

# **A catch-up strategy?**

## **China's policy toward foreign direct investment**

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One of the most drastic changes in China that has taken place during the reform era is that it has been transformed from a socialist autarky to the second largest host country for foreign direct investment (FDI) in the world, after the United States. From the onset of economic reform in 1979 to 2003, China absorbed a total of more than US\$550 billion in FDI, equivalent to about 40 percent of its gross domestic product (GDP) in 2003. The FDI inflows, combined with their ripple effects on the growth in China's trade and foreign reserves, as well as GDP, have been seen as the most important evidence of China's success in achieving economic growth through liberalization. While the earlier "late industrializers" such as Japan, South Korea, and Taiwan, generally believed that FDI would do more harm than good to local economic development, China's recent experiences seem to show the opposite. If the role of FDI in the late industrializers' catch-up endeavor has evolved from an obstacle forty years ago to a facilitator now, what changes in the world capitalist system caused this evolution? Is the FDI-led growth a well-articulated catch-up strategy of the Chinese national government, or an unexpected consequence of China's economic transition? Can the FDI-led growth be a new model for the economic development of late liberalizers in the twenty-first century?

This chapter argues that the changing role of FDI in facilitating economic growth in the late-developing countries (LDCs) was the result of changes in the global production system, and the consequent cross-border restructuring of industries in East Asia. The enviable FDI-led growth in China is not a well-articulated catch-up strategy of a Chinese developmental state. Rather, the late liberalization of FDI is actually an unintended consequence of the ongoing fiscal decentralization within the Chinese state. Fiscal decentralization provided local governments with strong incentives to compete with each other to offer concessionary terms for foreign investment. Given that the Chinese national government's policy toward foreign investment is not particularly liberal in comparison with other LDCs, this competition among Chinese local governments has played a pivotal role in China's FDI-led economic boom. Although FDI-led development has seemingly made China the most successful development story at the beginning of the twenty-first century, when taking into account its side-effects and limitations, such as deflationary effects on the domestic market, overexploitation of labor and the

environment, and limited spillover effects on national industrialization, it is still too early to tell whether FDI-led growth is a sustainable development strategy.

When comparing FDI development in China and Japan, the most eye-catching difference is that, whereas Japan is the largest FDI exporter in the region, China is the largest FDI recipient in the region. This sharp contrast between the two countries reflects the difference in their stages of development, as well as the rapid changes in the international political economy in the last half-century. When Japan (re-)joined the world economy after World War II, FDI was mostly concentrated in the sectors of infrastructure, mining, and, to a lesser extent, capital-intensive manufacturing. During that time, most countries were engaged in post-war reconstruction and import substitution industrialization (ISI). Governments in LDCs generally maintained a quite cautious, if not hostile, attitude toward inward foreign direct investment (IFDI). Against this backdrop, Japan joined the world economy, providing very limited market access to IFDI.

In the 1980s, when China joined the world economy, the world capitalist system as well as the characteristics of FDI had profoundly changed – namely, globalization of manufacturing and distribution had led to a rapid transformation in world trade patterns and the nature of multinational companies (MNCs), as well as the LDCs' development strategies. In East Asia, a regional restructuring has taken place in response to this transformation. Under this restructuring, Japan has become the largest source of outward foreign direct investment (OFDI) in the region, whereas China has had to face fierce competition among LDCs for IFDI. Therefore, this chapter starts with a section that analyzes the general trends in manufacturing globalization and the transformation of MNCs and FDI. Special focus will be put on cross-country restructuring and economic integration in the region. In this section, we will explain why there are mainly two types of FDI in China. The first type comes mostly from industrialized countries and is invested in services and capital-intensive manufacturing industries in order to obtain market access to China. The second type of FDI is mostly from other East Asian newly industrialized countries (NICs), especially Hong Kong and Taiwan. The majority of this type is concentrated on export-oriented, labor-intensive industries due to China's low cost of labor and land, and a less restrictive regulatory environment.

Despite the huge volume of FDI inflows to China, the national government's policy toward FDI is actually quite stringent in comparison with other LDCs. It is the Chinese local governments' eagerness for foreign capital that has made China attractive to foreign investors. Fiscal decentralization has engaged the "investment-hungry" Chinese local governments in fierce competition for foreign investment. In order to create an attractive investment environment in their jurisdictions, local governments help foreign investors circumvent the central government's policies. These institutional characteristics by and large determine the terms of investment – that is, how the investment benefits are distributed between foreign investors and the host country. The second section will analyze in detail how the characteristics of China's domestic political institutions unexpectedly resulted in the economic success of FDI-led growth. It also analyzes how FDI is distributed across regions and sectors within China.

The final section reflects upon whether FDI-led growth can be seen as a new model for economic development in late liberalizers such as China. The merits and shortages of the FDI-led development experiment in China will be analyzed through a comparison with three ideal typical catch-up strategies that were popular in the developing world in the twentieth century: the socialist development model, ISI, and export-oriented industrialization (EOI).

### **Global transformation and the rise of manufacturing FDI flows to the developing countries**

Since the mid-1980s, the transformation of the global production system has created a favorable environment for LDCs such as China to pursue growth through absorbing FDI. The FDI they absorbed was mostly from small MNCs based in other developing countries. These MNCs, seeking a cheaper production base for exports, are not as intimidating as MNCs from industrialized countries in terms of scale, technological sophistication, and bargaining power. Moreover, through labor-intensive production exports, this type of foreign investment can bring in more foreign reserves, jobs, and government revenues.

#### ***The changing role of FDI in developing countries***

FDI has a very long history in developing countries. Even before World War I, FDI was an important financing source for infrastructural development in the developing world. After World War II, the focus of FDI in developing countries gradually shifted from infrastructure, agriculture, and mining, to manufacturing. However, only since the mid-1980s has FDI in developing countries experienced phenomenal growth. This growth was even more astonishing in the 1990s. As shown in Table 7.1, FDI inflows to developing countries kept growing at a high speed through the 1990s. The only exception was 1998, when many developing countries were hit by the Asian financial crisis.

Two global trends have inspired the sharp increase in FDI flows to developing countries. One is the change in policy stances by developing countries themselves. Since the 1980s – driven by both the search for alternative policies from their earlier disappointing experiences with the import substitution strategy and the pressure from international economic organizations as well as governments and business groups in industrialized countries for more opening in trade and investment – almost all governments in the developing world have engaged in economic liberalization. The sharp increase in FDI inflows was partly a response to these opening policies (International Finance Corporation 1997: 11–14). The reduction of tariffs and constraints on investments provided a strong incentive for investment in manufacturing.

The second global trend behind this phenomenal increase was the ongoing changes in the international division of labor. As early as the late 1970s, political economists observed the emergence of a new international division of labor in which more and more production lines (and jobs) migrated from developed coun-

Table 7.1 FDI inflows to developing countries in the 1990s

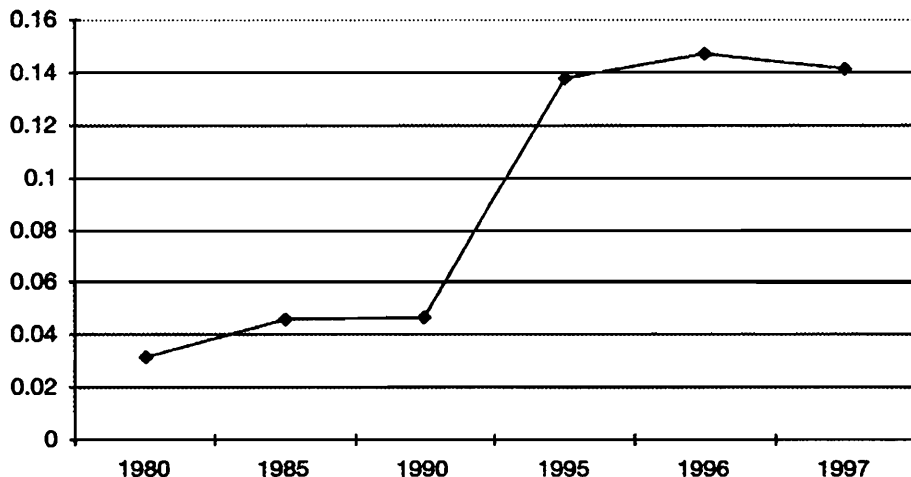
Year	Values (US\$m)	Share in the world total (%)	Growth rate (%)
1988–93 (annual averages)	46,919	24.61	44.66
1994	104,920	40.99	
1995	111,884	33.72	6.64
1996	145,030	38.42	29.63
1997	178,789	37.79	23.28
1998	194,005	28.08	8.51
1999	231,880	21.34	19.52
2000	252,459	18.19	8.87
2001	219,721	26.87	-12.97
2002	157,612	23.22	-28.27
2003	172,033	30.74	9.15

Sources: UNCTAD, 2000 *World Investment Report*, p. 291, and 2004 *World Investment Report*, p. 367.

tries to developing countries in search of cheaper production factors (Froble 1980). The new division of labor across national boundaries intensified as MNCs continuously adopted global strategies based on greater specialization and dispersion of activities. As the production process became more globalized and fragmented, companies invested in developing countries not only for new market access, but also for competitive production costs. In this process, companies specialized in production were emerging from the developing world. These companies, which excel in fragmenting production processes and reducing production costs, do not hesitate to migrate to other developing countries in the search for more competitive production prices. Thus, since the mid-1980s FDI flows *among* developing countries have made a significant contribution to the increase in FDI in developing countries. Most of this type of FDI was motivated by *outsourcing*, rather than *market access*. The output from the affiliates in which the MNCs invested in was mostly not aimed at the domestic market of the host country, but intended for export to third countries. As shown in Figure 7.1, FDI outflows from developing countries as a percentage of the world total grew from less than 5 percent in the 1980s to more than 10 percent in the 1990s. Even after the Asian financial crisis, the figure was still higher than the level of the 1980s.

### ***The economic restructuring and regional integration in East Asia***

Since the end of World War II, world trade and output has expanded at an astonishing rate.<sup>1</sup> Japan and the East Asian NICs, i.e., South Korea, Taiwan, Hong Kong, and Singapore, were probably the most significant beneficiaries of the expansion in world trade and output. After experiments with protectionist import substitution policies in the 1950s and 1960s, all these countries achieved their rapid post-war growth by adopting an export-led industrialization strategy. In turn, their rapid growth resulted in stronger pressure for protectionism in the



*Figure 7.1* FDI outflows from LDCs.

industrialized countries, especially the United States, as well as sharp increases in domestic production costs in these countries. Therefore, since the mid-1980s, stimulated by price hikes in domestic production and currency appreciation, Japan and the East Asian NICs have undergone economic restructuring. Put simply, restructuring takes place in two parts: first, companies shift resources domestically from declining sectors to promising sectors and then they relocate overseas the production of products and parts that can no longer be appropriately carried out at home (Fukushima and Kwan 1995: 11). The second part of the economic restructuring was one of the most important factors that led to the growth of intraregional investment in East Asia since the mid-1980s.

At the same time, influenced by the successful development experiences of the East Asian NICs, China and the Association of Southeast Asian Nations (ASEAN) countries began a series of liberalization policies in order to absorb FDI to accomplish their own export-led industrialization. They saw the rapid inflows of FDI from the region as “a quick way to jump-start the process of industrialization” (Yam 1997: 113).

### *The trends and patterns of FDI inflows to China*

The trends and patterns of FDI inflows to China by and large reflected these general trends in the developing world. However, as we will analyze in next section, owing to the aggressiveness of the Chinese local government in competing for foreign investment, in the 1990s China was by far the largest FDI recipient among developing countries. Table 7.2 shows the growth of FDI in China between 1979 and 2002. There was a big jump in FDI growth during the 1990s, pretty much consistent with the global trend. From Table 7.3 we find that for most of the time about half of FDI in China came from two East Asian NICs – Hong Kong and Taiwan. Together with FDI from Japan, East Asian foreign investment constituted

Table 7.2 FDI growth in China

Year	Number of projects	Pledged value (US\$m)	Growth rate (%)	Realized value (US\$m)	Growth rate
1979–83	1,392	7,742	n.a.	18.02	n.a.
1984	1,856	2,651	n.a.	12.58	n.a.
1985	3,073	5,932	123.76	16.61	32.03
1986	1,498	2,834	-52.23	18.74	12.82
1987	2,233	3,709	30.88	23.14	23.48
1988	5,945	5,297	42.81	31.94	38.03
1989	5,779	5,600	5.72	33.92	6.20
1990	7,273	6,596	17.79	34.87	2.80
1991	12,978	11,977	81.58	43.66	25.21
1992	48,764	58,124	385.30	110.07	152.11
1993	83,437	111,436	91.72	275.15	149.98
1994	47,549	82,680	-25.80	337.67	22.72
1995	37,011	91,282	10.40	375.21	11.12
1996	24,556	73,277	-19.72	417.25	11.20
1997	21,001	51,004	-30.40	452.57	8.46
1998	19,799	52,102	2.15	454.63	0.46
1999	16,918	41,223	-20.88	403.19	-11.31
2000	22,347	62,380	51.32	407.15	0.98
2001	26,140	69,195	10.92	468.78	15.13
2002	34,171	82,768	19.61	527.43	12.51

Source: China State Statistical Bureau, *China Foreign Economic Statistical Yearbook 2003*, p. 873.

Note

n.a., not available.

about two-thirds of FDI in China. The rapid growth of FDI in China can thus be seen as part of the ongoing phenomenon of regional economic restructuring in East Asia. It has long been recognized that there are two main types of FDI in China. One is from East Asian NICs, searching for cheaper production costs for labor-intensive exports. The other is from advanced countries, attracted by the huge potential of China's domestic market. The pattern here shows that the majority of the FDI inflows to China aimed at seeking lower prices for export production. As we will discuss in more detail later, most of this FDI was concentrated in manufacturing sectors in coastal China.

### **Domestic political institutions and foreign investment fever in transitional China**

Studies of international political economy have found that domestic political institutions play a crucial role in determining the pattern and sequence of economic liberalization (Keohane and Milner 1996). This is also the case in the late liberalization of China's foreign investment policy. The idiosyncratic

**Table 7.3** Top seven countries of origin for FDI inflows to China, 1992–2002 (US\$10,000)

<i>Country</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>
Hong Kong	841,653	1,889,297	1,983,568	2,040,183	2,067,732	2,063,200
Taiwan	105,335	313,913	339,134	316,516	347,484	328,939
United States	58,114	266,253	302,686	313,466	344,333	323,915
Japan	317,994	490,602	306,089	511,332	367,935	432,647
Germany	25,665	27,449	58,374	52,746	51,831	99,263
UK	21,553	57,066	108,584	100,931	130,073	185,756
Singapore	14,065	67,480	117,961	186,061	224,356	260,641
Subtotal	1,384,379	3,112,060	3,216,396	3,521,235	3,533,744	3,694,361
<i>Total</i>	<i>1,920,233</i>	<i>3,895,972</i>	<i>4,321,284</i>	<i>4,813,269</i>	<i>4,174,548</i>	<i>4,527,701</i>

Source: China State Statistical Bureau, *Chinese Statistical Yearbook* 2001, pp. 604–6, and 2003, pp. 672–4.

nature of central–local relations in China’s political system is a central factor in determining the pattern of investment liberalization.

### ***The evolution of the Chinese national government’s policy toward FDI***

The evolution of China’s national regulatory framework toward FDI can generally be divided into four phases. Each phase started with the promulgation of a new law or agreement that underpinned the regulatory framework for the next several years.

The first phase (1979–84) started with the promulgation of the Joint Venture Law (JVL) in mid-1979. As the first formal statement of the Chinese government’s commitment to foreign investment, the law provided the guidelines for foreign investment at the national level. In the meantime, the Chinese central government set up four special economic zones (SEZs) at the local level to experiment beyond the national regulatory framework to attract foreign investment. The four SEZs are Shenzhen, Zhuhai, and Shantou in Guangdong province, and Xiamen in Fujian province.

In retrospect, the JVL was more like a statement of principles than a carefully drafted law. Both the forms and terms are vague and even incomplete. The ambiguity of the law may in fact be desirable, for it provided the room for flexible interpretation and policy experiments to absorb FDI in a transitional economy. However, the ambiguity, together with the policy uncertainty in the broader policy context in this early stage of economic transition, resulted in a very modest growth of FDI. As shown in Table 7.2, the realized value of FDI from 1979 to 1983 was only US\$1,802 million.

The modest growth of FDI at the national level and the concentration of FDI in the four SEZs prompted China’s central policy-makers to enlarge the geographical areas open to foreign investment. Thus, China’s FDI policy entered the second phase in 1984 with the announcement of the Chinese central government’s decision to open another fourteen coastal cities to foreign investment.<sup>2</sup> This stage was characterized by the geographical expansion of special investment areas. It started

1998	1999	2000	2001	2002	Total	%
1,850,836	1,636,305	1,549,998	1,671,730	1,786,093	19,380,595	41.89
291,521	259,870	229,658	297,994	397,064	3,227,428	6.98
389,844	421,586	438,389	443,322	542,392	3,844,300	8.31
340,036	297,308	291,585	434,842	419,009	4,209,379	9.10
73,673	137,326	104,149	121,292	92,796	844,564	1.82
117,486	104,449	116,405	105,166	89,576	1,137,045	2.46
340,397	264,294	217,220	214,355	233,720	2,140,550	4.63
3,403,793	3,121,138	2,947,404	3,288,701	3,560,650	34,783,861	75.18
4,546,275	4,031,871	4,071,481	4,687,759	5,274,286	46,264,679	100.00

with fourteen cities, expanded to the Yangtze River Delta around Shanghai, the Golden Triangle Delta in Fujian, the Pearl River Delta in Guangdong, the entire island of Hainan, and then to almost all of coastal China. According to one estimate, by the end of 1989, the so-called "special investment areas" covered a total area of 420,000 square kilometers and a population of 280 million. This area is about three times the size of Germany, and its population is slightly larger than that of the United States (Fu 2000: 39).

During this period, with the promulgation of the Wholly Foreign-owned Enterprises Law and the Provisions for Encouragement of Foreign Investment in 1986, the national regulatory framework also gradually became clearer and more liberalized. The most significant liberalizing measure at this stage was the reform of the foreign exchange system. With the establishment of foreign exchange swap centers in most coastal cities during the late 1980s, balancing foreign exchange was no longer a big burden for FDI (Frisbie 1999: 15).

The improvement of the general policy framework as well as the expansion of opening areas resulted in a "great leap forward" of FDI in the second half of the 1980s. As shown in Table 7.2, from 1985 to 1988, FDI consistently grew at double-digit rates.

The austerity program and the power struggle among leaders over the direction of reform in 1988 finally led to the Tiananmen tragedy and the sudden disruption of economic liberalization and growth. The second phase thus ended with a sharp decline in FDI in 1989. However, in order to show their commitment to continuity of the "reform and opening" policy, less than one year after Tiananmen central policy-makers moved to open China up further. In the spring of 1990, they first announced the establishment of the Shanghai Pudong New Area for foreign investment, and then issued the Amendments to the JVL to grant more market access to foreign investors and, most significantly, allow foreign partners to act as joint venture board chairmen (Sun 1998: 16). In order to re-establish Shanghai as China's financial and trade center, the establishment of the Pudong New Area came with the opening of sectors that used to be off-limits to foreign investors, such as banking, insurance, real estate, and retailing.



The liberalizing momentum was further reinforced by Deng Xiaoping's "southern tour" in early 1992. The tour highlighted the Chinese central leaders' commitment to economic development through further integration with the world economy. Deng Xiaoping even said that Guangdong should take the challenge to catch up with the "four little dragons" within twenty years (Fu 2000: 56). The so-called Document No. 4 was therefore issued by the CCP Politburo in May 1992 to embody this commitment by starting a new round of relaxation on FDI in various sectors and geographical areas. In both 1992 and 1993, China's FDI grew by about 150 percent. For the remainder of the decade, China was able to absorb a huge amount of FDI inflows (see Table 7.2).

The 1999 US–China bilateral World Trade Organization (WTO) agreement marked the beginning of the fourth phase of the evolution of China's policy toward FDI. The agreement brought China's integration with the world economy to another new stage by committing China to a full opening of the domestic market to FDI in important sectors like banking and finance, telecommunications, and retailing in three to five years after joining the trade organization. Following a sharp decline in FDI after the Asian financial crisis in 1998, the Chinese government started another round of opening up high-tech industries to aggressively induce high value-added export companies to invest in China. Since 2000, with the combined effects of China's entry into the WTO and liberalization of investment in high-tech industries, there has been a resurgence in FDI growth.

To sum up, the Chinese central government adopted a gradual approach in inducing FDI. In the beginning, national policies were quite restrictive toward FDI in terms of ownership, management autonomy, and market access, as well as foreign exchange. Not until the 1990s, when both competition from other LDCs for foreign capital and pressure from advanced countries for market access were intensified, did the Chinese central government start broader liberalization of the FDI regime. Nonetheless, in comparison with other LDCs, China's national policies toward FDI in general are not particularly favorable to foreign investment, especially in areas such as ownership restrictions and capital controls. How did China nonetheless become the most attractive site for FDI in the developing world? The answer lies in its idiosyncratic political institutions.

### *The impetus of local "investment hunger"*

Fiscal decentralization has been considered one of the most important driving forces behind China's economic transition. It has, on the one hand, motivated local governments and state-owned enterprises (SOEs) to engage in spontaneous reforms by hardening their budget constraints and, on the other hand, deprived central policy-makers of the traditional instruments to keep local investment in line with central policy. As local governments at different levels of the administration increasingly had to rely on themselves to finance public expenditures, they would promote local economic growth by any means.<sup>3</sup>

Against this background, since the 1980s local governments in coastal areas have developed strong incentives to promote local development by attracting for-

eign investment. Observers of this phenomenon found that, in their efforts to create an environment conducive to foreign investment, local states in coastal China pretty much resembled the behavior of the *developmental state* of the East Asian NICs thirty years ago.<sup>4</sup> With sufficient autonomy from domestic social groups and the capacity to promote foreign investment and trade, these local governments play a vital role in “designing and shaping the development process” within their jurisdictions (Chung 1999: 920). Thus, the terms “developmental communities” and “local developmental states” are often used to characterize these local governments.<sup>5</sup>

What distinguishes these Chinese local developmental states from their predecessors in the East Asian NICs is the attitude toward foreign capital. Fearing domination by foreign capital, the East Asian developmental states generally chose to cultivate domestic private capital as the primary driver of their industrialization. However, the Chinese local developmental states targeted foreign investors as their most important partners in developing local economies. Since the early 1990s, especially after Deng Xiaoping’s southern tour and the issuance of Document No. 4 in 1992, numerous “economic development zones” have been established in coastal China to resemble the model of the four SEZs. By the end of 1995, the State Council had already permitted thirty-two “economic development zones” (EDZs), not to mention countless EDZs set up by government units at lower levels.<sup>6</sup>

The fiscal and financial reforms introduced since 1994 have reasserted central government control over financial resources in many areas; as a result, local governments desperately seek alternative resources to finance their increasingly burdensome expenditures. Foreign investment has thus become a key source of financing for local governments in coastal China. Competition among local governments for foreign capital has correspondingly intensified since the mid-1990s. They usually compete with one another by granting foreign investors concessions that are much more favorable than what the central government allows. According to one estimate, after counting all the concessions and tariff exemptions on imports by export processing companies, high-tech companies, and strategy industries, China’s actual average tariff rate in 2001 was only 3.6 percent, much lower than the nominal rate of 11.1 percent (Ma 2001: 4).

Table 7.4 shows that the top ten provinces that absorbed the most FDI in the 1990s were all in coastal China. Together they accounted for more than three-fourths of the total FDI China absorbed in that decade. The number one province, Guangdong, individually took away more than one-fourth of the national total. Partly because of the “enclave approach” forged by local preferential policies toward foreign investment, the geographical distribution of FDI in China was highly skewed toward the coastal areas throughout the reform period.

As discussed earlier, the majority of FDI inflows to China during the reform era were labor-intensive export companies from the East Asian NICs – especially Hong Kong and Taiwan. The concentration of FDI from these areas not only reflected the global trend of a new international division of labor and the resulting

**Table 7.4** The geographical distribution of FDI in China, 1992–2002 (US\$10,000)

<i>Province</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>
Guangdong	474,641	984,313	1,092,758	1,066,967	1,162,362	1,171,083
Jiangsu	146,324	284,371	378,568	532,577	521,009	543,511
Fujian	146,561	290,599	372,328	414,908	408,451	419,666
Shanghai	89,929	317,803	258,217	300,543	394,094	422,536
Shandong	102,685	188,267	260,143	276,497	259,041	249,294
Tianjin	26,259	62,368	116,176	158,686	200,637	251,135
Liaonin	68,012	139,693	151,471	156,838	173,768	220,470
Zhejiang	27,664	103,175	115,650	128,968	152,050	150,345
Beijing	36,159	81,731	137,911	110,648	155,290	159,286
Hainan	51,480	74,832	93,609	118,433	78,908	70,554
Subtotal	1,169,714	2,527,152	2,976,831	3,265,065	3,505,610	3,657,880
<i>Total</i>	<i>1,920,233</i>	<i>3,895,972</i>	<i>4,321,284</i>	<i>4,813,269</i>	<i>4,172,552</i>	<i>4,525,704</i>

Source: Chinese National Bureau of Statistics, *Chinese Statistical Yearbook* 2001, p. 607, and 2003, p. 675.

economic restructuring in the region, but also reflected the characteristics of the investment environment in China.

For foreign investors, after the basic consideration of markets and costs, uncertainty about future benefits and costs is probably the most important factor determining their choice of location. Thus, patterns of FDI flows reflect not only the distribution of markets and costs in different locations, but also the distribution of uncertainties. The huge domestic market in China cannot explain why the majority of FDI is export oriented. China should have attracted more import-substituting FDI, rather than export-oriented FDI. Thus, it is commonly argued that China's huge amount of labor-intensive exporting FDI should be attributed to its relatively cheaper production factors, i.e. labor and land. Yet production costs in other LDCs in the region, such as Indonesia and Thailand, are also low. Why, then, have these countries been unable to compete with China? The answer may be found in the characteristics of China's investment environment.

The Chinese investment environment is especially attractive to the labor-intensive export manufacturers from East Asian NICs for the following reasons. First, as economists have found, labor-intensive industries tend to be more resistant to uncertainty than capital-intensive ones. This is because labor is more flexible than product-specific machines in responding to changes in demand and taste. Thus, it is usually much easier to make investment decisions in labor-intensive industries than in capital-intensive ones, given the same degree of external uncertainty. Second, over the last two decades, but especially in the 1990s, China has outperformed most developing countries in reducing systemic uncertainty for foreign investment. China has probably the most stable currency and political system among the developing countries, especially after the Asian financial crisis, and its country risk has always been low. Finally, as a transitional economy, policy uncertainty is greater in China than in other developing countries. Policy uncertainty arises from the inherent institutional disadvantages in transition economies, such as the vagueness of regulations, lack of transparency in the legal system

1998	1999	2000	2001	2002	Total	%
1,201,994	1,165,750	1,128,091	1,193,203	1,133,400	11,774,562	25.51
663,179	607,756	642,550	691,482	1,018,960	6,030,287	13.06
421,211	402,403	343,191	391,804	383,837	3,994,959	8.66
360,150	283,665	316,014	429,159	427,229	3,599,339	7.80
220,274	225,878	297,119	352,093	473,404	2,904,695	6.29
211,361	176,399	116,601	213,348	158,195	1,691,165	3.66
219,045	106,173	204,446	251,612	341,168	2,032,696	4.41
131,802	123,262	161,266	221,162	307,610	1,622,954	3.52
216,800	197,525	168,368	176,818	172,464	1,613,000	3.50
71,715	48,449	43,080	46,691	51,196	748,947	1.62
3,717,531	3,337,260	3,420,726	3,967,372	4,467,463	36,012,604	78.04
4,546,275	4,031,871	4,033,289	4,636,700	5,247,126	46,144,275	100.00

and taxation, and negligible protection of property rights and intellectual property rights. However, export manufacturers from the East Asian NICs, and especially those from ethnic Chinese communities, have proved to be especially capable at overcoming these disadvantages. Unlike Western MNCs, which protect their investment through exhaustive contracts, small East Asian companies have been able to reduce the policy uncertainty of the Chinese central government through negotiating informal arrangements with local officials (Naughton 1997). As a result, the “enclave approach” forged by competition among Chinese local governments for foreign investment produced FDI inflows that are highly skewed toward small labor-intensive export-oriented FDI from the East Asian NICs.

### FDI-led growth as a catch-up strategy?

FDI’s contribution to China’s economic growth in the last twenty years has been considerable. Tables 7.5 and 7.6 show that manufacturing has consistently been the major sector attracting foreign investment. By the late 1990s, manufacturing accounted for 70 percent of total investment. These investments were mostly in labor-intensive sectors, thus creating numerous job opportunities and absorbing the redundant labor force of the transitional economy.

Table 7.7 shows that FDI’s contribution to China’s export grew from only 0.05 percent in 1980 to more than 50 percent in 2001 and 2002. This offers additional evidence that most of the FDI inflows to China were export-oriented. Nonetheless, as also shown in Table 7.7, FDI’s contribution to Chinese imports was even bigger. This is because most of the FDI’s exports took the form of import processing with very limited domestic value-added. As a result, the net contribution of FDI to China’s foreign trade was negative, rather than positive, throughout the reform era.

Thus far, FDI in China seems to be more import-inducing than import-substituting. Most of the export-oriented FDI is involved only in low value-added processing of imported raw materials and intermediate goods. The degree of inte-

Table 7.5 The sectoral distribution of FDI in China, 1993–2002 (US\$10,000)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
<i>Total</i>	11,291,719	n.a.	9,223,530	7,356,733	5,100,353	5,210,205	4,122,302	6,237,952	6,919,455	8,276,833
Agriculture, forestry, fishery, and water conservancy	119,147		173,578	113,931	106,531	120,420	147,170	148,314	176,174	168,804
Mining and quarrying					716,82	85,223	32,221	50,640	64,448	38,088
Manufacturing					2,706,457	3,082,722	2,533,180	4,425,430	4,884,686	5,926,985
Industry	5,117,368		6,164,763	5,048,588	200,059					
<i>Infrastructure, of which:</i>	387,837		191,836	200,059	677,533	371,823	273,138	205,774	395,703	253,220
Electricity and water provision	387,837		191,836	200,059	365,583	196,812	163,519	122,686	213,422	147,459
Construction					311,950	175,011	109,619	83,088	182,281	105,761
<i>Services, of which</i>	5,286,602		2,537,294	1,778,728	1,356,499	1,343,802	965,264	1,257,608	1,180,584	1,576,448
Transport and telecommunications	148,991		169,698	159,916	262,207	230,119	111,401	141,658	88,354	152,902
Commerce, marketing and catering	460,647		342,665	234,674	183,901	131,352	120,413	143,514	139,806	166,364
Real estate					622,227	664,752	417,785	523,213	503,061	721,713
Social services	4,525,268		1,878,919	1,314,141	266,888	301,193	301,680	425,463	428,884	498,789
Health and welfare industry	47,748		83,741	35,441	14,302	14,174	6,727	15,428	13,305	25,796
Education, culture, and media	103,948		62,271	34,556	6,974	2,212	7,258	8,332	7,174	10,884
Other	380,765		156,059	215,427	181,651	206,215	171,329	150,186	142,511	210,797

Sources: China State Statistical Bureau, *Chinese Statistical Yearbook* 2001, p. 608, and 2003, p. 676.

Note

n.a., not available.

*Table 7.6 The sectoral distribution of FDI in China, 1993–2002 (%)*

<i>Sector</i>	<i>1993</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>	<i>2002</i>
<b>Agriculture</b>	1.06	1.88	1.55	2.09	2.31	3.57	2.38	2.55	2.04
<b>Mining</b>	n.a.	n.a.	n.a.	1.41	1.64	0.78	0.81	0.93	0.46
<b>Manufacturing</b>	n.a.	n.a.	n.a.	53.06	59.17	61.45	70.94	70.59	71.61
<b>Industry</b>	45.32	66.84	68.63	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Infrastructure</b>	3.43	2.08	2.72	13.28	7.14	6.63	3.3	5.72	3.06
<b>Services</b>	46.82	27.51	24.18	26.6	25.79	23.42	20.16	17.06	19.05
<b>Other</b>	3.37	1.69	2.93	3.56	3.96	4.16	2.41	2.06	2.55

Source: Table 7.5.

Note

n.a., not available.

Table 7.7 The role of FDI in China's trade, 1980-99 (US\$million)

Year	Total exports (1)	FDI exports (2)	(1)/(2)	Total imports (3)	FDI imports (4)	(3)/(4)	Trade contribution (2) - (4)
1980	18,120	8	0.0005	20,020	34	0.0018	-26
1981	22,010	32	0.0014	22,020	111	0.005	-79
1982	22,320	52	0.0024	19,290	276	0.0143	-224
1983	22,230	330	0.0149	21,390	288	0.0135	42
1984	26,140	68	0.0026	27,410	399	0.0146	-330
1985	27,350	296	0.0109	42,250	2,064	0.0489	-1,767
1986	30,940	582	0.0188	42,910	2,430	0.0566	-1,848
1987	39,440	1,208	0.0306	43,210	3,122	0.0723	-1,914
1988	47,520	2,456	0.0517	55,270	5,747	0.104	-3,290
1989	52,540	4,913	0.0935	59,140	8,796	0.1487	-3,883
1990	62,090	7,813	0.1258	53,350	12,306	0.2307	-4,492
1991	71,840	12,047	0.1677	63,790	16,907	0.265	-4,860
1992	84,940	17,356	0.2043	80,590	26,371	0.3272	-9,015
1993	91,740	25,237	0.2751	103,960	41,833	0.4024	-16,596
1994	121,010	34,712	0.2869	115,610	52,934	0.4579	-18,221
1995	148,780	46,875	0.3151	132,080	62,942	0.4766	-16,067
1996	151,050	61,506	0.4072	138,830	75,604	0.5446	-14,097
1997	182,790	74,899	0.4098	142,370	77,721	0.5459	-2,821
1998	183,710	80,961	0.4408	140,240	76,717	0.547	4,244
1999	194,930	88,627	0.4547	165,700	85,884	0.5183	2,744
2000	249,212	119,441	0.4793	225,097	117,273	0.521	2,168
2001	266,155	133,235	0.5006	243,613	125,863	0.5167	7,372
2002	325,569	169,937	0.522	295,216	160,286	0.5429	9,651

Source: China State Statistical Bureau, *Chinese Foreign Economic Yearbook* 2003, pp. 881-2.

gration with the domestic economy is low, and there are limited spillover effects to domestic companies. Moreover, it is unlikely to cause much competition or economic restructuring within Chinese companies. Although labor-intensive manufacturing FDI has created jobs, helping to absorb many laid-off workers, and thus soothing the pain of economic transition, its contribution to China's economic transition is very modest.

In addition, the FDI-led growth strategy has recently aroused concerns about the exploitation of China's labor and environment. For example, scholarly research and journalistic reports on China's labor conditions agree that migrant workers in non-state sectors, including the booming township and village enterprises (TVEs) and foreign-invested enterprises (FIEs) from Hong Kong, Taiwan, and Korea, are subject to shocking exploitation (Chan 1998). Migrant workers from China's hinterland constitute the majority of the labor force in labor-intensive export-oriented FDI. A series of agricultural reforms in the early 1980s freed rural citizens from their bondage to farm work. But improvement in the rural standard of living waned, and even deteriorated, as the terms of trade in agriculture turned unfavorable in the middle of that decade. With the loosening of the household registration system (*hukou*), many young people from rural areas moved to the cities and newly established EDZs to try their luck. According to one estimate, there are more than 200 million "surplus" workers in the countryside. In the Pearl River Delta, where most Taiwanese and Hong Kong investment is concentrated, there are more than 2.2 million migrant workers from other provinces.

Finally, in order to keep China's exports competitive, since the mid-1990s the central government has adopted a mercantilist monetary policy that maintains an undervalued fixed exchange rate, on the one hand, and suppresses the growth of domestic money supply on the other. The resulting deflationary effects on import-competing sectors as well as on non-tradable sectors, especially in the hinterland, may undermine China's capabilities in economic adjustment when the terms of trade become unfavorable.

Without doubt, in terms of GDP growth, the FDI-led development strategy has helped China catch up very rapidly in last decade or so. Nonetheless, it is still too early to tell whether the FDI-led development strategy is sustainable in the long run, and worthy of being emulated by other LDCs. A comparison with other popular development models in history may help to clarify the merits and limits of the strategy currently employed by China.

Since the early twentieth century, LDCs have experimented primarily with three development models. They include *socialist planned development*, first employed by the Soviet Union in the 1920s and 1930s; *import substitution industrialization*, which prevailed in Latin America in the 1940s and 1950s; and *export-oriented industrialization*, made famous by the East Asian NICs in the 1960s and 1970s. Table 7.8 compares China's FDI-led development strategy with these three models.

Socialist planned development and ISI are development models created before World War II when the international environment was not favorable for free trade. In the first half of the twentieth century, international trade was mostly inter-



*Table 7.8 Comparison of four development models*

	<i>Socialist planned development</i>	<i>Import substitution industrialization</i>	<i>Export-oriented industrialization</i>	<i>FDI-led development</i>
International environment for trade	Unfavorable	Unfavorable	Favorable	Favorable
Market	Domestic	Domestic	International	International
State autonomy	High	Low	High	High
FDI policy	Unfavorable	Favorable	Unfavorable	Favorable
Currency	Overvalued	Overvalued	Undervalued	Undervalued
Monetary policy	Loose	Loose	Tight	Tight
Domestic distributive effect	Equalizing	Polarizing	Equalizing	Polarizing
Challenge	Low return on investment	Small size of domestic market	Fierce competition in international market	Fierce competition in international market

rupted by cyclical recessions, protectionism, and wars. LDCs had to rely upon expansion of the domestic market to carry out their industrialization. In order to nurture local infant industries, these economies usually raised protectionist tariff barriers to stifle foreign competition. Besides tariff protection, the governments would offer local firms other forms of assistance, such as subsidized financing and preferential access to foreign exchange. The socialist governments even went to the extreme of taking over all the means of production from society and abolishing all markets to carry out rapid industrialization through state planning. While the socialist planned economies confiscated the local facilities of MNCs, the ISI model encouraged MNCs to jump protection barriers and to produce locally in sectors where local firms lacked the capital or knowledge to start up.

In both the socialist and ISI models, local currency is overvalued for the purpose of acquiring cheaper imports of oil, raw materials, and capital goods for local industrialization. Monetary policies are kept loose, so the governments are better able to afford generous social expenditures and high domestic wages – both of which are deemed essential for expanding the domestic market. However, an overvalued currency discourages exports, and loose monetary policies invite government budget deficits as well as inflation. The socialist economies avoided these problems by eliminating money as the medium of exchange. Nonetheless, they paid the price of having inefficient economies. On the other hand, the ISI model is ultimately doomed to suffer hyperinflation and capital flight, which are the natural monetary effects of overexpanding the domestic economy.

In contrast, the EOI and FDI-led growth strategies prevailed at a time when international trade and investment, under the support of the US hegemony, was booming. To achieve rapid industrialization, both models took advantage of the rapid post-war expansion of the consumer market in advanced countries, especially the United States. In order to promote exports, governments employing EOI or the FDI-led development model would undervalue local currencies and adopt relatively tight monetary policies to suppress the prices of local production factors. Like the ISI strategy, the EOI model also used protectionist tariff barriers and various forms of preferential treatment to nurture local industries. The only difference between the strategies is that cultivated industries in the EOI model are groomed for international competition, whereas the aim in the ISI model is domestic monopoly. In order to provide local infant industries with a favorable growth environment, countries employing the EOI strategy, such as South Korea and Taiwan, usually set rigid restrictions for FDI. In contrast, countries adopting an FDI-led growth strategy, such as China and the ASEAN countries, view FDI as the primary driving force behind their export-oriented industrialization.

In the socialist, EOI, and FDI-led models, the state possesses a high level of autonomy from a weak and fragmented society. The autonomy allows the state great discretion in designing and guiding the development process. The socialist and EOI models have usually been praised for their egalitarian effects on the distribution of development benefits. The ISI model is criticized for its bias toward capital and workers in the ISI sectors. The strategy usually enlarges the gap in income distribution between the ISI sectors and the rest of the economy. The FDI-

led model that China has experimented with seems also, so far, to have a polarizing distributional effect on development outcomes. Given that three-fourths of FDI is concentrated in the development zones of the ten coastal provinces, FDI-led growth has intensified the problem of regional disparities in China. Despite the central government's recent effort at developing the hinterland by increasing infrastructural expenditures, regional disparities have continued to grow.

Meanwhile, the deflationary effect of tight monetary policy employed to serve the FDI-led strategy also has the negative externality of enlarging regional disparities. As noted earlier, a tight monetary policy is essential for export promotion because it can help suppress the prices of domestic production factors. However, a tight monetary policy also suppresses the growth of domestic consumption. Therefore, export growth achieved by having a tight monetary policy comes to some extent at the expense of producers for the domestic markets. As a transitional economy with huge domestic market, China did not adopt this policy until the mid-1990s. However, it is precisely since the mid-1990s that China has experienced an economic boom in FDI and exports. In the meantime, the domestic economy has experienced the most serious deflation since reform started. Since most of China's exports come from coastal provinces and the rest of the country has to rely upon the expansion of the domestic market for growth, tight monetary policy has an obvious distributive effect in favor of coastal provinces whose economies are specialized in exports.

Finally, in countries that implemented the socialist, ISI, and EOI strategies a period of impressive economic growth was typically followed by serious challenges. The socialist planned development model led to a severe incentive problem and suffered economically as a result of persistent low rates of return on investment. Production in the socialist planned system was inefficient and resources were wasted. Eventually, the accumulation of inventories as well as budget deficits reached a level that made transition inevitable. The difficulty with the ISI model is that domestic markets are small. Thus, the domestic market for consumption goods is easily saturated, with the result that governments that adopted the ISI strategy were forced to pursue the "deepening" of ISI by encouraging the development of manufacturing capabilities in basic and intermediate industries. As these investments usually require foreign borrowing or massive government spending, these economies soon encounter financial difficulties. The EOI model results in much longer and more impressive growth than the other two strategies. Thus, at one point development economists advocated the EOI strategy as *the model* for late development. However, since the late 1980s all successful cases of the EOI model have encountered the challenge of competition from countries that can offer cheaper exports. Export industries in these countries responded either by migrating to these new challengers for production or by moving to other more promising industries. The adjustment is so difficult that most of these countries have recently experienced their slowest growth rates since their economic take-off in the 1960s.

Strong international competition may catch up with China soon. After a decade or so of rapid economic growth led by FDI inflows and exports, China experi-

enced declines in both FDI and exports in the late 1990s, raising the question of whether the world market is large enough to sustain the rapid growth of China's exports. When other LDCs, such as Vietnam, Burma, and India, also joined the competition for cheap exports, China still desperately needed the FDI-led growth to spread from the limited coastal enclaves to the rest of the country. The relative decline in FDI inflows and exports at the end of the 1990s immediately attracted the attention of Chinese central government, which as a result began to encourage coastal local governments to "upgrade" their exports by aggressively absorbing high-tech investment from Taiwan, Korea, and Japan and, at the same time, providing incentives for foreign investors to move labor-intensive exports further into the heartland. Progress on both fronts has been very slow thus far. Most high-tech investors moved only their most labor-intensive production lines to China. Given the backwardness of research and development (R&D) facilities and the regulatory environment in China, these high-tech investors would rather keep their R&D, marketing, and financing divisions in their home countries. How "high-tech" the high-tech FDI in China will be is still an open question. In the case of labor-intensive industries, although local governments in the heartland have been very aggressive in absorbing labor-intensive FDI, the management and transportation costs for exports from China's inland areas are still too high to overcome. In 2000, the eleven EDZs set up in the hinterland absorbed less than US\$0.2 billion of FDI, only about 5 percent of the FDI absorbed by the thirty-two EDZs in coastal areas. Therefore, it is unclear whether China can keep its exports growing at the rate of 16 to 17 percent for another ten years. If not, then the sustainability of the FDI-led development strategy should be questioned.

## **Conclusion**

In the 1990s, China achieved enviable economic growth through aggressively absorbing export-oriented FDI. Yet this achievement should not be seen as resulting from a well-articulated design of a developmental state in the 1990s. It is more a result of the cross-border industrial restructuring in East Asia as well as the efforts of Chinese local governments in attracting foreign investment to promote local development in a time of fiscal austerity. In terms of growth in exports and foreign reserves, as well as GDP, China's experience of FDI-led development seems to be a successful model for countries at a similar development stage. However, a systematic comparative analysis with other development models shows that it is still too early to tell whether it is a sustainable development model for China as well as other late liberalizers. The development pattern has resulted in a polarizing development between China's different regions and sectors. In the long run, this polarization will have a negative effect on the economy. Moreover, the fierce competition among the LDCs will continue to force governments in these countries to maintain a deflationary monetary policy. The deflationary monetary policy, in turn, will impede the development of domestic markets, and thus further deteriorate the polarizing tendency of the FDI-led development strategy.

**Notes**

- 1 Underpinned by US hegemonic power, world trade expanded at an average annual rate of about 7 percent between 1953 and 1973, much higher than the rate of 0.9 percent during the interwar era and the 3.5 percent before World War I (see Yam 1997: 112).
- 2 The fourteen cities are, from north to south, Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai.
- 3 For how the fiscal decentralization has provided strong impetus for local officials to pursue local economic developments, see Oi (1992) and Wong (1991, 1992). Although we have witnessed the central government's recentralization efforts on the revenue side in the 1994 tax reforms, the trend of self-reliance on the expenditure side, if not intensified since 1994, has not changed through the post-Mao era. For the content and impact of the 1994 tax reform, see D. Yang (1994), Bahl (1998), and L.-Y. Zhang (1999).
- 4 For definition and the analysis of developmental state, see Johnson (1982), Deyo (1987), Amsden (1989), Haggard (1990), and Wade (1990).
- 5 For examples see Zweig (1995), Chung (1999), and Blecher and Shue (2001).
- 6 In 2000, the Chinese central government permitted another eleven EDZs to set up in the mid-west area as part of its effort to reduce regional disparities.