THE ROLE OF FOREIGN-INVESTED ENTERPRISES IN THE CHINESE ECONOMY

In 1999, the Chinese government reported a foreign direct investment (FDI) inflow in the amount of $40.4 billion.¹ This was a sharp drop from $45.6 billion in 1998, and government officials and economic analysts have begun to voice concerns about the economic effects of FDI contraction for China. Indeed, one of the alleged benefits associated with the impending Chinese membership in the World Trade Organization is to stem the contractionary FDI trend.

During the reform era and especially since 1992, foreign-invested enterprises (FIEs) have become an important component in the Chinese economy, often to an extent that outside analysts fail to appreciate fully. Just a few numbers may be helpful to illustrate this point. In 1995, manufacturing FIEs accounted for about 47 percent of Chinese manufacturing exports and 24 percent of manufacturing sales. In a number of industries, FIEs have established a dominant business position. In the electronics and telecommunications industry, for example, FIEs accounted for 95 percent of the Chinese exports and 61 percent of the sales. On average, foreign firms controlled 55 percent of equity of the manufacturing FIEs in China. If we

¹All dollar amounts are in U.S. dollars unless otherwise stated.
use 50 percent as the cutoff point to measure the allocation of control rights of a firm, by 1995, multinational corporations (MNCs) already established effective managerial control over FIEs in China, and the Chinese firms in joint ventures were minority shareholders.\(^2\) FIEs have become industrial leaders in a number of areas in the Chinese economy. Table 7.1 lists a number of such sectors and firms. The information is based on a study by the State Planning Commission (SPC). The FIEs’ encroaching market share is still a sensitive issue in China. The SPC presents the statistics in Table 7.1 in a sharply critical manner. In addition, the same report notes that in light industries, electronics, and the chemical industry, FIEs’ shares in sales have already exceeded 30 percent.

The growing financing and economic roles of FIEs in the Chinese economy can be described as an “FIE phenomenon.” This chapter explains this phenomenon in two ways. One shows that much of the presently accepted explanation does not hold up to close scrutiny and that there is need for a more rigorous interpretation of this issue. The other lays out an analytical framework that stresses the importance of China’s institutions and policies in understanding the FIE phenomenon. I call this framework an institutional foundation ap-

<table>
<thead>
<tr>
<th>Industries</th>
<th>Shares of Domestic Sales</th>
<th>Shares of Firms</th>
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<td>Baby Food</td>
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<td>Cosmetics</td>
<td>30</td>
<td>18.8</td>
</tr>
<tr>
<td>Glassware</td>
<td>30</td>
<td>3/5(^a)</td>
</tr>
<tr>
<td>Firms</td>
<td></td>
<td></td>
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<tr>
<td>Xerox</td>
<td>42</td>
<td></td>
</tr>
<tr>
<td>Motorola</td>
<td>70</td>
<td></td>
</tr>
</tbody>
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\(^a\)Three out of the five largest firms are FIEs.


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2These figures are based on Office of Third Industrial Census (1997).

3Much of the argument presented here is laid out in Huang (2000).
proach with the basic premise that the important financing and economic roles of FIEs in the Chinese economy have institutional roots. My approach has two main differences from conventional explanations. One is that the institutional foundation approach aims to uncover the alliance motivations of and the characteristics of Chinese shareholder firms, as opposed to the motivations and characteristics of foreign investing firms. I argue that Chinese motivations and their operating constraints are a critical part of the story underlying the FIE phenomenon. The other difference is that the institutional foundation approach constructs a micro story explaining growth and performance of FIEs. The typical approach relies on macro factors, such as economic fundamentals and the evolution of FDI regulations, as explanations.

There is also a microeconomic approach, which postulates that the most significant benefit associated with FDI is the technology that FDI capital is supposed to bring to a country. Indeed technology acquisition constituted the strongest motivation for China to open its doors to foreign trade and investment in the early 1980s. In an 1980 interview with journalists, Deng Xiaoping gave the rationale for establishing the four Special Economic Zones (SEZs) as follows:

Technology, science and even advanced production management, which is also a kind of science, will be useful in any society or country. We intend to acquire technology, science and management skills to serve our socialist production.4

Technology acquisition is nothing short of an intellectual mantra justifying FDI, but surprisingly there is little evidence that FDI inflows into China embody much hard or soft technology. FDI is more abundant in industries that are relatively low-tech, and foreign controls of Chinese firms are found to be quite significant even in those industries in which Chinese firms and entrepreneurs should possess competitive advantages. For example, foreign control of operations in China’s traditional handicraft industries is substantial despite the fact that these are industries the Chinese have practiced for thousands of years.

These analytical and empirical anomalies call for a more rigorous examination of FDI inflows into China than hitherto has been provided. The institutional foundation approach does that, and it argues that much of the explanation lies with gaining a better and detailed understanding of Chinese financial and economic institutions. This chapter begins by describing what is meant by the “FIE phenomenon” in China during the reform era and especially in the 1990s. The second section sketches a number of conventional explanations and describes their problems. The third section presents the institutional foundation approach and discusses some empirical evidence. This section concludes with a discussion of policy issues related to rising intra-firm trade associated with China’s large FDI inflows.

THE FIE PHENOMENON

Foreign investment is most commonly defined as “direct” when the investment gives rise to “foreign control” of domestic assets. Thus according to the International Monetary Fund (IMF), FDI “is made to acquire a lasting interest in an enterprise operating in an economy, other than that of the investor, the investor’s purpose being to have an effective voice in the management of the enterprise.” In the United States, the Department of Commerce defines FDI as a foreign investor’s stake exceeding 10 percent. A 10 percent threshold is quite common among countries in the Organization for Economic Cooperation and Development (OECD). Under this definition, if a foreign firm acquires more than a 10 percent stake in a U.S. concern on the New York Stock Exchange, this capital inflow is credited to the FDI account of the balance of payment statistics, not to the portfolio account. This brings up an important difference between the U.S. and China. A large share of FDI inflows into China finances foreign equity stakes in joint ventures—i.e., ownership alliances between foreign and domestic firms. There are usually only two investors in a joint venture, and unlike the diffused shareholding of publicly traded corporations, foreigners need to acquire a greater equity stake to establish “an effective voice in the management of the enterprise” in China.

The other purpose according to the IMF is to preclude “fake” FIEs from enjoying many of the policy benefits granted to FIEs, but to es-
establish “an effective voice in the management of the enterprise” also requires a higher foreign equity stake in China since most Chinese joint venture partners are state-owned enterprises (SOEs), whose shares, like closed corporations, are not traded.

FDI inflows are the most widely cited and watched measure of FDI. As the name suggests, FDI inflows connote the quantity of FDI received by the host country during a given period of time. This is to be distinguished from FDI stocks, which refer to the accumulation of FDI inflows at a given point in time. Table 7.2 reports FDI inflows as measured by the number of approved applications and the dollar values of approved and actual inward FDI inflows.

**FDI/Capital Formation Ratio**

As shown in Table 7.2, the absolute size of FDI inflows into China has been huge. In the 1990s, China accounted for about half of the total FDI going to developing countries. In 1996, the FDI inflow, on the

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of approved FDI applications</th>
<th>Approved FDI inflows ($ billions)</th>
<th>Actual FDI Inflows ($ billions)</th>
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<td>1.17</td>
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<td>1987</td>
<td>2,233</td>
<td>3.71</td>
<td>2.31</td>
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<td>1988</td>
<td>5,945</td>
<td>5.30</td>
<td>3.19</td>
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<td>1989</td>
<td>5,779</td>
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<td>12,978</td>
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</tr>
<tr>
<td>1992</td>
<td>48,764</td>
<td>58.12</td>
<td>11.01</td>
</tr>
<tr>
<td>1993</td>
<td>83,437</td>
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<td>1994</td>
<td>47,549</td>
<td>82.68</td>
<td>33.77</td>
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<td>1995</td>
<td>37,011</td>
<td>91.28</td>
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</tr>
<tr>
<td>1997</td>
<td>21,001</td>
<td>51.00</td>
<td>45.26</td>
</tr>
</tbody>
</table>

**Table 7.2**

Measures of FDI Inflows: Number of Projects, and Values of Approved and Actual FDI, 1979–1997

paid-in basis, amounted to $41.7 billion. This compares to about $80 billion that went to the United States in the same year. The third largest destination of FDI capital is the United Kingdom, which received $30 billion. This type of comparison led to the claim in the press that China was the second largest recipient of FDI capital in the world.

A more relevant measure is the relative size of FDI. Countries vary in their economic and market size, and the size of FDI flows ought to be gauged relative to the size of the host economy. The absolute size of FDI flows for the United States in 1996 is twice as large as the Chinese FDI, but the U.S. economy is roughly seven times as large (on the basis of official foreign exchange conversion). In that sense, the United States is less “dependent” on FDI than China is even though the absolute size of FDI flows is much greater.

A more useful measure is what is sometimes known as the “FDI/capital formation ratio.” The ratio is given by FDI divided by the total fixed asset investments made by foreign and domestic entities in a given year. This is a more empirically and conceptually useful measure. Empirically, the ratio tells us something about the relative importance of FDI to a country’s economy. Conceptually, the FDI/capital formation ratio is driven by the willingness on the part of foreign investors to invest in a country relative to the willingness on the part of domestic investors to do the same. If the FDI/capital formation ratio rises or falls within a short period of time (as it did in China in the 1990s), this would raise an interesting research question as to why foreign and domestic investors should view the same market growth opportunities differently.

Frequently business and academic analysts invoke China’s growing market size as an explanation for the explosive FDI growth in the 1990s. But this reasoning does not really settle the issue. When a firm invests in fixed assets (machinery, equipment, and other productive facilities), it puts down money today in the expectation of greater future profit payoffs. The key word here is future because investment is an inter-temporal activity and amounts to a decision to forgo current consumption in exchange of greater consumption possibilities in the future. Because there is no guarantee that the firm will make more money by investing in fixed assets as compared to investing the same money in safer bank deposits, a firm’s investment decision is
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guided by its belief of what the future holds in store. It will put down
more money if it believes that the market prospects in the future are
promising. It will put down less if it believes otherwise. If the growing
Chinese market size attracts lots of FDI (as measured by the increas-
ing share of FDI of capital formation), one has to prepare to argue
that for some reason domestic firms are not in the same position to
take advantage of the future market opportunities. A rising
FDI/capital formation ratio obviously suggests that domestic firms
are not investing as much as foreign firms. Is it because domestic
firms perceive the future market opportunities differently from for-
eign firms? Or is it because foreign firms are in a better position to
reap the rewards of the market growth than domestic firms? For ex-
ample, foreign firms may be able to offer a product lineup that is
more income elastic than what domestic firms can offer. Nokia and
Ericsson may offer mobile phone units to affluent Chinese con-
sumers that Chinese telecommunication equipment makers are un-
able to match. Or foreign firms may possess entrepreneurial talents
to spot future market opportunities that have eluded domestic firms.
Another possibility is that domestic firms are bogged down by poor
performance, burdened by mounting financial and social liabilities,
and beset with incentive problems and managerial incompetence.
No matter what explains the asymmetric investment behavior on the
part of foreign and domestic firms, a simple macro explanation fo-
cusing on market size (or on labor costs) is inadequate. Strictly
speaking, an account of FDI growth is not about FDI growth \textit{per se}
but is about why foreign firms have invested more than domestic
firms. To address why foreign investors are more willing than do-
mestic investors to invest (or vice versa), the FDI/capital formation
ratio comes in handy.

Between 1993 and 1997, on average, in China FDI flows accounted
for about 15 percent of total capital formation. This ratio is one of the
highest among all developing countries. Only Singapore, Chad, and
Hungary have a substantially higher ratio. As pointed out before,
even though the United States attracted a greater amount of FDI, the
relative importance of FDI in the case of the United States is far
smaller than it is in the case of China. FDI only accounts for some 6
percent of total investments; China’s FDI dependency is almost three
times as large. It is worth noting that China is commonly viewed as a
closed and controlled economy. According to the economic freedom
ranking devised by the Heritage Foundation in the United States, China is classified as a "mostly unfree economy." Yet its FDI dependency is higher—and in some cases substantially higher—than such completely open economies as those of the United States (with an FDI/capital formation ratio of 6.38 percent), the United Kingdom (12.4 percent), Hong Kong (10.24 percent), Taiwan (2.78 percent), Thailand (3.76 percent), and Malaysia (14.12 percent).

**Commanding Positions of Foreign-Invested Enterprises (FIEs) in the Chinese Economy**

A few statistics in Table 7.3 are quite startling. As of 1995, FIEs controlled almost half of China’s manufacturing exports (47.11 percent). In a number of industries, such as electronics and telecommunications, garments, leather products, printing and record pressing, cultural products, and plastics, FIEs have acquired a dominant position. They account for over 60 percent of Chinese exports. Their sales are not insignificant either. In four industries, their sales exceeded 50 percent of industry sales, and altogether FIEs accounted for 24 percent of the sales.

Often, China’s overall success in increasing export production is attributed to the strong export orientation of FIEs. That FIEs account for over 47 percent of Chinese export is often taken as evidence that FDI has contributed to China’s export success. The real story is far more complex, depending on two developments in China’s export front. One is export/GDP shares; the other is FIEs’ shares of Chinese exports. Between 1991 and 1997, FIEs’ share of Chinese exports has risen from about 15 percent to 40 percent, while export/GDP share rose by only 5 percent. This is *prima facie* evidence that FIEs have both created exports and diverted exports at the same time. During the course of the 1990s, as more FDI flowed in, foreign firms have taken over those Chinese firms engaged in export production. Thus the high share of FIEs in Chinese exports needs to be interpreted carefully. Export orientation is only a part of the story; export diversion from Chinese-owned firms is another—and frequently neglected—story.

The significant position of FIEs in the Chinese economy raises a natural question about who controls FIEs. Corporate control is a com-
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A complicated concept, but the simplest measure is an investor’s share of equity ownership of a firm. The higher the share, the more control an investor is said to have of a corporation since equity ownership is usually proportional to the amount of decisionmaking power. Since many FIEs in China are joint ventures, decisionmaking is shared between Chinese and foreign investors, and allocation of decisionmaking power is determined on the basis of respective shares of equity ownership.

Foreign firms have established majority controls over FIEs in most industries. Only in seven out of 28 manufacturing industries are foreign firms found with an average minority equity position—i.e., an equity stake less than 0.50. State-owned monopolies or oligopolies are typically found in those industries where foreign firms only command a minority stake. The tobacco industry is probably the best illustration. But it should be noted that even in this heavily monopolistic industry, foreign firms already enjoy a sizable minority stake, at 46.88 percent. As I will show in this chapter, while foreign firms have been able to make inroads into industries explicitly reserved for the most powerful government corporations, nonstate firms have been completely excluded. Another characteristic is that foreign majority equity controls seem unrelated to some of the well-known features of these industries. Foreign majority controls span both labor-intensive industries, such as garments and leather products, and capital-intensive industries, such as chemicals, machinery, and instrument manufacturing.

**Performance of FIEs**

In China, no less than in other countries, foreigners’ growing presence in industries steeped in national and political symbolism can be an emotionally wrenching experience. It is no longer considered normal business competition, proclaimed one worried Chinese official from the auto industry; it is nothing short of geopolitical war. Of the four so-called pillar industries designated by the Chinese government, FIEs have a significant presence in two of them. In electronics and telecommunications, FIEs’ equity stake has already exceeded that of domestic firms, at 53 percent in 1997. FIEs accounted for 47 percent of the assets and 63 percent of pretax profits. In the
<table>
<thead>
<tr>
<th>Manufacturing Industries (2-digit Chinese SIC)</th>
<th>Industry Distribution of Foreign Actual Capital</th>
<th>Ratio of FIE Exports to Exports of All Firms</th>
<th>Ratio of FIE Sales to Sales of All Firms</th>
<th>Ratio of FIE Exports to FIE Sales</th>
<th>Foreign Equity Shares of FIEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food processing</td>
<td>1.47</td>
<td>57.46</td>
<td>21.15</td>
<td>24.47</td>
<td>57.50</td>
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<td>Food manufacturing</td>
<td>4.56</td>
<td>38.65</td>
<td>30.48</td>
<td>16.57</td>
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<td>Beverage manufacturing</td>
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<td>26.20</td>
<td>4.46</td>
<td>56.43</td>
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<tr>
<td>Tobacco processing</td>
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<td>2.51</td>
<td>0.56</td>
<td>17.27</td>
<td>46.88</td>
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<td>Textile industry</td>
<td>8.89</td>
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<td>17.88</td>
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<td>Garments and other fiber products</td>
<td>6.00</td>
<td>60.51</td>
<td>50.81</td>
<td>71.74</td>
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<td>Leather and related products</td>
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<td>73.21</td>
<td>54.14</td>
<td>73.58</td>
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<td>45.77</td>
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<td>Printing and record pressing</td>
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<td>79.39</td>
<td>18.26</td>
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<tr>
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<td>73.56</td>
</tr>
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<td>1.41</td>
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<td>12.62</td>
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<td>Smelting and pressing of nonferrous metals</td>
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Table 7.3 — continued

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<tr>
<th>Manufacturing Industries (2-digit Chinese SIC)</th>
<th>Industry Distribution of Foreign Actual Capital</th>
<th>Ratio of FIE Exports to Exports of All Firms</th>
<th>Ratio of FIE Sales to Sales of All Firms</th>
<th>Ratio of FIE Exports to FIE Sales</th>
<th>Foreign Equity Shares of FIEs</th>
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<tr>
<td>Metal products</td>
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<td>61.14</td>
<td>26.64</td>
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<td>All manufacturing (total or average values)</td>
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<td>47.11</td>
<td>24.11</td>
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</tr>
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</table>
auto industry, where state-owned enterprises (SOEs) are more entrenched than those in electronics and telecommunications, and the government has attempted to tailor and limit foreigners’ equity participation, by 1997, foreign firms accumulated a significant stake in this industry, at 21 percent, as compared with 63 percent held by the government and only 3 percent held by Chinese private firms. Foreign shares of the seven largest auto firms came to 16 percent; the rest is exclusively held by the state.\(^5\)

FIEs are also much more profitable than domestic firms are. In 1996, China’s balance of payment account recorded a profit expenditure figure of $11.6 billion, a sharp increase from past years. Profit expenditure represents profit distribution to foreign investors. The profit figures look even more impressive if one looks beyond FIEs themselves and compares their performance with China’s main form of corporate organizations—SOEs. The story about the sharply differing fortunes of FIEs and SOEs can be told from a number of perspectives. The simplest is the rise of FIEs as a significant force in China’s economy from a de novo presence only 18 years ago. As of 1996, there were 43,542 industrial FIEs and 240,447 FIEs in the entire economy. Industrial FIEs accounted for 16 percent of the industrial value-added and 17 percent of assets.\(^6\)

Probably, the thing that distinguishes FIEs most from SOEs is their financial performance. In 1996, 43,542 industrial FIEs reported a posttax profit of Renminbi (RMB) 40.79 billion, while some 86,982 SOEs managed to churn out a paltry 500 million more, at RMB 41.26 billion. Other financial measures tell exactly the same tale. In all likelihood, these amounts understate FIEs’ success and SOEs’ woes. FIEs are suspected of using transfer pricing to hide profits (discussed later); SOEs, on the other hand, exaggerate their profit and sale figures to make their income statements look attractive to banks and have very conservative write-off policies on their accumulated inventories and conservative provisions against their large accounts receivable.

\(^5\)These data are reported in State Bureau of Machinery Industry (1998).

\(^6\)All these figures and those reported below cover only enterprises that are independent accounting units.
THE FAILURE OF CONVENTIONAL WISDOM

Despite the growing importance of FIEs in the Chinese economy, most of the academic literature has not attempted to explain the FIE phenomenon as defined here—i.e., the factors that account for the growth of FDI over time and the increasing importance of FIEs in the Chinese economy. Academic writing on FDI in China have focused on relatively targeted subjects. For example, economists have focused on the economic effects of FDI in China, such as export performance and economic growth via effects on productivity and competitiveness of markets. Economic writings thus approach FDI from a developmental perspective and focus on an issue that all developmental economists care about—economic growth. Exactly how FDI gets to be so important is usually left out in this discussion; instead the financing and economic roles of FIEs are taken as a starting point of analysis, and the interest is to explore their implications. Political scientists have approached the study of FDI from a totally different perspective. Their principal focus is on the effect of increasing FDI on the ability of the state to maintain control over its own economic and political agenda. This approach is rooted in the "bargaining" literature on FDI. Again why there is a high demand for FDI in the Chinese economy and why FIEs have grown so quickly are left out in this account.

What is important to note is that the Chinese patterns of FDI described above are not easily clarified by conventional explanations. In this section, I discuss the explanations based on conventional wisdom into macroeconomic and microeconomic explanations and discuss them in turn.

Macroeconomic Explanations

Macroeconomists often invoke the so-called "savings-investment" gap theory to explain FDI flows. The reasoning is straightforward. An internal imbalance in a developing economy—a resource gap

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7See Kamath (1990) and Pomfret (1991) in economics and Pearson (1991) in political science. In addition, Shirk (1994) tangentially addresses the issue of state control, although the subject matter is not limited to FDI.

8The discussion in this section is based on Meier (1995, especially pp. 247–263).
between its savings and its investment requirements—leads to an external imbalance on the country's balance of payment: Shortage of foreign exchange. This shortage must be financed by a combination of drawing down the foreign exchange reserves and an inflow of foreign exchange in a variety of forms. FDI is one such inflow.

The saving-investment gap, however, is conspicuously incongruous with China's large FDI absorption. In the 1990s, China had one of the highest savings rates in the world, at 41.76 percent between 1994 and 1997. The puzzle is that China's reliance on FDI deepened at the very time when the capital shortage was being alleviated. By all indications, China should be awash in capital. China's savings rate rose from an initially high level throughout the reform era. Between 1986 and 1992, the savings rate hovered around 36 percent, but between 1994 and 1997, the savings rate rose to 42 percent, second only to Singapore (51 percent).9 The acceleration of the savings rate coincided closely with an explosive growth of FDI. Between 1979 and 1997, the gross cumulative FDI flows were $220 billion on the paid-in basis. Much of this FDI was invested since 1992. Between 1992 and 1997, the total FDI inflow was a whopping $196.8 billion. Thus China imported more capital when it saved more and imported less capital when it saved less! China's balance of payment statistics bear out this suspicion. In the 1990s, China ran a current account deficit only in 1993, and simple economic logic would predict that in other current account surplus years China is a net capital exporter, not an importer. This is precisely what happened. On average between 1994 and 1997, China exported capital to the rest of the world to the tune of almost 3 percent of its GDP. The large FDI inflows, on top of large current account surpluses throughout much of the 1990s, led to a huge accumulation of foreign exchange reserves, to the tune of $140.9 billion six months into 1998.

The simultaneous large FDI inflows and the large capital outflows at a very low rate of return are rather strange from the point of view of the capital shortage argument for FDI. The Chinese are striving to give up the ownership of their economy only to use the capital surpluses to invest in low-yielding government bonds in America. In a

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9The savings rate is defined as the difference between GDP and final consumption divided by GDP. The data are reported in State Statistical Bureau (1998).
country of poor peasants, China borrows heavily from the rest of the world so that it can finance government spending in industrialized countries, an outcome a former Chinese central banker calls "scandalous." By all indications, the Chinese are poor arbitrageurs. The country pays on average 8 percent on its foreign debt but only gets 5 percent returns on its investments abroad. One is hard pressed to think of an economic justification for this outcome but if there is, fund shortage is not one of them. Given China’s status as a capital exporter, any convincing explanation for China’s high FDI dependency needs to move beyond the capital shortage argument.

Another version of the macroeconomic story postulates that FDI is driven by China’s market size. The idea is simple and straightforward: MNCs are attracted to China’s economic fundamentals—fast income growth, a large population, a cheap and disciplined labor force, etc. This explanation, which focuses on the economic fundamentals, is correct, by definition and default. It is not hard to imagine that FDI inflows would have to be modest if these economic fundamentals were not sufficiently attractive to investing firms. However, it is important to recall that the rapid growth of the roles of foreign companies in China is relatively recent. The real surge in FDI inflows took place after 1992; the cumulative FDI inflows between 1992 and 1997 accounted for some 89 percent of FDI stock between 1979 and 1997. During the 1980s, FDI grew steadily, but not at a spectacular rate, even though Chinese economic growth was already quite impressive during this period. Thus, if we accept the notion that economic fundamentals drive FDI inflows, this gap in timing needs to be explained.

The economic fundamentals explanation poses other puzzles. The good economic fundamentals themselves do not automatically drive up FDI inflows. For one thing, foreign firms may prefer exporting to investing in foreign sites, and overseas investments thus occur only when there are impediments to exporting. In addition, FDI policies of host countries can be promotional or restrictive, and these policies have a big effect on the levels of FDI. This is abundantly clear when one examines the history of FDI in East Asian newly industrialized economies (NIEs)—countries that grew extremely fast in the 1970s.

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10 Quoted in Smith (1998).
and 1980s but without much foreign equity participation. Amsden (1989) points out that the number of multinationals in Korea is smaller than in any other late industrializing countries. Policy barriers against FDI were an important reason. In a 1980 survey, 23 percent of the foreign executives in Korea listed “cumbersome bureaucratic procedures” as the number one impediment Stallings (1990). Japan, the world’s second largest economy, has a level of FDI inflows lower than the level of Greece Graham (1994). Thus, the economic fundamentals explanation provides a necessary but not a sufficient account of FDI growth—i.e., those countries with high levels of FDI must have good economic fundamentals but there can be countries with good economic fundamentals but with low levels of FDI. This distinction between necessary and sufficient conditions for FDI growth often gets blurred in the business press.

To a large extent, the economic fundamentals explanation asks the wrong question in the first place. Even if good economic fundamentals drive up FDI inflows, the core issue is not the growth of FDI inflows per se. The core issue is the growth of FDI inflows relative to the growth of domestic investments. If the foreign share in fixed asset investment is expanding, it must mean that domestic investment is not rising as fast. To be sure, good economic fundamentals induce more investment, but why have there been more foreign investments? Do foreign firms have a better edge in responding to the growth opportunities than domestic firms? Do foreign firms, for some reason, see the market opportunities that elude domestic firms? Or do foreign firms have an optimistic bias, while domestic firms have a pessimistic bias? This is an especially important issue because more and more of FDI inflows are now financing asset purchases from domestic firms, rather than newly generated investments. Strictly speaking, an account of FDI growth is not about FDI growth per se but is about why foreign firms have invested more than domestic firms (as the increasing share of FDI of domestic capital formation indicates). Thus our story has to start with explaining why, over time, foreign firms have gained advantages relative to domestic firms and the factors causing the advantages of foreign firms to rise over time.

Cheap labor, in and of itself, does not drive up FDI. It is important to stress that FDI is an ownership arrangement—i.e., each investor puts up the capital to establish an equity stake in a firm. As an ownership arrangement, FDI is one of many cross-border alliances between a
foreign and a Chinese firm. Low labor costs motivate MNCs to locate their production in China, but low labor costs per se do not mean that MNCs have to resort to an FDI arrangement. Except for those situations in which contractual complications naturally arise, such as asset-specificity and the associated opportunism, contract production results in the same cost-saving benefits as does FDI. For example, a Hong Kong firm can contract out a firm in China to produce goods and services according to the exact specifications it lays out, and the Hong Kong firm will reap the same labor-saving benefits as investing in China. The question is not whether or not producing in China is cheaper or more expensive than in Hong Kong; the question is, why do so many firms from Hong Kong resort to FDI rather than contractual production to realize labor-cost savings benefits.

One form of market transactions is export processing. Under export processing, a Chinese firm still relies on a foreign firm for the latter's overseas marketing capabilities, but it remains a separate ownership entity from the foreign firm. The foreign firm has no equity stakes in the Chinese firm, and the relationship between the Chinese and foreign firms is fundamentally contractual. But their relationship is not completely arms-length either, since a lot of coordination is involved between them. For example, the foreign firm supplies designs, specifications, and components to the Chinese firm, and the Chinese firm produces the goods in accordance and receives a payment for the goods delivered to the satisfaction of the foreign firm.

The history of export-oriented FDI in China is one of replacing market transaction mechanisms, such as export processing, with non-market transactions through intra-affiliate cross-border sales. National figures on FIE exports and contractual exports are only available since 1996, but more systematic data are available for Fujian and Guangdong provinces—which have received the lion's share of FDI. In Fujian province, in 1988, the FIE exports to export processing ratio was 3.64; it rose sharply to 22.45 in 1990 and then to 45.47 in 1992. In Guangdong province, FIE exports rose less dramatically but still far faster than export processing. At the national level, in 1996, FIE exports were about twice the size of contractual exports.

Another measure is to compare the amount of capital that finances FDI with the amount of the capital that finances contractual production. In the Chinese statistical classification, investment data are
broken down by direct investments (FDI) and other investments. Other investments are essentially contractual capital flows, such as leasing, compensation trade, and export processing. In 1983, contractual capital flows were about 45 percent of the FDI inflows, but they took a sharp decline in 1984 and experienced further declines since 1988. Between 1992 and 1996, contractual capital flows virtually disappeared, but since 1996, they have risen in magnitude. The declining contractual capital flows relative to ownership capital flows coincided closely with the rounds of FDI liberalization in the 1980s and 1990s. In 1984, fourteen coastal cities were given expanded power to approve FDI projects; in 1988, the government pushed for further economic openings. Between 1992 and 1996, the Chinese government initiated another round of extensive and far-reaching liberalization of FDI controls. Thus, when a domestic firm and a foreign firm are given a choice between an ownership and a contractual arrangement, they prefer to enter into an ownership arrangement. This preference for an ownership arrangement over a contractual one needs to be explained.

**Microeconomic Explanations**

Microeconomic explanations for FDI are also problematic. Microeconomic explanations start with the notion that FDI transfers know-how from home firms to host firms and to the extent that transferring such know-how is costly, via a contractual arrangement home firms then extend common ownership over facilities overseas to facilitate such a transfer.

The know-how explanation is problematic. First, if know-how refers to knowledge to operate advanced equipment and machinery, there is simply no evidence that FDI has brought much “hardware” know-how to China. No doubt, some FDI projects bring advanced technology to China, but many do not. The industries in China with the largest share of FDI are often those with a low capital content and low “knowledge worker ratios” (i.e., engineers to blue collar worker ratios). In the 1990s, FDI originating from Hong Kong and Taiwan accounted for between 50 to 70 percent of Chinese total FDI inflows, and much of this kind of FDI contains a low content of hardware know-how. Many Hong Kong and Taiwanese simply capitalized their
Contrast this pattern with China’s technology imports through trade. Technology imports refer to importation of technology licensing, patents, and turnkey projects. In contrast to FDI, technology imports transfer technology to the host country via arms-length market transactions rather than through an ownership arrangement. Research by United Nations Centre on Transnational Corporations (1992) shows that typically the level of technology transfer associated with FDI is of more recent vintage and is more sophisticated as compared with the kind of technology transferred via arms-length market transactions. China, however, exhibits precisely the opposite pattern. This is shown by the country origins of technology trade vis-à-vis country origins of FDI. The majority of China’s technology trade is with OECD countries, whereas the majority of China’s FDI originates from non-OECD economies.

In the standard account of FDI, FDI materializes only when the know-how needed to operate the capital assets cannot be disembodied from the capital itself. Given the high degree of maturity and standardization of the capitalized equipment, it is a mystery why Chinese firms could not simply import these items. It would be a win-win situation for both sides. The equipment and machinery of Hong Kong and Taiwanese firms have been rendered increasingly uneconomical because of rising labor costs since the late 1970s, and the opening of China would have provided an opportunity for these two economies to transition very quickly to service economies.11 Not only is there thin evidence of “hardware technology transfer,” some researchers have reported on “negative technology transfer” associated with FDI—i.e., Chinese firms possessed more advanced hard-

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11 Despite the image of Hong Kong as one of the most important financial centers in the world, manufacturing and its ancillary operations were still an important part of Hong Kong’s economy until quite recently. In 1993, manufacturing employment accounted for 22.6 percent of total employment. Thus, at a per-capita income greater than that of Great Britain and a rental price several times as that of Manhattan, Hong Kong still retained a substantial tie to labor-intensive manufacturing activities. I argue in my book (Huang, 2000) that this is strongly related to the fact that investing in China was made cheaper to Hong Kong manufacturing firms because of the institutional configuration of the Chinese economy. This allowed Hong Kong firms to retain their labor-intensive manufacturing operations in the territory longer than would have been economically feasible.
ware than the investing firms from Hong Kong and Taiwan.\footnote{See Young and Lan (1997).} Thus, overseas Chinese firms invest in China not to transfer technology but to exploit the strong research and development capabilities of mainland Chinese firms.

There is in fact a negative correlation between FIEs’ equity shares and asset intensity. The fixed asset turnover ratio is the ratio of sales to net fixed assets. It measures the sales generated per unit of net fixed assets deployed and measures capital intensity of an industry, with a high ratio denoting low capital intensity and a low ratio denoting high capital intensity. Table 7.4 shows the equity ratios of FIEs and the fixed asset turnover ratios of eight industries—four of these FIEs have the highest equity shares and four of them have the lowest equity shares. The average asset intensity levels of the high FIE equity group is actually higher than that for the low group, 3.17 compared to 2.09. Tobacco processing and petroleum processing are heavily

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<th>Industries</th>
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<td>Top four industries</td>
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<tr>
<td>Electronics and telecommunications</td>
<td>0.55</td>
<td>3.21</td>
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<td>Leather products</td>
<td>0.52</td>
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<td>Garments</td>
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<td>Food manufacturing</td>
<td>0.47</td>
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<td>Average</td>
<td>0.51</td>
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<td>Bottom four industries</td>
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<tr>
<td>Tobacco processing</td>
<td>0.02</td>
<td>2.69</td>
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<td>Petroleum processing</td>
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<td>Smelting and pressing of ferrous metals</td>
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<td>Special purpose equipment</td>
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<tr>
<td>Average</td>
<td>0.05</td>
<td>2.09</td>
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\footnote{Source: Based on the data in State Statistical Bureau (1997). NOTES: Industries selected for this table refer to those in manufacturing only; FDI is restricted in mining and public utilities. FIEs’ equity shares are calculated as the ratio of FIEs’ equity in a sector to the value of equity of that sector. Fixed asset turnover ratios equal sales divided by net fixed assets.}
capital-intensive activities, and yet FIEs have almost no presence.\textsuperscript{13} This suggests that FIEs are more dominant in industries of low capital intensity. The same pattern holds when one looks at the data for all industries. The simple bivariate correlation between fixed asset turnover ratio and FIEs’ industrial equity shares for 1996 was not only positive but large, at 0.70.

The second type of evidence is more direct. It comes from survey and interview research conducted by scholars. Two researchers, Stephen Young and Ping Lan, have conducted the most systematic study on this topic so far. Their data come from a postal survey of 361 FIEs in Dalian city and interviews with managers from 36 of these FIEs. Their findings suggest that, on average, the level of technology as embodied in the FDI was two years ahead of China’s existing level even though the “technology gap” between investing countries and China was commonly perceived to be 20 years. The “technology package” was in most cases incomplete, meaning that the package included only one or two of the three components that constitute a complete technology transfer—product, process, and organizational technology. Less than 25 percent of technology transfer projects incorporated all three components. One interesting finding of their research is that foreign firms apparently invested in China to source Chinese technology, in that a significant number of Chinese firms were more technologically advanced than their foreign investors.\textsuperscript{14}

Technology is an intrinsically difficult concept to measure and quantify. FDI researchers correctly point out that what FDI brings to China is not hardware but software—referring broadly to foreign managerial and organizational skills and expertise. It is again important not to take such a claim at its face value, and it is important to examine the empirical evidence indicating such a function of FDI inflows into China. Organizational know-how transfer is harder to document because of its intangible nature, but again anecdotal and piecemeal evidence suggests that it is implausible to argue that the organizational know-how is present in all FDI projects (numbering

\textsuperscript{13} It is likely that the government’s restrictions on FIEs explain this outcome.

\textsuperscript{14} See Young and Lan (1997).
over 80,000 in 1993 and more recently declining to about 20,000).\textsuperscript{15} For one thing, FDI is not the only mechanism to import organizational know-how; for relatively simple and standard organizational know-how, again a contractual arrangement is entirely feasible. A Chinese firm can hire a foreign manager—for example by hiring a retired foreign manager at a cost that would be a fraction of the present value of the future cash flows on the sold equity. For years, Korean firms did exactly that to build up their organizational and managerial expertise when the economy was shifting from light and labor-intensive industries to capital and technology-intensive industries in the 1970s.

As any business owner would know, ceding equity is an expensive way to access managerial expertise and usually one only gives up equity in absence of alternative sources of financing. In venture capital projects, for example, debt financing is usually unavailable because banks value a stable source of cash flow, while technology entrepreneurial start-ups entail high risks (defined as high variance of their cash flows) and therefore they have to rely on equity capital from venture capitalists who are seeking to reap the huge upside if the project succeeds. In other situations, stock options are given to managers when these managers possess hard-to-measure and intangible attributes or when owners use stock options as a monitoring device. None of these conditions readily applies to Chinese firms in labor-intensive and mature industries actively seeking FDI, and, even if some of these conditions apply, there is no reason why foreign suppliers of capital should disproportionately be sought out at the expense of domestic capital suppliers in many situations.

The anomaly does not stop there. According to the Office of Third Industrial Census (1997), in 1995, there were 49,559 industrial FIEs at or above the level township and yet there were only 31,992 foreign employees. Assuming at minimum one foreign employee needs to be present to transfer intangible skills and know-how, this is a strange result indeed. There were 17,567 FIEs without any foreign employees.

\textsuperscript{15}It is interesting that, in interviews, SOE managers typically invoke importing organizational know-how as a motivation to seek out foreign joint venture partners. Often in the same conversations, they also describe their own reluctance to spend money on training and human resource development.
AN INSTITUTIONAL FOUNDATION APPROACH

The fundamental premise in this chapter is that the growing roles of FIEs in the Chinese economy are driven not only by foreigners’ supply of equity capital but also by the Chinese demand for foreign equity capital. The demand side of the story relates to the perceived benefits associated with foreign equity capital and to the Chinese motivations to form alliances with foreign firms. The central idea of this chapter is that desire for capital and technology do not constitute the full universe of Chinese alliance motivations and that Chinese alliance motivations are partially a function of Chinese economic institutions and policies. Thus, I term this the institutional and policy factors approach. Four such institutional factors are examined below: state ownership, economic decentralization, financial market inefficiency, and policy benefits.

State Ownership

An important feature of SOEs’ behavior in China and in other reforming socialist economies is that SOEs have an insatiable investment appetite. Despite the impressive results of its economic reforms, China remains a partially reformed Centrally-Planned Economy (CPE). In 1994, state-owned enterprises employed 67 percent of all urban employees and accounted for 57 percent of the total gross fixed capital formation. In comparison, as of the late 1970s, the state sector accounted for 32 percent and 23 percent, respectively, of the gross fixed capital formation in Taiwan and Korea.16 The investment demand of state-owned enterprises is viewed as inefficient and excessive in reforming or partially reformed CPEs. Excess investment demand implies two kinds of behavior unique to SOEs in CPEs. Ex ante—excess investment demand means there are weak self-enforcing constraints on investment demand; ex post—demand for investments constantly exceeds the potential supply of investible resources, such as capital, intermediate goods, or, as the case may be, foreign exchange. Excess investment demand arises because there is a fundamental asymmetry in the incidence of costs and benefits associated with undertaking investment activities.

16Wade, 1990, p. 177.
in a CPE. Benefits—enhanced reputation and higher financial rewards—accrue to the investors, while investment costs are borne by society at large. This is a situation analogous to “negative externalities” in market economies, and the consequences are similar: The costs of the affected activities are lower than socially optimal; therefore incentives to undertake these activities are stronger than when the external costs are taken into account. As Kornai\textsuperscript{17} comments:

Expansion drive is a fact of life for the bureaucracy. And because this system has only bureaucrats and no real owners, there is an almost total lack of internal, self-imposed restraint that might resist this drive.

A second and closely related characteristic of SOEs has to do with the budgetary environment in which they operate. SOEs are said to face “soft budget constraints,” which refer to a bureaucratic readiness to provide financial assistance and, ultimately, to prevent bankruptcy.\textsuperscript{18} Soft budget constraints, in essence, imply zero risks for the investment activities undertaken by a SOE. They are the second reason why restraints on investment demand are not self-enforcing on SOEs.\textsuperscript{19} The lack of a credible threat of bankruptcy shapes alliance motivations and behavior profoundly. For one thing, it is entirely possible that forming joint ventures is an extension of the excess investment demand on the part of SOEs. But there are more subtle connections. Launching joint ventures can be a costly proposition, especially for cash-constrained SOEs. There are two common funding approaches. One is that SOEs contribute their best-performing fixed assets and workforce to new ventures to finance their equity stakes when they have low cash reserves. The other approach is that SOEs borrow heavily to finance their equity injections into new ven-

\textsuperscript{17}Kornai, 1992, p. 163.

\textsuperscript{18}For further illustrations, see Kornai, 1980, #228.

\textsuperscript{19}One may object by pointing to a similar phenomenon in market economies—savings and loan institutions in the U.S. economy. But this observation is a mere restatement of the same point. Savings and loan institutions are federally insured and hence face a similar budgetary environment as a normal CPE firm. The recklessness of their behavior then critically depends on the degree of government supervision; if government supervision becomes lax, as it did in the 1980s, behavior tends to be reckless. For a more substantial treatment of this topic, see Huang (2000).
tures. This is evidenced by the fact that in sectors with a high foreign equity stake, SOEs tend to be highly leveraged, as measured by debt to equity and debt to asset ratios. The simple bivariate correlation between SOEs’ debt levels and FIEs’ sectoral equity stake is very high. For the debt to asset ratio, it was 0.74 and for debt to equity ratio, it was 0.72. The four sectors with highest foreign equity stakes are electronics and telecommunications equipment (55 percent), leather and related products (52 percent), garments and fiber products (49 percent), and food manufacturing (47 percent). The SOEs’ debt to asset ratios in these four sectors are, respectively, 0.76, 0.86, 0.71, and 0.77. The average debt to asset ratio for all the industrial sectors is 0.68.

There are both balance sheet and income statement implications from these asset contribution methods. By forming joint ventures, SOEs essentially convert their fixed assets into long-term financial holdings on their balance sheets. In a number of cases, because SOEs took on so much debt to finance their equity stakes in FIEs, they put themselves in a technical bankruptcy under Chinese law, when shareholder equity is negative and when sudden collapse of operating revenue creates a default situation. In less dramatic situations, because the shareholder SOEs are left with the least productive assets and workforce, their profits tend to plummet after joint ventures are created. Those SOEs that contribute cash became highly leveraged and heavily burdened with interest payments. Here a critical driver of SOE alliance behavior is the \textit{ex ante} expectation of bailouts by the state, and thus SOE managers tend to discount the costs and even the real bankruptcy prospects as a result of the aforementioned manners of financing joint ventures. Because loan obligations are soft or fiscal subsidy is readily available to SOEs in distress, SOE management may not feel constrained by the excessive burdens of asset conversion and expansions.\footnote{Their \textit{ex ante} expectations can turn out to be false \textit{ex post}, and this is highly likely when conflicts between Chinese shareholders and foreign shareholders escalate, with the Chinese shareholders insisting on dividend distribution while foreign shareholders insist on profit retention.}

\footnote{It is important to note that this is one of a few possible interpretations. Another possibility is that FIEs tend to gain advantages in sectors in which SOEs are failing. Thus high debt levels are not \textit{ex post} but \textit{ex ante}.}
SOEs are also motivated positively to launch projects. A World Bank study finds an “engineering” motive particularly strong among Chinese SOEs (Byrd, 1987). An engineering motive can refer to a desire to produce an excellent product or to adopt the newest technology. The benefits are both psychological and tangible. A system of ranking enterprises and varying bonus, wage, and credit treatments according to their technological sophistication accentuate enormously the appetite for new technology.

The effect of a strong engineering motive on FDI can be illustrated by either the demand or supply sides of the story. On the demand side, it accentuates the demand for the type of capital closely bundled with technology. On the supply side, the high demand of Chinese SOEs for technology increases the owner-specific advantages possessed by MNCs. Many foreign investors readily confirm the constant demand for technology transfer from their Chinese partners and often such a demand is economically wasteful. The Chinese capacity to integrate technology is often poor, and as one Chinese economist pointed out, on average, the Chinese spend $1 on technological absorption for every $10 of technology import, an opposite ratio from Korean and Japanese firms in the 1960s and 1970s.23 A senior Otis Elevator Company executive reflected on this issue in a Harvard Business School case study (1997, p. 8):

We found the Chinese employees were always very eager to learn and improve their operations, but we still faced many difficulties in transferring technology. There were few engineers at the plants and a serious shortage of trained staff. When we transferred our drawings, CTOEC [China Tianjin Otis Elevator Company] often did not know what to do with them. This didn’t, however, stop them from pressuring us to transfer our latest technology.

A third connection between state ownership and demand for FDI has to do with the sharp differences in terms of operational autonomy granted to SOEs vis-à-vis that granted to FIEs. Although many foreign executives complain about governmental restrictions placed on their operations, FIEs enjoy far greater autonomy than SOEs. SOE managers are appointed by the government (specifically by the

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23See Wu (1996).
Organization Department of the Chinese Communist Party). Appointment decisions can often be a politicized process. In addition, SOEs are often subject to detailed and discretionary bureaucratic interference and to predatory taxes and fees. Herein lies a strong incentive to convert SOEs into FIEs on the part of the SOE managers—to arbitrage the significant differences in the legal, regulatory, and organizational autonomy between these two corporate forms. This motive gives rise to one of the most widely observed asset stripping actions undertaken by Chinese SOE managers—i.e., to deliberately undervalue the contributed assets and to evade the asset appraisal procedures stipulated by Chinese law. The reason is straightforward: Chinese SOE managers are motivated to increase the probability of creating joint ventures with foreign firms by giving up control.24

The arms-length relationship between government and FIEs is evidenced in a number of ways. First, the political control is much weaker in FIEs as compared with SOEs, not only by default but also by a rather explicit regulatory design. None of the FIE laws makes any explicit references to the Communist Party and mandates the establishment of party organizations within FIEs. To some extent, this is in contravention of the Charter of the Chinese Communist Party, which requires a party organization where there are more than three Communist Party members. A brief reference to the role of the party within FIEs is found in a manual prepared under the auspices of the Ministry of Foreign Economic Relations and Trade, which describes the role of the party as monitoring illicit conduct and educating FIE workers on ideology. No managerial role is prescribed.25 In contrast, the 1986 Factory Director Regulations governing SOEs assigned broad and specific powers to the Communist Party, such as those ensuring the “socialist character of management,” compliance with laws, fair distribution of interests among state, enterprise and workers, etc.26 These functions would directly affect managers’ production and wage/bonus setting policies. The reference to the Communist Party in the 1988 SOE Law was briefer, stipulating a

24According to one study, about 90 percent of joint ventures were formed without going through an asset appraisal process. See Qian (1996).
monitoring and supervisory role to ensure compliance with party and state policies and regulations (Article 8). Interestingly, almost exactly identical wording referring to the Communist Party also appears in the 1991 Collectively Owned Enterprise (COE) Law (Article 10), although there is no similar provision in the 1990 Township and Village Enterprise (TVE) Law.27

The 1979 Equity Joint Venture Law established FIEs as independent legal persons separate from that of their shareholders and with a corporate structure broadly similar to that found in market economies. FIEs were to be shareholding corporations with limited liability and with a board of directors representing the interests of their shareholders. The ownership interests were transferable. Thus, from the onset of the open-door policy, FIEs acquired a corporate form that SOEs did not achieve until the 1993 Company Law, which gave legislative recognition to the legal independence of SOEs. Under the company law, SOEs acquired the set of organizational and corporate attributes that FIEs acquired 14 years earlier.

As an independent legal entity, FIEs were endowed with a set of de jure decision rights that exceeded those of SOEs, at least in the 1980s if not today. The division of these decision rights between government and enterprises has a large effect on the degree of operational autonomy available to firms. Probably the most important control right is the right to appoint managers. The 1979 Equity Joint Venture Law and an assortment of laws on other forms of FIEs vest this power with a board of directors. For SOEs, until the Company Law of 1993, which also established a board of directors for SOEs, this power resided with the supervisory line bureaus or ministries.

The differences in the de jure treatments of FIEs and SOEs do have a tangible effect on the actual operations of firms. In the 1980s and 1990s, several rounds of SOE reforms aimed at assigning significant fiduciary responsibilities to SOE managers. The 1988 SOE Law gave broad powers to SOE managers, including asset disposal. However, a number of surveys suggest that SOE managers are sharply constrained, even in the areas of operations in which they have been given explicit autonomy. A World Bank survey of 156 SOEs in 1994

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shows that more than 60 percent of the SOEs surveyed indicated that they did not have autonomy in decisionmaking over trade, disposal of assets, and mergers and acquisitions. The Communist Party wields considerable power over personnel issues. A State Council study, cited in the aforementioned World Bank study, indicates that most SOEs did not have full investment authority, personnel decision rights, and the right to set wages. The conclusion from the study was that most of the 14 rights specified by the 1988 SOE Law remained with the line bureaus.28

Survey data indicate that FIEs are more independent from the government. In a 1995 survey, American firms in China ranked “bureaucratic interference” as the number three problem after inflation and rising accounts receivable,29 even though only a few years earlier, it routinely took years to negotiate an investment deal with the Chinese government. In the early 1990s, Shanghai pioneered in setting up a “one-stop agency” to approve FDI applications, a practice copied by many regions. However, there is no similar agency for dealing with domestic investment applications. In 1995, ten government departments organized a comprehensive survey on managerial evaluations of their operational autonomy. Unlike the previous studies I cited, this survey included SOEs, collective firms, FIEs, and private enterprises, making a direct comparison possible.30 The survey reveals, in a convincing fashion, that non-SOE managers enjoyed a far higher degree of operational autonomy, at least in their subjective evaluations. When asked what were the difficulties of improving enterprise management, the top three impediments cited by the SOE managers were, in descending order, (1) wrong managerial selection system, (2) incomplete delegation of authority over labor and personnel issues, and (3) too many surplus workers. All these factors were fundamentally driven by the structure of government-business relationships.

In contrast, the top three impediments cited by FIE managers all focused on internal operations of firms. They were (1) poor quality of

30The survey is reported in previous citation (1996).
managers, (2) lacking advanced managerial techniques, and (3) poor asset management. Considering that many FIEs are affiliates of SOEs, this ranking is remarkable, in that it was almost exactly identical to the one given by private enterprise managers, indicating that FIEs have come to enjoy a similar level of operational autonomy as private enterprises. In the same survey, 67.3 percent of SOE manager-respondents picked “evaluation by supervisory authorities” as their top concern, while only 39.7 percent of FIE manager-respondents did so. Of SOE manager-respondents, 15.4 percent gave “coordinating relationship with government agencies” when asked to pick activities to which they devote most of their time and effort. Only 7.9 percent of FIE manager-respondents did so.

**Economic Decentralization**

Arguably, one of the most prominent characteristics of contemporary China is the decentralized management of its economy. Compared with those of other developing and reforming centrally planned economies, Chinese regional officials not only control an enormous amount of economic resources but also make many decisions and policies quite autonomously from the central government. A proxy (although imperfect) indicator is the share of tax revenue collected by regional governments. In the early 1990s, regional governments collected about 66 percent of consolidated tax revenues and accounted for 67.4 percent of the total expenditure. In 1995, after the 1994 fiscal recentralization, the regional share was 47.8 percent on the revenue side but was still 70.7 percent on the expenditure side.

The first and foremost manifestation of economic decentralization is that a vast majority of SOEs are under the direct control of regional governments. “Control” here means broadly *de facto* ownership.

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31 The survey does not give the size breakdowns of the enterprises. The survey noted that 87.7 percent of the surveyed enterprises were large and medium sized. However it is not known whether the SOEs were larger than the FIEs. Size matters because government controls large enterprises more tightly than smaller enterprises.

32 The top three impediments cited by private enterprise managers were (1) lacking advanced managerial techniques, (2) poor asset management, and (3) low quality of managers.

33 This is calculated from SSB (1997), p. 235.
rights—the rights to make crucial decisions, to receive residual cash flows, and to dispose of assets. In 1995, there were 87,905 industrial SOEs, of which 83,167 were owned by regional governments. The locally owned SOEs accounted for 65 percent of total SOE assets and 64 percent of sales. The ownership functions of regional governments are complemented by the broad regulatory power in their hands. Despite central policy prohibitions, it is widely known that local governments set up trade barriers against interregional trade as well as to curtail capital exports. This means that often it is difficult for a firm located in Province A to invest in Province B because of capital restraints.

The combination of ownership and regulatory functions in the hands of regional governments has a strong effect on interregional investment patterns. Consider the contrast between Shanghai Automotive Industrial Corporation (SAIC) and First Automotive Work (FAW) in Changchun, Jilin province. In 1997, SAIC had 36 billion yuan in assets, about four times of that of FAW (9.4 billion yuan). Yet each one of its 38 subsidiaries and affiliates are located in Shanghai. FAW, despite its smaller size, made active acquisitions outside Jilin province. Its subsidiaries and affiliates are located in Beijing, Xinjiang, Shandong, Qinghuai, etc. The fundamental difference between SAIC and FAW is that SAIC is controlled by the Shanghai municipal government, whereas FAW is controlled by the Ministry of Machinery Industry in Beijing, and thus it is not tied to the Jilin province.

The local ownership arrangement means that foreign capital plays a unique role that would be absent under an alternative ownership arrangement. Because there are no similar constraints on the mobility of foreign capital, foreign firms are free to fund firms wherever there is a capital shortage. Given the immobility of domestic capital, interregional capital competition then becomes indistinguishable from competition for foreign capital at the international level. This dynamic plausibly explains why China can have high FDI inflows while having the world’s highest savings rate. Capital-rich regions or firms export capital to foreign countries via large trade surpluses because domestic investment opportunities are limited by regulations.

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34The data are from the 1995 industrial census. See Office of Third Industrial Census (1997).
and policies. Capital-poor provinces import capital from foreign countries to make up for the shortage. The overall effect is that foreign companies have come to play an arbitrage role that is lacking in the domestic financial market and thus have acquired a greater financing role in the Chinese economy, given the enormous financial market inefficiency of financial segmentation along regional lines.35

MNCs are not only multinational; they are, first and foremost, multi-regional in China. Motorola, Schindler, Otis, Volkswagen, Ford, Nabisco, etc. have all established operations across the country, and, increasingly, Western MNCs are creating a holding company structure to coordinate their complex activities and interactions among their subsidiaries or affiliates and to economize on shared overhead costs. These cross-regional investments or acquisitions are not limited to Fortune 500 corporations. A prominent example is Hong Kong–based China Strategic Investment Ltd. China Strategic Investment, with sale revenues of only $84 million in 1992, acquired 200 companies in China during a span of two years between 1992 and 1994. Its joint ventures are located in more than nine provinces, and its China Tires Holdings, via its acquisitions of tire plants in five provinces, emerged to be the largest tire producer in China in 1994 (Lim, 1994).

The second connection between economic decentralization and FDI demand is local protectionism. Chinese regional governments, in a way, all pursue a version of import substitution strategy analogous to the one pursued by Latin American countries in the 1970s, and this strategy has exactly the same effects on FDI. Because trade is restricted, either via implicit or explicit tariffs or quotas, market access is conditioned upon building and operating production facilities behind a protective wall. In this case, the interregional trade restrictions act exactly the same way as trade restrictions at a country level: They both raise returns from investments relative to trade and thus induce the type of investments that are designed to get behind trade protection to access the market. Because of the mobility of foreign

35There are specific examples of foreign companies playing this arbitrage role. China Strategic Investment’s typical approach is to finance its acquisitions from the proceeds from revenues generated by previous acquisitions. This strategy enabled it to acquire some 200 companies between 1992 and 1994, even though its sales revenue in Hong Kong amounted to only $80 million.
equity capital relative to domestic equity capital, import substitution strategy at the regional level induces more foreign investment.

The second effect is less direct. Import substitution strategy, as is well-known in economics, creates rents and induces rent-capturing activities (Krueger, 1974). Rents accentuate domestic capital immobility; regional governments are not only loathe to export capital to other regions, they are also loathe to import capital from other regions, lest rents created in their regions accrue to other regions. This would mean that regional governments would demand something more than capital before agreeing to any rent-sharing arrangements without outsiders. Foreign companies are the beneficiaries of this preference because they possess know-how and technology and because FIE status itself commands a premium.

A Harvard Business School case on Otis in China provides a fascinating account of this dynamic. In 1984, Otis and Tianjing Elevator Company (TEC) entered an agreement to form a joint venture, China Tianjin Otis Elevator Company (CTOEC). As the business expanded, Otis felt increasing need to set up additional joint ventures in other parts of the country, because of the market segmentation. However, this attempt was frustrated by the Tianjin municipal government. The Tianjin municipal government viewed such an attempt by Otis as fostering competition, and in 1988, it rejected Otis’ plan to set up another joint venture in Suzhou in Jiangsu province, even though CTOEC, in which TEC had a controlling stake at 65 percent, would have a 50 percent stake in the new venture.36 In another deal, Otis tried to set up a joint venture in Guangzhou to capture the booming market there. This time, the Guangzhou government rejected the original proposal because it would involve equity participation from TEC.

Both of these episodes illustrate the extent of local protectionism in China. The Tianjin and Guangzhou governments viewed Otis’ actions as shifting rents to other regions and as resulting in a pure financial redistribution. Neither government is averse to Otis’ participation, but each wary of either benefiting competitors or allowing competitors to share a portion of its market growth. The Guangzhou

36The original agreement has given TEC approval power for business expansion plans in China. See Otis (1997).
episode illustrates how strong this consideration is. The Guangzhou government was willing to accept a minority stake in the joint venture with Otis on the condition that Otis would drop TEC’s participation.

Thirdly, regionally based capital competition erodes barriers against FDI at the national level. It is well-known that Chinese localities compete with each other to attract FDI by reducing taxes and land-use fees and by provisions of infrastructure. To some extent, this is similar to the expensive bidding war among Ohio, Pennsylvania, and Ontario for a Honda plant in 1987. In the United States, this kind of bidding war changes the regional distribution of FDI without necessarily increasing the level of FDI in the country.37 In China, this bidding does increase FDI inflows at the national level, because of two critical differences between China and the United States. One is that the policy resources under the command of the Chinese regional governments are much greater than those of American counterparts. Regional governments can offer far greater inducements compared with those of their counterparts in the United States. The other difference is that unlike the United States, China started from a position of tight restrictions and controls on FDI inflows. The effect of regional bidding for capital is that it brings down the nationwide barriers against FDI by equalizing policy and tax treatments to the level of the most liberal region. This is easily illustrated by the example of the four SEZs and the 14 coastal cities, which were initially given greater power to approve FDI projects at far higher dollar thresholds than other provinces. As these privileged regions began to attract large FDI inflows, other regions began to demand the same approval authority. Gradually, the central government extended the approval authority to other regions as well. It is also true that many of the FDI liberalization measures have been adopted by the central government after they have been implemented at the local level, such as permitting FDI in retail, telecommunications, and real estate.

37 See Graham (1994) for an analysis of this episode.
Financial Market Inefficiency

One of the sources of financial market inefficiency has already been alluded to—segmentation of supply of capital along regional lines—and it induces a level of demand for foreign capital that would not materialize if domestic capital had been permitted to move more freely. Another source of financial market inefficiency has to do with the well-known failure of Chinese banks to channel credits to their most productive uses. The lending bias operates in two ways. One is that an overwhelming proportion of credits is directed toward SOEs; SOEs account for over 70 percent of bank lending, even though their output shares have declined to 40 percent. Nonstate firms, while more productive and profitable, were starved of credit financing during the entire reform era, until recently when the government removed credit quotas in late 1997.\(^{38}\) Lending bias also means that banks are serving a heavily redistributitional function across regions that the budget of the Chinese central government inadequately provides for. There is strong evidence that the central bank’s refinancing—enforced via the reserve requirements on specialized banks—redistributes financial resources from deposit-surplus regions to deposit-deficit regions. Deposit-deficit regions—i.e., regions that lend more than they have deposits for—are northeastern provinces, which are the strongholds of large and heavily loss-making SOEs. Deposit-surplus regions are typically liberal southern provinces, such as Jiangsu, Zhejiang and Guangdong, that have a fast-growing nonstate sector.

One of the consequences associated with this lending bias is that efficient but private firms are denied access to China’s vast savings pool and are too liquidity-constrained to finance their expansion. Spotting a potentially profitable opportunity, foreign firms, especially those from Hong Kong and Taiwan, become the suppliers of capital to the liquidity-constrained but fundamentally sound business operations. This is one of the most important reasons why FIEs dominate China’s labor-intensive industries. In industries such as garment and shoe-making, Chinese private firms ought to have possessed strong competitive advantages, but poor allocative decisions of Chinese financial institutions imply that a severe mismatch be-

\(^{38}\)See McKinnon (1994).
tween human and financial capital exists—i.e., efficient private firms cannot get financing, whereas inefficient SOEs are favored. The outcome of this allocative pattern is that private entrepreneurs access capital—sometimes short-term capital—by selling their own equity shares to MNCs based in Hong Kong and Taiwan. Similarly, poor allocative decisions on foreign exchange lead to the same outcome. Because foreign exchange is allocated administratively, much of the official allocation has gone to SOEs to satisfy their import needs. Export-oriented private firms find it extremely difficult to access foreign exchange as a result. Foreign exchange is a critical resource for export-oriented firms because they need to source quality components and machinery from abroad to produce quality products. Hence, to access foreign exchange, domestic private entrepreneurs exchange their equity stakes with MNCs based in Hong Kong and Taiwan. In these two illustrations, the financing roles of MNCs arise not because China is short of capital but because its financial allocation is hugely inefficient. And it is this type of inefficiency that has prevented production linkages between Chinese and foreign firms based on a contractual arrangement. An equity arrangement—i.e., FDI—is favored not because it is intrinsically superior but because the contractual alternative is rendered unviable.

Policy Benefits

Probably the best understood institutional source of demand for foreign equity capital has to do with the policy benefits granted to FIEs in excess of those granted to SOEs. The most widely cited benefit is tax treatment. FIEs are granted tax exemptions and in general are taxed at a lower level than SOEs. In addition, FIEs are granted tariff exemptions on office and production equipment imports. Foreign observers believe that the tax regime is more liberal than similar regimes in other FDI host countries, and this has led to a high level of FDI inflows into China (Dean, 1988).

39 One nonstate company I interviewed in Suzhou possessed very advanced know-how in making precision machinery, and its products were exported to many countries. Because of its nonstate status, it could not secure any credit financing from Chinese banks, and thus it formed a joint venture with a Hong Kong trading firm—which had marketed its products abroad but had little technical know-how—in order to secure the needed capital.
This account is plausible, but it is by no means complete, and it is even slightly misleading. For one thing, beginning in 1993, Chinese authorities have moved to equalize tax treatments of domestic firms and FIEs, and thus tax benefits have declined in importance as a driver of investment behavior. International evidence suggests that tax treatments in general have a weak effect on the distribution of FDI across countries. In the case of U.S. corporations, the U.S. government taxes their profits on a global basis, and thus the tax saving effect of investing in China will be offset by a tax increasing effect in the United States. It is worth emphasizing that the benefit of lower taxes primarily falls on the Chinese shareholders and thus increases their incentives for a corporate conversion into FIEs to qualify themselves for a better tax treatment. Thus demand for FDI is greater than otherwise would be the case, and it may result in a more accommodating stance toward demands made by foreign firms than otherwise would be the case. For example, it is plausible to imagine that without tax benefits, Chinese shareholders may resist foreign requests to take a controlling stake in joint ventures.

There are also less publicized policy benefits conferred on FIEs. During much of the reform period, foreign exchange constituted a valuable asset to firms in its possession in part because RMB was overvalued for many years and in part because, under a protectionist trade regime, access to imports was highly valued. Here there are critical differences between FIEs and domestic firms. First, exporting FIEs could retain 100 percent of their foreign exchange earnings, while domestic firms could retain only a portion and had to sell the balance to the central bank at the official rate. Thus, for each export transaction, FIEs made a surplus equivalent to the amount the RMB was overvalued. The foreign exchange premium began to decrease since the early 1990s as the scope of the foreign exchange market expanded.

Second, strictly speaking, what domestic exporting firms are allowed to retain is not foreign exchange but foreign exchange entitlements. FIEs, on the other hand, retain foreign exchange cash. This has subtle but important implications for the value of the foreign exchange retention. Converting entitlements into foreign exchange subjects the user firm to closer bureaucratic scrutiny and thus limits the “option” value of such a retention. In addition, converting entitlements into foreign exchange is by no means a certain process. In 1986 and, to a
lesser extent, in 1993, authorities restricted such conversions because China ran a large foreign trade deficit. Thus, for domestic firms with foreign exchange entitlements, they bear some expropriation risks, from which FIEs are immune.

There are significant policy implications in this line of analysis. Our analysis of the significant and rising roles of FIEs in the Chinese economy raises a number of policy implications. It is generally the case that rising FDI is accompanied by rising intrafirm trade rather than interfirm trade. Intrafirm trade refers to trade between parent firms and their subsidiaries or affiliates abroad as opposed to the interfirm trade among unrelated entities at an arms-length distance. The rise in intrafirm trade has a number of pertinent policy implications.

For Chinese policymakers, intrafirm trade poses thorny challenges. One is the possibility that MNCs engage in transfer pricing to maximize profits on a global rather than a location-specific basis. Transfer pricing shuffles profits away from the taxing arm of the host governments, and therefore it reduces the tax base in the host country. Another effect is that transfer pricing reduces dividend shares of business partners in the host country. This is an especially important concern because most FIEs take the form of joint ventures.

The institutional benefits discussed above give rise to strong incentives for MNCs to engage in transfer pricing. Researchers in general have found strong evidence that MNCs are motivated by reduction of tax liabilities in the host country to engage in transfer pricing. Thus, relative tax rate differentials between home countries and China are a likely source of transfer pricing behavior. It ought to be noted, however, that the Chinese corporate income tax rate on FIEs is not inordinately high. In SEZs, the applicable rate is 15 percent; in economic and technological development zones, it is 24 percent, and in the rest of the country is 33 percent. Hong Kong’s corporate income tax rate is 15 percent, and, given the fact that most FIEs originating in Hong Kong are located in SEZs, the apparent corporate tax rate equalization should have diminished such an incentive.

It is possible that the entire tax burden on FIEs located in China is still quite high. The value-added tax is 17 percent, and, in addition, local governments often impose discretionary levies. Most impor-
tantly, transfer pricing reduces profit shares accruing to the Chinese shareholder, and the Chinese tax allows FIEs to deduct their accumulated—rather than just current—losses for up to five years. These two motivations are probably stronger than income tax avoidance. Another facilitating condition is that China exempts FIEs from tariffs on imported inputs. Import duties often deter transfer pricing behavior since over-invoicing of the import bill would increase tariff liabilities.

The evidence on transfer pricing is limited and indirect. Its presence is suggested by a number of empirical anomalies rather than direct proof. One piece of evidence is that, despite putative operational efficiency, and managerial and technological know-how, there are in fact more loss-making FIEs than the supposedly moribund SOEs. In 1995, according to the Third Industry Census, 39.5 percent of FIEs reported losses, as compared with 34 percent of SOEs. Sun (1999) has reported some evidence for under invoicing of Chinese exports to Hong Kong and over invoicing of Chinese imports from China. In general, after taking into account freight and insurance costs, the average unit price of Chinese exports at Chinese customs was about 85 percent of the average unit price reported by Hong Kong customs. On the import side, again after deducting the freight and insurance costs, Chinese unit prices, on average, exceeded their Hong Kong prices by about 15 percent. Under invoicing exports and over invoicing imports are telltale signs of transfer pricing behavior.40

For U.S. policymakers, the rising prominence of FIEs in the Chinese economy also raises important policy questions. The significant and growing financing and economic roles of FIEs in the Chinese economy set China apart from Japan and Korea, which absorbed little FDI during their comparable stages of development. This has implications for U.S. economic policies toward East Asia. First, U.S. exports, to some extent, are not a full measure of U.S. companies’ penetration of the Chinese market. US companies export directly to China but

40It is important to read this result with caution. The study does not break down trade between intrafirm and interfirm trade, and therefore it does not show that export under invoicing and import over invoicing are more pervasive among MNC affiliates than among unrelated entities, a logical inference from the transfer pricing logic. Another note of caution is that transfer pricing is only one of the explanations consistent with export/import mis invoicing. Capital controls and capital flight engaged in both by FIEs and domestic firms can also give rise to this phenomenon.
also produce inside China and sell locally produced goods there. The benefits from these sales are not reflected in the trade data but are reflected in the corporate earnings of U.S. corporations. In 1996, one FIE, Motorola (China) Electronics Co., Ltd., exported $690 million worth of goods, but the export value of the entire SOE sector came to $581 million. The export success of Motorola not only benefited Chinese employees but also Motorola’s shareholders.

Second, U.S. trade policy is made on the assumption that political and economic boundaries coincide perfectly. This assumption is increasingly indefensible in light of shifts in industrial locations and of the associated changes in the direction of trade. The area where this assumption should be challenged to its core is Asia. Kojima first put forward the hypothesis that some FDI activities are trade-oriented and others are anti-trade-oriented. Trade-oriented FDI activities are in areas where the home economies are losing comparative advantage and the host economies are gaining comparative advantage. Anti-trade-oriented FDI activities are in areas where the host economies have a comparative disadvantage. Although this view has been challenged, especially the claim about anti-trade-oriented FDI, the claim about trade-oriented FDI activities does seem to accord with the character of much of the FDI inflow into China.

Hong Kong is an extreme but highly illustrative example of trade-oriented FDI activities and of the effects of this kind of FDI on trade flows. By the early 1990s, four-fifths of Hong Kong manufacturing firms had relocated to China. Such investments have reoriented Hong Kong–China trade patterns: Most trade activities are directly related to the subcontracting investment activities undertaken by Hong Kong firms in China. In 1993, 74 percent of Hong Kong’s domestic export to China was related to outward processing; of the import from China, it was 74 percent in 1993. In effect, Hong Kong operates as a trading corporation that contracts out production units

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41 The best example is the emergence of so-called “Greater China,” an area encompassing southern China, Taiwan, and Hong Kong, where economic integration has increasingly penetrated political divisions. See Jones, King, and Klein (1993).
42 See Kojima (1973).
in China—through the provision of production designs and materials—and purchases and distributes the finished goods worldwide.

The concentration of manufacturing locations in China has caused major changes in the direction of trade with the United States and has vastly complicated the management of trade deficits with the region. Briefly stated, labor-intensive goods that previously came from Korea, Taiwan, Hong Kong, and a number of Southeast Asian countries are now increasingly coming from China. This has produced a widening trade deficit between China and the United States and a dwindling trade deficit with the other two members of “Greater China.” The U.S. trade deficit with China has risen concomitantly, with a sharp decline in its deficit with Taiwan and Hong Kong, at least until 1994. It is this rise in the trade deficit that has complicated an already fragile political relationship between China and the United States, for rather unnecessary reasons, because the U.S. deficit with “Greater China” rose by a far smaller margin. While the U.S. deficit with China rose by about sixfold between 1987 and 1992, its deficit with “Greater China” has risen by 9.6 percent. It is also difficult to argue that the rise in the deficit has been a result of China’s import restrictions; China’s imports from the United States have grown at a double-digit rate every year, except for 1987 and 1990. A far more plausible reason for the rising deficit with China is the trade reorientations that are associated with shifts in industrial locations in East Asia.

Given this production-trade link, an aggressive bilateral trade stance can lead to a number of undesirable outcomes. Reduced U.S. demand for goods from China can slow down the rapid capital integration between once politically hostile regions, such as Taiwan and Korea on the one hand and China on the other. It may also impede the process of import liberalization in China by creating a foreign exchange shortage and a regionwide slowdown of economic growth. These outcomes may not be consistent with U.S. long-run economic and political interests in the region. A subtle but important implication of the production-trade link is the possibility that U.S. investment and trade interests may be in conflict with each other. Since the 1992 Memorandum of Understanding, the United States has been pressuring the Chinese to liberalize further China’s market access to U.S. goods and to phase out internal trade regulations and “onerous” import restrictions, such as import quotas and strict sani-
tary standards. However, domestically oriented investments depend on a high tariff structure to be profitable, as illustrated in the case of the automotive firms, and foreign investors typically request protection when they undertake protection-induced investments.45 Thus, overly aggressive market-opening measures as demanded by the U.S. trade representative may in fact undermine the interests of U.S. MNCs with subsidiaries already established in China. This conflict between U.S. trade and investment interests will come into sharper focus if China agrees to the “fast-track” accession terms of the WTO.

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45The Indonesian oil boom in the mid-1970s, which increased the attractiveness of the Indonesian domestic market and induced import-substituting FDI, coincided with an intensification of its infant industry phase. See Azis (1994), pp. 406–407.


