Foreign Direct Investment in the People's Republic of China: Preferences, Policies and Performance

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Abstract

In establishing an investment policy in post-Mao China, policy was designed to gain the benefits of foreign direct investment (capital inflow, job creation, export growth, and the upgrading of technology and skills) without suffering any of the perceived negative consequences. As a result policy makers have attempted to segregate the investment regime, restricting or prohibiting investment where domestic Chinese producers might be vulnerable to international competition, whilst encouraging investment to produce exports and where there is little or no domestic capacity. In the process, considerable autonomy over investment policy has been devolved to local governments, which in turn have been heavily influenced by the interests of foreign investors in shaping local investment strategies. From the mid-1990s, the policy of shielding domestic producers from competition was challenged from both external actors seeking the creation of a level playing field, and internal actors who questioned the logic of the status quo. But whilst there has been considerable liberalisation, including the extension of forms of investment and ownership – not least as a result of China's WTO entry criteria – conceptions of social stability, the potential impact of investment on such social stability, still remain crucial determinants of investment policy.

INTRODUCTION

China's emergence as a major recipient of Foreign Direct Investment (FDI) in the post-Mao era has not only been hugely important for China itself, but has also had a significant impact on the rest of the world. Whilst some foreign companies have managed to establish a foothold in the Chinese economy – producing in and selling to China – the biggest impact has come from those who have used China as an investment platform – assembling in China and selling to external markets. With such investment to China resulting in a transfer of manufacturing employment from not only other export-led developers but core economies in the advanced industrialised world, Chinese policy has frequently come under scrutiny.

Whilst some of this scrutiny is based on how best to compete with China (for example, from Indian academics and policy makers), more often it has been based on dissatisfaction at the lack of equity in Chinese policy. In short, the Chinese authorities have been accused of failing to establish a level playing field that gives foreign actors the same level of access to China that Chinese exports have to other markets. Such inequity has been at the heart of Chinese investment policy which was built on one very simple and straightforward question – how to get all the advantages of encouraging investment whilst avoiding all the disadvantages?

Policy has thus been heavily influenced by what policy makers have perceived to be three key potential disadvantages: the impact on government autonomy and the ability to direct the nature of economic change; the impact of international competition on domestic producers; and the impact of integration with the global economy on financial stability. As a result of these perceptions, investment policy has been driven by three key questions: what type of investment should be sought? into which sectors? and where should that investment be located?

The answers to these three questions have changed as perceptions of the disadvantages have changed. For example, as the logic of maintaining production in loss making state owned enterprises (SOEs) was challenged in the second half of the 1990s, so the force of the logic of protecting them from international competition declined. Indeed rather than seeing foreign investment as a problem for loss making SOEs, some policy makers came to see investment as at least a partial solution to the problem as a new source of capitalisation. Policy has also changed in response to external political pressure – most notably as a result of China's entry into the World Trade Organisation (WTO) in 2001. But whilst these changes have combined to create a ***more*** liberal investment regime, fears of the potential disadvantages have far from totally disappeared, and often result in policies that temper (if not reverse) the liberalising intention of earlier changes.

While national leaders have clearly done a huge amount to create the overall framework for investment policy, they have not been the only actors. In particular, local governments have played a significant role in establishing specific policies to attract investment within the wide framework set down by the central leadership. To this end, they have adapted policy to meet the demands of investors – which suggests that local governments in China in part act as a means for the transmission of external actors' interests into actual investment policy at the point of implementation.

SETTING THE POLICY FRAMEWORK

Sea Changes, Watersheds and other liquid based definitions

In an era when economists debate when, not if, China will become the world's biggest trading economy, it is salutary to remember that China is a relative newcomer to the global political economy. Indeed, well into the 1980s, the capitalist global economy was still officially perceived of as bad and dangerous, rather than the key determinant of Chinese economic growth that it was to become. It is also worth remembering (and perhaps difficult to comprehend) that it is not that long ago that all international economic contacts were closely controlled by the central government – virtually no money or goods moved in or out of China without the approval of the State Council in Beijing (well, legally at least).

The origins of the contemporary policy framework for foreign investment can be found as recently as the first law allowing equity joint ventures passed in July 1979 – or at the earliest, the ideational decision to reject class conflict and embrace economic reconstruction as the party's primary task in December 1978. Even then, whilst investment flows grew, they grew from a very low base, and were initially restricted to four Special Economic Zones[1] and later 14 open cities along the coast. Notwithstanding incremental reforms that opened more parts of China to investment – both in terms of geography and industrial sector – and made it easier for foreigners to invest, capital flows were still relatively small when a combination of a limited retreat from reform and the suppression of the Tiananmen Square demonstrations resulted in a partial retreat from China in 1989.

The initial decision to pursue economic reform in 1978 not so much necessitated ***changing*** an existin policy-making framework as ***creating*** a new one. For Fung, Iizaka and Tong (2002, 4) initial policy reforms entailed simply legislating to ***permit*** foreign investment, with the shift to ***facilitating*** and encourage investment not occurring until 1986 with what become known as the “twenty-two regulations”. Although investment grew rapidly in these early periods, it grew from a very low base, and it was not until Deng Xiaoping gave his overt and support for proto-capitalist production and foreign investment in his tour to Southern China in 1992 (the nan xun)[2] that China became a significant force in the global economy. Indeed, FDI in 1993 alone was more than the cumulative total for 1979-92.

Following the nan xun, a range of new policies were introduced to increase investment flows into previously closed domestic sectors[3]. However, the biggest impact came through the strategy of providing incentives for investors to use China as an export production/assembly base. Notwithstanding the impact of WTO entry discussed below, manufacturing for export still remains the main reason for investing in China (accounting for around three-quarters of all investment), and foreign invested enterprises also remain the primary source of Chinese exports.

If the first phase of entailed permitting and the second facilitating investment, policy entered a new phase in 2001. In joining the WTO, Chinese negotiators agreed to implement a range of domestic policy reforms designed to allow greater access to the Chinese market, and to guarantee equal treatment for Chinese and foreign companies. When fully implemented, the policy changes required to make China WTO compliant should theoretically undo the basis of policy since 1978 – to protect domestic producers in the domestic market whilst simultaneously subsidising exporters. Although the early “permitting” phase provides interesting insights into the dynamics of reform politics in post-Mao China, the focus in this paper is on the transition from facilitation to WTO compliance; and the tension between the requirement to meet WTO entry criteria on the one hand and the desire to control investment on the other is an issue that reoccurs throughout the following discussion.

The Alphabet Soup of the FDI Decision Making Bureaucracy

Not least because of the still rather ambiguous relationship between the Chinese state and the market, investment policy is overseen by a complex and occasionally bewildering overlapping set of bureaucratic agencies. For much of the reform period, three organisations shared responsibility for investment policy. The State Planning Commission[4] set overall plans for development and established the overall legal framework for policy, whilst the State Economic and Trade Commission (SETC) and the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) effectively divided the Chinese economy into domestic and international sectors. SETC dealt with the domestic economy, deciding which economic sectors should be open to investment, and what conditions should apply to investment in each individual sector. But while SETC decided where investment went, MOFTEC had authority over the investment itself – it was responsible for developing strategies to attract investment, for formulating and implementing necessary legal changes, and acted as the ombudsman in cases of disputes between Chinese and foreign partners.

In addition to specific investment policy, MOFTEC was also responsible for developing China’s foreign trade regime which was of crucial importance for the vast majority of investors who sought to import components into China to produce exports in foreign invested enterprises. Together, these three agencies were responsible for producing "The Catalogue Guiding Foreign Investment in Industry", which is discussed in detail below.

China's administrative system was established to manage a planned economy, and this structure remained more or less intact despite the transition from planning to a more market oriented economy in the 1990s. The disjuncture between the reality of economic activity and the structure of economic planning led to administrative reforms in 1998 and 2003 designed to move from government control over the economy to government supervision and regulation. The State Planning Commission was ultimately merged with the Structural Reform Office of the State Council to create a new State Development and Reform Commission which, while MOFTEC merged with SETC to create a new Ministry of Commerce (MOC).

As such, FDI policy now falls under the joint control of the MOC and the SDRC. But while two responsible agencies might be better than three, they do not have a complete monopoly in setting FDI policy. Individual ministries, for example, are responsible for establishing specific investment policies in their own area in cooperation with the MOC and produce their own separate guidelines for investors. As China operates currency controls and provides a wide range of tax incentives for different types of investments, policy requires cooperation with a range of financial and fiscal agencies – most notably the State Administration of Foreign Exchange (SAFE), the Ministry of Finance, the People's Bank of China, and the customs and tax agencies. As with the Ministries, these agencies can and do produce separate guidelines for investors that countermand MOC/SDRC regulations. For example, even though there are overall rules produced by the MOC and SDRC stipulating the conditions for waiving import duties, the General Administration of Customs' isssues a more specific set of regulations that in some cases cancels the waiver and reimposes duties

Not surprisingly, investors (both potential and actual) typically argue that although these regulations are now usually publicly available (and in languages other than Chinese), it is still extraordinarily difficult to come to a final understanding over what can and cannot be done (and under what conditions). It also makes it extremely difficult for Chinese policy makers to coordinate their actions. For example, Wu and Tang (2000, 64-5) show that introducing new capital control regulations from 1998-99, ensuring that they were correctly implemented, and then establishing legal penalties for non-compliance entailed separate regulations from SAFE, the People's Bank of China, MOFTEC, the Bank of China, the State Council, the Ministry of Personnel, the National People's Congress, the Ministry of Supervision, and the General Administration of Customs.

In addition, while the SDRC and the MOC have overall control, horizontal coordination between different ministries and agencies remains weak. Although the introduction of the capital control regulations more or less worked as planned, it is often the case that there is a lack of coordination between different agencies in the policy formulation process. New regulations are issued and laws are passed that cannot (or will not) be implemented successfully by all affected agencies, resulting in the need for new “sets of implementing regulations and revised laws” (OECD 2003, 16-17).

The Decentralisation of Power and the Global-Local Nexus

While the central government sets general policy and provides the overarching legal framework for investment, a further complication is that control of most investment has been deliberately devolved away from the central government. In 1996, the State Council amended regulations on investment oversight by lifting the ceiling on projects that did not need central government approval from US$10mn to US$30mn[5], with approval rights granted to “closely affiliated institutions” of specified government agencies[6], all provincial level governments[7], and officially registered development zones. Just to add a level of confusion, local authority is countermanded by industry specific legislation that insists on central government approval for investment in those industries identified in The Catalogue – notably many of the sectors that have been liberalised as a result of WTO entry. Nevertheless, in practice, it is often local governments that have hands-on approval power and control over projects. As Guang (2000, 49) notes:

> “the central government does not have much power to intervene in individual FDI projects locations. The location is essentially a matter between foreign investors and the governments at the provincial and local levels”

For those investors seeking cheap production sites to make exports, local control has been a good thing. Not only does it speed the approval process, but local development zones also have the power to offer tax breaks, help with start-up costs and other incentives to attract investors[8]. There is “cut throat competition” (Braunstein and

Epstein 2002, 27) to attract investment, with local authorities and development zones often prepared to undercut each other to win projects. And as individual cities can have more than one development zone (Shanghai currently has nine) it is not just a case of city competing with city. And not surprisingly, some investors play off different development zones against each other to gain the maximum possible incentives[9].

For those attempting to produce in China to sell in China in competition with domestic producers, local autonomy is a different issue altogether. Local governments can and do set their own regulations for approving investment projects in accordance with local economic conditions, even if the project meets central government criteria. As they are often classified as "*neibu*" or "internal" regulations that are not made public, you only know that they exist by contravening them – much to the frustration of potential investors (OECD 2003, 19).

Even when investment is approved by higher authorities, local governments have considerable formal and informal power over the operation of foreign invested enterprises[10]. Examples include local companies negotiating tax exemptions not available to foreign competitors; foreign companies being forced to adhere to higher safety, labour and environmental standards that local companies simply ignore; the awarding of contracts to local companies irrespective of price and quality; the inability of foreign companies to get access to transportation facilities; and the imposition of myriad ad hoc fees for just about any activity whenever the local government feels like it.

The Local-Global Nexus and National Regulation

In the 1990s, local governments also found new ways of financing local projectd through the creation of International Trust and Investment Corporations (ITICs), many of which attempted to raise foreign capital by issuing their own bonds and borrowing from foreign banks. These ITICs were not only under local control, but pretty much fell outside any form of central government regulation. And when one of the largest, the Guangdong ITIC collapsed in 1998 with US$4 million worth of outstanding debts owed to foreign investors, the central government refused to offer any or to honour its international debts.

Compared to other forms of investment, the ITICs have not been particularly significant – as we shall see below, investment in productive capacity is much more important. Nevertheless, the rise and stumble, if not fall, of ITICs, provides an interesting example of policy making in a period of rapid change in the transition from socialism in China. As already noted, although China is a unitary state, local governments have considerable power in not only implementing but in shaping policy initiatives. The growth of ITICs in part reflected the existing power of local governments, which often created new corporations without seeking permission from higher authorities. But these ITICs in themselves were also intended to enhance that power by providing new sources of local financial autonomy at a time when the central government was attempting to claw back control. As has often been the case, the establishment of an effective national regulatory mechanism only took place after ITICs had already proliferated leading to “chaos and mismanagement” (Gao and Liu 1999, 53) – and with the collapse of the Guangdong ITIC, after a crisis threatened to undermined international confidence in investing in China.

Even then, it was not until 2001 that the People's Bank of China issued detailed regulations governing ITICs actions rights and responsibilities, requiring them to be centrally registered and approved, and banning them from issuing bonds overseas. It took another four yeas "after years of crackdown" that the China Banking Regulatory Commission announced that the remaining 59 ITICs were now essentially economically viable (People's Daily 2005). Again, as has often been the case, the creation of new central investment regulations was at the very least complicated - if not actually obstructed - by local governments keen to protect their own financial interests and autonomy.

CONTROLLING INVESTMENT

The case of local autonomy brings us back to the key question of what the (central) government has been trying to achieve through a policy framework designed to (partially at least) control investment, and whether this policy has been successful. The basic objective of attempting to gain the benefits of participating in the global political economy without suffering any of the perceived drawbacks has remained largely consistent. However, the understanding of what is or isn't beneficial has changed over time – as too have understandings of where the balance should lie in accepting potential problems in return for potential rewards. Policy, then, has been far from static in each of the three broad policy considerations established in the introduction to this paper - what type of investment should be sought, into which sectors and where that investment should be located.

What Type of Investment?

One of the striking characteristics of Chinese investment policy is that in stark contrast to other developing states in East Asia, non-productive investment - "hot capital" or portfolio investment - has played a strictly limited role. While the trend might be upward, portfolio investment still only accounts for around five per cent of inward investment, with the vast majority of FDI in productive capacity. The primary sector accounts for only 2-4 per cent of FDI, the tertiary sector around 24-28 per cent (mostly in real estate), with the remaining vast majority in manufacturing. If we break down the manufacturing sector itself, then we can say that the main reason for investing in China is to produce textiles, apparel, footwear, toys, and electronic goods. It is this last sector where FDI is growing fastest, with a particularly striking growth of FDI in computer related manufacturing for export – indeed, 17 of the top 20 FIE exporters are in electronic related manufacturing.

Controlling investment - hot capital versus productive capacity

Although firms in Shanghai began issuing shares in the mid-1980s, stock markets (in Shanghai and Shenzhen) only began operations in 1990[11]. Since then, foreigners have been restricted to investing in those shares nominated in foreign currency[12] - known as B-shares – and do not have access to the much larger stock of A-shares denominated in RMB which are reserved for domestic investors. The maintenance of capital controls, the lack of transparency and concerns about corruption and the immature (though improving) regulatory environment has also made portfolio investment unattractive for many potential investors[13].

Whilst these restrictions have arguably denied Chinese firms the ability to raise much needed capital, as the 1997 Asian financial crises dramatically showed, they also helped shield China from the volatility of global capital flows. Despite a reduction in portfolio investment in 1998 as investors withdrew from East Asian economies in general, the very low level of such investments in China minimised the impact on the economy in general. Indeed, for Yu Yongding (1999a) the underdevelopment of China's financial markets combined with continued strong capital controls were the key reasons for China escaping the turmoil of 1997 pretty much intact.

Policy making in regards to non-productive investment not only represents a trade off between securing new sources of capitalisation and avoiding financial instability, it also represents a trade off between capitalisation and maintaining policy autonomy. For example, maintaining currency controls and a currency peg against the US dollar allowed the authorities to lower interest rates when growth in the domestic economy was slow. Although the RMB-dollar peg was abandoned in July 2005, the value of the renminbi was still closely controlled, and only allowed to fluctuate by 0.3 per cent against the value of a basket of currencies each day[14]. This change came at a time when China's large trade surplus with the US was – not for the first time – generating ever louder complaints that a deliberately undervalued RMB was discriminating against US producers. China's leaders were quick to deny that US pressure had informed the decision making process, and the general line pushed through the media to the domestic audience was that the reform made sense for China, and had been solely informed by domestic interests and considerations. Despite these public proclamations, the suggestion that the reform was at least in part designed to silence external demands for even more radical changes does not appear to be too wide of the mark.

In theory, maintaining currency and convertibility controls should mean that policy makers could change interest rates without having to worry about the impact on capita flight and subsequent exchange rate adjustments impacting on the price of Chinese exports. But this theoretical policy autonomy has been far from complete and it has not always been that easy to prevent capital flight (Ding 1998; Wu and Tang 2000; Gunter 1996; 2004). In some cases, enterprises exploit rules and regulations – for example, manipulating the timing of inward and outward remittances and debt repayments to ensure that capital stays in higher yielding foreign accounts as long as possible. In other cases, individuals and enterprises simply act illegally – by making unauthorised outward investment, faking payment requests for expenses supposedly owed oversees[15], faking import invoices to show higher prices than were actually paid, and the through straightforward smuggling (Yu 1999).

As such capital flight is often illegal, it is not surprisingly impossible to come to firm conclusions about its significance. The high-point was between 1997 and 1999, when speculation was rife about a possible devaluation of the RMB. Calculations of the extent of capital flight during this era range from a high of almost US$90 billion to a low of US$53 billion[16], and even if we accept the lower figure, then capital outflow was roughly a third of all capital inflows into China during the same period (CD 2002). Yang and Tyers (2000, 5) calculations suggest that there was actually a net outflow of capital from China of around US$30 billion from 1996-98.

Although the previous years had seen a gradual liberalisation of capital controls (de facto at least if not always de jure) concern at the extent of capital flight “when the stability of the yuan and hence, the credibility of the central government, was perceived to be in danger" resulted in the introduction of new restrictions on currency transactions in 1998 that appeared at first to stem the flow (Wu and Tang 2000, 63). But Gunter (2004, 74) argues that largely through mis-invoicing of trade, capital flight soon recommenced and even increased. Writing in 2004, he argued that "accumulated PRC capital flight since 1984 is approximately $923 billion with almost half of this total occurring in the last 5 years".

Although this paper is primarily concerned with inward rather than outward capital flows, this brief discussion of capital flight is important for two key reasons. First, most basically, it is an example of how Chinese policy makers have attempted to gain the benefits from participation in the global economy (for example, through inward investment and a beneficial export environment) without suffering from the potential drawbacks (for example, potential financial instability and decreased autonomy over setting exchange and interest rates). Second, notwithstanding these attempts to control the benefits and drawbacks, it shows that even in a relatively closed financial system with strong controls over currency flows and convertibility, China cannot act in isolation. If interest rates are much lower in China than elsewhere, then people can and do find ways of moving money to more advantageous locations (Yu 1999a, 11).

Foreign observers have long suggested that the underdeveloped nature of China's financial markets is one of the key constraints on China's future economic growth (Cheong 2003). This view is increasingly shared by China's own economists and leaders, and notwithstanding the dangers of financial instability, a number of policy initiatives have been introduced to facilitate investment. For example, after WTO entry in 2001, foreigners were permitted to directly trade B-shares rather than being forced to work through local brokers, and Chinese residents were allowed to trade in B-shares[17]. Foreign investment companies are also incrementally being allowed to operate in more economic sectors, although policy remains for the time being in a "permitting" rather than "encouraging" mode. And although foreign investors have made considerable gains from portfolio investments in recent years[18], it remains very much a minor form of investment – and much less important than in the huge growth of investment to South East Asian economies during the 1980s and 90s.

Controlling Investment by Sector – the Catalogue

FDI policy, then, has been concerned with ensuring that the right sort of investment goes into the right sort of places. In addition to restricting portfolio investment, until fairly recently at least, this also meant that investment was permitted and even encouraged if there was no domestic sector to compete with. More important, foreign capital was encouraged to produce exports to other markets, thus generating jobs, fiscal revenue and foreign currency without impacting through competition on domestic producers. But foreign investment in those sectors where existing Chinese producers might find it difficult to compete with "powerful international capital owners" (Jin Bei 1997, 65) was either prohibited, or made extremely difficult.

Encouraging investment to produce exports was originally conceived of as a relatively minor supplement to the domestic economy. However, particularly since 1992, the investment-export nexus has become a major source of economic growth - and alongside the protection of domestic producer, investment policy has been a crucial component in the governments strategy of creating “reform without losers” (Lau, Qian and Roland 2000). As one of China’s most influential trade official, Wu Yi, put it in 1998:

> “If we cannot keep exports and investment growing, our macroeconomic growth target will be at risk …. It's not exports for exports’ sake, we have to help achieve an 8 per cent growth rate in GDP …. It's a political issue to boost exports …. proper export growth is critical in helping the nation reform State-owned enterprises, create jobs and promote social stability” (Wang Yong 1998).

From 1995, this differential approach to foreign investment was formalised in “The Catalogue Guiding Foreign Investment in Industry” which, on an industry by industry basis, shows where investment is prohibited[19], restricted, encouraged or permitted[20]. The Catalogue was first amended in 1997, and then more fundamentally altered in 2002 and 2005 in the wake of China’s WTO entry[21]. These last two amendments increased the number of sectors open to foreign investment, allowed wholly foreign owned enterprises to operate in more areas without having to join with a Chinese partner. They also removed WTO-incompatible requirements in these sectors on the utilisation and repatriation of foreign exchange, the use of imported “advanced technology” and/or local content, and on requirements to export a stipulated percentage of the goods produced within China (Wang Rongjun 2004).

Prohibited Investment

Prohibited sectors include those deemed to be essential services (compulsory education, postal service), investment in industries considered to be essential for national defence, those that produce harmful and "persistent …. pollutant products", and industries that are illegal under domestic Chinese law (for example, pornography). Whilst investment in such sectors is often prohibited in other states, there are three other key prohibited sectors in China.

First, the catalogue "protects" China's cultural heritage by prohibiting investment in traditional medicines, the cultivation of rare plant and animals, speciality teas, decorative carvings and so on. Second, investment is prohibited in key economic sectors such as fishing, the production and supply of power and water, and futures companies. Third, and perhaps most interesting, foreign investment is prohibited in those areas that the leadership perceives could damage its monopoly on political power in China by undermining its monopoly on the dissemination of news and information. Such prohibitions exist across the news medias, more general publishing and entertainment industries, and also in what is called "social investigation"[22].

Encouraged Investment

Encouraged sectors can be divided into three. The first is the above mentioned investment to produce exports – indeed, any enterprise that exports all of its produce falls into the encouraged category irrespective of what it is producing. The second is those previously restricted or closed sectors that became "encouraged" in the 2005 version of the Catalogue to conform to the terms of China's WTO entry criteria. These include the joint exploration of energy resources, automobile manufacturing[23], international and domestic transportation, distribution of goods within China, higher education, and accounting and auditing in the ranks of encouraged industries. However we should note here that while investment is officially "encouraged", ownership restrictions remain that do not always encourage foreigners to invest in reality – an issue we will return to after the discussion on restricted investment below.

The third main category is where investment provides what the domestic economy cannot – be that shortages of finance capital for large and expensive infrastructure energy and environmental projects, or where technology and know-how not currently abundantly available in China. For example, there is a separate "Catalogue of Encouraged Hi-tech Products for Foreign Investment"[24] that lists 721 items where investment is encouraged to improve China's technological base.

Promoting technology transfer was one of the earliest enunciated objectives of investment policy after 1978 – and in some respects the objective has not been attained. To be sure, investment has introduced new machinery, technology and know-how. This is particularly true for investors who want to sell their goods in China, who typically have to meet technology transfer expectations if the investment project is to be approved. Since WTO entry, US companies in particular have also increasingly exported machinery to China to make components for use in export production, rather than simply exporting the components themselves. Exporters are also increasingly sourcing from the many Chinese enterprises that have altered their processes and structures to engage with the export based foreign invested sectors. But while things are changing, the majority of those who export for export in China still source the majority of their materials and components from elsewhere (particularly in hi-tech industries). Linkages between export oriented areas and sectors and the rest of the domestic national economy remain relatively weak, and the technological and developmental spill-overs of export oriented growth remain, in many areas, to be attained (Steinfeld 2004; Lemonie and Unal-Kesenci 2004). At the very least, the footprint on the domestic Chinese economy is much smaller than the gross investment figures might lead us to conclude.

Restricted Investment

Restrictions are primarily used in those sectors where injections of foreign capital are welcomed, but only if the foreign interests remain subordinate to national interests and if national development objectives are not distorted by external actors. They cover those economic sectors that are deemed central to national economic development, and this need to remain out of foreign ownership or control – for example, the production and processing of certain foods (most notably grain), medical and pharmaceutical products, raw material exploration, power plants, chemical goods and processing, wool cotton and silk production, and so on.

Restrictions are thus used as a means of imposing a form of macroeconomic control over the national economy – not just in terms of exercising control over external economic actors, but also in terms of controlling the actions of key domestic Chinese actors. One of the features of the reform process in China is the extent to which local authorities have competed with each other, not only to attract investment, but also to establish their own productive capacity irrespective of national goals and strategies (Tsai 2001)[25]. As local investment strategies are based on local need, and often ignore the overall national economic structure, they are termed “blind investments” (mangmu de touzi)**.** In order to maintain production in local factories, local authorities have set up trade barriers preventing "imports" from other parts of China, leading some to characterise local governments as acting like old feudal or "dukedom" economies (zhuhou jingji) (Shen and Dai 1990).

This strategy has maintained employment in enterprises that might not be able to exist in a competitive market (domestic, let alone international), and also provides finances for future local projects through local revenue collection (Li, Qiu, and Sun, 2003). But the lack of a national and market rational control of investment has resulted in the duplication of productive capacity and massive over-supply in a number of areas, and for some, is a key structural impediment to the long term sustainable development of the Chinese economy:

> Regional protectionism – by protecting the backward, inflating trade costs, blocking the equitable allocation of resources, and hindering the formation of large-scale economies – is becoming the main cause for the weakening international competitiveness of Chinese enterprises (Hou 2004: 24)

In truth, such foreign investment is not as important in these sectors as domestic sources of capital, but the 2002 and in particular 2005 amended Catalogues are thus partly used as a way of disciplining domestic actors - and not just external investors – by restricting investment into sectors where there is excess capacity and duplicated "blind investment" – it is a tool of domestic economic management as well as a means of regulating international economic relations.

There is a regional development aspect to restricted investment. As the general issue of spatial development strategies will be dealt with in detail below, here it is suffice to say that there is a differential regional treatment of restricted investments. The restricted category is “trumped” by a separate catalogue that outlines investment that is encouraged in China’s less developed regions. In effect, what is restricted in China’s coastal provinces may well be encouraged in northeast, central and western China (on a case by case basis)[26].

Whilst some specifics are provided on the nature of the restrictions in the catalogue, the full and detailed restrictions for each industry can only be found by referring to the specific laws and regulations for that industry. But in general, there are five main forms of restriction. The first relates back to the issue of technology transfer, and entails either stipulating specific amounts or types of technology to be transferred to China, or the extent to which local content and suppliers must be used. Second, investors may have to guarantee that they will export a certain proportion of any produce - indeed, the 2002 amendments allowed any firm that exported more than 70 per cent of its produce to move from the restricted to permitted category (Lauffs and Tan, 2002). Third, restrictions are used to prevent individual foreign companies taking a dominant market share by limiting the scope of their investments. For example, investors can not take a majority share in Chinese chain stores selling newspapers that have more than 30 outlets[27].

Fourth, the Catalogue identifies those economic sectors where the normal autonomy of local authorities does not apply (see above), and ministerial or State Council approval is required. These sectors include many of those that have been liberalised as a result of WTO entry – as with the changes to encouraged industries, the 2002 and 2005 revisions to the restricted category was partly inspired by the need to ensure that domestic laws were WTO compliant. But the maintenance of restrictions ensures that the central government retains a degree of control over newly liberalised sectors – an example of how an apparent liberalisation of policy can be at least qualified (and some have argued contradicted) by the supplementary regulations[28].

Finally, investors are not permitted to establish wholly owned enterprises, and are forcing them into a partnership with a Chinese company which will typically retain a majority share holding. As noted above, restrictions on ownership forms are also retained in some encouraged sectors - and for some investors, constraints on ownership forms means that whatever the official designation in the Catalogue, the industry is not an attractive investment option. And whilst some sectors remain protected by official policy, meeting the preferences of investors has gone a long way to shape the evolution of ownership policy in the reform era.

Controlling Investment – Ownership Forms

Anthony Yeh (2000: 39-40) provides a useful description of the three major forms of foreign investment in China[29]. The first is compensation trade. Here ownership remains in the Chinese company, and foreign investors are reimbursed with goods produced by the enterprise in which it is invested and where ownership resides. This can include investing in the production of one commodity, but being reimbursed with a different commodity – for instance, you invest in cameras, but get paid in computers produced by the same enterprise).

The second more important form is Joint Ventures. Initially, the preferred Chinese government option was Equity Joint Ventures, first accepted as a legal form of ownership in 1979. Here, the two sides pool investment capital in agreed proportions and share profits and loses in proportion to their equity stake. With contractual Joint Ventures, the Chinese partner provides land, factory building, and labour, while the foreign partner provides equipment, capital and technical expertise. But despite the fact that Joint Ventures were what the Chinese government favoured, and are still the only possible form of investment in most restricted and some encouraged industries, they are not the ownership form of choice for the majority of foreign investors. At the end of 2005, around 65 per cent of cumulative FDI had taken the form of contractual or equity joint ventures with Chinese companies. However, wholly foreign owned enterprises (WFOEs) became increasingly popular in the 1990s, becoming the single largest form of new investment in 1998, and the dominant form accounting for around three quarters of new investment projects by value in 2004 (US Department of State, 2005).

The changing nature of ownership forms is an example of how Chinese policy has evolved to meet the requirements of potential investors. It might be obvious, but where policy has been most successful, it has been when the interests of Chinese policy makers and potential investors have coincided. Or perhaps more correctly, the biggest successes have been when Chinese policy serves the interests of international finance capital. Indeed, attempts to change the nature of investment have been far from successful when they have not coincided with the interests of investors. For example, when the central government removed tax exemptions on imported goods used in foreign funded enterprises in 1996, FDI declined to such an extent that the government back-tracked and reintroduced tax exemptions on such imports from 1st January 1998.

Mergers and acquisitions (M&A)

If joint ventures represented a first type or wave of investment, and WFOEs a second, then the decision to alter the basic strategy of industrial policy in the mid 1990s has generated a new third wave. Chinese leaders had long been seeking a way of reducing the financial burden of keeping loss making State Owned Enterprises operating without increasing the social/political and economic burden of coping with increased unemployment. In 1995, a new policy emerged association with the slogan “grasping the big and letting go of the small” (zhuada fangxiao)[30], whereby small SOEs were allowed to be transferred to private ownership - officially referred to as “shareholding transformation” (gufenhua) rather than “privatisation” (siyouhua) - allowing the government to concentrate on larger enterprises. In effect, rather than seeking ways of reforming the existing system, the new emphasis was to change the system and create a new one – from economic reform (gaige) to systemic change or reconstruction (gaizhi) (Yang, 2004).

Crucially for this paper, the move from reform to reconstruction facilitated a rethink of the benefits of utilising foreign capital as a means of financing not just domestic enterprises in general, but the SOEs themselves – the supposed lynchpins of the domestic economy. Initially, this entailed China’s larger (and successful) SOEs raising money through listing and issuing Initial Public Offerings on overseas stock markets – initially Hong Kong and Singapore, but more recently also New York. From 2002, new regulations have also facilitated foreign investment in some SOEs (particularly in northeast China) through M&A.

We should not get carried away. Green and Liu (2005: 169) argue that when it comes to privatization, there is a "line in the sand". Most of the loss making SOEs are at the local level, and whilst they and SOEs at the centre that continue to lose money will be "let go", this will leave a core of SOEs that will be protected from privatisation. In addition, as the Shanghai TV host Larry Lang Xianping provocatively publicised, the main purchasers of the new shares have been the enterprise managers themselves – and usually after they have restructured the enterprise to ensure that the shares are offered below their real market value. And compared to other developing countries, the share of M&A in China's share of inward investment is relatively low – around 15-20 per cent compared to roughly half in competitor economies. Nevertheless, 20 per cent marks a fourfold increase from the 1990s, and M&A are predicted to become the next "third wave" of investment challenging WFOEs as the reconstruction of SOEs continues (Woodard and Wang 2004).

Where Investment Should Be Located

One of the consistent themes in official discourses on investment policy in China, and an issue referred to throughout this paper, is the extent to which FDI can contribute to official regional development strategy. Initial investment policy deliberately limited the geographic scope of investment to limit the risks of links with the capitalist global economy – to prevent contagion from capitalist economic and bourgeois political ideas. Rapid economic growth in these zones built on influxes of foreign capital soon led to representatives of other coastal cities lobbying for similar rights (Hamrin 1990, 83) and the gradual opening of virtually all of China for foreign investment. Nevertheless, while there have been changes in the location of investment, this has entailed the original zones' shares of overall investment declining as other coastal cities and zones have witnessed increased investment. But while the geographic spread of investment has increased from south to north along China's eastern coast, there has not been a significant relocation of investment from coast to interior, with around 90 per cent of all investment going to just eight coastal provinces from Liaodong in the North to Guangdong in the south[31].

The initial uneven ability to attract investment formed part of a wider strategy of not just allowing but facilitating an uneven geographic development strategy. Particularly during the Premiership of Zhao Ziyang up to 1987, what became known as the "Gold Coast" provinces became the main focus of development strategy. When representatives of interior provinces complained, they were told that if the coastal provinces were to get rich first, then wealth would then trickle down into the interior and that investment policy would eventually be changed to focus on their needs[32].

The promise to move the geographic focus of investment policy to the West eventually came to fruition as part of the wider remit of the new State Council "Office of the Leading Group for Western Region Development of the State Council" in 2000. Not surprisingly, the shift in emphasis from the eastern coast to the West left representatives from China's central and northeastern provinces asking when their turn would come, contributing to the creation of the "Northeast Office"[33] in 2003. At the time of writing, the "Rise of Central China" was a strategy without an office - or perhaps more cynically, a rhetorical assurance to leaders from central china that they had not been forgotten without an office.

As Goodman notes when the government announced plans to “Open up the West” in 1999 many observers thought that this presaged a reversal of policy. The only way that the massive inequalities between the coast and the interior and/or West could be resolved in anything other than the (very) long term was by moving back from liberalisation and the market and providing the government to transfer the necessary financial resources through a more centralised and planned economy (Goodman, 2004: 318). But while the government has used budgetary resources to direct more resources to the centre, west and northeast, there has occurred within the existing paradigm, not by a rejection of liberalisation. Indeed, as already noted, attracting more foreign investment to non-coastal areas is a key component in this desire to redress unequal regional growth.

Rather that turning back from liberalisation, the specific policies designed to attract more investment has sometimes entailed further liberalisation – and indeed, greater liberalisation than is the case for similar investments along the coast. For example, the Ministry of Commerce works with the NDRC to produce the “Catalogue of Priority Industries for Foreign Investment in the Central-Western Region”[34] which outlines on a province-by-province basis industries where there are special incentives to encourage investment irrespective of their status in the main Catalogue. In addition, the decision to encourage foreign M&A was primarily driven by the need to deal insolvent SOEs in the northeast – and recapitalisation through foreign M&A is at the heart of the strategy to revitalise the northeast.

Investment policy played a crucial role in facilitating the rapid economic growth in coastal provinces that Zhao Ziyang put at the heart of his uneven regional development strategy. To date, the government's success in replacing this original strategy with a new one based on increasing non-coastal China's share of investment has been limited - investment in the interior is up, but is still massively dwarfed by investment to the coast. Investing in China's interior has up to now been primarily to either gain access to China's raw material supplies, or to produce in China to sell in China. These two priorities will continue to be important determinants of the location of investment - indeed, increasing domestic demand is likely to remain the single most important reason for investing in the interior in the near future.

But investing in China to produce exports is also beginning to be a factor in attracting investment away from the coast. Increasing production costs on the coast are making both Chinese and foreign producers look to the interior for alternative lower cost production sites. Government spending on new highways and airports is also making it easier to get components into and exports out of non-costal provinces - particularly those provinces that border on a coastal province with good port facilities (Roberts, 2005). Just as developing states in East Asia shed production to less developed states like China as they got richer and more expensive to produce in, so China's policy makers hope that rising wealth and production costs on the coast will lead to the shedding of productive capacity to the interior rather than to other developing states.

Evaluating the Success of FDI Policy

In terms of attracting investment to produce exports, it seems difficult to argue that policy has been anything other than an overwhelming success. China became the second biggest recipient of FDI in the world after the United States in the 1990s, and FDI grew more than twenty-fold since the beginning of reform period. In 2002, China actually surpassed the US as the world's major recipient of non stocks and shares FDI reaching US$52.7 billion. Cumulative FDI in China in the reform period exceeded US$600 billion at the start of 2006, and China accounts for something like 20 per cent of global FDI in developing countries. Annual average growth rates of around 8 per cent would have been unattainable without the FDI-trade linkage; those areas engaged in export production have the highest per capita GNP rates; it has had a positive impact on balance of payments and foreign currency reserves; FDI has created new jobs; FDI has upgraded skills, raised factor productivity, increased technology transfer and encouraged reform of domestic Chinese industries (Houde and Lee 2000). Investment policy also successfully shielded many domestic producers from international competition. Of course, some will argue that this was the wrong thing to do, and thus the intention of the policy was misguided - but in terms of evaluating policy, it was successful in that policy did what it was intended to do

But whilst it is hard to be critical, it is not impossible. For example, Huang Yasheng (2002) argues that rather than being seen as a great success, the amount of foreign investment in China instead illuminates the structural failings of the domestic Chinese economy to efficiently allocate finances (and resources) – FDI has filled the gaps caused by the failings of the domestic system. Again, for this article, the focus is on whether policy has been successful in its own rights, and four key areas can be identified where policy might not have met its objectives – or perhaps more correctly, where we can question if the success of policy outcomes is as clear as might appear at first sight.

The first is the extent to which investment policy has resulted in the expected and hoped for technology transfer and technological upgrading of Chinese industries – an issue already dealt with above. Second, despite the huge inflows, foreign invested enterprises still account for only around three per cent of the workforce in China. Of course, Fan and Zhang (2003: 9-10) are entirely correct when they point out that this three per cent "mitigates the issue of unemployment in China. Just imagine one percentage increase in unemployment that will translate into many economic and social problems". It is not that policy has been unsuccessful in generating new jobs, but that the impact of investment on job creation has not been as great as the gross figures might suggest.

However, the third reason for questioning the success of policy is the extent to which the benefits of investment have been achieved at the expense of the exploitation of the Chinese work force (Chan, 2001). Lack of space forbids a full consideration of the argument here, but the general argument is that many of the jobs that investment policy has created are low skilled labour intensive jobs where (primarily) women work for long often illegal hours in unsafe conditions for very low wages.

The fourth question is whether investment policy has actually generated as much ***foreign*** investment as the figures suggest. It is generally accepted that FDI figures for China overstate the real extent of "foreign" investment due to the significance of "round tripping"[35]. This refers to the process of domestic Chinese actors investing in Hong Kong (often through a shell company) to re-invest in China to take advantage of the preferential treatment offered to foreign investors. There is a considerable literature on the importance of round-tripping in FDI into China. While the very nature of the process makes it difficult to be exact about its extent, the consensus is that around a quarter of all "foreign" investment is in fact from China, though Wu *et al* (2002: 102) argue that the figure is likely to be "much higher":

> "the Hong Kong-based Political and Economic Risk Consultancy (PERC) concluded in December 2001 that out of the US$100 billion FDI to China and Hong Kong in 2000, probably only US$36 billion were real FDI, with most of that going to China"

Again, it is not that investment policy has failed, but that policy has generated dysfunctional outcomes, and that the inflow of finances is not quite as impressive as appears at first sight.

Conclusion

It is still too early to make definitive statements about the long term impact of WTO entry on China's investment policy. For many of those who negotiated China's entry into the WTO, the trajectory of China's economic future should have been set by WTO entry obligations that lock China into a path of irreversible liberalisation. The reality has not been quite so clear cut. While it is unlikely that policy will be reversed, whether reforms will proceed along a smooth path towards full liberalisation is quite another matter altogether.

This uncertainty is in part due to changes in the Chinese leadership which has tempered the liberalising agenda (and logic) of the late 1990s. WTO entry and the *gaizhi* reforms outlined above are most often associated with the policy preferences of Zhu Rongji. First as first Vice Premier with special responsibility for financial reform and later as Premier, Zhu championed the drive place economic efficiency at the heart of government policy – often in the face of considerable “bureaucratic obstruction to fundamental reform” (Fewsmith 2001, 574). Notably, researchers from the major think-tanks – most notably the Chinese Academy of Social Sciences – later complained that their opinions were not always listened to by Zhu Rongji who instead privileged the advice provided by specialist hand-picked advisors[36]. Indeed, the decision to join the WTO has been depicted as an attempt by Zhu to use external pressure to enforce change on reluctant domestic actors who were concerned that international competition at this stage could damage not just the Chinese economy, but also social and therefore political stability (Fewsmith 2001; Breslin 2003).

When Zhu was replaced as Premier by Wen Jiabao in March 2003 following Hu Jintao’s assumption of the party leadership the previous year, one of the first things that the new leadership did was to re-engage with the economic policy advisors that the previous leadership had ignored (or who felt that the leadership had ignored them). This included holding regular meetings to hear the latest thinking - and quite a lot of this latest thinking was at best sceptical that the specific terms that Chinese negotiators had agreed to in order to join the WTO were in China’s (or at least the current regime’s) best interests. By the summer of 2004, the Hu-Wen leadership was distancing itself from Zhu Rongji’s efficiency agenda and the argument that growth alone would solve China’s social problems. A new focus emerged on the urgent need for the government intervention to spread growth more equably and to take care of those who had been left behind in the transition from socialism.

It would be wrong to suggest that Hu and Wen have reversed the liberalisation of investment policy. Indeed, achieving the desired goal of getting more money into central, northeastern and western China, might require more, not less, liberalisation (in some sectors at least). As is abundantly clear to Chinese policy makers, investment policy tends to work best when it meets the interests of the investors, and at best is irrelevant when it doesn't. But in other areas, liberalisation has not been as rapid and as complete as some expected would be the case after China joined the WTO (with the way in which The Catalogue was amended in 2004 being a good example of how the devil is often in the detail). Again, policy makers are aware of what investors want – its just that they are also aware of what this might mean for key domestic groups. In this respect, though the specific terms of the debate might have moved on, the desire to gain the benefits and not suffer the drawbacks of engagement with the capitalist global political economy remains the key simple determinant of Chinese investment policy.

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1 The original four SEZs were Xiamen in Fujian Province, and Zhuhai, Shantou, and Shenzhen in Guangdong. When Hainan Island was later separated from Guangdong to become a province in its own right in 1988, it was also established as the fifth SEZ

2 Wong and Zheng (2001) argue that the nanxun is not only Deng Xiaoping’s major legacy for Chinese politics, but a key watershed in China’s post-1949 history akin to the Great Leap Forward and the Cultural Revolution.

3 For good overviews of these policy changes, see Tso (1998), Rosen (1999) and Lemoine (2001).

4 Renamed the State Development Planning Commission in 2000.

5 That larger projects are often split into two or more smaller projects to fall within the guidelines is something that is admitted in private only.

6 The State Council, China Academy of Sciences, Shipping Industry General Corporation, Ordnance Industry General Corporation, Aviation Industry General Corporation, Aerospace Industry General Corporation, Nuclear Industry General Corporation, Oil and Chemical Industry General Corporation, Nonferrous Metals Industry General Corporation, and the General Logistics Department of the People’s Liberation Army.

7 Provinces, autonomous regions and the municipalities of Beijing, Tianjin, Shanghai and Chongqing.

8 At the time of writing, China had 13 “Bonded and Free Trade” Zones, 35 “Economic & Technological Development” Zones (including the Hainan Yangpu Zone which is sometimes listed separately), 133 “Regional Development” Zones and 13 “Border Economic Cooperation Zones”, which all have the power to offer incentives for investors.

9 Perhaps not surprisingly, all of the people who have admitted to me that they have done this, all insisted on anonymity.

10 Frustration with the actions of local governments became clear from many of the industry submissions to the House of Commons foreign affairs committee

investigation into UK relations with China in 2001 (which I served as specialist advisor to). The examples below come from submissions to the investigation, and subsequent interviews with UK based companies between 2002 and 2005, but are symptomatic of the problems faced by investors from other states as well.

[11] The Industrial and Commercial Bank of China had been operating an extremely small scale trading counter since 1986.

[12] US$ in Shanghai and HK$ in Shenzhen.

[13] For an overview of the evolution of China's stock markets, and government regulation of them, see Green (2003).

[14] The US Dollar, the Euro, the Japanese Yen and the Korean Won. The band or fluctuation was subsequently widened to 3 per cent each day – but for currencies other than the dollar where the 0.3 per cent band remained.

[15] For example, patents, commissions, travel expenses, transportation and insurance.

[16] It is perhaps worth noting that the lower estimate comes from the State Foreign Currency Administration which is responsible for preventing illegal capital flight.

[17] New rules introduced in 2001 were subsequently revised in 2003 largely due to their lack of success in attracting more investment.

[18] The high points being 100 per cent annual returns in 2000 and 2001 (Alexander and Zunun 2004, 2).

[19] Some specified prohibited sectors are open to investment from Hong Kong and Macao as part of the "Closer Economic Partnership" agreement.

[20] If an industry isn't listed, then it is deemed to be "permitted", but the exact terms of permission need to be negotiated on a case by case basis.

[21] The Catalogue was formally amended in 2004, but came into operation on 1 January 2005. It was originally jointly produced by the State Development and Planning Commission, the former State Economic and Trade Commission and the former Ministry of Foreign Trade and Economic Cooperation. After the administrative reform discussed above. the 2004 amendments were jointly issued by the new State Development and Reform Commission and the Ministry of Commerce.

[22] Surveys, polls, etc.

[23] Complete automobiles rather than engines, parts etc which had previously been encouraged.

[24] Introduced by the Ministry of Science and Technology and the Ministry of Commerce in June 2003.

[25] Though Huang (1996) argues that the central authorities have had more power to control investment spending in the provinces than other authors suggest. The key for Huang is that despite economic decentralisation, there is still strong political integration between provincial and central leaders.

[26] In addition, there are separate geographic restrictions on where banks can operate, although the national scope is being gradually expanded.

[27] The same regulation applies to the distribution of books, magazines, pharmaceutical products, pesticides, mulching films, processed oil, chemical fertilizers, grain, vegetable oil, sugar, tobacco, and cotton.

[28] For example, "The Chinese government has also proposed and implemented new measures that appear to protect and promote domestic industry and disadvantage foreign business, sometimes in contravention of its WTO commitments". (CECC 2005, 99)

29 Other less significant forms include cooperative development of resources, Build-operate-transfer (BOT) for infrastructure projects, Foreign Investment Companies (since 1995), Foreign Investment Stock Companies, and incorporative purchases.

30 This is often associated with the 15th party congress in 1997, but was in fact first announced as party policy by the central committee in September 1995.

31 Guangdong, Shanghai, Jiangsu, Fujian, Shandong, Liaoning, Zhejiang and Tianjin.

32 I covered these debates in detail in Breslin (1996).

33 Officially the “Office of the Leading Group for Adjustment and Renovation of the Old Industrial Base under the State Council”.

34 First issued in 2000 and amended in 2004. This catalogues covers all of the provinces in the three “formal” regions (northeast, centre and west) away from the coast.

35 This process is referred to as “transit FDI” by UNCTAD.

36 Advice which, it has been argued, largely confirmed his pre-existing preferences.