economy. Ed. By Jane Khanna. 1995. The Center for Strategic & International Studies. Washington, D.C. p.45-47.

It has regained its original function of entrepot of China, which it lost since 1950s,[34] and now serves as the trade middleman between China and the rest of the world. Today, Hong Kong is China's number two largest trade partner and the largest FDI source, contributing greatly to its foreign exchange income and providing expertise in management, marketing, information, and advisory services for Mainland China. Mainland China and Hong Kong have become close economic partners. In the process of emerging as a world city, Hong Kong's economy has become progressively tied to that of China through its Guangdong connection, and vise versa.[35] Trade with China has grown spectacularly. Over the last fifteen years since the open-door policy came into effect, imports from China have grown by more than 20 times to constitute over one third of Hong Kong's total imports in 1995.[36] Export to China have grown by over 540 times, and consisted of over 20 percent of Hong Kong's total exports in 1995.[37] After the return of Hong Kong to China as a Special Administrative Region on July 1, 1997, China and Hong Kong's ties become even closer. With China's foreign exchange reserve

[34] After breakout of Korean War, the West started blockade and sanction against China. Hong Kong lost its traditional entrop and middleman role of China.
[35] *China 2020, Development Challenge in the New Century*, the World Bank, Washington D.C. 1997. P.86.
[36] Ibid. p.86.
[37] Ibid. p.86-87.

of US dollar 140 billion only next to that of Japan, China's promise of supporting of Hong Kong Dollar's linkage with the US dollar thwarted the international speculators' attack earlier this year.[38] A kind of collaborative economic relationships between Hong Kong SAR and China has accelerated both Hong Kong's post-industrial development and Guangdong's industrial development. International commerce, finance, trade, transportation and services remain Hong Kong's primary function, while Guangdong is expected to initiate a program of technological enhancement, labor training, and product upgrading within its industrial development (Sun 1996: 230).

The Hong Kong-Guangdong production integration through transnational investment is a crucial turning point in Chinese history and has profound meaning for its socialist transformation to a market economy with Chinese characteristics. The smooth transfer of Hong Kong's sovereignty on July 1, 1997, the free legislation election held as scheduled in May, 1998, and the first assembly for commemoration of Tiananmen Incident after the return of Hong Kong was conducted as usual in Victoria Park, all of these showed Chinese government won't kill this goose which lays golden eggs. It is in China's interest to keep

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[38] *China News Digest*, October, 1998 Topic on Hong Kong Financial Crisis.

Hong Kong's status quo for fifty years, if Hong Kong goes well, the chance that China can find a peaceful formula for reunification with Taiwan --- a much bigger prize economically and politically--- is greatly enhanced.

5.3 Roles of Hong Kong Investment: Economic Integration of Hong Kong SAR and Mainland China

When I went to Hong Kong in 1993, Hong Kong gave me an impression of an international cosmopolitan which was lacking in the neighboring Guangzhou, capital of Guangdong province. I felt Hong Kong's future was quite important to China's future development direction. In last two decades Hong Kong has become the actual economic capital of South China.

Under the Sino-British Joint Declaration, Hong Kong retains a high degree of autonomy, and is allowed to retain its present social, economic and legal systems for 50 years. Among the assurances that the Joint Declaration provides to the people of Hong Kong is:

- Continuation of the existing economic and social systems and protection of property rights and foreign investment.

- Free movement of goods and capital and free convertibility of Hong Kong currency.
- Continuation of Hong Kong's monetary and financial policies, with no taxes paid to the central government.
- The retaining of English common law and protection of all fundamental human rights by law.
- The right of free movement to and from Hong Kong.
- Autonomy in conducting external commercial relations.
- An independent judiciary and a fully elected legislature of local people

The language of the Sino-British Declaration is sweeping. For example, article 5 reads: "The current social and economic systems in Hong Kong will remain unchanged and so will the lifestyle, ... Private property, ownership of enterprises, legitimate right of inheritance and foreign investment will be protected by law."[39]

Over one year has passed since Hong Kong returned to China's sovereignty, Hong Kong's development is totally beyond the China observers' expectation. The opposite thing happened: With a smooth development towards a democratic society which Hong Kong never

[39] *Basic Law of Hong Kong, Sino-British Joint Declaration*, 1984. Hong Kong, Beijing. 1997.

enjoyed in last 150 years under British administration, Hong Kong's economy went into its serious recession in recent decades due to the contagious Asian financial crisis. However, in comparison with other East Asian countries, Hong Kong's survival ability is impressive.[40] In the last two decades, Hong Kong has served an important role in China's economic development, and will continue to do so.

Initially, China established Special Economic Zones of Shenzhen, Zhuhai, Shantou, and Xiamen, all, except Shantou, situate next to Hong Kong and Jinmen, Taiwan, in order to attract overseas Chinese investment. Hong Kong investment crossed the border and went to the neighboring Shenzhen SEZ to set up production branches by utilizing low-cost labor and land. As China responded by expanding its privileged policies for FDI to Guangdong and other areas, and setting up regulations and laws for FDI, Hong Kong investors ventured to Guangdong, and later other provinces. Hong Kong was replaced by Guangdong's labor, which is demonstrated by Hong Kong's current labor composition which is biased toward service workers.

Cross border and inter-firm freight and personnel movement have also increased. The demand for information, labor, and freight traffic

[40] *"Hong Kong: A New Beginning: Special 1997 issue". Far East Economic Review.* 160, p.144. Dec. 1997.

necessitates new skill training and road networks, forcing Hong Kong government to improve higher education and transportation facilities. The so-called "Front Shop of Hong Kong, and Back Factory of Guangdong", (qianmianchuchuang, houmiangunchang), with Hong Kong concentrating on marketing and Guangdong on production, is now the established mode of transnational production. The garments the domestic traders purchased to sell for domestic inland and foreign markets were mostly made in Guangdong while the design came from Hong Kong in an amazing efficient style. Successful exploitation of Guangdong's labor and land resources has increased the competitive edge of Hong Kong's export industries. As Hong Kong adjusts its public investment to strengthen the economy, it also becomes more dependent on Guangdong.

Investment from other East Asian economies is mostly routed through Hong Kong, notably from Taiwan, where the authority banned direct "Three Connections" with the Mainland: Shipment, Mail, and Telecommunication.[41] The transnational capital generates a flow of goods, technology, finance, and labor. Hong Kong, with abundant expertise in Guangdong investment, is able to provide information and managerial services to the overseas investors. Besides benefiting from these transnational flows, the metropolis takes on an additional "comprador"[42] role for the province's external trade.

The new relations with Guangdong are equally beneficial to Hong Kong: broadening existing production, restructuring labor, offering new investment possibilities, diversifying the economy, Hong Kong's investment covers a wide distribution. Through working with the Hong Kong businessmen, China learned to manage and negotiate with foreign investors. Its experience and wisdom concerning FDI in China turned Hong Kong into the place where potential investors would come to gather information. Hong Kong was crucial to FDI in China, as its experiment became the blueprint for FDI operations by other overseas businessmen.

Therefore, the "Front Showcase in Hong Kong and Back Factory in Guangdong" spatial division of labor involves marketing, design, and administration took place in Hong Kong, and manufacturing and assembly being done in Guangdong. Capital, technology, machinery, and management come from the international metropolis, and the province

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[41] Maria Hsia Chang, " *the Future of Taiwan-Mainland Relations*," paper in book edited by Lin & Myers, Contemporary China and the Changing International Community. University of South Carolina Press. P.199-201.1994.

[42] Comprador refers to the bourgeoisie class in the Third World who acts as a vehicle for the transmission of economic dominance by the industrially advanced countries. They are the agents of foreign establishments acting as intermediary in business affairs and in charge of local employees. In the process, they disseminate private capitalism and exercise influence in development.

provides labor and land. This form of production cooperation propels Guangdong's recent speedy growth and maintains Hong Kong as a world city. For Guangdong, Hong Kong's entrepreneurship, investment, infrastructure, transportation, and financial market make it the indispensable bridge, its trade and communication the expedient window to the world market. Meanwhile, Guangdong is not the sole beneficiary of this process, as it contributes significantly to the growth of Hong Kong's tertiary industry and restructuring Hong Kong to become a world financial center (Hong Kong-China Key Facts).

For South China's economic development, Hong Kong has taken on seven crucial roles: (1) Hong Kong serves as the catalyst of China's transition to market-oriented economy. With China's "completely openness" after Deng's South Tour Talk, the market system has penetrated in to each corner of China from Hong Kong. Investment from Hong Kong brings with it the free enterprise mode of manufacturing and trade. The new market economic model is adopted by local enterprises doing business with foreign investors. The state administration also has to learn the rules of the market economy and makes regulations for the market. (2) Hong Kong investment brings in, apart from new financial capital, economic stability. Part of this capital comes from remittances to families and friends. The rest comes from investment and business loans from the metropolis' business associates. These liquid funds work as a reserve to moderate exchange and saving. With Hong Kong dollars circulating widely, albeit unofficially in South China, Guangdong has a stable hard currency as an alternative medium of exchange (Sung, forthcoming). As the value of Hong Kong dollar is pegged to the US dollar, it acts as a buffer in slowing down inflation and levering out fluctuations in Guangdong. Compared with North China, Guangdong has a lower rate of inflation. The steadier Hong Kong economy provides a stabilizing effect on Guangdong's economy (Zheng, 1991). (3) Hong Kong is the agent for industrialization in South China. Investment from Hong Kong speeds up the industrialization in the coastal area, through furnishing technology, finance, and overseas market. The Overseas Chinese invested labor-intensive export oriented enterprises absorb large number of rural surplus labor and accelerate the process of rural industrialization and urbanization (Lin, 1997). Guangdong's industrial output growth is largely attributed to the growth of FDI. In 1989, more than 97 percent of FDI was channeled to export industries which include the technologically more advanced automobile, chemical, and computer production. Hong Kong accounted for approximately 90 percent of FDI and provided employment for an estimated 3.5 million jobs.[43] Obviously, this kind of economic partnership is mutually beneficial to both Hong Kong and Guangdong. The international business network and modern commerce and technology forwarded by Hong Kong combined with South China's land, labor and raw materials from both Guangdong and other provinces enhanced the production capacity and international competitiveness of this region. Through Guangdong's transportation network, Hong Kong links with other part of the country and opens up both an import and an export market (Sung, 1996: 127-131). (4) Hong Kong changes Guangdong's closed economy into an open economy. The province has intentionally and successfully adopted an outward-oriented economic development strategy. Externally, Guangdong opened up its borders for international investment and trade; internally, it encouraged export-oriented industrialization. The proximity to Hong Kong gives Guangdong a more advantageous location to exploit Hong Kong's as the conduit toward international market and to utilize its informational and financial support to reach the world market. For international trade, Hong Kong's free flow of information and prominent international position are a hub of information, and a convenient meeting point of business

[43] Economic Report, Publication of Hong Kong Trade Development Council, 1990.

between China and outside world. With superior infrastructure and a team of professionals, Hong Kong is an excellent transshipment port for import and export freight. Guangdong has the highest export value among China's thirty some provinces, and over 80 percent goes to Hong Kong. Nearly 40 percent of China's export to Hong Kong are for reexport to other countries.[44] (5) The Guangdong-Hong Kong connection has major effects on Hong Kong's economic development. By transplanting manufacturing industries into Guangdong, a deindustrialization process took place in Hong Kong. The service sectors, namely trade, finance, advisory, and tourism have grown into the pillar industries of the territory. The restructuring process sets up a distinct division of function in the production process between Guangdong and Hong Kong, the formation of a relationship of "Front Showcase and Back Factory." With Hong Kong specializing in production planning, financial management, new product design and development, marketing and business negotiation, and Guangdong concentrating on manufacturing, development in capital and technology intensive industries integrating the two places economically, making them increasingly interdependent (Chan T. 1992). (6) Hong Kong has become the highly ranked central

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[44] *China Economic News*, Hong Kong, September7 1991.

city in the Guangdong urban hierarchy. Through its international economic network, Hong Kong has integrated the central part of the province, the Pearl River Delta, to transnational production and international trade (Lin, 1997: 45-57). The Delta's spatial economy continues to expand outward to other parts of the province. Within the Delta itself, the urban places have formed a hierarchy, joined by production and trade linkages. Each city has its specific economic function and position, determined by the outward-oriented economy. With Hong Kong being the center of international trade, production management, transportation, finance, information, and tourism, Guangzhou, the provincial capital, will become the cultural, political and economic core of South China and the exchange node between Guangdong and other provinces. Other lower level and smaller cities have productive and administrative functions, mainly concentrate on the maintaining the transnational and domestic manufacturing work. Within this urban region, Hong Kong, despite its highly autonomous status, is economically situated on the highest stratum. (7) Hong Kong serve as the intermediary for overseas Chinese investment which registered in Hong Kong to avoid their own countries' scrutiny and the political sensitivity of diversifying their fund into Mainland China's market. Hong Kong absorbed the South Coast of China into the production and distribution networks of companies run by Overseas Chinese. (8) Hong Kong is also the intermediary for Mainland and Taiwan's trade and investment.[45] Since the Taiwan authority only allows indirect economic contact with the Mainland, a large amount of Taiwan's investment has located in Guangdong and Fujian through Hong Kong. Since Hong Kong has become China's Special Administrative Region, Taiwan's no contact policy with the Mainland become more and more difficult to maintain. China has over 160 main countries in the world recognizing PRC as the sole government of China, while Taiwan just maintains diplomatic relations with scores of tiny states. Mainland and Taiwan realized limited direct shipment between Xiamen and Gaoxiong last year. And the talk between the two sides of the strait restarted in October this year. Final unification will be inevitable, given the mutual economic needs of Mainland and Taiwan, the strong cultural and family links, and the rising Chinese international status. Finally, with respect to true "foreign" investors, there are two major roles for Hong Kong in foreign investment in China: demonstrator and middleman. Hong Kong opens the way for outside investors, as it demonstrates how foreign investors should

[45] An-chia Wu. "*Taipei-Peking Relations: The Sovereignty Issue*", paper in the book of Contemporary China and the Changing International Community, ed Lin and Myers. 1994. Pp.190-191. USC.

approach and negotiate vis-à-vis their Chinese counterparts. It also is an effective go-between in identifying business partners, finding the appropriate bureaucracies, and advising on management and official processes.

5.4 Future Prospects of Hong Kong

Open to FDI and outward industrialization have been accepted as the national development strategy in China, and two decade experience show this strategy as effective and positive to economic development. There is a general consensus in China the present trend of the country's development is on the right track. Hong Kong's investment in China has been undeniable to China, especially south China's growth. Therefore, Hong Kong's role as the catalyst and leader should remain, so long as it continues to produce growth. The present growth trend through FDI should be maintained and expanded. China is emphasizing the investment to the huge inland and west areas. Armed with the language and cultural advantages, Hong Kong and overseas Chinese investment are more aggressive than "foreign" investment in exploring new markets and catching new opportunities offered before them.[46] Being part of Guangdong, Hong Kong will continue to play an important role.

[46] "*China Encourages FDI in Central and West Regions*".People's Daily, November 18,1998.

CHAPTER SIX

CONCLUSION AND SOME LESSONS FOR DEVELOPING COUNTRIES IN UTILIZING FDI

As a source of FDI, overseas Chinese investment, especially from Hong Kong and Taiwan, have dominated China's open policy. Moreover, Hong Kong investments have been overwhelmingly concentrated in the adjacent Guangdong province, including Shenzheng and Zhuhai SEZs and even more so in the Pearl River Delta region.

Ethnically, Hong Kong based firms are typically Chinese and many were founded by emigrants from China, or their offspring, following a series of war after the collapse of the last dynasty and before the founding of the People's Republic (Weidenbaum and Hughes, 1996: 64). The tendency of Hong Kong Chinese to invest back to Mainland China reflects a tradition of investment by overseas Chinese. The revival of this tradition, made through China's open policy in 1979, is unprecedented in size and scope. Thus, in the 1980s, as costs in Hong Kong were soaring, firms there were looking for exactly the kind of low cost export platform offered by SEZs and the other designated areas in the Mainland. On the other side, in comparison to Western and Japanese multinationals, FDI from Hong Kong faces significantly lower barriers due to cultural, linguistic, and geographic proximity. As Weidenbaum, and Hughes point out, Overseas Chinese retain deep psychological ties to ideas of Chinese civilization and an inherited understanding of Guo Qing, or unique situation of China. In Asia, Guanxi, or connection underpins the development of business and social networks and, by implication, the spatial pattern and organization of Hong Kong investments in Mainland China. Indeed, guanxi, which emphasizes the importance of trust, family connections and personal relations, exists even among extremely large organizations operating on an Asian and even global scale to create what Weidenbau and Hughes, 1996, p.24-33, refers to as the overseas Chinese model, in comparison to bureaucratic "formal" western counterparts (Weidenbau and Hughes, 1996:148).

Many Western firms are looking to overseas Chinese in North America and Asia to go between organizations to facilitate deals with Chinese government. On July 1, 1997, as China's development capacity was formally married with the economic power of Hong Kong, the Pearl River Delta had already become an integrated industrial region of considerable size, dynamism and influence over the rest of China after almost two decades of active promotion of FDI from Hong Kong. This development of FDI through Hong Kong connections is radiating beyond Guangdong to other part of the country. The large share of FDI from Asia is not seriously affected by the crisis occurred in July 1997, the inflow of FDI from Asian sources drop only slightly of 1.5 percent this year.[47]

China has developed as a more and more real market, and rapid economic development has made the country a prime target for multinational companies. The author believes that despite the challenges of Asian crisis, China's attractiveness to FDI remains bright. The reform of the state-owned enterprises and further liberalization of FDI policies are under way. Some industries that had been closed to foreign investors, including air transport, general aviation, retail trade, foreign trade, banking, insurance, accounting, auditing, legal services, and mining and smelting of precious metals are gradually being opened. Moreover, there is also a significant potential for FDI participation in the infrastructure. Foreign investors are now allowed to acquire state-owned firms. As a result, the already great importance of FDI to China's economy is likely to grow. Thus, while FDI inflow to China might fall below US$ 30 billion in the next few years,[48] there is reason to believe that this will be a

[47] *China News Digest*, November 12 1998.
[48] *"Falling Foreign Direct Investment: A Threat to China's Sustained Economic Growth"*. One Country, the Hong Kong General Chamber of Commerce, Chamber publications – Economic Reports 1998.

temporary adjustment. China will still utilize remarkable FDI to transform and develop its socialist market economy. About 300 of the world's 500 largest multinational companies have already invested in China.[49] Correspondingly, in terms of the average size of foreign invested enterprises, before 1992, it was around US$ 1.55 million. An upward trend appears to be emerging. The figure hit US$ 2.47 million in 1995 and US$ 2.98 million in 1996.[50] On the surface, these figures are impressive, but when expressed in per capita terms, a quite different picture emerges: By the end of 1995, estimated per capita FDI was US$ 105. In comparison, other East Asia countries come up with US$840, Chile with US$290, Hungary with US$350.[51] In considering a country with a huge population of 1.2 billion, about 22 percent of the world's total, there seems to be more leeway for FDI in China. FDI has played a key role in fueling the Mainland China's buoyant economic growth over the past decade. The government is channeling more investment in infrastructure, the so-called "bottleneck" of obstacles, to foster economic growth. Rising FDI is desperately required especially in energy, transportation, and telecommunications. The coastal region is still the hot

[49] Zhang Xiaoqiang , foreign invest division chief of China's State Planning Commission, Feb.2, 1998. Xinhua News Agency. http//www.pc21.com

[50] *"Falling FDI: A Threat to China's Sustained Economic Growth"*. Hong Kong General Chamber of Commerce Publication, Economic Reports. 1998.

spot for FDI. In 1996 alone, the contracted capital investment in this region was US$64.5 billion and the realized investment was US$36.5 billion.[52] Both of these number represent almost 90 percent of the whole country's new foreign capital utilization during 1996. China needs to take a closer look into the problem of regional disparities in FDI distribution. More preferential policies need to be implemented in the interior provinces. The Chinese Government is only concerned about the growth of foreign capital inflow but also the transfer of foreign technology to improve the domestic productivity.

Four lessons can be made following from China's experience with FDI:

The first, Governments in the developing countries need for selectivity and a strategic approach to FDI in the context of national policies to encourage socio-economic development and technological advancement. Second, in the case of China, It is notable that a conscious development-oriented framework for FDI does not necessarily inhibit FDI. China has a much more regulatory policy regime than India and yet it receives several times the amount of FDI than India.[53] It may be argued that China is a unique case because of the enormous size of its potential market and can

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[51] Ibid.

[52] *China Statistical Yearbook*, 1998. The coastal region refers to 11 provinces and provincial level municipalities: Liaoning, Hebei, Tianjing, Shangdong, Jiangsu, Shanghai, Zhejing, Fujian, Guangdong, Hainan, and Guangxi.

therefore afford to impose strict regulations. However, other much smaller Southeast Asian countries, such as Malaysia and Thailand, also receive more FDI, despite their relatively more restrictive regimes, than several Latin American countries. It should be noticed that many African countries have among the most liberal regimes regarding FDI and yet many attract very little FDI, if any at all (UNCTAD 1996c). Thirdly, China's experience underlines the conclusions from wider research which indicates that FDI depends largely on factors such as a country's per capita income and growth and the availability of infrastructure and appropriate labor, rather than on a liberal trade and investment regime and investment incentives. Importantly, research suggests that the direction of causality be from economic growth to FDI rather than vice versa.[54] Last but not the least, the political and economic stability in the developing countries is foremost important to develop economy.

I am confident in the idea that China will become an economic force to be reckoned with in the next century. China's rise is the leading expression of the rise of developing countries of India, Brazil, Mexico,

[53] Financial Express, the Dynamics of FDI, Thuesday, November 18,1997, New Delhi.
[54] Kumar, Nagesh (1996) "*Foreign Direct Investment and Technology Transfers in Development: A Perspective on Recent Literature*". UNU/INTECH Discussion Paper No. 9606, UNU/INTECH, Maasstricht.

to name a list. The new millenium is full of opportunities and challenges for the developing countries to catch up.

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