Universidade de Aveiro
2005

Secção Autónoma de Ciências Sociais, Jurídicas e Políticas

Maria Eugénia Cardoso
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Investimento Directo Estrangeiro na China

Análise de uma história de sucesso

Foreign Direct Investment in China

An analysis of a success story

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Dissertação apresentada à Universidade de Aveiro para cumprimento dos requisitos necessários à obtenção do grau de Mestre em Estudos Chineses, Área de Negócios e Relações Internacionais, realizada sob a orientação científica do Prof. Doutor Robert Dernberger, Professor Emeritus of Economics da Universidade do Michigan, e do Prof. Doutor Clyde Stoltenberg, Professor of Business Law na Universidade da California- Long Beach.

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acknowledgments

First of all, I would like to express my debt of gratitude to Prof. Robert Dernberger and to Prof. Clyde Stoltenberg for their invaluable orientation, steady encouragement and patience. I have no words to express the honor I feel to be given the opportunity to be supervised by them.

My admiration and thanks also goes to all other professors of the Master in Chinese Studies of Aveiro University. Indeed, I was overwhelmed by their unbelievable humbleness and kindness particularly when considering their impressive academic records.

I also want to express my gratitude to Prof. Pedro Vilarinho, without whom this excellent program would have never existed, as well as to Prof. Serrano Pinto and Dra. Helena Costa for all the support given whenever I needed in the last few years.

I would also like to thank the staff and professors at Macao University that I had the pleasure to meet. Among them, I am especially thankful to Jenny Lou, to Prof. Aliana Leong and to Dr. João Baptista Leão for their incredible hospitality.

I also wish to express my gratitude to Prof. Manuel Martins Lopes and to Prof. Cai Yun for their invaluable support during my stay in Beijing.

I owe a very special thanks to my friend Zhou Jing for her help and friendship. Without her, this study as it is, would not have been possible.

Finally, I would like to express my gratitude to all my family and friends who stubborningly kept believing in me, even at the times when I had lost all my faith in myself.

To all, thank you.

resumo

O presente trabalho propõe-se não só analisar o sucesso extraordinário da China em captar investimento directo estrangeiro, bem como demonstrar como este sucesso está directamente relacionado com o empenho dos líderes chineses em alcançar o mesmo. Com este objectivo descreve-se como o quadro legal que rege o investimento directo estrangeiro na China tem vindo a ser liberalizado de uma forma pragmática, gradual e contínua através da implementação de uma série de políticas e de leis que visam fundamentalmente conseguir a captação de um elevado nível deste tipo de capital estrangeiro. O presente estudo descreve também como este processo evoluiu de acordo com as necessidades políticas dos líderes chineses em conseguir apoio para as reformas económicas por parte das facções mais conservadoras do regime.

abstract

This study examines China's extraordinary success in attracting foreign direct investment. The study reveals that this success is directly related to the unquestionable commitment to this aim by the Chinese leadership. It describes how the Chinese foreign direct investment regime has been liberalizing in a pragmatic, gradual and continuous manner through the implementation of a series of policies and laws that aimed fundamentally at attracting high levels of inbound foreign direct investment. It also shows how this process has been defined by the leadership's political necessity to obtain support for the reforms from the most conservative factions of the establishment.

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INTRODUCTION

China's success in transforming itself from an impoverished country following an autarkic and self-sufficient policy into a leading player in the international economy is one of the most extraordinary economic development stories in the world.

Since the start of reforms in 1978, real gross domestic product (GDP) growth has averaged 9,5 percent[1] raising capital income five folds and enabling the People's Republic of China (PRC) to make unprecedented strides in reducing poverty[2].

The country's amazing growth is even more striking when compared with Russia's and India's, its two largest neighbors: in 1988, China's GDP was less than half of Russia's; only ten years later, Russia's GDP was less than half of China's; on per capita basis, two decades ago China and India were about equal; today, China is about twice as rich as India. Indeed, if each of China's provinces were accounted as individual economies, about 20 out of top 30 growth regions in the world in the past two decades would be Chinese.

The transformation of the Chinese economic landscape has also been dramatic. From non-existence in 1978, in 2002 the non-state share of the economy was estimated to represent 60 percent of GDP.[3] Also, due to the uneven growth of its economic sectors, during this period China was able to rectify its pre-reform distorted industrial structure, which consisted in an unusually high proportion of agriculture in the total GDP. In fact, from 1978 to 2002, the annual average rate growth of the primary, secondary and tertiary sectors of the Chinese economy was respectively 4.7 percent, 11.4 percent, and 10.3 percent.[4]

Moreover, at the end of the century, China's share of total world trade had sextupled compared with its share in 1977, making it the seventh largest trading country in the world.[5]

---

[1] It should be noted that, particularly during the late 1990s, there was heated debate surrounding the accuracy of China's GDP growth numbers published by the Chinese authorities not only among westerner scholars, but also among Chinese economists. For a detailed record of this debate, see Holz (2003).

[2] According to the World Bank (1996), in a period of less than 20 years, over 200 million Chinese were lifted out of absolute poverty and, in the process, the percentage of the population subject to malnutrition decreased from around 50 percent to less than 5 percent. Furthermore, international comparison shows that the time needed for doubling per capita GDP was 58 years in England during the period 1780-1838, 47 years in the United States during 1839-1886, 34 years in Japan during 1885-1919, and 11 years in Korea during 1966-1977. China has set a new record – per capita GDP in China doubled within only 9 years between 1978 and 1987, and doubled again in another 9 years between 1987 and 1996. World Bank (1997).

[3] Tseng and Zebregs (2002), p. 2.

[4] Cai and Wang (2002), p. 9.

[5] Lardy (2002), p. 4.

The driving force for these extraordinary developments has been the implementation of massive economic reforms aiming at China's industrialization and economic development. Among these reforms, one of the most important features was the increasing openness of Chinese economy, particularly to trade and foreign direct investment (FDI).

Indeed FDI inflows to PRC have risen from insignificant values in the late 1970s to US$40 billion per year (about 5 percent of GDP) in the second half of the 1990s (see Table 1).

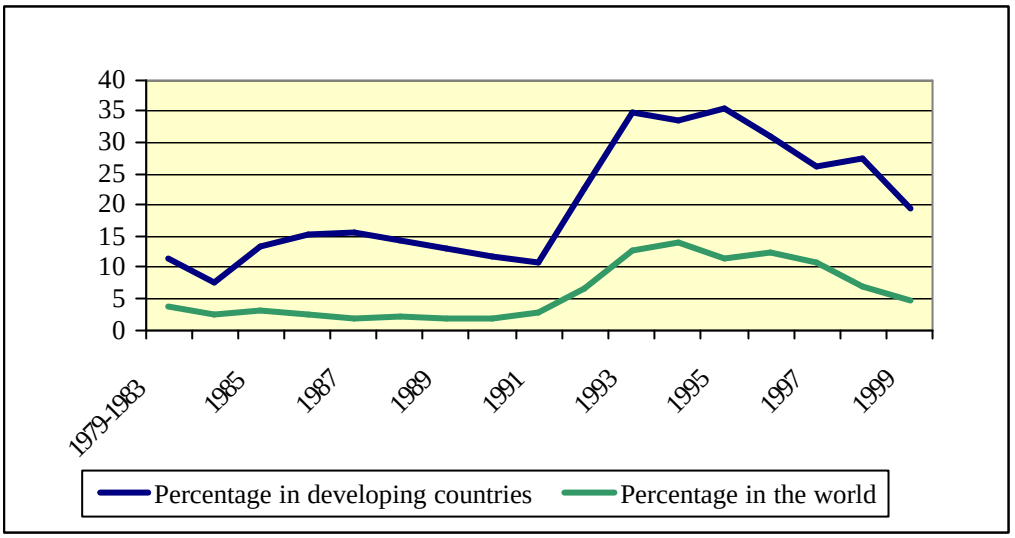
Table 1: FDI Inflows as a Proportion of GDP, 1979-2003

Year	Realized FDI (US$ million)	Proportion of GDP (%)
1979-82	1 769	0.1
1983	916	0.2
1984	1 419	0.4
1985	1 956	0.6
1986	2 244	0.6
1987	2 314	0.7
1988	3 194	0.8
1989	3 393	0.8
1990	3 487	0.9
1991	4 366	1.1
1992	11 008	2.3
1993	27 515	4.6
1994	33 767	6.2
1995	37 521	5.4
1996	41 726	5.1
1997	45 257	5.0
1998	45 463	4.8
1999	40 319	4.0
2000	40 715	3.8
2001	46 878	4.0
2002	52 740	3.3
2003	53 510	3.5

Sources: MOFCOM and USCBC statistics (web sites).

In an international comparative perspective, and particularly in the 1990s, China's FDI shares in developing countries and in the world have both experienced a significant rise over time (see Figure 1).

Figure 1: China's Position in Terms of Actual FDI Inflows in Developing Countries and in the World: 1979-1999 (%)



Sources: Zhang (2002), p. 50, Table 1.

In fact, throughout this period, China has become the second largest FDI recipient in the world after the United States (US) and the largest host country among developing countries. From 1979 to 1999 actual FDI inflows into China amounted to US$306 billion, which is equivalent to 10 percent of direct investment worldwide and about 30 percent of the investment amount for all the developing countries put together during these two decades. In 2002 China's FDI inflows have even surpassed those of the US, making it the world's leading destination for foreign direct investment for the first time in history.

Although part of FDI inflows into China may be exaggerated because of overvaluation and round-tripping[6] an obvious question arises: What explains the PRC's success in attracting FDI?

A number of empirical studies have emerged attempting to answer this question[7] which can be broadly categorized into two groups: studies at the national level (why foreign firms invest in China)[8] and those at the regional level (why a foreign firm chooses a specific region within China)[9].

[6] Round-tripping FDI refers to capital originating from China that returns disguised as FDI to take advantage of tax, tariff, and other benefits. Both the issues of overvaluation and round-tripping will be further addressed later in this study.
[7] For a review of the existing studies on the determinants FDI in China see Wei (2003).
[8] See, for example, Wei (1995, 2000), Dees (1998), Zhang (2000), Hong and Chen (2001) and Wei and Liu (2001).
[9] See, for instance, Gong (1995), Head and Ries (1996), Chen (1996), Chen (1997c), Wei et al. (1999), Berthelemy and Demurger (2000), Cheng and Kwan (2000), Zhao and Zhu (2000), Wei and Liu (2001), Zhang (2001a), Coughlin and Segev (2000) and Sun, Tong and Yu (2002).

The large majority of these studies are based on the Eclectic Paradigm of International Production proposed by Dunning, also known as the OLI framework. In summary, Dunnings argues that firms invest abroad because of ownership (O), locational (L) and internalization (I) advantages. Ownership advantages relate to the multinational's ability to compete with their rivals; locational advantages relate to the multinational's willingness to invest in one host country rather than in others; and finally, internalization advantages relate to the ability of the multinationals to internalize the previous O and L advantages.

According to the mainstream analysts, FDI in China as been motivated by the following main factors. First, its market size and largely unmatched economic growth rates. Second, its foreign trade, which have turned China, since 1997, in one of the top ten trading nations in the world. Third, its cheap and abundant supplies of labor.

A number of studies have also identified the Chinese Diaspora as an important determinant of the country's FDI inflows,[10] an argument strongly supported by the fact that the majority of investment in China originated from regions with many cultural affinities with China.

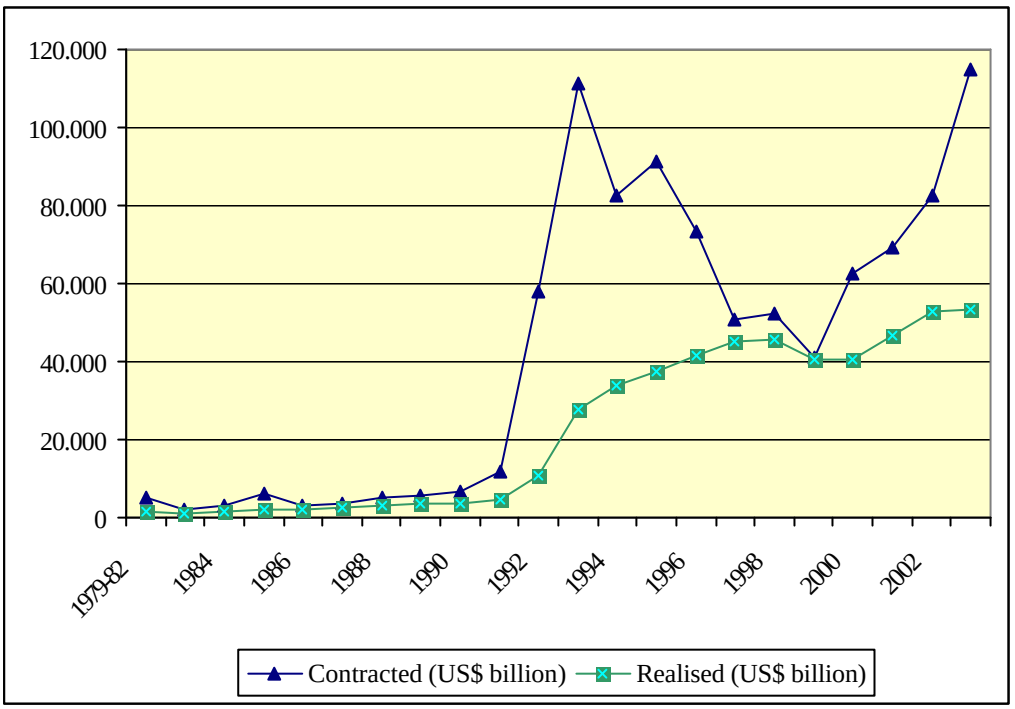
But despite the conventional wisdom that economic fundamentals and cultural aspects are the major explanatory factors of FDI in China some voices have risen defending that these lines of reasoning are debilitantingly inadequate to account for the variant patterns of FDI in China unless the Chinese institutional reality is taken seriously.

In fact, relevant to a broader theoretical literature that looks at how political arrangements affect economic performance, a few studies started to explore the connections between institutions and investments through the prism of FDI in China. For example, heavily based on statistical data-oriented analysis and aided by multiple regression techniques, Jun (2000) establishes for the first time a systematic empirical causal link between the institutional effects and investment behavior in China. Also, Huang (1999, 2003) suggests that FDI in China can be better explained by an institutional foundation argument. His main proposition is that the absorption of large volumes of FDI by China is not a sign of the strengths of its economy but it is rather a sign of its fundamental weaknesses nurtured by the Chinese institutional reality.

Following this theoretical line of reasoning, and although this study does not intent to dispute the economic and cultural FDI determinants in China, it will focus on its legislative and political dimensions. Using a both descriptive an analytical approach it is its

intention to document how the long-term commitment of the Chinese government to the open-door policy has significantly contributed to China's success in attracting FDI.

Figure 2: China's FDI Inflows Growth, 1979-2003



Sources: MOFCOM FDI Statistics (web site).

Indeed, although there was a very impressive upward trend of FDI flows into China during the entire reform period (see Figure 2), a closer look at the growth trends (particularly in the contractual amount) reveals that these inflows began to show signs of an extraordinary upward surge at three points, i.e., in and around 1984, around 1992 and around 2000. In this way, it is possible to divide the whole 1979-2003 period into four sub-periods in which the volumes of FDI flows assumed quite different and overall increased magnitudes i.e., from 1979 to 1983, from 1984 to 1991, from 1992 to 1999 and beyond 2000.

As it will be analyzed in this study, perhaps not coincidentally, these four sub-periods (particularly at their outset) were market by major political events, institutional innovations or policy changes to improve, clarify and liberalize the foreign direct investment environment.

[10] See, for example, Sender (1991). Tanzer (1994), Berger (1994), Oxfeld (1993), Kao (1993), Jansson (1994), Suryadinata (1995), Hamilton and Waters (1995), EAAU (1995), Ong and Nonini (1997), Huang

Finally, this study will also describe how the FDI policy in China has evolved according to the reformers' necessity of overcoming the internal opposition from the most conservative sectors of the establishment. In this way, it will document how FDI has in fact constituted a powerful political tool used by the pro-reform leadership to guarantee its maintenance in power.

This work is organized as follows. Part I constitutes an introduction to the study of FDI in China, which includes a definition of what is considered FDI by international standards, the most important forms that this kind of investment can assume in China, as well as their different legal requirements throughout the reform period. Part II analyses the story of FDI in China focusing both on the evolution of its legal and political framework and on the dynamics of its flows trends and patterns, namely, on year-by-year upwards or downwards, ownership structure, sources, geographical distribution and sectoral composition. For a better exposition of our arguments, Part II is sub-divided in the four previously identified phases. Finally, Part III of this study presents our conclusions.

(1998) and You-tien (1998).

PART I: An Introduction to the Study of FDI in China

Defining FDI by International Standards

According to the Organization for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF)[11], foreign direct investment is a component of a country's national financial accounts that can be defined as a category of international investment made by a resident entity in one economy (direct investor) with the objective of establishing a lasting interest in an enterprise resident in an economy other than that of the investor (direct investment enterprise).

It should be noted that "lasting interest" implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor. In fact, the main distinguishing feature of FDI from other forms of foreign capital is the concept of managerial control over an enterprise in which foreign capital participates. Accordingly, most of the OECD countries defines foreign investment as "direct" when a foreign investor has acquired an equity share of 10 percent or more in a domestic enterprise. In this way, a "portfolio investment" through stock markets can become "direct investment" when its value passes an artificially set threshold of equity ownership ratio. Or, in other words, when the foreign investor has a sufficiently large share of equity so that s/he will have a considerable degree of influence.

FDI statistics typically report two types of FDI data, i.e., the actual amount (also know as the realized, utilized, or arrived amount) and the contract amount (also know as the approved, pledged, or committed amount). Whereas the actual amount is the quantity of FDI that has actually arrived at a given time, the contracted amount refers to the amount of FDI that the investors plan to invest at the time when the project contract is approved. However, the planned total investment may not arrive in one lump sum, as it may came in installments over a period of time. Consequently, there is usually a time lag between the two sets of data.

Because of its inherent characteristics, FDI is often thought to be more useful to a country than mere investments in equity of its companies. This is supported by the idea that equity investments are potentially "hot money" which can leave at the first sign of trouble, whereas FDI is a kind of investment that is durable and generally more rewarding for the receiving country. In fact, in order to acquire supplemental funds, sophisticated technology, managerial expertise and/or critical know-how, most countries in the world

actively encourage several different forms of foreign capital participation in domestic enterprises.

Defining FDI in China

China's FDI official statistics[12] reveal that its definition of FDI does not necessarily follow the international guidelines and therefore include cases that may not be considered as FDI by international recognized standards. This study, to be consisted with the international norm, will focus on those modes of foreign direct investment that are not only world widely recognized as such, but that also represented the overwhelming majority of FDI in China throughout the reform period, namely, equity joint ventures (EJV), contractual joint ventures (CJV), wholly foreign-owned enterprises (WFOE) and joint exploration projects (JE).

In the following section, we will analyze the legal and regulatory requirements of these different investment modes in China throughout the reform period.

Equity Joint Ventures

According to the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment (hereinafter referred to as Equity Joint Venture Law) adopted on July 1, 1979 and amended on April 4, 1990 and March 15, 2001, equity joint ventures are limited liability companies established between foreign companies, enterprises, other economic organizations or individuals (hereinafter referred to as foreign investor), and Chinese companies, in which the foreign investor shall, in general, hold at least 25% of the registered capital.[13]

Both the foreign and the Chinese side may contribute investment in the form of cash, machinery, buildings, intellectual property, critical managerial know-how, and other types of transferable property interests. The Chinese partner's contribution may also include the right to the use of a site provided for the equity joint venture during the period of its operation.

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[11] OECD (1999) and IMF (1999).

[12] Official foreign direct investment statistics for China are regularly disseminated by the Ministry of Commerce (MOFCOM) in the annual publication S*tatistic on FDI in China* and on MOFCOM's web sites. The same data are integrated into the statistical systems of other national agencies such as the National Bureau of Statistics (NBS) and the State Administration of Foreign Exchange (SAFE).

[13] The proportion of total enterprise capital subscribed by the foreign investor in an equity joint venture may be less than 25 percent, though, in such cases, the venture is not entitled to tax rebates on imports of goods for its own use or to other tax exemptions and reductions normally granted to foreign-invested enterprises.

The net profit of a joint venture is distributed among the parties to the venture in proportion to their respective contributions to the registered capital.

According to the original Equity Joint Venture Law, the registered capital of these enterprises could not be reduced during the term of the venture (which was ordinarily from 10 to 30 years), although it could be extended to 50 years, in certain circumstances, or even beyond 50 years, if approved by the State Council. This changed with the 1990 amendment of the law, after which the initial registered capital was allowed to be reduced even though this still required approval as it represented a change in the contract that was originally approved. Furthermore, the foreign investor could now withdraw his or her investment by transferring his or her share to the Chinese partner or to a third party or by closing the joint venture altogether. Nevertheless, closure remained being only possible after both a resolution to this effect has been passed by the board of directors and approval has been granted by the concerned authority.

In an equity joint venture the existence of a board of directors is mandatory and its size and composition must be determined through consultation among its parties. In general this is decided according to the parties' ratio of equity contributions. Although the chairman of the board originally had to be from the Chinese side and the vice-chairman a representative of the foreign partner, this requirement has been deleted from the law with the previously mentioned 1990 amendments.

Furthermore, according to the original EJV Law, these companies could be formed in the sectors of energy, building materials, chemical and metallurgical industries; machine building, instrumentation, meter and offshore oil exploitation equipment manufacturing; electronics, computer and communications equipment manufacturing; light industries, particularly textiles, foodstuffs, medicines, medical apparatus and packaging; agriculture, animal husbandry and fish breeding; and tourism and service trades. Equity joint ventures were not, however, limited to these sectors, which were merely stated as examples. Limits to setting up equity joint ventures were subsequently imposed in the 1995, 1997 and 2002 catalogues for the guidance of foreign investment industries.[14]

The original version of the EJV Law also contained a requirement to submit production and operation plans to the competent authorities for filing. Nevertheless, it should be noted that in 1979, when this set of rules were formulated, the Chinese economy was still functioning according to five-year and annual production plans, so this requirement merely placed the same obligation on equity joint ventures as on other business units. By the mid-1990s mandatory central planning had in practice been largely

[14] This issue will be further addressed later in this study.

replaced by indicative planning so that production plans no longer fulfilled any practical role. In this way, the deletion of this requirement in 2001 due to its inconsistency with the market economy and consequent contravention of World Trade Organization (WTO) rules represented a formal recognition of disuse rather than a change in policy.

Regarding technology and export requirements, these were broader and weaker for equity joint ventures than for wholly foreign-owned enterprises (see below). In fact, in addition to adopting advanced technology and management methods to widen the variety of products, raise both the quantity and quality of output, and save energy and materials, these joint venture were also expected to provide technical and managerial training.

In the original version, equity joint ventures were told to give priority to domestic sources in purchasing production inputs, although they were also told that they could make such purchases on the world market provided that these were made using foreign exchange raised by the joint ventures themselves. Furthermore, although no fixed export minimum was specified in the original law, joint ventures were encouraged to market their products outside China. Since following China's accession to the WTO enterprises can not be required to fulfill export performance requirements, balance their exports and imports or balance their foreign exchange income and expenditure, these exhortations had no longer force, constituting only mere expressions of preference. Consequently, this article was deleted in 2001 as a trade-related investment measure violating the WTO Trade Related Investment Measures (TRIMs) agreements. In fact, in responding to market forces, both international and domestic, equity joint ventures, like all other enterprises, will sell in whichever market is most profitable. As such, it appeared unnecessary to retain a clause encouraging any particular form of enterprise to export its output.

Contractual Joint Ventures

Although in the early years of the reform period contractual joint ventures were the most popular mode of FDI, there was no separate and specific legal framework regulating their operations. This was only possible because contractual joint ventures were also considered to be joint ventures, being, as such, regulated largely by the Equity Joint Venture Law. In fact, it took China almost one decade to adopt and promulgate the Sino-Foreign Contractual Joint Venture Law (hereinafter referred to as the Contractual Joint Venture Law), which was only adopted at the First Session of the Seventh National People's Congress and promulgated by Order no. 4 of the President of the People's Republic of China on April 13, 1988, becoming effective from the date of promulgation.

Indeed, contractual joint ventures can be defined as joint ventures where the foreign investor does not need to set up a new corporation in China: the foreign investor and the Chinese partner participate in the joint venture by doing business using the Chinese business license under a co-operative, contractual arrangement.

Originally, the contractual joint venture structure was limited to export-oriented companies. Recently, this mode of FDI has been utilized to allow foreign investment in areas where foreign participation via equity joint venture would violate Chinese regulations.[15]

In fact, due to their nature, contractual joint ventures are much more flexible than equity joint ventures as they face much less legal requirement.

To start with, and contrary to equity joint ventures, it is not mandatory that contractual joint ventures have legal person status. They may or may not have such status, accordingly to the desire of the different parties involved.

Also, the Contractual Joint Venture Law does not state that these ventures shall be limited liability companies and does not specify the share of the different partners, except in the case of a contractual joint venture which has legal person status, in which case the foreign partner must provide in general not less than 25 percent of the registered capital.[16]

Furthermore, according to the law, in establishing a contractual joint venture contract, the Chinese and the foreign parties are free to establish among themselves the investment or conditions for co-operation, the distribution of earnings or products, the sharing of risks and losses, the manners of operation and management and the ownership of the property at the time of the termination of the contractual joint venture. Moreover, the investment or conditions for co-operation contributed by the Chinese and foreign parties may be provided in cash or in kind, or may include the right to use of land, industrial property tights, non-patent technology or other property rights.

In practice this means that capital contributions to a CJV may be in the form of natural resources rights and labor, which is not permitted for an EJV. Also, that if investment involves non-cash contributions, the non-cash components do not necessarily have to be factored in to the equity equation of a CJV, as is mandatory for an EJV.

[15] The Chinese regulations prohibit WFOEs from offering services in some industries. However, under the CJV format, the service provider is a Chinese legal entity engaged in a contractual arrangement with a foreign entity, and as such, there is no violation of the Chinese law.

[16] As with EJVs, the proportion of total enterprise capital subscribed by foreign investors in a CJV may be less than 25 percent, though in such cases the venture is not entitled to tax rebates on imports of producer goods for its own use or other tax exemptions and reductions normally granted to foreign-invested enterprises.

Regarding corporate structure, and according to the law, a contractual joint venture shall establish or a board of directors or a joint managerial institution. If it is the desire of the different partners, it can also entrust to a third part its operations and management. It should be noted that this was originally not allowed in EJVs. If fact, before the 1990 amendments of the EJV Law, neither the second nor the third option was available for EJVs. As of 1990, however, the last option has become possible in EJVs, although subjected to several prerequisites.

As with an equity joint venture, the registered capital of a contractual joint venture could not originally be reduced during the term of the venture, but may now be reduced if approval is granted. Also, and as with the Equity Joint Venture Law, the Contractual Joint Venture Law was emended in advance of China's accession to the WTO to comply with its commitments. In particular, Sino-foreign contractual joint ventures no longer have to balance their foreign exchange receipts and expenditures.

Wholly Foreign-Owned Enterprises

According to the Law of the People's Republic of China on Enterprises Operated Exclusively with Foreign Capital (hereinafter referred to as the WFOE Law) adopted in April 1986 and revised in October 2000, WFOEs are limited liability companies incorporated in China with capital solely contributed by foreign investors. Furthermore, the law states that these companies' liability is limited to the extent of its total registered capital. Also, the law protects WFOEs from confiscation by the state, except under special circumstances, in which case legal procedures will be followed and compensation made. The bilateral investment treaties (BITs) that China has signed with many countries[17] routinely include a clause guaranteeing this protection.

The investment contributed by a foreign investor may be provided in convertible foreign currency or in the form of equipment, industrial property rights, know-how or, with approval, profits in ren min bi (RMB) from other enterprises in China.

In the original law, WFOEs were required the following: to use advanced technology to develop new products, save energy and raw materials, upgrade existing products and/or to substitute for imports; or to export at least 50 percent of their output value. These requirements have been since removed in compliance with WTO rules and replaced with a general exhortation to adopt advanced technology and equipment, engage in the development of new products, realize the upgrading of products, conserve energy and raw materials and be export-oriented.

[17] This issue will be further address later in this study.

The original law also stated that these enterprises, to sell its products, had to engage a Chinese foreign trade company on a commission basis. However, in 2000 this was revised to allow WFOEs to sell their own products in China or to freely appoint other business organizations to do so.

Also, according to the 1986 law, WFOEs were not allowed to operate in the areas of news, publishing, broadcasting, television and film production, domestic commerce, foreign trade and insurance, and post and telecommunications. Furthermore, to operate in the areas of public utilities, communications and transport, real estate, trust investment, and leasing, an approval by the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) was required. However, following the 2000 revision of the law, the two articles embodying these restrictions have been deleted and replaced by advice to consult the relevant sections of the catalogues for guidance of foreign-investment industries.

Originally, registered capital could not be reduced during the term of the contract. This prohibition has also been relaxed following WTO entry to take account of the fact that actually utilized investment may be less than the contracted amount.

WFOEs compares favorably to CJVs or EJVs when protection of property assets and managerial autonomy is concerned. Nevertheless, WFOEs also embed some disadvantages. For example, when deciding for a WFOE entry mode, foreign investors will not be able to count on the experience, market intelligence, and operational know-how of a local partner. Also, they will have to carry alone the burden of all the necessary sunk-cost investments, as well as all the land and building investments. These are factors that may subject foreign investors to a higher degree of risk.

Joint Exploration Projects

In the early reform period, in 1982, China published the Regulations of the People's Republic of China on the Exploration of Offshore Petroleum Resources in Co-operation with Foreign Enterprises. Later, in 1993, it published the Regulations of the People's Republic of China on Chinese-Foreign Co-operation in the Development of Continental Petroleum Resources. These sets of regulations established the operating rules for joint exploration projects in China.

Joint exploration projects are co-operative contracts signed between a foreign company and a Chinese entity meant at jointly exploring both inland and offshore oil, gas, or other mineral resources. In general, the foreign partner is selected through an international competitive bidding process.

These projects involve two very distinct phases. In the first, the exploration stage, the foreign partner is expected to bear alone all the necessary start-up investments and risks associated with the geophysical surveying and exploration processes. Only after, if the resources found are considered to be suitable for extraction and commercialization starts the second phase of the project, this is, the production stage. Only at this point is the Chinese partner responsible for its share of costs, risks and profits. However, it should be noted that very often when deciding the ratio of costs/profits of the different parts, the initial investments are also taken into consideration, and in this way, the foreign partner is compensated for his sole initial efforts.

As with CJVs, it is not mandatory for the joint exploration projects to have legal person legal status. Also as with CJVs, the method by which the share of costs/profits is established is not stipulated in detail by the regulatory framework constituting merely a matter of negotiation between the parties involved. It should however be noted that, in general, in the development phase, the Chinese partner share is 51 percent. This is not surprising if one considers that in such projects China effectively transfers part of its sovereign possessions over its natural resources to the foreign investor, even though as an exchange for being alleviated from the responsibility for the huge start-up capital that these projects usually oblige to.

From the foreign investor point of view, although these projects represent high potential profits, they are also associated with high levels of risk, exactly because of the high start-up capital and sunk investments that they involve.

Other Forms of Investment

As said, EJVs, CJVs, WFOEs and JE projects together represent an overwhelming majority of all foreign-invested enterprises (FIEs) in China. Nevertheless, reflecting the growing needs and complexity of foreign business operations in China, China has also begun to experiment with a variety of new foreign investment structures or variants of these investment modes. As a result, the following are all forms of corporate structures being explored.

Foreign Investment Joint Stock Limited Company

A Foreign Investment Joint Stock Limited Company is defined as a company jointly established, through subscribing a certain amount of capital, by companies, enterprises or other economic organizations or individuals from outside China and those within China on

the principle of equality and mutual benefit. In this way, each shareholder contributes the same amount to the registered capital being liable to the company by its share of the registered capital. Regarding the company, it is liable to its debts by all of its assets. A Foreign Investment Joint Stock Limited Company is subject to the jurisdiction of the Chinese laws and regulations governing foreign investment enterprises.

Investment Company

An Investment Company is defined as a limited liability company established by a foreign investor exclusively with his own capital or in co-operation with a Chinese investor. A foreign investor who applies for establishing an investment company must be creditworthy and financially strong and must have already established a certain number of enterprises in China. In addition, the registered capital of an investment company cannot be less than US$30 million. The scope of business of an investment company can also be more extensive than that of ordinary foreign enterprises. Nevertheless, currently investment companies can only invest in those sectors of industry, agriculture, infrastructure and energy where foreign investment is encouraged and allowed.

Build-Operate-Transfer and Transfer-Operate-Transfer

Build-Operate-Transfer (BOT) means that investors undertake an industrial or an infrastructure project in Chinese territory, construct and operate the project and then transfer the title of the project back to China upon expiry of the contract term. BOT projects are allowed in a limited range of infrastructure areas such as coal-fired power stations, hydroelectric power stations under 250 MW, high grade roads, local railways, bridges, tunnels, city water supply sources, water purification plants and sewage treatment plants. Such projects are included in national and local five-year plans and are carried out by limited liability companies in which the registered capital is at least 25 percent of total investment. The foreign investor in a BOT company is selected by international competitive bidding.

Transfer-Operate-Transfer contracts are different versions of BOTs. In these arrangements China transfers the title of an already existing project to the foreign investor, which, after operating it for a contracted period of time, re-transfers its title back to China.

PART II: The Story of FDI in China

Introduction

At the eve of the reform period, China was a virtually closed country. Indeed, the very idea of possible integration in the global economy was still an issue subjected to strong controversy as it was seen as potentially hampering China's effort at self-reliance and, therefore, compromising its sovereignty. Accordingly, China foreign trade system was characterized by state trading corporations, strict control over foreign exchange and by a highly overvalued currency. These, taken together, strongly discouraged exports. Furthermore, after decades of following a policy of autarky and self-sufficiency, China had virtually no foreign debt and no foreign investment.

Perhaps the best way to describe the ideological sentiment at the time towards the issue of foreign participation in Chinese economy is to quote from two leading official publications. The official newspaper of the Chinese government, *People's Daily*, wrote, "We will never permit the use of foreign capital to develop our domestic resources as the Soviet revisionist do, will never run undertakings in concert with other countries and also will never accept foreign loans. China will never have neither domestic nor external debts." (January 2, 1977). *Red Flag*, the journal published by the Central Committee of the Chinese Communist Party (CCP), claimed that, "Ours is an independent and sovereign socialist state. We have never allowed, nor will we ever allow, foreign capital to invest in our country. We have never joined capitalist countries in exploring our natural resources; nor will we explore other countries' resources. We never did, nor will we ever, embark on joint ventures with foreign capitalists." (March, 1977).[18]

Viewed under this historical perspective, the decision to open China to the world and to allow foreign investment in the country seems nothing less than extraordinary. However, in order to understand what led to this decision, it is also necessary to see it under the economic and political contexts in which it occurred.

To start with, according to the mainstream opinion found in the literature, China was, at the time, facing serious economic development problems. In fact, albeit China had made impressive progress in the technical level of its industry after 1949, after decades of isolationism and of the particularly disruptive period of the Cultural Revolution, in the late 1970, the general technological level in basic industries was far behind from the levels of developed countries such as the United States, Japan, and Western Europe.

This had already been acknowledged by Mao's appointed successor Hua Guofeng whom, in trying to overcome China's industrial underdevelopment situation, launched in early 1978 a very ambitious program that featured massive acquisition of Western machinery and technology.[19] However, these massive imports led to the largest trade deficit in PRC's history, and as the trade deficit built up, foreign exchange reserves were scaled down.

Indeed, China's foreign reserves at the end of 1979 were estimated by the Japan External Trade Organization (JETRO) at only US$1.3 billion. This, plus an estimated value of US$2.23 billion of its holdings of gold, was equivalent to approximately five and a half months' imports from the non-communist world in 1978. Furthermore, this trade deficit crisis emerged in a ongoing scenario of dramatic decrease in state enterprises' profits - from 24.3 percent in 1966 to 16.4 percent in 1978 - and of overall shortage of experienced engineers and lack of infrastructure to absorb new technologies.[20]

Nevertheless, according to some analysts, in late 1978, China had no urgent need to adopt economic radical reforms. For example, Shirk[21] argues that the country was not experiencing an economic crisis and that its economy was operating more efficiently than the Soviet economy. Accordingly, she defends that Chinese economic performance and living standards could have been substantially improved through minor adjustments in the economic system, which had already been tried in Soviet Union with good results. These included modernizing planning methods, shifting factory decision-making from party secretaries to managers, evaluating managers on the basis of long-term performance including profits, introducing a labor market and piecework bonuses, or increasing agricultural investment. Following this line of reasoning, Shirk argues that Deng Xiaoping's decision to introduce reforms in late 1978 was dictated not by economic necessity, but by Deng's political interest in discrediting the successor of the "Gang of Four", Hua Guofeng, as well as in seizing the reins of power from him. Accordingly, she argues that it was the competition for party leadership and the need to legitimize the leadership of the reformers that provided the opening for political innovation.

Indeed, apart from the questionable economic urgency, the adoption of the open up policies reflected an important personal political change: the rise of Deng Xiaoping to power.

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[18] Cited in Wei (1999), footnote pp. 40-41.
[19] This program was later abandoned.
[20] Chen (1982), pp. 477-478.
[21] Shirk (1994), pp. 10-11.

It should be noted that, as early as 1975, when Deng Xiaoping re-emerged from one of his periods of political obscurity, and although he was not an economist himself, he had already commissioned the drafting of a series of economic development documents designed to achieve what Deng called China's four modernizations: the modernization of agriculture, of industry, of science and technology, and of national defense.

According to a document entitled "Some Questions on Accelerating Industrial Development"[22] which was drafted by the State Planning Commission (SPC) and highlighted by Deng himself at a State Council meeting as early as 1975, the modernization of this areas where absolutely crucial to the economic development of China. Moreover, this could only be achieved by following a set of policies profoundly rooted on the country's opening to the outside world.

In this landmark document, three main points were emphasized. First, China had not only to acquire new technology and equipment from other countries, but also to strongly engage in international trade: "We should introduce new technology and equipment from other countries and expand imports and exports."[23] Second, it was defended that the country should introduce and improve modern industrial management methods, as they were essential for China's modernization: "...industrial management is a vital issue and it must be handled well."[24] Finally, in this document it was stated that China should import technology and equipment for natural resource exploitation by paying with coal and petroleum: "...to accelerate the exploitation of coal and petroleum in our country, we may sign long-term contracts with foreign countries and fix several localizations of production under condition of equally and mutual benefit and according to common practices in international trade ... so that the foreign countries can supply us with complete sets of modern equipment suitable to our needs and we can repay them with coal and petroleum we produce."[25]

As a consequence, the drafters were fiercely attacked by the most radical factions of the Chinese political establishment as being "capitalist" and, eventually, Deng Xiaoping was once again politically ostracized and condemned to a last period of political obscurity.

After this been said, it is not so surprising that, following the downfall of the "Gang of Four", the empowered reformers headed by Deng Xiaoping reintroduced their political ideas of opening up China to the outside world.

[22] See Deng (1984).
[23] Ibid, p. 44.
[24] Ibid, p. 45.
[25] Ibid, p. 47.

Furthermore, the initial 1975's ideas of introducing and acquiring advanced technology and management methods from foreign countries were further developed to allow inward FDI into China's domestic economy. In fact, the reformers had decided to draw on the successful experience of other developing countries (particularly those of the East and Southeast Asian economies) in attracting and utilizing FDI to accelerate the transfer of advanced technology in order to speed up the economic development of their respective domestic economies.

Another important reason strongly supporting the introduction of FDI in China was the fact that it was considered to be an efficient substitute mechanism for China's nonexistent commercial financial system in allocating investment funds.[26] Indeed, although China's level of savings was considerably high at the beginning of the reform period, the country had no means of mobilizing its own resources, as its banking system was merely a conduit for allocating funds in accordance with the national economic plan. It also lacked the infrastructure and experience to make loans on a commercial basis. Moreover, stock markets were nonexistent, hitherto politically taboo. In this way, foreign companies, themselves funded via their own domestic capital markets, were expected to provide the necessary funds to build the productive capacity in China so urgently needed to its economic development. Furthermore, foreign companies would be able to do so on a profit-making basis which was completely out of reach to state-owned enterprises that operated (and largely continue to operate) under a "soft budget constraint".

All in all, since the very beginning of the reform process, the attraction of FDI was considered to be a key pillar of China's "opening up" policies. Indeed, this was an important goal as it was expected not only to introduce technologies, know-how, and capital, but also to develop China's export sector. Furthermore, as a fundamental part of the open-door policy, the success or failure of the FDI policies was expected to have major consequences in the political destiny of China's pro-reform leaders.

[26] This point is well made in Professor Huang Yasheng writings, for example, in Huang (1999).

Phase One: 1979-1983

Special Economic Zones

In December 1978, at the Third Plenum of the Eleventh Central Committee, China endorsed economic reform and open-door policy in the form of the Special Economic Zones (SEZ) policy. As a result, after July 1979, the SEZs of Shenzhen, Shantou, and Zhuhai were created in the Guangdong province. In October 1980 a fourth SEZ was created in Xiamen in Fujian province.

The Chinese SEZs were created drawing on international experience and having has main economic objectives to attract foreign investment by offering concessionary tax policies and a favorable investment environment. Also, as similar areas established in Taiwan, South Korea, and other developing countries in the 1960's and 1970's, the SEZ in China were meant to be essentially export-processing zones.

Indeed, the Chinese coastal provinces of Guangdong and Fujian, with their abundant land and low-cost labor, were very attractive for the development of light-industrial, labor intensive manufacturing activities. Furthermore, the population in the two provinces shared culture and languages with, and had a historically close economic tie to the overseas Chinese business communities, particularly those in Hong Kong, Macao, and Taiwan. In this way, an improved political and economic climate was expected to enhance the interest of the overseas Chinese in investing back home.

It should be noted that this was indeed a realistic project given that many of Hong Kong leading industrialists had been born in Shanghai or in the coastal provinces, and had migrated to the colony in the 1940s. There were also legitimate expectations regarding Taiwan. In fact, Taiwan and Fujian had been part of the same province during the Qing period and there was every reason to expect significant investment (albeit via Hong Kong to start with) if Taiwan industrialists could be offered suitable incentives. These hopes also drawn on the fact that the ongoing process of structural change in Hong Kong and Taiwan had led to rising costs in recent decades, which in turn had threaten to undermine the competitiveness of these economies in many of their traditional, labor-intensive product lines. Such developments had prompted an increasing number of manufacturers to actively seek offshore locations as alternatives and, in this way, to be highly receptive to the exploration of the obvious complementary features of the Chinese coastal provinces.

After this been said, it becomes clear what led to the decision of first opening Southern China to foreign investment. Nevertheless, another question remains: Why so few SEZs, if China had endorsed the open-door policy nationwide?

The reasons that led to this decision reside in the political motivations of the SEZs policy. In fact, apart from its economic objectives, perhaps more importantly, this policy also had very specific political goals.

First, because SEZs were easily contained geographically, as Jun puts it[27], they were intended as "policy laboratories," where reformers could test policy initiatives within a controllable degree of economic and political risk. As such, in this areas the reformers decided to adopt what Wei defines as a "trial-and-error" approach[28], or in the words of Ding and Zhimin[29], the policy of "*shidian*", which literally means the "experimental grounds".

In fact, the SEZs were meant to be delimited areas were reform schemes could be first experimented with in selected enterprises, sectors or regions. Then, if a scheme did not work at the local level, the top leadership would bury it without inviting too much political fuss. On the other hand, those measures that proved to be effective and successful in the SEZs could be extended, whenever feasible, to the rest of the country.

It is in this sense that the SEZs could be considered "laboratories" where various methods aimed at overcoming the drawbacks associated with a central-planning system could be developed and where fresh concepts that originated in market economies outside China could be introduced into, absorbed by, and tested in SEZs. And as said, a few SEZ allowed these experiments to happen without causing excessive turmoil, which would inevitably jeopardize the reform efforts.

It should be noted that although economic reform was officially endorsed in 1978 and started in 1979, at this time reformers still faced hard ideology constrains and a significant level of resistance from the old system, particularly from the inland provinces and heavy industries that had been favored and protected by the policy of autarky and self-sufficiency.[30] Indeed, after decades of following such policies many Chinese leaders remained committed to the self-reliance Maoist ideology. As such they argued that international engagement could only lead to loss of national sovereignty and to cultural pollution.

[27] Jun (2000), p. 33.
[28] Wei (1999), pp. 39-40.
[29] Ding and Zhimin (1997), pp. 36-37.
[30] On this subject see for example Shirk (1984) and Crane (1990).

As previously noted, Deng Xiaoping had become himself the target of this kind of xenophobic backlash when he suggested in the mid-1970s that expanding foreign trade would strengthen China as a nation.

Under this context, the establishment of only four special zones could be presented to conservative skeptics as a way to gain the benefits of foreign investment while restricting foreign cultural influence to only a few small areas. Also, by starting out with only a few zones, the reformers aimed at reducing the expected resistance to the reforms from the powerful planning, finance, and industrial bureaucracies in the Communist party, and in this way, to prevent the new policies from being blocked by the hard-liners in the establishment.

It should be noted that this was only possible because, instead of forcing the central bureaucracies to change the way they planned and administered the economy, the pro-reform leaders bypass them allowing the SEZs to escape the plan by exempting the zones from the strictures of the command economy.[31] In this way, apart from the unique freedoms to offer a number of investment inducements not available elsewhere in China, the SEZs were also allowed to organize their economies on a market basis with floating prices. Furthermore, under the particular status of the SEZs, the local authorities enjoyed a considerable degree of autonomy: they had independent power to draw up development plans, organize their implementation, examine and approve investment projects, issue licenses and land-use permits, and coordinate the work of banking, taxation, customs, and frontier inspections. Moreover, Beijing also offered the SEZs provinces generous financial subsidies in the form of fiscal and foreign exchange revenue contracts. In fact, beginning in 1980, Guangdong and Fujian were awarded five-year fiscal contracts permitting them to retain almost all of the taxes and industrial profits generated by firms in their jurisdiction. In this way, Guangdong was obliged to pay the center only 1 billion yuan a year and Fujian received a subsidy from the center of 150 million yuan annually while all other revenues were provinces' to keep. These revenue-sharing agreements with the central government allowed the provinces to keep a relatively large share of their tax revenue, which they were able to use to upgrade the inadequate or nonexistent (in places such as Shenzhen, which had been a mere border village) physical infrastructure. It should be noted that, in contrast, the three provincial-level cities of Beijing, Tianjin and Shanghai were still required to turn over from 63 to 88 percent of their revenues. In terms of the special policy of foreign exchange retention, the SEZs were allowed to retain all of the hard currency

[31] Studies on the Chinese SEZs include, to name a few, Chi (1981), Osborne (1986), Crane (1990), Dong (1997) and Wei (1999).

they earned from trade, in contrast with the average of 25 percent allowed to other localities. Furthermore, Guangdong and Fujian also were granted special foreign exchange retention rates higher than those for other provinces.[32] These set of special financial incentives offered to the areas not only motivated local officials to develop their local economies in a pragmatic, profit-oriented manner, but also greatly facilitated the export expansion and the rapid overall economic growth of Guangdong and Fujian provinces.[33]

When officials from other provinces saw the economic benefits these areas received from exports, joint ventures, and freedom from the plan, they began to demand for their share of special privileges. Indeed, it had become clear that, unless they were also granted with similar discretion over tax rates and other terms, they could not compete with the SEZs and their provinces for foreign business partners or export markets. Consequently, as the success of the initial experiments resulted in a strong demonstration effect, China witnessed a growing geographical competition for special foreign economic benefits. These, in turn resulted in a widespread support for the open up policies. Indeed, the particular privileges given to a few areas had proved to be a very successfully strategy for reorienting local officials all over the country away from self-reliance and towards the world economy.

Last but not least, a final political aim of the Chinese SEZ had to do with China's goal of reunification with Hong Kong, Macao, and eventually Taiwan. In fact, setting up the SEZs in the Southeast coast served China's cause of reclaiming her sovereignty over these territories. The rapid economic growth in the SEZs would certainly help to narrow the gap in living standards between them and the bordering Chinese regions. The growing volume of trade and investment was also expected to facilitate the economic integration between Mainland China, Hong Kong and Taiwan.

All in all, the emergence of the SEZs was a breakthrough development in launching China's market-oriented reform. In fact, the four SEZs became the first state-approved capitalist enclaves to lead the nation on its long march towards a market-structured economy.

[32] For a description of the special conditions allowed to SEZs provinces by the central government in terms of taxes and contributions, see Bramall (2000), pp. 377-380.

[33] Guangdong, in particular, became an economic success story and was able to reduce its dependence on central infrastructure and capital investment funds from 80 percent of the total in 1979 to 2 percent in 1992. Goldstein (1993), p.21.

FDI Regulatory Framework

When China started its economic reforms in the late 1970s, because of its previous autarkic and self-reliance strategy, it had almost no experience with private ownership not to mention foreign investment. Although some 10,000 private companies existed in China when the PRC was established in 1949, by as early as 1956 the country had virtually abolished all private business, which had been transformed into joint state-private enterprises. Moreover, although some individual firms were restored in the wake of the Great Leap Forward, these were again suppressed during the Cultural Revolution.[34] Indeed, socialist ownership was the only recognized form of property by the 1975 Constitution of the PRC.[35]

Notwithstanding these facts, after the milestone decision of adopting the SEZs policy, China envied all the necessary efforts to create the necessary legal framework under which foreign investment could operate in its territory.

The first result of such efforts was the promulgation, in 1979, of China's first law on foreign investment, the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment, commonly know as the Equity Joint Venture Law.

At the first sight, this set of only 15 articles seems vague and sketchy to say the least. Indeed, terms on many important issues, such as market access, taxation, foreign exchange, land use, and labor management, were either omitted or lacked proper definition. But apart from its obvious rudimentary nature and many pitfalls, the political importance of the EJV Law was tremendous. Indeed, it was the first document signalizing the change of direction of the Chinese government from its previous position of isolationism and autarky, to international engagement and co-operation.

This is clearly shown in its first article where it is it is stated that "With the view to expand international economic co-operation and technological exchange, the People's Republic of China shall permit foreign companies...to establish equity joint ventures together with Chinese companies...within the territory of the People's Republic of China, on the principle of equality and mutual benefit...".

For the first time in the history of the People's Republic of China, not only foreign presence in the economy was allowed, but it was as well expected to contribute to the country's economic development.

[34] For the story of private business in China, see Conner (1991).

[35] However, in the reform era, private businesses, after a rather tentative start in early years, have developed at an impressive rate. This led to the recognition in the 1999 constitutional amendment that private sector is an "important component" of the country's economy.

Furthermore, in the second article it is stated that “The Chinese Government shall protect, according to the law, the investment of foreign joint ventures, the profit due to them and other lawful rights and interests in a equity joint venture...The state shall not nationalize or requisition any equity joint venture.”

Considering that China until very recently had strongly condemned capitalism and completely forbidden private property, this article can indeed be considered nothing less than revolutionary.

Another of such features of this landmark document was the introduction of the limited liability concept in the Chinese law. Indeed, article four of the EJV Law states that “An equity joint venture shall take the form of a limited liability company.” It should be highlighted that the idea that the managers of an enterprise or business are entitled to its profits when successful, but are protected from liability, in failure, was neither intuitively appealing nor obvious to the Chinese central planners. In fact, the concept of limited liability is a very Western one, where, for centuries, there has been the conviction that the benefits to society from encouraging commerce in this way would eventually outweigh the detriment to contractual claimants or even tort victims. In China, however, the acceptance of this concept, especially in light of the leftist politics of the Cultural Revolution, could not be taken for granted.

Still in the fourth article of the EJV Law it is stated that “The proportion of the foreign joint venture’s investment in an equity joint venture shall be, in general, not less than 25 percent of its registered capital.” It should be noted that the law does not set upper ceilings. Thus, theoretically, foreign equity contribution in a joint venture could be anywhere between 25% and 99%.

This rather unusual requirement reflects both the liberal nature of China’s original EJV Law and the eagerness of the Chinese law regulators to attract foreign direct investment, particularly if considering that most of the developing nations, when legislating foreign participation in their economy, set tight controls over ownership in fear of foreign domination of domestic industries.

But apart from its breaking-through characteristics, in practice, due to the vagueness and sketchiness of its nature, the EJV Law was more a statement of principles than a detailed regulating guideline for the presence and operation of foreign capital in Chinese territory. As said, terms on many important issues such as market access, taxation, foreign exchange, land use, and labor management, were either not mentioned at all or poorly defined. For example, regarding land use, while the law stipulated that land could be used as part of a joint venture investment when fees were paid to the state

(article five), it said nothing about how this should be done. Also, while the mentioned article stated that "The technology and equipment contributed by a foreign joint venture...must be really advanced technology and equipment that suits China's needs" it did not defined what it meant by "advanced" or "suitable to China's needs".

As expected, this sort of ambiguity caused the EJV Law to be very difficult to follow or to implement. Moreover, it created a sense of insecurity among foreign investors, particularly in those with no experience or contact with the Chinese reality. Also, it caused that, for every contract and on every small detail of the agreements, prolonged and protracted negotiations between the Chinese and foreign partners were almost mandatory.

Acknowledging this situation, and in order to both improve the investment climate and increase the confidence of foreign investors, in late 1983 Chinese authorities put in place the Detailed Implementation Act of the EJV Law. This document, which was constituted by a total of 118 articles, provided a higher level of detail on all aspects of regulation of joint ventures operations, as it constituted both an augmentation to and a summary of the key elements of several pieces of legislation affecting FDI issues during this period, which included the PRC Income Tax Law Concerning Joint Ventures, the Registration and Management of Joint Ventures, and the Regulations on Labor Management in Joint Ventures.

Nevertheless, at the time, China's FDI regulatory framework remained rather limited. To start with, apart from the SEZs, there was not much locational choice. In fact, even though FDI was legally allowed beyond the SEZs, the investment environment as a whole was not favorable and, worse still, it was clouded in uncertainty.

Another difficulty faced by foreign investors were the lengthy screening processes, which were strictly controlled by Beijing. Indeed, Investors first had to prepare a preliminary proposal based on their initial contacts. This proposal had to be submitted to the local government or the ministries in charge and through them to the central government for approval. If approved, the participants could then start negotiations. A new proposal based on the negotiated agreement, together with a feasibility study, had again to be submitted to the local government, the ministries, and the central government for further approval. If passed, the participants could then start the second round of negotiations on the final contract, which then was directly submitted to the central government for final approval. Only then, did the project contract become valid. At the time this whole process usually took at least 3 months.[36] Also, as a general rule, projects

[36] For further details, see Lee and Ness (1986).

valued at over US$3 million had to be approved directly by the Ministry of Foreign Economic Relations and Trade (MOFERT),[37] although exceptions to this general rule existed.[38] The SEZs, for their part, were given independent approval authority for light industrial projects up to RMB 30 million and heavy industrial projects up to RMB 50 million.

It should be noted that there is evidence that the restrictive nature of China's FDI regulatory framework at the time went beyond what the law stipulated. For instance, although the EJV Law set no upper ceiling on foreign ownership, there are indications that in practice the foreign ownership of many joint ventures was intentionally kept to minority positions. According to one study on FDI at the time[39] of the 14 cases analyzed, foreign ownership in 9 held a minority position, 4 had a 50:50 equity ownership ratio, and there was only one case in which the foreign investors held a majority position of 60 percent.

Consistent with the restrictive approach to foreign ownership, prior to 1986 China did not even had a national law governing WFOEs. In fact, 100 percent foreign-owned subsidiaries, an increasingly popular mode of FDI in China today, were permitted only on an experimental basis within the geographic confines of the SEZs.

As said, the EJV Law and its implementation rules represented a huge political step forward in China's commitment to the open-door policy. Nevertheless, to effectively attract, legislate and regulate the presence of FDI in its territory, China still had a very long way to go.

FDI Tax Policies

Although the EJV Law in its seventh article stated that a equity joint venture may "enjoy preferential treatment for reduction of or exemption from taxes", the fact is that it did not specify the terms in which such treatment would be offered. As said, it was only after the 1983 Implementing Regulations for the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment that these ambiguous issues were clarified.

Specifically regarding taxation, these clarifications came through the Equity Joint Venture Income Tax Law, the Foreign Enterprise Income Tax Law, and the Industrial and Commercial Tax Regulations.

[37] It was later renamed the Ministry of Foreign Trade and Economic Co-operation, or MOFTEC.
[38] The cities of Beijing and Guangzhou were authorised to approve projects valued at up to US$10 million.
[39] See Chu (1987).

The initial tax concessions offered in the Equity Joint Venture Income Tax Law (see Table 2)[40] included tax holidays for newly established joint ventures that were scheduled to operate for a period of ten years or more, including a total tax exemption for the first two years commencing from the first profit-making year and a 50 percent reduction for the three subsequent years. There was an additional 15 to 30 percent reduction in income tax for an additional ten years for certain types of joint ventures in remote and poor areas; and a refund of 40 percent of the income tax paid on the reinvested funds for any joint venture partner that reinvested its share of profits for a period of at least five consecutive years. Also included were the authorization of a local tax exemption or reduction when local governments found this appropriate, and finally, loss carry-forward was allowed to be taken into account in determining the first profit-making year and in calculating taxable incomes.

Table 2: Equity Joint Venture Income Tax (pre-1984)

Taxpayer	Tax Base	Tax Rate
Equity Joint Venture	Net income derived from production, business operation and other sources.	33%
Foreign equity holder	After-tax equity profits that are to be remitted out of China	10%

Sources: The Joint Venture Income Tax Law and its implementing rules. Cited from Wei (1994), p. 80.

The tax incentives included in the Foreign Enterprise Income Tax Law (see Table 3)[41] were mainly: a tax exemption for the first profit-making year and a 50 percent reduction in the tax for the following two years for enterprises engaged in agriculture, forestry, animal husbandry, and other low-profit operations, including deep pit mining operations. There was also an additional tax reduction of 15 percent to 30 percent, if approved by the Ministry of Finance, for an additional period of ten years. Also allowed were the authorization of tax exemption or reduction of local taxes, when the local government found appropriate, for enterprises having an annual income of less than RMB 1 million and loss carry-forward for a maximum of five years.

[40] The Equity Joint Venture Income Tax Law also applied to co-operative joint ventures created as a legal entity.
[41] The Foreign Enterprise Income Tax Law also applied to wholly foreign-owned enterprises and the foreign partners in the co-operative joint ventures in which each partner retains its identity in joint operations.

Table 3: Foreign Enterprise Income Tax (pre-1984)

Taxpayer	Tax Base	Tax Rate
Foreign enterprises with establishment in China	Income from production, business operations, and other sources	Progressive rate schedule, from 20% on the first RMB 250,000 of taxable income for the year to 40% on income in excess of RMB 1 million, plus an additional 10% for local income tax
Foreign enterprises without establishment in China	Income from dividends, interests, rental, royalties, and other sources	A flat rate of 20%

Sources: The Foreign Enterprise Income Law and its implementing rules. Cited from Wei (1994), p. 81.

Table 4: Consolidated Industrial and Commercial Tax (pre-1984)

Taxpayer	Taxable Activities	Tax Base	Tax Rate
Foreign-invested enterprises and foreign firms	Production of industrial products, importation of foreign goods, commercial retailing, communications, and provision of services.	Sales for manufactured products, gross receipts for services rendered, and purchase price for imports and agricultural products	42 different rates form 1.5% on certain basic necessities to 69% on top-quality cigarettes

Sources: The Industrial and Commercial Tax Regulations and various Ministry of Finance notices. Cited from Wei (1994), p. 79.

The tax concessions offered in the Industrial and Commercial Tax Regulations (see Table 4) were mainly exemptions for the importation of machinery, equipment, spare parts, and materials by China-foreign offshore oil exploration and extraction joint operations for their own business use.

The FDI firms within the SEZs were also granted exemption from income tax on the remitted share of profits; exemption from export duties and from import duties for equipment, instruments, and apparatus for producing export products, as well as the easing of entry and exit formalities.

FDI Behavior

Despite China's initial willingness to encourage (although at this time, still very timidly) foreign direct investment in its territory, during the initial years of the reform period FDI influxes remained rather low.[42] Indeed, from 1979 to 1983, FDI inflows averaged only US$1 375 million in contractual value and US$537 million in realized value per annum (see Table 5).

Nevertheless, considering the difficulties and uncertainties felt by foreign investors during the first years of the open-door policy, this is not surprising at all. Indeed, given the sketchy nature of the initial foreign investment regulatory framework, in practice there were no rules to clearly delineate the parameters within which foreign and private businesses could operate. Consequently, foreign investors were rather reluctant and cautions about investing in China during this period.

Table 5: China's FDI Growth, 1979-1983

Year	Projects (number)	Contracted (US$ million)	Realized (US$ million)
1979-82	920	4 958	1 769
1983	638	1 917	916
Cumulative	1 558	6 875	2 685
Average	311.6	1 375	537

Sources: OCDE (2003), p. 190.

Regarding entry modes (see Table 6), during the initial year of the reform period and as expected given the overall investment environment, foreign investors strongly opted by CJV (about 28 percent of the realized FDI).

Table 6: FDI by Type, 1979-1983 (US$ million Realized FDI)

Year	EJV	%	CJV	%	WFOE	%	JE	%
1979-82	103	5.82	530	29.96	0	0.00	487	27.53
1983	73.6	8.03	227.4	24.83	42.8	4.67	291.5	31.82
Cumulative	176.6	6.58	757.4	28.21	42.8	1.59	778.5	28.99
Average	35.32	6.58	151.48	28.21	8.56	1.59	155.7	28.99

Sources: OCDE (2003), p. 195.

It should be noted, however, that at the time the options open to foreign investors in terms of mode of investment were rather restrictive. Indeed, WFOEs were not allowed beyond the geographical confines of the SEZs, which explain its insignificant numbers in the initial years of the open up policy (about 1.6 percent). Consequently, almost by default CJVs, became a relatively safe mode of investment particularly when compared to EJVs.

In fact, as they are flexible in organization (e.g., the venture does not have to form a distinct legal person), capitalization (e.g., the venture does not have to observe the minimal 25 percent foreign equity requirement), and profit-sharing (e.g., the venture does not have to share profits by reference to equity ratios), they therefore best facilitated the short-term behavior of foreign investors relative to other modes of investment.[43]

Regarding the rather abnormal high percentage of joint exploration projects in the overall realized FDI, it should be remembered that very early in the reform period, in 1982, China published the Regulations of the PRC on the Exploration of Offshore Petroleum Resources in Co-operation with Foreign Enterprises allowing, for the first time since the foundation of the PRC, foreign exploration of its natural resources.

It should also be remembered that toward the end of the 1970s offshore oil exploration in China was expected to be very promising and potentially profitable as the PRC opened its hitherto largely unexplored continental shelf - specifically in the Bohai Gulf, the South Yellow Sea, the Pearl River Estuary Basin, and the Yinggehai and Beibu Gulfs of the South China Sea.[44] Consequently, following the eagerness of foreign investors to explore China's apparent unlimited resources, by the end of 1983, China National Offshore Oil Corporation had signed a total of 31 contracts with a number of well-known foreign oil companies with a total foreign investment of more than US$1.374 billion. Most noteworthy among them were Mobil, Chevron/Texano, Amoco, JNOC (Japan National Oil Corporation), Phillips, BP (British Petroleum), ELF (Societe Nationale Elf Aquitaine) and Arco (Atlantic Richfield). But apart from JEs and a few high profile cases such as Beijing Jeep Corporation whose total investment was US$51.03 million, the size of FDI projects during the early period appeared small, averaging less than US$1 million in 1981[45].

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[42] This is particularly true when compared with the following years' FDI inflows, as it will be seen later in this study.
[43] See previous discussion of CJVs as a mode of FDI.
[44] However, the initial high expectations were tempered somewhat in subsequent years when world petroleum prices dropped significantly after 1983.
[45] Jun (2000), p. 131.

Table 7: Sources of FDI, 1984 (Contracted Value)

Country/region	As % of total FDI inflows
Hong Kong and Macao	76%
Japan	7%
United States	6%
Germany	4%
Singapore	2%
Thailand	1%
Others	1%

Sources: *Zhongguo duiwai maoyi nianjian*, 1985 [Almanac of China's Foreign Trade and Economic Relations, 1985]. Cited from Jun (2000), p. 132.

Regarding sources of FDI during the first years of reform, investment from Hong Kong (including Macao) dominated the FDI inflows to China (see Table 7).

This is hardly surprising considering that all the SEZs were located in the Southeast coast of China. Moreover, given the rudimentary nature of the initial regulations concerning foreign investment, it was only natural that the large majority of the pioneer investors originated from areas with strong cultural and linguistic affinities with China. Indeed, these investors were much more prepared to deal with the expected difficulties presented by the still largely unregulated Chinese investment environment.

Also, in what geographical distribution is concerned, it was only "rational" for investors to cluster in areas where they were culturally familiar so that they could count on informal means, such as kinship ties, to reduce transaction costs. Little wonder that during the initial period, a very high portion of FDI headed for Guangdong, Shanghai and Fujian, the three provinces that enjoy the closest cultural ties with overseas Chinese business communities (see Table 8).

Table 8: Geographical Distribution of FDI, 1979-1984

(% of cumulative contract value)

Provinces/municipalities	As % of country total
Guangdong	82%
Shanghai	5%
Fujian	4%
Beijing	2%
Hainan	2%
Tianjin	1%
Zhejiang	1%
Shandong	1%
Rest of China	2%

Sources: *Zhongguo duiwai jingji nianjian* [China Foreign Economic Statistical Yearbook] (various years). Cited from Jun (2000), p. 132.

Regarding sectoral distribution, as expected, most of the investment projects were in the form of manufacturing/processing of labor-intensive products, real estate development, and hospitality business that did not require a large investment commitment or highly advanced technology (see Table 9).

Table 9: Sectoral Distribution of FDI in China, 1981

Industrial Sector	Number of EJVs	Foreign Capital (US$ million)	(%)
Light Industry	4	3.465	17%
Food Processing	3	5.293	26%
Electronics	3	4.930	25%
Machinery	3	2.353	12%
Textile	2	2.462	12%
Tourism	2	0.128	1%
Petroleum	1	1.000	5%
Commerce	1	0.200	1%
Communications	1	0.150	1%
Total	20	19.981	100%

Sources: *Zhongguo jingji nianjian*, 1982 [Almanac of China's Economy, 1982]. Adapted from Jun (2000), p. 131.

All in all, the initial favorable results of the first open-door policy encouraged the Chinese pro-reform leadership to give a giant step forward in order to further encourage FDI inflows. The second phase of the story of FDI in China was about to begin.

Phase Two: 1984-1991

Expansion of the Geographical Areas Open to FDI

In February 1984 when Deng Xiaoping visited Shenzhen, Zhuhai and Xiamen SEZs, he pointed out: “For us to establish SEZs and adopt open-door policies, we must have a clear guiding ideology that is not to constrain but to release” and that “The development and experience of Shenzhen has confirmed the correctness of our policy and of establishing special economic zones.” He also said: “in addition to the existing SEZs, we can consider to open several more areas and port cities, such as Dalian and Qingdao. These areas will not be named SEZs but can apply some of the special policies implemented in SEZs”.[46]

In order to implement Deng’s speech and to prove further the government’s commitment to the stability, continuity, and long-term nature of the open-door policy, in May 1984 the Chinese government announced the opening up of fourteen coastal cities. These were Shanghai, Tianjin, Dalian, Qihuangdao, Yantai (including Weihai), Qingdao, Lianyungang, Nantong, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhangjiang and Beihai. A year later, virtually all the major urban and semi-urban coastal areas on China’s coastline were thrown open to foreign investment: the Pearl River Delta in Guangdong province; the Yangtze River Delta centred on Shanghai; the Xiamen-Zhangzhou-Quanzhou Triangle centred on Xiamen in Fujian province; the Laiodong Peninsula including Dalian; Hebei in North China next to Beijing and Tianjin; and Guangxi in South China.

As expected, the granting of special rights to particular provinces fuelled the demand for equal rights from other areas. As a response the Chinese leadership in 1985 approved a special 50 percent rate for four autonomous regions (Inner Mongolia, Xinjiang, Guangxi, and Ningxia) and three provinces (Yunnan, Guizhou, and Qinghai) in China’s interior.

If politically the opening of the 14 coastal cities demonstrated China’s commitment to the open-door, economically, the 14 coastal cities meant a far wider latitude of location choice for foreign investors and better access to China’s domestic market. In fact, taken together, the initial SEZs and the newly open coastal open cities virtually formed a coastal belt that, from a geographical viewpoint, was important not only for linkage with foreign markets but also for its wider connection with the massive domestic inland areas.

This coastal belt constituted a significant portion of the Pacific Rim, which made it well positioned, from North to South, to attract FDI from Japan, South Korea, Taiwan, and the Southeast Asian countries, as well as from the United States, Canada, and Europe. With their relatively more sophisticated existing labor force, technical capabilities, and infrastructures, it was hoped that quicker, better and more sustainable returns in terms of capital formation, technological progress, structural transformation, and overall economic development would be gained, and at a lower cost.[47]

The coastal open cities were permitted to offer tax incentives for FDI firms similar to, but less generous than, those offered in the SEZs. The coastal open cities, however, were encouraged to establish "Economic and Technological Development Zones" (ETDZs) that could offer terms as generous as those offered in the SEZs.

It should be noted that the encouragement to establish the ETDZs in the coastal open cities had several basic considerations. First, drawing from the experience of the first four SEZs, the ETDZs were encouraged to build infrastructure and provide energy, communications, and other basic public facilities necessary for production and new technology development enterprises. This could greatly improve the investment environment and facilitate the economic development of the open cities. Second, by offering investment incentives in the ETDZs along the coastline from North to South, foreign investors were provided more opportunities to locate their ventures where the transaction cost was least. Third, by expressly designating the goals of the ETDZs, the Chinese government wanted to make it clear that, while the coastal open cities should effectively utilize FDI and foreign technologies to improve and upgrade the industrial and technical capabilities of the existing firms and gradually spread out to the inland areas, their primary objective was to concentrate on the establishment of more technology intensive productive projects through FDI.

Indeed, from the perspective of regional development and the intended eventual diffusion effect, the coastline belt was believed to be able to spread its direct and indirect influence to the immediate inland and more regions. Also, for all inland provinces, the coastal belt provided a window through which economic vitality in utilizing FDI could be transmitted back to the home provinces in the form of investment, technology transfer, information services, and the training of personnel.

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[46] Liu Xiangdong ed. (1993). *Zhongguo duiwai jingji maoyi zhengce zhinan* [A Guide to China's Policies Regarding Foreign Economic and Trade Relations], Beijing: Jingji guanli chubanshe, p. 865. Cited in Chen (1997b), p. 9.
[47] Wei (1994), p. 62.

In order to attract further FDI and to speed up the diffusion process, in May 1985, three "development triangles" - the Yangtze River Delta Region (around Shanghai), the Pearl River Delta Region (around Guangzhou), and the Minnan Delta Region (around Xiamen) - were designated as coastal economic open areas and granted most of the FDI preferential policies implemented in the fourteen coastal open cities.

Following the trend, the expansion continued to include Liaoning and Shandong peninsulas as coastal economic open areas in 1988. In fact, this last expansion of the open policies for FDI, termed "coastal development strategy", had as consequence the extension of these policy to the entire coastal areas. This was recorded on the document "Coastal Development Strategy" jointly issued by the Chinese Communist Party Central Committee and the State Council. This document stated that "We must continue to expand the open policies, accelerate the development of externally-oriented economy in the coastal areas, and actively participate in international exchange and competition, so that the economic development and prosperity of the coastal areas can bring the development of the whole national economy".[48]

Zhao Ziyang, at the time the CCP general secretary, who was at considerable pressure from party conservatives, sought backing among coastal officials by traveling through many of the coastal provinces and drumming up support for his "coastal development policy." Within this policy, he defended the concept of unbalanced growth by arguing that economic and cultural differences between the coastal and inland areas made it impossible for all parts of the country to develop at the same speed. Therefore, the coastal areas should be allowed to move ahead by using their better labor, communications and infrastructure, and scientific and technological capacity to attract foreign business and expand exports.[49] The "coastal development strategy" stressed two main points. First, it would develop labor-intensive industries in the coastal area, and second, these labor-intensive processing industries should base their products for export on imported raw materials.

In fact, this strategy effectively brought all eleven coastal provinces and municipalities together to acquire foreign capital, technology, raw materials and international market opportunities. It enabled China to take advantage of its abundant cheap labor endowment and to increase significantly the ability of its manufacturing sectors to compete in the international market.

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[48] Liu Xiangdong ed. (1993). *Zhongguo duiwai jingji maoyi zhengce zhinan* [A Guide to China's Policies Regarding Foreign Economic and Trade Relations]. Beijing: Jingji guanli chubanshe, p. 866 cited in Chen (1997b), p. 12.
[49] Shirk (1994), p.40.

The 1988 coastal development strategy policy included three localities in inland Sichuan among the eight granted special open zone status.[50]

With the implementation of the "coastal development strategy", many special open zones were established in the coastal provinces and municipalities. In particular, Hainan Island became a province and China's fifth - and largest - SEZ in April 1988.

By the end of 1989, the so-called "special investment areas" in China, a generic term including the SEZs, open cities, and delta regions and peninsulas, embraced close to 300 cities and counties along China's coast. They amounted to a total area of 420,000 square kilometers and a population of 280 million. Put in international perspective, the combined size of these areas was roughly equivalent to 3 times the size of Germany and their population in aggregate was larger than that of the United States.

It should be noted that appealing to the coastal region as a whole did not mean the end of favoring particular regions. In fact, after Zhao was fired in 1989, Premier Li Peng, despite his reputation as a conservative with leanings toward the center, adopted a succession strategy that involved building his own provincial support base.

Indeed, capitalizing on the resentment Shanghai had long felt toward Guangdong's special privileges, Li Peng became the patron of Shanghai's New Pudong Economic Development Area and granted Shanghai both grater autonomy over foreign trade and investment and more revenues. As a result, in June 1990, the concepts of SEZ and ETDZ were extended to the Shanghai Pudong New Economic and Technological Development Area.

But there was another reason behind the creation of the Pudong Area. In fact, perhaps the most decisive force behind this decision was China's desire not to be seen as diverting its course of reforms in the wake of the 1989's Tiananmen dramatic events which, very legitimately, had caused serious doubts on the part of foreign investors about whether or not China would continue to pursue reform and the open-door.

It should be noted that throughout the 1980s, Deng Xiaoping's economic reforms had been continually challenged by other veteran communist leaders who feared a loss of central control over the economy and hence over society.

Aware of these facts, a major concern of foreign investors at this time was that the communist leadership would reverse the policy of economic reform and opening up. In particular, there were serious worries about possible changes in economic policy after the departure of Deng Xiaoping from the political scene in view of the persistent difficulties

[50] In June 1992, as will be discussed in further detail later in this study, Beijing authorised twenty-one additional cities, located along the Yangtze River and in the Northeast, to offer special incentives to foreign

that had been experienced by Chinese leaders in the post-1949 period in appointing stable successors.

Nevertheless, these worries were largely laid to rest as a result of the establishment of a ruling group centered on Jiang Zemin. From 1989 on, Jiang took on all the top national leadership posts and gathered around him a group of leaders who shared the same outlook: a firm commitment to persevere with economic reform coupled with a determination to retain power by deferring political reform.

The stability of the country's leadership ensured that policy debated were conducted within the confines of the policy consensus established by Deng, with differences of emphasis or over the pace of reform replacing differences in principle over the very existence of an economic reform program.[51]

In fact, less than a year after Tiananmen, instead of turning inward, in a very internationally publicized way, China moved further in its opening up process. The first of such moves came exactly in the spring of 1990 when China decided to open Pudong in Shanghai for foreign investment. Policy makers with respect to the opening of Pudong were reportedly "lightened and encouraged" by Deng Xiaoping's remark that "The country must be courageous and accomplish new things to show to the world that we stick to the open policy."[52]

It should be noted that Pudong New Area, connected to Shanghai proper by highways and cross-river tunnels, is a triangular area surrounded by Huangpu and Yangtze rivers and Hangzhou bay. It has an area of 350 square kilometers and a population of 1.1 million. It should also be noted that, by developing Pudong, the goal was to turn greater Shanghai into an international hub of finance and trade, or the New York of China, so that it could serve as catalyst for the development of the whole Yangtze River Valley. The valley, which includes major cities such as Nanjing, Wuhan, and Chongqing, was at that time home to roughly 400 million people and its combined agricultural and industrial output accounted for about 40 percent of the country's total.

The Shanghai Pudong New Area offered preferential treatment to foreign investors similar to those found in the SEZs. Production FIEs and FIEs engaged in energy or transport construction projects in this area paid an enterprise income tax of 15 percent.

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investors.

[51] The 16th congress of the Chinese Communist Party, which took place in November 2002, appointed a new "forth generation" of leaders who have clearly been selected on criteria which include their commitment to maintaining the policies of economic opening up and reform. Variations in policy emphasis will doubtless emerge in coming years, but it is highly unlikely that there will be any major changes in policies affecting FDI.

[52] *People's Daily*, Overseas Edition, 1 October 1991.

FIEs with an operating life of more than 15 years and engaged in the construction of energy or transport projects were eligible for a five-year enterprise income tax exemption starting from the first profit-making year and a 50 percent reduction in the following five years. In addition to SEZ-like preferential policies, accompanying the opening of Pudong was a steady relaxation of sectoral restrictions on FDI.

One of the important sectors to first undergo liberalization was banking. Chinese leaders realized that it was impossible to revitalize Shanghai as China's premier financial center any time soon without the modeling effect of foreign banks, and that Shanghai itself would not be able to attract enough capital for the development of Pudong. It was against this backdrop that in September 1990 the Shanghai Regulatory Measures relating to Foreign Financial Institutions and Joint Chinese-Foreign Financial Institutions (or the Shanghai Financial Measures) came out.

It should be noted that the Shanghai Financial Measures allowed, for the first time, foreign banks to start branching operations beyond the geographical confines of the SEZ.[53] This had a striking effect. Indeed, almost immediately 30 foreign banks applied for permission and the first six approvals were announced in early 1991.[54]

In the wake of the publication of this document, other provincial and city officials reportedly were all clamoring for permission from Beijing to tap foreign capital by allowing the presence of foreign banks and financial institutions in their jurisdiction.[55] As a result, the number of foreign banks and financial institutions increased rapidly in the1990s, and foreign insurance companies also made their debut in China at the time.

Another important sector that allowed a significant degree of liberalization was real estate. In May 1990, a month after Pudong was declared open, the State Council issued the Interim Measures for Land Investment, Development, and Management by Foreign Businesses (Foreign Business Land Development Measures), which were applicable in the SEZs and coastal open cities, including the Pudong New Area. These measures allowed the transfer and re-transfer of usage rights of land in China and large-scale land developments schemes by foreign investors. This represented a new breakthrough in China's FDI regulatory framework with respect to foreign participation in land development projects. Indeed, until then China had prohibited the leasing or any form of transfer of land

[53] As was the case with the WOFEs, foreign banks had been accepted only on an experimental basis within SEZs under the 1985 SEZ Foreign Bank Regulations. In 1985-90, 31 foreign banks established branches or subsidiaries in the SEZs. The first foreign bank to open a branch in the SEZ was the Hong Kong and Shanghai Banking Co. *Beijing Review*, 27 January-2 February 1992, p. 24.

[54] Of the 6, 2 were US banks (Citibank; Bank of America), 2 were Japanese banks (Industrial Bank of Japan; Sanwan), and 2 were French banks (Basque Indosuez; Credit Lyonnais). Pomfret (1992).

[55] *Asian Wall Street Journal Weekly*, 3 August 1992, p. 1.

except for the land used by joint ventures in accordance with special land-use legislation. In fact, according to China's 1982 Constitution (Article 10), "no organization or individual may appropriate, buy, sell, or lease land or otherwise engage in the transfer of land" This absolute ban was lifted with the adoption of the amendments to the 1982 Constitution and the Foreign Business Land Development Measures in 1990.[56] The lifting of the prohibition of foreign participation in land development, very much like in the banking industry, had an immediate effect on the pattern of FDI in China.

Overall, the development of the Pudong New Area marked an important turning point in China's foreign investment policy: the focus of foreign investment was now shifted from peripheral areas to China's industrial centers.

Consequences of the Geographical Opening to FDI

One effect of the dramatic expansion of the geographical areas open to foreign investment was that it made the SEZs less "special."

For one thing, decentralization of project screening power now went beyond SEZs to include all the open cities. The open cities were all given independent powers to approve FDI projects up to a certain level. Shanghai, Tianjin, and Beijing, for instance, were now authorized to approve projects valued up to US$30 million.[57] The decentralization of project screening power contributed to an increased enthusiasm for FDI at the local levels, and made it possible to simplify and speed up the approval process for FDI projects. While the overall picture of applications efficiency was not totally clear up and down China, the situation was apparently improving in the coastal areas. In Shanghai, for instance, the time of the approval process was reportedly reduced from at least 3 months in the early 1980s to at most 45 days in the latter part of the 1980s.[58]

Furthermore, it should be noted that, in the past, there had been mainly two important factors that explained the success of SEZs: the geographic proximity to Hong Kong and Taiwan and the special policies granted by the central government. While the connection with Hong Kong was still important, the effect of the special policies was

[56] The constitutional amendments deleted the phrase "or lease land" and provided the "right to the use of land may be transferred according to law." The maximum periods for land lease are 70 years for residential use; 50 years for industrial use; 50 years for educational, cultural, and sport facility purposes; and 40 years for commercial, tourism, and recreational use.

[57] Although the approval power for other cities was increased only to US$10 million at the time, eventually they were all raised to US$30 million, as China's FDI regulatory framework was further liberalised in the early 1990s

severely weakened during the spread of the open zones and economic reform throughout the nation. Indeed, the main political-economic factors that justified the exclusive preferential policies for the SEZs in the early 1980s no longer existed at the end of the decade. In the initial stage of reform and opening, it was important for Beijing's reform-minded leaders to make sure that the whole nation would see the benefits of the new policies. Therefore it was in their interests to provide "preferential policies" to the "*shidian*" (experimental-ground) enterprises, sectors and regions. Meanwhile, when China was still a tightly controlled central-planned economy, those "*shidian*" regimes had to receive special autonomy to carry out local experiments of market-oriented reforms. But after more than 10 years of successful economic reforms, Deng Xiaoping's policy of market-oriented reform had become a more consensual policy in the Party and its leadership. As various open zones had proliferated all over the nation and the door of the whole Chinese market has been flung open to foreign investors, the SEZs were apparently no longer the only "window" to the world economy.

Moreover, special policies for the SEZs and coastal open cities had aroused bitter feelings from other provinces, especially those in the interior parts of China. According to their opinion, special policies were more necessary in poor provinces to speed up their development processes. For instance, although Shenzhen received little direct investment from the central government, domestic investment from enterprises of other provinces poured in to the SEZ to take advantage of the special policies. In this sense, abolishing the special policies for SEZs had turned into a very useful card for the post-Deng leadership in winning the support of the majority of the 30 provinces and autonomous regions for the reform movement.

Improvement of the FDI Regulatory Framework

Contrary to EJV, which were theoretically allowed in all Chinese territory since the beginning of the reform period, WFOEs were only permitted within the SEZs. As the SEZ regulations stipulate "In order to develop external economic co-operation and technical exchanges and promote the socialist modernization program, in the special economic zones, foreign citizens, overseas Chinese, compatriots in Hong Kong and Macao and their companies and enterprises are encouraged to open factories or set up enterprises and

[58] It was reported that Shanghai and Tianjin, among others, set up an information service center for foreign investors and took a variety of measures to cut back on the red-tape in a bid to attract foreign investment. *China Daily*, 15 November 1987.

other establishments with their own investment, and their interests shall be legally protected".[59]

As said, China until very recently had condemned capitalism and had completely banned private ownership. Given this historical background, to allow WOFEs outside the SEZs was indeed a very delicate issue that aroused strong ideological controversy.

It should be remembered that the SEZs had been presented to the most conservative factions of the Communist Party as a way to gain the benefits of foreign investment while restricting foreign cultural influence to only a few small areas. In this way, allowing the establishment of WFOEs outside the SEZs was seen by the most conservative Chinese sectors as precedent that would inevitably lead to the cultural pollution of the Chinese People. Furthermore, it would represent a major setback in the country's long road to socialism, as it would represent the existence of a private sector in the heart of China's still very much untouched socialist economy.

But despite the ideological controversy, as with the promulgation of the EJV Law, China pro-reform leadership again decided to take a huge step forward in China's open-door policy. In 1984, following a long and passionate debate, the Chinese government formally announced that the private sector was a supplementary part of socialist economy granting in this way legal status to the private economy. With this landmark statement, the Chinese government laid out the ideological ground for the promulgation of the first law in the PRC history ruling private ownership.

With this major policy shift, the first wholly foreign-owned enterprise outside the SEZs was set up in Shanghai, in 1984.[60] By the end of 1985, four months prior to the formal adoption of the Law of the People's Republic of China on Enterprises Operated Exclusively with Foreign Capital (the WFOE Law), more than 120 wholly foreign-owned enterprises had been established, with a total investment of approximately US$570 million.[61]

In April 1986, China government finally issued the WFOE Law, which specified that "China permits foreign enterprises, other foreign economic organizations and individuals... to set up enterprises exclusively with foreign capital in China and protects the lawful rights and interests of wholly foreign-funded enterprises". China had become the first socialist country in history to adopt a law that allowed nationwide exclusively foreign-owned firms in its territory.

[59] Chu (1987), p. 79.
[60] It was a 3M Company of the United States, and it started operating in 1985. Ibid.
[61] *Beijing Review*, May 5, 1986, p. 16.

It should be mentioned that, although the WFOE Law was adopted in 1986, and perhaps due to the difficulty in explaining the coexistence of foreign capitalist firms alongside the Chinese state enterprises in the country's economy, ideological justification for this decision only emerged in October 1987 when the 13th Party Congress propagated a new neo-Marxist theory. According to this new ideological line of reasoning, it was stated that China was in a "primary stage of socialism," which was said to have begun in the 1950s and was expected to last one hundred years thereafter. Accordingly, at the stage China was at the time, whatever was "conducive to the growth of the productive forces is in keeping with the fundamental interests of the people and, therefore, needed by socialism and allowed to exist".[62]

The WFOEs Law defined a wholly foreign-owned enterprise as a limited liability company established in China with capital contributed exclusively by foreign investors. In its third article, it stated that such companies should "be established in such manner as to help the development of China's national economy". Also, that these firms should "use advanced technology and equipment or market all or most of their products outside China". Furthermore, in its fourth article, it provided that the "The investments of a foreign investor in China, the profits it earns and its other lawful rights and interests are protected by Chinese law." Moreover, its fifth article stipulated that "The state shall not nationalize or requisition any enterprise with foreign capital", and that if required by public interest, "enterprises with foreign capital may be requisitioned by legal procedures and appropriate compensation should be made."

It should be noted that, compared to joint ventures, WFOEs faced greater sectoral restrictions and performance requirements. Indeed, WFOEs were prohibited from operating in such sectors as the media; retail and wholesale; and telecommunications. Also, public utilities, transportation, real estate, trusts, and leasing were restricted sectors for WFOEs. In practice this meant that, to operate in the restricted sectors, the WFOE needed direct approval from the central government. And for a WFOE to be approved, it "had to" employ advanced technology, develop new products, or produce import substitutes, or else have an export ratio of over 50 percent. By comparison, joint ventures were only "*encouraged*" to employ advanced technology or engage in export-oriented production, although these did not constituted legal requirements.

It should also be noted that the WFOE Law was useful both to foreign investors and to China. From the perspective of foreign investors, the WFOE mode allowed the maintenance of a maximum level of operating independence from Chinese participation

[62] Zhao Ziyang, then the Party's General Secretary, cited in Baum (1994), p. 140.

and, therefore, to have a high degree of control over financing, marketing, pricing, the production schedule, quality control, purchase of materials, technology employed, and even external relations of various subsidiaries. Also, WFOE permitted full access to all corporate resources and technology from the parent company while being able, at the same time, to effectively protect their technologies. From the Chinese perspective, there were also two particularly important reasons to allow the establishment of wholly foreign-owned enterprises. The first was to increase China's competitiveness in the world FDI market by providing foreign investors with more entry alternatives to invest in China. Considering the growing initiatives of other developing countries to attract FDI, especially the East and Southeast Asian countries, this point assumed special relevance. The second was to accelerate the introduction of the much desired new and high technology products through local production. Indeed, it was expected that foreign investors entering in WFOE mode would be more willing to bring to China their most advanced technologies.

Following the adoption of the WFOE Law, China continued its efforts to improve its investment environment. In October 1986, China issued the Provisions of the State Council of the People's Republic of China for the Encouragement of the Foreign Investment. These provisions were intended "To improve the investment environment, facilitate the absorption of foreign direct investment, introduce advanced technology, improve product quality and expand exports in order to generate foreign exchange and develop the national economy."

In this way, more than demonstrating that serious attention had been given to providing investment incentives, this document also marked a new stage in foreign investment policy development. In fact, the new measures not only addressed directly some of the most difficult problems cited by early investors, but also improved the investment climate both by adding new incentives and by removing uncertainties.

For example, the new measures clarified the existing arrangements that joint ventures had autonomy in making decisions outside of plan targets, in setting salaries and bonuses, and in hiring senior management personnel. Furthermore, equity joint ventures were granted privileged access to supply of water, electricity and transportation (paying the same price as state-owned enterprises) and to lower interest loans.

Perhaps the most important policy initiative contained in this document was the right given to foreign ventures to swap foreign exchange among themselves. In fact, balancing the foreign currency account had been the major difficulty facing many early investors.[63]

[63] This issue is fully addressed later in this study.

But Chinese government efforts to efficiently attract and utilize FDI in order to develop China's economy did not stop here. In December 1987, the first state investment guideline was issued in which priority industries were highlighted and prohibited areas were also specified. It represented the first attempt by the government to channel foreign capital into priority sectors. Furthermore, in April 1988, nearly nine years after the issue of the Equity Joint Venture Law, the long-waited CJV Law was finally passed by the National People's Congress.

It was also during this year that China first initiated its efforts to attract foreign investment from Taiwan.

Indeed, given that Taiwan is officially accepted by the authorities on either side of the Taiwan straits as an integral part of China, Taiwan investment is considered to be in fact domestic, instead of foreign, and as such, it does not enjoy the preferential treatment given to foreign firms. In this way, Taiwanese investment posed special problems.

The solution for these constrains came in the form of the 1988 China's promulgation of the Regulations on Encouraging the Investment of Taiwan Compatriots (REITC).[64] It should be noted that the significance of this document was enormous, as it represented a compromise by Mainland China by viewing Taiwan investment as domestic[65] but granting it the same preferential treatment as foreign investment. Also, to allay Taiwan's investors' fears of expropriation, it explicitly prohibited nationalization of Taiwan investment without compensation (REITC, 8th and 9th sections).[66]

Between 1988 and early 1992, the pace of liberalization slowed markedly following the post-Tiananmen purge of Zhao and the resurgence of a more 'conservative' faction within the CCP. As said, in the wake of the Tiananmen incident in 1989 it looked as though China would reverse its open-door policy. Instead, China's opening reform policy not only survived the political maelstrom but also intensified. Specific to the foreign investment, China's FDI regulatory framework continued with little delay to undergo further liberalization.

In the early 1990s, the Chinese government further liberalized FDI policies and amended and established a series of laws and regulations aiming at achieving a more rapid and healthy development of FDI inflows into China.

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[64] Coincidentally, with martial law in Taiwan repealed in July 1987, Taiwan lifted its ban on civilian visits to the mainland and relaxed its control over foreign currencies around 1988.

[65] As such the duration of Taiwan-invested firms had no limits and, moreover, Taiwan investors were permitted to hold the position of chairman of the board of directors of joint ventures. By comparison, foreign nationals were not allowed to do so until 1990 when the 1979 EJV Law was amended.

[66] These provisions were again reaffirmed in the Law regarding the Protection of the Investment by Taiwan Compatriots promulgated by the NCP in 1994.

In the spring of 1990, the Amendments to the Equity Joint Venture Law and the Wholly Foreign-Owned Enterprise Implementing Rules were adopted. For the Amendments to the Equity Joint Venture Law, two significant changes are worth mentioning. The first is the abolition of the stipulation that the chairman of the board of a joint venture should be appointed by Chinese investors. As mentioned, until then, foreign investors, regardless of the size of their equity stake, were not allowed to hold the position of chairman of the board of directors, and the duration of equity joint ventures, albeit already having undergone a round of relaxation in 1986, was nonetheless still limited to a maximum of 50 years. With the amendments to the 1979 EJV Law in April 1990, this restriction was effectively removed. The second is the provision of protection from nationalization, as the document declared formally that the state should not nationalize or expropriate foreign-invested ventures under normal circumstances.

Regarding the Wholly Foreign-Owned Enterprise Implementing Rules, which was based on the principles of the Wholly Foreign-Owned Enterprise Law, it provide a complete legal structure to facilitate the actual performance of these enterprises.

Continuing its efforts in establishing adequate regulatory legal framework to enhance China's attractiveness to foreign investment, in 1991 China published a unified tax code. The new tax code eliminated yet another discriminatory element in China's regulatory framework by treating WFOEs equally as other modes of FDI for tax purposes.

Accompanying these developments were a series of steps taken by China to align itself with international practices in the protection of intellectual property rights.[67] In addition, many "inside documents" which might affect FDI firms were opened to the public to increase the transparency of China's FDI regulatory framework. As a result, a series of laws and regulations relating to FDI were adopted after 1991, including the Foreign Investment Enterprise and Foreign Enterprise Income Tax Law, the Corporation Law, the Regulatory Provisions of Foreign Banks, the Securities Exchange Law, the Banking Law, and the Foreign Exchange Control Regulations.

In respect to Taiwan, in 1990 and 1991 and in the absence of formal intergovernmental contacts, two civilian yet officially authorized organizations were established, respectively, the Strait Exchange Foundation in Taipei and the Association for Relations Across the Straits in Beijing. These organizations were expected to deal with a wide variety of issues that went from civil affairs to prevention of crime and protection of rights of Taiwan investors in Mainland China.

[67] This issue will be address later in this study.

In conclusion, the second phase of the story of FDI in China witnessed both a rapidly growing body of FDI laws and regulations and a great improvement of the overall FDI environment, in a undeniable demonstration of the Chinese government's commitment to the open-door policy.

Bilateral Investment Treaties

An additional evidence of the importance China attached to promoting inbound FDI is the country's signing of bilateral investment treaties, which started as early as 1982, with the adoption of the first treaty with Sweden. Nevertheless, it was only in the mid-1980s that the speed of signing agreement accelerated (see Table 10).

On 22 January 1987, China also became an adherent to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards or the so-called New York Convention of 1958, which is considered to be the most important multilateral treaty on international arbitration. On 9 February 1990 China became equally a member of the Washington Convention on the Settlement of Investment Disputes between States and Nationals of other States of 18 March 1965, which would only came to full effect on 6 February 1993.

The growing Chinese integration in the international web of treaties can be understood as representing Chinese leaders recognition that unless foreign investors felt that their investment were sufficiently protected they would not invest in significant ways. Indeed, in this way, it represented an important part of the overall efforts to accommodate foreign investors needs and desires in order to enhance China's appeal to foreign capital.

Table 10: Bilateral Investment Treaties Signed by China, 1982-1991

Parties	Signature			Entry into Force		
Sweden	March	29	1982	March	29	1982
Germany	October	7	1983	March	18	1985
Belgium-Luxembourg	June	4	1984	October	5	1986
Finland	September	4	1984	January	26	1986
France	May	30	1984	March	19	1985
Norway	November	21	1984	July	10	1985
Austria	September	12	1985	October	11	1986
Denmark	April	29	1985	April	29	1985
Italy	January	28	1985	August	28	1987
Kuwait	November	23	1985	December	24	1986
Singapore	November	21	1985	February	7	1986
Thailand	March	12	1985	December	13	1985
Sri Lanka	March	13	1986	March	25	1987
Switzerland	November	12	1986	March	18	1987
United Kingdom	May	15	1986	May	15	1986
Australia	July	11	1988	July	11	1988
Japan	August	27	1988	May	14	1989
Malaysia	November	21	1988	March	31	1990
New Zealand	November	22	1988	March	25	1989
Poland	June	7	1988	January	8	1989
Bulgaria	June	27	1989	August	21	1994
Ghana	October	12	1989			
Pakistan	February	12	1989	September	30	1990
Russian Federation	July	21	1990			
Turkey	November	13	1990	August	19	
Czech Rupublic	December	4	1991	December	1	1992
Hungary	May	29	1991	April	1	1993
Mongolia	August	26	1991	November	1	1993
Papua New Guinea	April	12	1991	February	12	1993
Slovak Republic	December	4	1991	December	1	1992

Sources: OECD (2003), pp. 214-216.

The Intellectual Property Rights Concept

Before the economic reforms in 1978, the concept of intellectual property rights (IPR) was not fully enshrined in Chinese law nor was it widely accepted. Indeed, copying of foreign products was widespread although it should be noted that this was partly encouraged by the policies of autarky and import substitution that reigned for the first three decades after the foundation of the People's Republic of China in 1949. Nevertheless, the need for legislation to protect intellectual property rights was recognized very early in the reform process. In fact, in the late 1970s reform process the government

had already realized that without such protection it would be difficult to attract foreign investment embodying new technology. It was also realized that legal recognition of patent rights was necessary to stimulate and nurture indigenous inventiveness.

As a result, the Chinese government initiated co-operative links with other countries in step with its promulgation of specific intellectual property rights protection legislation. On 3 June 1980, China became a member of the World Intellectual Property Organization (WIPO). Just over two years later, on 23 August 1982, the Standing Committee of the National People's Congress (NPC) passed the Trademark Law of the People's Republic of China, which came into effect on 1 March1983. This was followed by a Patent Law, effective from 1 April 1985. On March 1985 China became a member of the Paris Convention for the Protection of Industrial Property.

Nevertheless, these measures were insufficient because they lacked an effective foundation in civil law to accommodate intellectual property rights protection.

This problem was rectified in April 1986 when the NPC passed the general Principles of the Civil Law of the People's Republic of China, which came into effect on 1 January 1987. This new civil law code contained the first explicit definition of intellectual property rights as the civil rights and of legal persons, and the first affirmation of the rights of authorship/copyright as rights of citizens and legal persons.

During the following six years, China entered into a number of international agreements to strengthen the protection of intellectual property rights. In 1989 China was one of the first countries to sign the treaty on Intellectual Property in Respect of Integrated Circuits adopted by WIPO. In October the same year China also became a member state of the Madrid Agreement for the International Registration of Trademarks under WIPO auspices.

The signing of these international agreements was paralleled with China's efforts to continue to fill gaps in its domestic IPR legislation. A Copyright Law, passed by the NPC Standing Committee in September 1990, went into effect on 1 June 1991. This was supplemented soon after by the Regulations on the Protection of Computer Software, effective from October 1991, and by the Regulations on the Implementation of the International Copyright Treaty, effective from 25 September 1992, which specifically protects the rights of foreign authors.

Foreign Exchange Management and FDI

Shortly after the beginning of the reform period, in 1980, Chinese government promulgated the Provisional Regulations on Foreign Exchange Control, which was followed in 1983 by the promulgation of the Foreign Exchange Implementation Act. Under the regime supported by these documents, FIEs were required to open a RMB deposit account and a separate foreign exchange deposit account with either the Bank of China or another bank approved by the State Administration of Foreign Exchange (SAFE), the institution that ruled foreign exchange (FX) operations in China. In this way, all foreign exchange receipts and disbursements should flow through the foreign exchange account. However, because the RMB was not convertible into foreign exchange, these rules effectively required FDI firms to generate all foreign exchange needed for the remittance of dividends, expenditures and other distributions through exports.

In this way, FIEs in China faced indeed a very strict FX system, specially considering that achieving a FX balance was a critical operating issue for most FDI firms in China. Indeed, as for them to be able to pay their foreign currency denominated charges such as imported capital goods, raw materials, loans, and expatriate salaries, they required a regular source of foreign currency.

Nevertheless it should be noted that despite the stringency of this system, when compared to their Chinese counterparts, FIEs were granted a somehow more favorable treatment. For example, as said, FIEs were allowed to have their own FX accounts with the Bank of China. However, domestic firms were not.[68] Furthermore, whereas FIEs could retain foreign currencies for their own use, domestic firms were required to sell them to the state. Also, whereas Chinese enterprises were required to secure government approval before they could spend FX, FIEs were not subject to such restrictions.

Although the Chinese government recognized that this was a critical operating issue for most FDI firms in China, there were also strong economic foundations supporting the Chinese government adoption of such a tight foreign exchange management policy. To start with, the Chinese government wanted to protect its foreign exchange reserves. Also, Chinese leaders wanted to encourage FDI firms to export their products and, in this way, further help the improvement of China's overall trade balance. Lastly, they wanted to promote localization of FDI firms so as to speed up the transfer of technology and the upgrading of China's manufacturing capabilities. Under this perspective, it was not surprising that little assistance to FDI firms to meet FX constrains was available from the

[68] This restriction has been relaxed in the 1990s.

Chinese government. Indeed, at that time, if FIEs expanded their business scope beyond what had been originally planned and specified in contracts, or if they failed to reach their exports targets, there was really not much options they could reach to.

As the number of FIEs in China grew, so did the problems these companies felt in balancing their FX accounts. The situation got particularly difficult for those FIEs that heavily depended on import sources of supplies or whose products aimed primarily at domestic markets. Furthermore, even when FIEs managed to successfully sell their products on domestic markets, they were unable to convert RMB into hard currency and thus unable to repatriate profits and to pay for importation of supplies.

The situation became even worse when China incurred in billions of dollars of trade deficits in 1985 and the country's foreign reserves level diminished by 38 percent in the first 6 months of 1986.[69] Facing a FX crisis, many FIEs were forced to halt operations temporarily or to withdraw altogether.

A much publicized case involved Beijing Jeep Corporation, a joint venture with American Motors Corporation (the latter sold its equity to Chrysler). At one point, the firm was deeply mired in foreign exchange problems. It was only after a high–level lobbying effort by the US that the Chinese government decided to provide additional foreign exchange to the venture.[70]

Overall, it had become evident that the existing stringent FX regulatory regime was totally inadequate for the FIEs operational needs.

In order to face this problem, in 1986 China took a number of innovative measures, most of them contained in the Foreign Exchange Balance Act and the Provision for the Encouragement of Foreign Investment. Indeed, although these documents reaffirmed FIEs' need to balance their own FX accounts through exports, they also contained substantive measures whereby these enterprises could generate additional FX. Specifically, the two provisions offered the following options to help FDI firms to balance their foreign exchange accounts:

Domestic sales of sophisticated products

This option was designed to provide temporary relief for FDI firms with limited foreign exchange by allowing them to sell sophisticated products produced by advanced or key technology provided by the foreign partners on the domestic market. This option

[69] Over the reform years, while China has by and large enjoyed a favourable trade balance, it incurred a trade deficit of RMB 13 billion in 1985. This prompted the government to tighten import controls, bringing about a 70 percent reduction in the trade deficit and an increase of US$4.7 billion in foreign exchange reserves in 1987.

was applied on a product-by-product basis. Therefore, the viability of the option depended on the sophistication of the technology provided by the foreign partner and the availability of a potential buyer of the products on the domestic market.

Foreign exchange adjustment

This option provided the opportunity to a foreign investor who established two or more ventures in China to adjust foreign exchange accounts through balancing the surplus in one venture with the deficit in another. The feasibility of this option depended largely on the agreement of all parties, particularly when the joint ventures involved different Chinese partners. Adjustment could be arranged either as a swap, in which case these ventures were actually buying and selling foreign exchange at a rate on which they agree, or as a parallel loan, without charging interest from each other.

Reinvestment of RMB profits

This option allowed foreign investors to reinvest their RMB profits in Chinese domestic enterprises as an equity owner with a plan to begin or expand export production. Foreign exchange earned from such exports was allowed to be distributed to these RMB investors for repatriation. However, the effectiveness of this option largely depended on the export performance of the invested enterprises.

Domestic products export

This option allowed FDI firms to purchase domestic products and sell them abroad. However, the resale of domestic goods that were subject to export quotas, under central administration and required an export license was not allowed unless special approval was granted by MOFTEC. The purpose of this option was to enable foreign investors to use their existing distribution networks in the international market to solve a temporary foreign exchange problem. Therefore, a limit was set on the approved quantity of domestic products to be purchased for export by FDI firms within the amount needed for the shortfall in its operation of the year plus a necessary amount for profit repatriation.

Government assistance

The Foreign Exchange Balance Provisions stated that direct assistance by means of foreign exchange allocation was the responsibility of the jurisdiction that granted the original approval of a given project. However, this option was subject to two preconditions.

[70] For a fascinating account of the case, see Mann (1989).

First, the government was only responsible for a foreign exchange imbalance that was obviously not the direct result of a venture's failure to fulfil its contractual obligations for exports and the generation of foreign exchange. Second, the government should consider direct assistance only when it was necessary. As a result, although this option provided the FDI firms with the possibility of government direct assistance, the feasibility of the direct assistance depended almost entirely on government decisions and sometimes on the particular circumstances.

Mortgage RMB on foreign exchange

This option provided the foreign investors with the opportunity to obtain a RMB loan from the Bank of China and other banks designated by the People's Bank of China for working capital or for investment in fixed assets through depositing an equivalent value of foreign exchange as a security. By adopting this option, foreign exchange that may have been converted into RMB could be kept by the FDI firms for other purposes.

Import substitution

This option allowed FDI firms to sell import substitutes on the domestic market to solve their foreign exchange problems. According to the Import Substitution Measures, a product which may be confirmed as an import substitute should meet the following conditions: first, the product should be equipped with advanced technology needed by the country, and the producer should be facing temporary difficulties in balancing its foreign exchange account in the initial period of operation in the process of increasing the local content of its product; second, the relevant product should be one that was imported at the time and would continue to be imported by the central or local governments; third, the specifications, performance, and delivery time of the product and the technical and training services that were offered should meet the requirements of the domestic purchaser. Furthermore, the product should reach international quality standards. Because of these requirements, it was very clear that only technologically advanced FDI firms were eligible to apply for import substitution status.

Foreign exchange swaps.

Undoubtedly, the above options had greatly improved the situation of foreign exchange management of FDI firms. However, balancing foreign exchange would continue to be a problem until the RMB became convertible. A significant move made in this direction was the establishment of Foreign Exchange Adjustment Centers, or the so-

called swap centers. Through these centers, FIEs were allowed to negotiate among each other to adjust their FX surpluses and deficits at a rate agreed upon by both parties.

Starting in Shenzhen and Shanghai, FX swap centers soon mushroomed wherein FIEs could trade RMB and FX. By 1990 about 90 swap centers had been established Taken together, these centers served to reallocate a very impressive 20 percent of all FX earnings in China.[71]

Despite the operating rules for swap centers tended to differ somewhat from one city to another, and the rate at which foreign exchange was traded was generally higher than the official quotes, the swap system seems to have worked reasonably well for FIEs to solve FX headaches. Indeed, according to one survey conducted by the US-China Business Council in 1991, after the inception of the swap system, the onus of balancing foreign exchange – once arguably the most difficult issue facing many FIEs in China – became less of a problem. Also, the report concluded that although some bureaucratic obstacles still remained, the situation of balancing foreign exchange had improved since the late 1980s.[72]

Indeed, the establishment of swap centers to facilitate the operations of FIEs was another major path-breaking development in China's FDI regulatory framework. It also represented the Chinese leadership's firm commitment to the improvement of foreign investment environment in China's grounds.

Evolution of the FDI Tax Policies

In 1984, with the extension of the special policies for FDI from the SEZs to the fourteen coastal cities, the Chinese government issued the SEZs and the Coastal Cities Tax Reduction and Exemption Regulations. As a result, even greater investment inducements and privileges were provided to foreign investors operating in the SEZ in the Southern coastal areas of China. (see Table 11)

First of all, the enterprise income tax for all types of FIE in SEZs was set at a low of 15 percent, irrespective of the nature of the enterprise, manufacturing or not. This compared favorably to the 24-30 percent tax rate for FIEs elsewhere in the country. Second, FIEs in SEZ engaging in services and with foreign investment exceeding US$5 million and an operating life of ten years or more were exempt from the enterprise income tax in the first profit-making year and was permitted a 50 percent reduction in the following

[71] Lardy (1992), p. 81.
[72] See Frisbie (1992), p. 15.

two years. Moreover, whereas profit repatriation from elsewhere in China was subjected to a 10 percent remittance tax, the SEZs imposed no such taxes. Finally, SEZ authorities routinely waived the 3 percent local tax.

Table 11: Main Features of the 1984 Tax Regulations

Location	FDI National Income Tax	Local Income Tax	Tax on Profits for Repatriation
SEZs	15% for production and non-production FIEs	Exemption or reduction are possible	Exemption
ETDZs in the 14 coastal cities	15% for production FIEs	Exemption or reduction are possible	Exemption
OUAs of the 14 coastal cities and those of Shantou, Zhuhai and Xiamen	24% generally; 15% in an investment exceeds US$30 Million with a low profit margin, or involves intensive technology or knowledge, or develops energy, transportation, or ports; 20% reduction over the regular tax due for firms that do not meet the above requirements but are in one of the designated sectors.	Exemption or reduction are possible	No exemption or reduction

Sources: The 1984 SEZ and Coastal Cities Tax Reduction and Exemption Regulations. Cited from Wei (1994), p. 85.

The primary objective of the 1984 tax regulations was to attract more FDI inflows into China, and at the same time, to facilitate the implementation of the uneven regional development strategy through tax incentives to affect the location decision of foreign investors and, therefore, to influence the spatial distribution of FDI inflows into China.

In 1986, further tax incentives were offered to the technologically advanced and export-oriented FDI firms under the Encouragement Provisions (see Table 12).

For example, to promote FDI, this document contained deeper tax cuts for “technology advanced” or export-oriented” enterprises (or TAEs and EOEs). Under it FIEs classified as TAEs were eligible for a three-year extension of a 50 percent enterprise income tax reduction, subject to a minimum reduced tax rate of 10 percent. On the expiry of the ordinary tax holidays, FIEs qualified as EOEs, i.e., with an export ratio of more than

70 percent in a given year, were eligible for a 50 percent reduction in the enterprise income tax in that year, subject to a minimum reduced tax of 10 percent.

Table 12: Tax Incentives under the 1986 Encouragement Provisions

Type of Enterprises	Income tax	Tax on Profits for Repatriation	Tax Refunded
TAEs	50% further reduction for 3 years after the expiration of the initial period allowed for reduction and exemption	Exemption	100% refund for income paid on the reinvested portion if reinvestment allows an operational period of no less than 5 years
EOEs	50% further reduction after the expiration of the initial period allowed for reduction and exemption if it exports 70% or more of its annual products	Exemption	100% refund for income paid on the reinvested portion if reinvestment allows an operational period of no less than 5 years

Sources: The Encouragement Provisions and the Ministry of Finance's Tax Rules. Cited from Wei (1994), p. 86.

Obviously, the aim of the Chinese government was to incorporate the tax incentives with its regional economic development and industrial development strategies. This reflected the government growing concern over the relationship between FDI inflows into some economic sectors and industries and the overall goals of national economic and technological development.

With the decentralization of power, the open coastal cities began to provide preferential treatment to foreign investors. Like the SEZs, the open cities were now authorized to offer a variety of investment inducements, including concessionaire tax rates. However, unlike the SEZs that set a flat enterprise income tax rate of 15 percent for all FIEs, different tax benefits were granted to FIEs in the open cities, depending on their nature and location. Generally speaking, the dividing line was between the so-called Economic and Technological Development Zones (ETDZs) and the Old Urban Districts (OUDs).

Within the ETDZs, the enterprise income tax rate was 15 percent for production FIEs. In addition, projects valued over US$30 million and scheduled for 10 years or more

could enjoy tax exemptions for the first 2 profit-making years and a 50 percent tax reduction for another 3 years. They could also enjoy an exemption from the 3 percent local tax, as well as from custom tariffs on capital goods, raw materials, intermediate inputs, and office supplies imported for their own use. Finally, the 10 percent remittance tax was also exempted.

In the OUDs, on the other hand, the enterprise income tax for FIEs was 24 percent, a rate also applicable in the "delta regions". But for projects that were high-tech or knowledge-intensive, or valued over US$30 million and had a long payback period, the tax rate was 15 percent. Projects unable to meet the conditions for the 15 percent tax rate could be eligible for a 20 percent tax reduction if the investment was in priority sectors.

Finally, like in the ETDZs, FIEs in the OUDs could be exempted from 3 percent local tax. But unlike in the ETDZs, FIEs in the OUDs were not allowed exemptions from the remittance tax.

With the implementation of the Encouragement Provisions in 1986, and particularly with the adoption of the "coastal development strategy" in 1988, attracting FDI through offering tax incentives become very popular throughout China. From 1987 to 1990, local governments competed with each other to offer tax incentives for attracting FDI. In most cases, the local governments extended the period and added categories under which FDI firms were entitled to various tax concessions for business income tax. Some local governments also offered unauthorized concessions in industrial and commercial tax, and particularly, they granted more tax exemptions and reductions for Taiwanese investment and increased the income tax refund on reinvestment.[73]

However, the "tax concession war" proved to be ineffective in influencing foreign investors' location decisions. Conversely, it created an impression in the minds of foreign investors that China had unstable and inconsistent tax policies, which was detrimental to the Chinese government's persistent efforts to create a sound tax climate. As a result, the State Administration of Taxation (SAT) had to order the local governments to delete or to revise all tax provisions not mandated by national legislation, in order to provide a consistent and sound tax climate for FDI.

Meanwhile, the tax discrimination between FIEs and WFOEs in China was consistently objected to by foreign investors. In fact, when the WFOEs Law was first published in 1986, there were no explicit tax concessions for this mode of FDI investment. WFOEs were required to pay taxes in accordance with the original Foreign Enterprise Income Tax Law. Under that law, the enterprise income tax for WFOEs was charged at a

[73] Wei (1994), p. 86.

progressive rate, from 20 percent on income at RMB 250,000 to 40 percent on income over RMB 1 million. A local tax surcharge of 10 percent was also chargeable, bringing the total rate to a maximum of 50 percent. As a result, except for very small operations, WFOEs generally paid higher taxes than joint ventures. In 1989 proposals were reportedly submitted to the NPC to end the discriminatory tax treatment towards WFOEs[74] The proposals, however, did not pass until April 1991 when China promulgated the Foreign Investment Enterprise and Foreign Enterprise Income Tax Law, commonly know as the Unified Tax Law (see Table 13).

China had decided finally to treat all forms of FDI (i.e., EJVs, CJVs, and WFOEs) equally for tax purposes.

Table 13: Foreign Investment Enterprise and Foreign Enterprise Income Tax (Implemented July 1, 1991)

Taxpayer	National Income Tax Rate	Local Income Tax Rate	Exemption and Reduction
Foreign-invested enterprises	30%; 15% for productive firms in the SEZ and the ETDZs; 24% for productive firms in the OUAs of the cities in the coastal development zones (15% if involves energy, ports, transportation, or other priority projects).	3%; exemption or reduction are possible	2 years exemption plus 3 years 50% reduction for productive firms scheduled to operate for 10 years or more; further 10 years reduction of 15-30% for firms in agriculture, forestry or husbandry, or located in specified areas; tax exemption for profits for repatriation.
Foreign enterprises with establishment in China	30%; 15% for those having establishments or sites.	3%; exemption or reduction are possible	
Foreign enterprises without establishment in China	20%; a reduced 10% or even exemption for royalties derived from technology transfers that relate to specific areas		

Sources: The Foreign Investment Enterprise and Foreign Enterprise Income Tax Law and its implementing rules. Cited from Wei (1994), p. 89.

[74] *People's Daily*, 21 December 1990.

FDI Behavior

The energetic expansion of geographical areas open to foreign investment and the continuing effort to improve the regulatory framework and the overall investment environment correlated with a steady growth of FDI in China (see Table 14).

Table 14: China's FDI Growth, 1984-1991

Year	Projects (number)	Growth (%)	Contracted (US$ million)	Growth (%)	Realized (US$ million)	Growth (%)
1984	2 166	239%	2 875	50%	1 419	55%
1985	3 073	42%	6 333	120%	1 956	38%
1986	1 498	-51%	3 330	-47%	2 244	15%
1987	2 233	49%	3 709	11%	2 314	3%
1988	5 945	166%	5 297	43%	3 194	38%
1989	5 779	-3%	5 600	6%	3 393	6%
1990	7 273	26%	6 596	18%	3 487	3%
1991	12 987	78%	11 977	82%	4 366	25%
Cumulative	40 954		45 717		22 373	
Average	5 119.25		5 714.625		2 796.625	

Sources: OCDE (2003), p. 190.

Indeed, in the first nine months alone after the 14 coastal cities were open, more than 400 contracts were signed, totaling US$880 million, which was about 1.5 times the cumulative FDI in the entire previous five years in these cities.[75]

The growth trend continued by and large in the second part of the 1980s. In 1986, however, due to that year severe FX crisis, there was a sharp drop in FDI: contracted FDI declined from US$6.333 billion in 1985 to US$3.330 billion in 1986. But after the new policy initiatives adopted by the Chinese government to address this issue, foreign investors responded favorably and investment started to pick up again. Indeed, in 1987 and 1988, although China encountered serious inflation foreign investment inflows continued to grow. In 1989, due to the political shock waves in the immediate aftermath of the Chinese government's violent suppression of the Tiananmen events, FDI inflow growth was significantly stunned. Nevertheless, in 1990 FDI a total of 7,273 new FDI projects were signed, with a contract value amounting to US$6.596 billion. These represented an impressive rise of 26 percent and 18 percent respectively over the comparable figures of the previous year. This tendency has continued throughout 1991,

[75] *Beijing Review*, 10 December 1984, p. 16.

with an increase of 78 percent of new FDI projects and 82 percent in contracted FDI relatively to the previous year.

Overall, between 1984 and 1991, the cumulative contract value of foreign investment was US$45.717 billion (an average of US$5.715 billion annually). Actual foreign capital inflows amounted to US$22.373 billion (or US$2.797 billion per year). Compared with the annual figures of the previous period, these figures represent an increase of about 4 and 5 times, respectively.

Table 15: FDI by Type, 1984-1991 (US$ million realized FDI)

Year	EJV	%	CJV	%	WFOE	%	JE	%
1984	254.7	17.95	465.0	32.77	14.9	1.05	522.9	36.85
1985	579.9	29.65	585.0	29.91	13.0	0.66	480.6	24.57
1986	804.5	35.85	793.8	35.37	16.3	0.73	260.3	11.60
1987	1 485.8	64.21	620.0	26.79	24.6	1.06	183.2	7.92
1988	1 975.4	61.85	779.5	24.41	226.2	7.08	212.6	6.66
1989	2 037.2	60.04	751.8	22.16	371.4	10.95	232.2	6.84
1990	1 886.1	54.09	673.6	19.32	683.2	19.59	244.3	7.01
1991	2 299.0	52.66	763.6	17.49	1 134.7	25.99	169.0	3.87
Cumulative	9 522.6	42.56	5 432.3	24.28	2 484.3	11.10	2 305.1	10.30
Average	1 190.325	42.56	679.038	24.28	310.538	11.10	288.138	10.30

Sources: OCDE (2003), p. 195.

Regarding modes of investment, for the whole 1984-91 and when comparing with the previous period, there was a dramatic shift in terms of growth pattern of different entry modes. As Table 15 shows, while EJVs and WFOEs gained importance, the opposite happened regarding CJVs. Particularly important is the steady growth of the WFOEs. Indeed, in 1991,WFOEs already accounted for more than 25 percent of all the realized FDI in China. Considering that this mode of investment involves more foreign commitment of the kind of capital that is reversible only at great cost, the growth of WFOEs presence in China strongly suggest that foreign investors during this period began increasingly to make longer-term commitments. This, is turn, reflected the improvement in China's overall investment environment for foreign investors.

The increasing level of confidence of foreign investors was also reflected in systematic statistical evidence showing a dramatic shift of FDI from tourism-related services (included in wholesale and retailing, catering) to manufacturing and infrastructure projects during this period (see Table 16).

Table 16: Sectoral Distribution of Realized FDI in China, 1979-91 (%)

Sector	1979-86	1987-91
Agriculture, forestry, animal Husbandry and fishing	2.98	2.41
Manufacturing	39.59	77.33
Construction	1.63	1.68
Transport, warehousing, post and telecommunications	1.48	0.87
Wholesale and retailing, catering	7.40	1.33
Real estate	31.21	13.51
Health care, sports and social welfare	0.34	0.46
Education, culture, arts, broadcasting, film and TV	0.42	0.39
Scientific research and technical services	0.05	0.18
Others	14.89	1.85
Total	100	100

Sources: Adapted from Wei (2003), p. 42.

Indeed, as manufacturing and infrastructure projects normally involve a great deal of immobile site-specific investments and are therefore more exposed to risks associated with institutional uncertainty, the rise of foreign investment in these kinds of projects can be generally interpreted as a positive sign of the increased confidence of foreign investors in the institutional guarantees of property rights in the host country.

It should be noted that the rise of FDI in manufacturing toward the end of 1980s also suggests that the situation regarding the foreign exchange problems that many FDI firms had suffered from in the mid-1980s had been successfully surpassed. Indeed, for unlike non-manufacturing industries such as hotels which were able to balance foreign exchange relatively easily, unless FDI manufacturing projects could either export their products sufficiently, or find reliable local supplies of raw materials and/or quality intermediate parts, they were most prone to foreign exchange headaches.

Regarding FDI sources (see Table 17), Hong Kong, including Macao, continued to be the most active player in the investment scene in realized value for the 1986-91 period. However, it is important to note that in reality the real share attributable to Hong Kong is likely to be even smaller. In fact, evidence suggests an increasingly number of Western multinationals were making investment in China through their subsidiaries in Hong Kong in order to benefit from the preferential policies enjoyed by the region[76].

[76] This issue will be further addressed later in this study.

Table 17: Sources of FDI, 1986-1991
(% of total Realized FDI inflow per year)

	1986	1987	1988	1989	1990	1991
Hong Kong	59.22	68.64	64.74	60.04	53.91	55.09
European Union	8.0	2.3	4.9	5.5	4.2	5.6
United States	14.54	11.36	7.39	8.38	13.08	7.4
Japan	11.74	9.5	16.11	10.5	14.44	12.2
Taiwan	-	-	-	4.56	6.38	10.68
Total	93.5	91.8	93.14	88.98	92.01	90.97

Sources: MOFCOM FDI Statistics (web site).

Finally, regarding geographical distribution of FDI, as Table 18 shows, there were some signs that FDI was now also reaching Central and Western China, regions that accounted during the period 1985 to 1989 respectively for about 7 percent and 5 percent of the total realized FDI. But perhaps more worthy of notice is the fact that during this period FDI was undoubtedly meandering northward among the coastal provinces.

Table 18: Geographical Distribution of Realized FDI in China, 1985-1989 (%)

Year	1985-89
Eastern Regions	**87.9%**
Guangdong	40.7%
Beijing	9.9%
Shanghai	9.5%
Fujian	6.9%
Jiangsu	3.7%
Tianjin	3.6%
Liaoning	3.6%
Shandong	3.5%
Hainan	1.8%
Guangxi	1.7%
Zhejiang	1.6%
Hebei	1.5%
Central Regions	**6.9%**
Western Regions	**5.1%**
Total	**100%**

Sources: Adapted from Wei (2003), p. 41.

All in all, the behavior of FDI inflows into China during this period reflected the fact that the country was developing what was rapidly becoming one of the most liberal foreign investment environments in the developing world. This paved the way for a new investment boom beginning in 1992.

Phase Three: 1992-1999

From Regional to National Development Policies

In early 1992, in an event that was soon to be considered a milestone in China's economic reforms, Deng Xiaoping made a visit to Wuchang, Shenzhen, Zhuhai and Shanghai. Indeed, as in 1984, when Deng's visit to Shenzhen served to boost SEZs, Deng Xiaoping's 1992's 'spring tour' marked the beginning of another phase of China's FDI inflows as he explicitly declared his support for the successful economic development assisted by foreign direct investment. Perhaps more importantly, he also expressed the desire to see the pace of liberalization quickened. "For a large, developing country like ours, the economic growth rate must be a bit faster," he said. "Reforms and opening require bold moves and courageous experiments and must not proceed like a woman with bound feet."[77] To drive home his support for speeding up economic reforms, he challenged Guangdong to catch up with the "four little dragons" within 20 years.

The underlying themes of Deng Xiaoping's 'spring tour' to Southeast China were recorded in Central Committee Document no. 4, issued in June 1992 and entitled, "The CCP Central Committee's Opinions on Expediting Reform, Opening Wider to the Outside World, and Working to Raise the Economy to a New Level in a Better and Quicker Way."[78] This document, reportedly drafted under Zhu Rongji, later to become China's Premier, market a new stage in China's reform and open-door policy. This new tide was further reinforced at the 14th Party Congress of October the same year, during which Jiang Zemin, the then Party's General Secretary, declared for the first time that the goal of China's reform was to establish a "socialist *market* [emphasis added] economy."[79]

This document contained three key decisions. First, a whole series of border cities and counties were opened to foreign trade and investment; the areas targeted were on the border with Russia in Heilongjiang-Jilin and Xinjiang-nei Menggu, and on the border with Burma and Vietnam in Yunnan and Guangxi. The clear intention was to broaden the scope of the coastal development strategy of the 1980s to include China's inland borders

[77] Deng Xiaoping (1993), "Zai Wuchang, Shenzheng, Zhuhai dengdi de tanhua yaodian," p. 370. Cited in Ju (2000), p. 56.

[78] This document gave legitimacy to a process that had been going on for some time under the auspices of local government. Some of the zones certainly do date from 1992 and after; for example, the Suzhou industrial park, set up in collaboration with Singapore's government, formally came into being in May 1994. However, the Chengdu Economic and Technological Development Zone was established in July 1990, and the one in Kunshan dates from as early as 1985. For the history of these zones, see the official Special Economic Zone web site.

as well. As a result, more than fifteen border cities and counties in the Southwest, Northwest, North and Northeast of China were declared open border cities. Some were authorized to offer coastal FDI preferential policies, while others were mandated to reopen or expand their existing border trade ties with neighboring countries or to set up economic development zones.

The second element of Document no. 4 was to open up all the provincial capitals. In part this was because many of these were closely linked in economic terms to the newly opened border regions. It also seems to have reflected the view that the provincial capitals were a central focus of provincial economic growth.

The third element of the 1992 strategy was perhaps the most important in that it focused on the opening up of the 'dragon': the Yangzi River corridor between Chongqing in Sichuan, and Pudong in Shanghai, the 'dragon's head'. This third decision therefore involved the opening up of five yangzi cities, and a sixth was added in March 1993.

To facilitate the implementation of this policy, a series of measures have also been taken to make more concessions to attract foreign investors. First, the application of preferential policies to FDI would gradually shift from regional priority to accommodating national and local industrial development policies. For example, as long as they were in line with state or local industrial policy and involve high or new technology, any FDI project was entitled to the same preferential treatment as applied in the ETDZs, regardless of its location. Second, some service industries, such as aviation, telecommunication, banking and retail trade, were opened to FDI participation in a limited and experimental fashion. In this way, some designated coastal cities were allowed to host FDI banking, finance, and retail entities. Shanghai, as a major commercial center, was also permitted to host a FDI insurance company. Third, to develop further foreign trade and processing industries in the coastal areas, more bonded zones were to be established. Fourth, the government allowed foreign business people, either those with an intention to set up FDI firms in a later stage or land developers, to buy land use rights for building infrastructure facilities, including residential, commercial, industrial, and recreational real estate.

With the implementation of these new policies, during the first nine months of 1992, almost 2,000 economic development zones were set up being a large proportion of them located in inland areas.

In fact, the economic development zone policy had became extremely popular throughout China, since the local officials saw it "not only as a way to gain access to

[79] "Political Report" to the 14th Party Congress, in *Foreign Broadcast Information Service, Daily Report, China*, 13 October 1992, 23-43.

international business but also as a means of gaining benefit and privilege."[80] As a result, the establishment of economic development zones eventually went out of control. By early 1993 as the press reported "nobody knows exactly how many such zones, which attract foreign investment with a variety of tax breaks and other favorable policies, have been launched in China."[81] The uncontrolled spread of economic development zones created some unintended negative consequences, such as economic overheating; shortages of funds, energy, transport, and raw materials; the appropriation of good farmland for factories; and competitive cutting of tax rates and land prices to attract foreign investors.[82] All of these led to the 1993 rectification of all existing economic development zones and the requirement of central approval for all new economic development zones in order to solve the above mentioned problems and ensure the healthy development of FDI.

It should be noted that the Chinese approach of gradually extending regional openness to FDI has proved relatively successful in a number of aspects. First, the selective establishment of SEZs, beginning with a small number and gradually adding more, effectively gained nationwide support for the market-oriented economic reform drive. Second, the fast economic growth and development in SEZs and the coastal provinces not only provided the Chinese government with valuable experience in market-oriented economic reform, but also produced strong demonstration effects to the inland areas. Third, the increasing economic ties between the coastal and the inland regions created significant benefits for both regions.

However, in the 90s, the increasing inequalities between the coastal and the inland regions due partly to the implementation of the uneven regional development strategy to FDI could not be ignored. Therefore, it seemed necessary for the Chinese government to offer more preferential policies to the inland areas to help them attract FDI.

As a result, from the mid-1990s onwards, the Chinese government started to encourage FDI flows into the Central and Western regions[83] as part of attempting to

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[80] Shirk (1994), p. 41.

[81] Yin Xin, "Government to Tighten Restrictions on Zones," *China Daily Business Weekly*, February 7, 1993, p. 1, in *Foreign Broadcast Information Service, Daily Report, China,* February 9, 1993, p. 33. According to this source, the State Economic Planning Commission estimates 1,700 zones, the State Council SEZ Office, 1,800, the State Land Administration, 2,700, and the Ministry of Agriculture, 9,000. The first three figures include zones at the national (95), provincial, and city level; the last one includes those at the township level. Even the People's Liberation Army has its own national development zone located in the Shantou SEZ. "PLA Inaugurates Economic Development Zone," Xinhua News Agency, February 12, 1993, in *Foreign Broadcast Information Service, Daily Report*, *China*, February 12, 1993, p. 17. Cited from Shirk, S. (1994), p. 41.

[82] Ibid, p. 42.

[83] The Central region comprised the eight provinces of Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei and Hunan. The Western region consists of twelve provinces and provincial-level administrative units: Chongqing (formerly a municipality in Sichuan province, now a municipality directly under the central

spread the benefits of economic development to China's vast interior, although it should be noted that the development of the early 1990s - a strategy to open the areas alongside the borders, alongside the river, and alongside the coast - was clearly already a demonstration of this effort.

In 1996 the government raised the project approval limit of provincial authorities in the Western region to US$30 billion to bring it in line with that of the open coastal areas.

Since 1997 the Chinese government has formulated a series of preferential policies to encourage development in the Central and West regions, such as increasing government investment in these regions, prioritizing infrastructure facilities, increasing fiscal transfer disbursement, applying the land use preferential policy and encouraging rational movement of personnel. Also, additional preferential policies concerning FDI into the region have been also put into practice, such as applying tax preference policies, expanding areas of foreign investment, extending foreign investment channels, releasing conditions for foreign fund use and adopting preferential policy on the regions rich mineral resources.[84]

However, one should not conclude that the uneven development strategy had been entirely discarded. Indeed, at the end of the century, the emerging pattern was one in which the coast, the Yangzi Valley, and all the inland provincial capitals, develop more quickly and act as channels for capital, technology, and information for their respective hinterlands. Nevertheless, they still relied largely on the coastal areas and capitals for labor, energy, and materials.

Notwithstanding this fact China had, for all practical purposes, become a completely open country.

Further Improvements of China's FDI Regulatory Framework

The solid consensus in favor of economic reform in the "third generation" of leaders grouped around Jiang Zemin allowed the process of FDI absorption to become further routinized and entrenched as part of China's economic system.

Indeed, throughout the 1990s the patchy legal framework governing FDI in China was refined and expanded so that by the end of the decade a body of law and regulations was in place. Furthermore, experience gained in the 1980s also enabled the authorities to

government); Sichuan province, Guizhou province; Yunnan province; Tibet autonomous region; Shaanxi province; Gansu province; Ningxia autonomous region; Qinghai province, Xinjiang autonomous region; Inner Mongolia autonomous region; and Guangxi autonomous region.

[84] Additional incentives to direct FDI more positively to the Western region began in 1999.

expedite the process of examination and approval of foreign investment projects so that, as the decade progressed, it became less arduous and time-consuming.

As said, Deng Xiaoping's remarks during is 1992 spring Southern tour had electrifying effects, one of which were the adoption of the already mentioned Document no. 4. One important element contained in this document was a new round of relaxation on FDI in high value-added service industries. Accordingly, Beijing, Dalian, Guangzhou, Qingdao, Shanghai, Tianjin and the SEZs were authorized to experiment with FDI in retail and tourism in addition to banking and real estate discussed previously.

It should be noted that, in China, the service sectors had previously been monopolized by state-owned enterprises for both political and economic reasons. Politically, banking and insurance, for instance, were considered to be arterial industries that had a great impact on the national economy. Economically, retail and wholesale, for instance, were highly profitable. Thus, the opening of these tertiary industries signaled yet another significant FDI policy development from a previously single focus on manufacturing to a now double-pronged emphasis on both industrial production and high value-added tertiary sectors. Indeed, a new era had began, where the "export-promotion" FDI regime followed until this time was complemented with a exchanging technology for market regime, best known as the "technology-promotion" FDI regime.

Although this gradual shift was largely due to pressures from the US and West European countries that had increasing trade deficits with China due to China's export boom,[85] it came in line with a growing awareness by the Chinese leadership that technology transfers from industrial countries might only be possible if a market-oriented FDI was allowed.

Furthermore, China high growth rates were placing enormous stress on its basic infrastructure, which were forcing China to take actions in order to smooth out infrastructure bottlenecks. One solution was to encourage foreign investment in infrastructure projects.

Shifting foreign Investment to infrastructure projects away from export-oriented industries presented challenges, however, because projects in the road, rail and power sectors usually have long payback periods. As such, these projects posed very high risks to foreign investors.

Acknowledging this fact, China endorsed effort to remove obstacles to foreign involvement in infrastructure projects. To start with, China's decided to allow current account convertibility including debt servicing, which went a long way toward alleviating

[85] Zhang (2002), p. 50.

these projects financing problems. In addition, China also offered fiscal inducements for FIEs investing in long-term infrastructure projects. For example, foreign investors engaged in harbor or wharf construction were allowed to pay the enterprise income tax at 15 percent. Alternatively, if the operating life of a project was not less than 15 years, foreign investors could apply for a 5-year tax holiday, starting from the first profit-making year, and a 50 percent tax reduction for 5 additional years.

Perhaps more important than tax relief, to accommodate FDI in infrastructure projects, China begun to experiment with foreign participation on a build-operate-transfer basis. As already said, under the BOT formula, foreign investors were permitted to build, for example, a highway, operate it for a certain period for capital recuperation, and then transfer it to the host country.

But China's efforts in establishing regulatory legal framework for FDI didn't stop here. In 1994, the Chinese government implemented measures to reduce the "overvaluation" problem. Indeed, as the large majority of FDI inflows into China were now constituted by equipment and technology,[86] in translating the amount of these investments into cash, there was a tendency from foreign investors to overvalue the amount of FDI. The motives behind this phenomenon included: a larger share of dividends for the foreign investors than for the Chinese partners resulting from the higher equity share of foreign investors compared with their local partners; lower taxes arising from larger capital expenditures and depreciation credits; and more management control. However, from the Chinese perspective, overvaluation strongly reduced the potential contribution of FDI to the development of the country's economy. Indeed, it lowered tax revenues for the government, as well as the share of revenues accruing to the local partners in joint ventures. In order to deal with this problem, the State Administration for Import and Export Inspection and the Ministry of Finance jointly promulgated the Administrative Procedures for Appraising Foreign-Invested Property in early 1994 and began to monitor more closely the fulfillment of contractual commitments with respect to the actual value and quality of equipment in FDI projects.

Another important step China has taken to improve its FDI regulatory framework during this period was the 1995 publication of the Provisional Regulations on Guiding Foreign Investment, or the FDI Guideline. Its promulgation signed that the period of China's FDI policy experimentation, which started in the SEZs in the early years of the reform, was winding down.

[86] United Nations (1995), p. 59.

It should be noted that prior to its first appearance, sectoral investment priorities were often treated as "*neibu*", i.e., information only for the eyes of bureaucrats but not readily available to foreign investors. As such, the FDI Guideline presented to foreign investors for the first time a detailed sectoral road map (including whether WFOEs or joint ventures were preferred or required) under four categories of projects: encouraged, restricted, prohibited, and permitted.

In encouraged sectors, such as improvement of the ecological environment, investors could expect a warm welcome, face fewer performance requirements, and enjoy higher managerial control and greater tax incentives. In restricted areas, such as production of washing machines or refrigerators where the market was already crowded, projects required central-level approval, and investors were expected to justify the project by demonstrating some advantages to China. Prohibited areas included sectors that either had security implications (e.g., air traffic controls or electric power grids), were politically sensitive (e.g., radio and TV broadcasting) or culturally repugnant (e.g., prostitution). Finally, the permitted category was a neutral catchall for areas not covered by other three categories.

Indeed, it seemed that China had finally become confident and clear, broadly speaking, about which sectors ought to be closed off to foreign participation and which should be thrown wide open.

Furthermore, by translating ad hoc policy into written commitments in the form of the FDI Guideline, one important objective was to temper the arbitrary and capricious character of the screening process and to make China's FDI regulatory framework more predictable and transparent. In fact, this document was formulated in order not only to provide guidance for foreign direct investment towards sectors which suited China's national economic and social development plan, but also to protect the lawful rights and interests of foreign investors in accordance with relevant state laws.

In December 1997 the FDI Guideline was revised aiming at broaden the scope of foreign investment encouraged by the state and to stress some key points relating to industries. The revision also meant further meeting of the demands of industrial structure adjustment and the principle of favoring the absorption of advanced technologies. Moreover, the 1997 FDI Guideline fully embodied the policies of encouraging foreign investors to invest in the middle-and-western regions.

On November 15, 1999, China signed an agreement with the US on China's terms for accession to the WTO, which constitutes the latest example of China's willingness for greater integration into global economic regime. This agreement that has been a full 13

years in the making [87] demonstrates China's increasing readiness to play by the "rules of the game" of international standards.

Indeed, after almost two decades of "crossing the river by groping for stepping stones," a phrase that Chinese often use to describe the incremental approach of their reform endeavor, China's was finally prepared to completely embrace international engagement.

Further Adherence to Bilateral Investment Treaties

During the 1990s China continued its efforts in establishing a bilateral investment treaty program. As mentioned previously, China initially concluded its BITs in the 1980s with developed capital-exporting countries (25 in total). The pattern changed in the early 1990s, when China started signing BITs with the governments of other developing countries and transition economies. By the end of 1999, 57 BITs had been signed with developing counties, 20 with developed countries and 17 with the Central and Eastern European countries of transition. Among the developing countries, the countries of the Asia and Pacific region have concluded the largest number of BITs with China with more than 50 percent of the total (33 BITs). The Central and Eastern European transition economies were also actively involved in BIT agreements during the 1990s, signing 17 contracts with China during that time. China has also signed 15 BITs with countries in Africa and 9 countries in Latin America and the Caribbean (see Table 19).

At the end of the century, China ranked third (after Germany and Switzerland) among top countries in terms of the number of BITs concluded, and first among developing countries in transition economies.

[87] In July 1986 China applied to the General Agreement on Trade and Tariffs (GATT) to resume its status as an original contracting party. For more discussions on China's efforts in this regard, see Jacobson and

Table 19: Bilateral Investment Treaties Signed by China, 1992-1999

Parties	Signature			Entry into Force		
Argentina	November	5	1992	June	17	1994
Armenia	July	4	1992	March	18	1995
Bolivia	May	8	1992	September	1	1996
Greece	June	25	1992	December	21	1993
Kazakhstan	August	10	1992	August	13	1994
Korea, Republic of	September	30	1992	December	4	1992
Kyrgyz Republic	May	14	1992			
Moldavia	November	7	1992	March	1	1995
Philippines	July	20	1992			
Portugal	February	3	1992			
Spain	February	6	1992	May	1	1993
Turkmenistan	November	21	1992	June	6	1995
Ukraine	October	31	1992	May	29	1993
Uzbekistan	March	13	1992	April	14	1994
Vietnam	December	2	1992	September	1	1993
Albania	February	13	1993	September	1	1955
Belarus	January	11	1993	January	14	1995
Croatia	June	7	1993	July	1	1994
Estonia	September	2	1993	June	1	1994
Georgia	June	3	1993	March	1	1995
Lao People's Democratic Republic	January	31	1993	June	1	1993
Lithuania	November	8	1993	June	1	1994
Slovenia	September	13	1993	January	1	1995
Tajikistan	March	9	1993	January	20	1994
United Arab Emirates	July	1	1993	September	28	1994
Uruguay	December	2	1993			
Azerbaijan	March	8	1994	April	1	1995
Chile	March	23	1994			
Ecuador	March	21	1994			
Egypt, Arab Republic of	April	21	1994			
Iceland	March	31	1994			
Indonesia	November	18	1994	April	1	1995
Jamaica	October	26	1994			
Peru	June	9	1994	February	1	1995
Romania	July	12	1994	September	1	1995
Cuba	April	24	1995			
Israel	April	10	1995			
Morocco	March	27	1995			
Oman	March	18	1995			
Yugoslavia, Federal Republic of	December	18	1995			
Algeria	October	17	1996			
Bangladesh	September	12	1996			
Cambodia	July	19	1996			
Lebanon	June	13	1996	July	10	1997
Mauritius	May	4	1996	June	8	1997

Oksenberg (1990).

Saudi Arabia	February	29	1996	May	1	1997
Syria	December	9	1996	November	1	2001
Zambia	June	21	1996			
Zimbabwe	May	21	1996	March	1	1998
Congo, Democratic Republic of	December	18	1997			
Macedonia	June	9	1997	November	1	1997
South Africa	December	30	1997	April	1	1998
Sudan	May	30	1997	July	1	1998
Barbados	July	20	1998	October	1	1999
Cape Verde	April	21	1998			
Ethiopia	May	11	1998	may	1	2000
Yemen	February	16	1998			
Bahrain	June	17	1999	April	27	2000
Qatar	April	9	1999			

Sources: OECD (2003), pp. 214-216.

Development of Intellectual Property Rights Legislation

In order to enhance the countries appeal to the foreign investors, and accordingly to the shift towards a technology-promotion FDI regime, China continued its efforts regarding the development of a consistent and solid intellectual property rights legislation, as well as its commitment to international agreements.

Regarding the latter, on 15 October 1992 China was accepted by WIPO as a member of the Bern Convention for the Protection of Literary and Artistic Works and on 30 October 1992 China became a member of the UNESCO Universal Copyright Convention. Also, on 30 April 1993 China became a member of the WIPO Convention for the Protection of Producers of Phonograms Against Unauthorized Duplication of their Phonograms. China also became a member of the WIPO Patent Co-operation Treaty on 1 January 1994.

In what internal legislation is concerned, on 1 December 1993 the Law of the People's Republic of China on Combating Unfair Competition went into effect. Basic IPR laws passed in the 1980s, notably those on trademarks and patents, were also refined and expanded. The Trademark Law and its Implementing Rules were revised in 1993 to expand the range of trademarks protected to include services trademarks as well as commodity trademarks in line with the requirements of the GATT Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS). In February 1993, the NCP Standing Committee adopted the Supplementary Regulations on Punishing Criminal Counterfeiting of Registered Trademarks. Also, the Patent Law was revised in September

1992. The new law expanded the scope of patent protection to all types of technological inventions, whether new products or new techniques, including pharmaceutical products and substances obtained by means of a chemical process, foods, beverages and flavorings. Furthermore, the duration of an invention patent was lengthened from 15 to 20 years from the date of application. In addition to extending the protection of a patented process to include products directly produced by that process, the new law stipulated that the importation of patented products requires the explicit permission of the patent holder.

In parallel, recognizing that many people in China do not understand the concept of intellectual property rights, the government has endeavored efforts to educate the population by a variety of means. The promulgation of each of the laws mentioned above was followed by widespread publicity in the mass media and by the distribution of texts of the law and of explanatory videotapes. The government has also run numerous training classes to explain new IPR laws to the general population, sometimes, as in the case of the revision of the Patent Law, involving millions of people.

Moreover, the government has also devoted resources to training a large number of officials responsible for implementing IPR laws, which has been done in co-operation with WIPO and other international organizations and has included classes mounted in China and overseas.

Today, IPR education and research is conducted at over 70 higher education institutions; some major universities, including the People's University of China (Beijing) and Beijing University, offer higher degrees in IPR subjects.

Further Foreign Exchange Management Reforms

Beginning in 1994, China conducted a new round of foreign exchange management reforms. Three major changes are worth mentioning. First, China for the first time since 1949 abolished the official exchange rate and adopted a unified market floating exchange rate published daily by the central bank based on the previous closing rate in a foreign exchange market participated in by 18 designated Chinese banks and nearly 100 foreign banks doing business in China. Second, China established a foreign exchange market for financial institutions, which was expected to provide and stabilize the market exchange rate, improve liquidity, and help eliminate the black market. Finally, China abolished the foreign exchange quota retention system.

Obviously, the single exchange rate system, a stable foreign exchange market, and a relatively efficient arrangement of foreign exchange demand and supply through the

market mechanism would have a strong and positive impact on the process of RMB convertibility. As a result, in December 1996, the Chinese government announced that it would adopt IMF Article 8, removing all remaining restrictions on foreign exchange transactions three years ahead of its original target. As the first step, RMB would be convertible on current account from the start of December 1996. This included all payments for international goods and services trade repayments of loans and profit remittance. It also obliged China not to introduce discriminatory currency practices or multiple currencies in the future.

This was an important step, which would improve the authorities' ability to use indirect monetary policy instruments to adjust external balance and stabilize the RMB. It would also greatly assist China's international traders and foreign investors.

Further Developments of the FDI Tax Policy

In 1993, China announced two important decisions relating to FDI firms: first, China decided to introduce, although gradually, national treatment for FDI firms; second, China decided to change fundamentally its old taxation system. These two major policy changes marked the beginning of the third period of taxation policy development.

It should be noted that the decision to introduce national treatment for FDI firms had two important objectives. To start with, in line with China's initial efforts to get into the World Trade Organization, it aimed at establishing a level-playing field for both domestic and FDI firms in order to meet WTO's regulations. But perhaps more importantly, this decision also represented an attempt to solve a growing problem relating to FDI inflows: the round-tripping phenomenon.

Round-tripping is a phenomenon that involves a circular flow of capital out of China (in most cases to foreign affiliates of Chinese transnational corporations) and then a subsequent "reinvestment" of this "foreign" capital back in Chinese territory. Through this scheme, Chinese investors manage to avoid the regulatory regime governing domestic investment and to benefit from the more favorable foreign investment's regime.

It should be noted that this practice had become common use for Chinese investors. Indeed, one estimate suggested that round-tripping inward FDI accounted for 25 percent of China's FDI inflows in 1992.[88]

Aware of this situation, in 1994, the Chinese government implemented measures to reduce round-tripping incentives. As said, it initiated policy reforms aimed at equalizing

[88] Harrold and Lall (1993), p. 24.

the treatment of domestic and foreign capital, in particular, the reduction of tax incentives for FDI, and more generally, the gradual movement towards a national treatment based regulatory regime governing investment.

Pioneer Shenzhen implemented the national treatment policy in 1996. According to the regulations worked out by the Shenzhen government, preferential policies including tax incentives given to FDI firms would no longer be offered.[89]

As said, combined with the implementation of national treatment, China also profoundly reformulated its taxation system. The new taxation system, which includes Value-Added Tax, Consumption Tax, Business Tax and Individual Income Tax, took effect on January the 1st, 1994, and applied to both domestic enterprises and FDI firms.[90]

There were also changes in the tariff-free treatment granted to FDI firms on their imported equipment and construction materials. The new rules stipulated that FDI firms established after April the 1st, 1994 would pay import taxes on imported equipment and construction materials.

Obviously, from the early 1980s up to late 90s, China's tax policies for FDI have been shifting gradually from the initial tax concessions toward a more rational and consistent tax system, in a pragmatic effort to linking up with international tax disciplines.

FDI Behavior

On a yearly average, during the 1992-99 period, China attracted 37,379 FDI projects with a contract value of US$57.70 billion, which represents a 7.3 times and 10 times increase over the comparable figures for the previous 8 years (see Table 20).

In fact, immediately following Deng Xiaoping's Southern tour, FDI in China has under-gone rapid growth. In both 1992 and 1993 actual investment more than doubled. Beginning in 1993, China emerged as the largest recipient of FDI among developing countries and second in the world.

[89] It should be noted that while this FDI policy change might improve the regulatory framework in the longer term and help to overcome jealousy among domestic enterprises and abuse of the system such as round-tripping, there was also the fear that it might reduce the degree of preferential treatment for foreign investors, which might discourage some foreign investors in the short term. However, the continuing fast growth of aggregate FDI inflows into China, the more diversified sectoral distribution of FDI, and the geographical expansion of FDI into inner regions since the beginning of the implementation of national treatment have shown that the positive effect of national treatment on foreign investors was much stronger than the suggested short term discouragement to FDI inflows into China.

[90] In order not to increase the tax burden on FDI firms established prior to 1994, a five-year grandfather refund system was set up so that the actual tax burden on FDI firms under the new taxation system would not exceed the level they would have paid under the old taxation system.

Table 20: China's FDI Growth, 1992-1999

Year	Projects (number)	Growth (%)	Contracted (US$ million)	Growth (%)	Realized (US$ million)	Growth (%)
1992	48 764	276%	58 124	385%	11 008	152%
1993	83 437	71%	111 977	92%	27 515	150%
1994	47 549	-43%	82 680	-26%	33 767	23%
1995	37 011	-22%	91 282	10%	37 521	11%
1996	24 556	-34%	73 276	-20%	41 726	11%
1997	21 001	-14%	51 003	-30%	45 257	8%
1998	19 799	-6%	52 102	2%	45 463	0%
1999	16 918	-15%	41 223	-21%	40 319	-11%
Cumulative	299 035		461 667		282 576	
Annual	37 379.38		57 708.375		35 322	

Source: OCDE (2003), 190.

After 1993 FDI inflows to China started to decline. It should be noted, however, that in many ways the torrid growth in 1992 and 1993 is an inappropriate base for comparison with later FDI performance. The fact is that the previous high growth was a result of pent-up demand for FDI in 1989, 1990 and 1991.

Indeed, China had slowed down the pace of economic reforms in 1989 and 1990 in the wake of Tiananmen crisis. In number of projects, the FDI growth in 1989 and 1990 was, respectively, -3 percent and 26 percent. In contracted FDI, 6 percent and 18 percent and in actual FDI, 6 percent and 3 percent. Nevertheless, as China's economic fundamentals themselves remained quite sound, in 1992, as soon as the government signaled a change in policy, FDI growth resumed at an extremely fast pace to compensate for the artificially suppressed growth in 1989 and 1990.

Furthermore, the fall in contracted investment in the years after 1993 was also a result of China's domestic economic cycles. Indeed, economic growth had been unsustainably high in the early 1990s, which led to record price inflation. Gross domestic product expanded by a record 14 percent in 1992, setting off an inflationary spiral that peaked in 1994, when consumer prices increased by about one-forth. As early as mid-1993 (and during the following years) Zhu Rongji, then serving as both vice-premier and governor of the PBC initiated contractionary monetary and fiscal policies that eventually reduced aggregated demand and moderated price inflation. The central bank mandated the local banks to reduce lending, on the one hand, and to accelerated debt payments on the other. In fact that are evidence that part of the slower pace of FDI growth in 1994 and 1995 was a consequence of the reduced flow of round-tripping FDI, itself a consequence

of the contractionary policies. One of the first effects of the liquidity pressures was a net reduction of capital outflows. In 1994 the net capital outflow turned negative, i.e., there was a net capital inflow from the Chinese overseas subsidiaries. If a significant portion of the capital outflows were destined to come back as round-tripping FDI, then the domestic liquidity crunch would also put downward pressures on FDI inflows as well.

One piece of evidence supporting this connection is the behavior of contractual FDI. Indeed, contractual FDI inflows are extremely sensitive to the movement of capital outflows. It should be noted that, in China, a FDI contract with a foreign firm is often sufficient for entitlement to many of the FIE policy benefits. As a result, the relationship between capital outflow growth and contractual FDI growth during the early 1990s was almost on a one-on-one basis; the Pearson-correlation between the two was about 0.96. In contrast, actual FDI growth was about one-third less sensitive to capital outflow growth; the Pearson-correlation between the two was about 0.66. Thus, negative capital outflows would imply a sharp reduction in contractual FDI growth and a moderate reduction in actual FDI growth. This accords with FDI performance in 1994 and 1995.

Furthermore, FDI arrival rate actually improved in 1994 and 1995. This ratio was 0.408 in 1994 and 0.411 in 1995, respectively, as compared with 0.189 and 0.247 in 1992 and 1993. The narrowing of this gap is, in fact, a measure of the optimism on the part of foreign investors and an indication of the willingness of foreign investors to translate their pledges into actual investment projects.

To the extent that round-tripping FDI mainly boosts contractual FDI (the denominator in the calculation of the arrival rate), a reduction in round-tripping FDI improves FDI implementation. The Pearson-correlation between capital outflow growth and the FDI implementation ratio is –0.538.

By 1996 growth and inflation were down to a more sustainable single-digit level. But just as a soft landing was in sight, the Asian financial crisis hit. The crisis reduced export growth and put further downward pressure on prices, leading to slower economic growth and deflation. In response, in August 1998 China shifted from a policy of tightening to one of macroeconomic stimulus through increased expenditures that focused largely on public sector infrastructure investment (about 2.5 percent of gross domestic product). The fiscal program was supplemented with a relaxation of monetary policy, reflected in multiple cuts in nominal interest rates on loans, and other steps. The government also sought to shore up exports by increasing the share of value-added taxes rebated on goods sold internationally and, for the first time, authorizing private firms to trade directly in the international market rather than working through established state-owned trading

companies. In 1999 it also initiated new lending programs by state-owned banks to support export growth.[91] Nevertheless, the absence of capital account convertibility, relatively greater reliance on foreign direct investment rather than short-term foreign borrow and inflows of foreign equity capital, and massive foreign exchange reserves meant that, in the short run, China was rather insulated from the crisis. Indeed, and unlike the most severely affected countries in the region, China's economic growth remained well into positive territory: the value of its currency was maintained at a fixed rate and foreign capital inflows in the form of direct investment remained large.

Yet China did not go entirely unscathed by the crisis. Foreign direct investment inflows plateaued in 1998, and then declined in 1999. As a result, China's rank as a destination for foreign direct investment on a world-wide basis slipped from number two, a rank it had held for several years, to third in 1998, and then fifth, in 1999.[92] Moreover, reduced foreign direct investment and declining foreign banks lending to China contributed to a capital account deficit in 1998, the first such deficit China had recorded since 1992.

Table 21: FDI by Type, 1992-1999 (US$ million Realized FDI)

Year	EJV	%	CJV	%	WFOE	%	JDP	%
1992	6 114.6	55.55	2 122.5	19.28	2 520.3	22.90	250.1	2.27
1993	15 347.8	55.78	5 237.6	19.04	6 505.6	23.64	424.0	1.54
1994	17 932.5	53.11	7 120.2	21.09	8 035.6	23,8	678.2	2.01
1995	19 977.9	53.24	7 535.6	20.08	10 316.8	27.50	590.2	1.57
1996	20 754.5	49.74	8 109.4	19.43	12 606.1	30.21	255.5	0.61
1997	19 495.4	43.08	8 930.0	19.73	16 187.5	35.77	356.0	0.79
1998	18 388.0	40.45	9 719.0	21.38	16 470.0	36.23	179.0	0.39
1999	15 827.0	39.25	8 234.0	20.42	15 545.0	38.56	384.0	0.95
Cumulative	133 837.7	47.36	57 008.3	20.17	88 186.9	31.21	3 117	1.10
Average	16 729.713	47.36	7 126.038	20.17	11 023.363	31.21	389.625	1.10

Source: OCDE (2003), p. 195.

Regarding modes of investment (see Table 21), following the trend that started at the end of the precedent period, during the 1990s, the average proportion of WFOEs in

[91] People's Bank of China and Ministry of Foreign Trade and Economic Co-operation, "Guidelines on Credit for Supporting Exports with Foreign Inputs," and People's Bank of China, State Development Planning Commission, Ministry of Finance, and Ministry of Foreign Trade and Economic Co-operation, "Provisional Regulations on Lending to Foreign Trading Enterprises through Special Administered Accounts," both cited in PBC (2000), pp. 14-15.

[92] Bank for International Settlements, *Joint BIS-IMF-OECD-World Bank Statistics on External Debt* (www.bis.org/wnew.htm [June 21, 2000]).

total realized FDI (about 31 percent) continued to be superior to that in CJV mode (about 20 percent). Also, throughout this period and as had happened previously, EJVs continued to be the most preferred mode of direct investment in China, standing in average for 47 percent of the actual FDI in China.

In terms of sectoral distribution (see Table 22), the major proportion of FDI continued to be drawn to the manufacturing field, which took up almost 59 percent of the total realized FDI for the 1992-1998 period.

Table 22: Sectoral Distribution of Realized FDI in China, 1992-1998 (%)

Sector	1992-1998
Agriculture, forestry, animal husbandry and fishing	1.54
Manufacturing	58.63
Construction	3.25
Transport, warehousing, post and telecommunications	2.56
Wholesale and retailing, catering	3.63
Real estate	25.43
Health care, sports and social welfare	0.83
Education, culture, arts, broadcasting, film and TV	0.34
Scientific research and technical services	0.32
Others	3.48
Total	100

Source: Adapted from Wei (2003), p. 42.

Beyond aggregate statistical data, perhaps as a better reflection of the improving investment environment, especially with respect to the protection of intellectual property rights and domestic market access, a growing number of large technological multinational corporations began to invest heavily in China during this period. Indeed, there were reports that major computer manufacturers all moved rapidly to set up both manufacturing and software development ventures in China after the promulgation of the Copyright Law in 1990. According to a Chinese study, in 1991-95 FDI in the computer industry in China reached US$1.3 billion and output value generated by FDI firms accounted for 60 percent of the country's total. Leading the field in term of investment were IBM, AST, Compact, Siemens, Conner, Seagate, Phillips (Taiwan), Intel, and Hewlett Packard.[93]

Evidence also suggests that, due to the steady liberalization of China's FDI regulatory framework during the 1990s, FIEs were becoming increasingly able to capture a large share of China's domestic markets. Indeed, at the turn of the twenty-first century

[93] Cited from Jun (2000), p. 149.

foreign manufacturers led by Motorola, Nokia and Ericsson had captured 95 percent of the market for cellular phones;[94] Coca-Cola was the dominant supplier of carbonated beverages with a market share fifteen times its closest domestic competitor;[95] McDonalds and Kentucky Fried Chicken, with almost 900 outlets between them, dominated China's rapidly growing fast food market;[96] Kodak had captured half of the market for film and photographic paper;[97] Volkswagen, through two separate joint ventures, controlled more than half of the domestic automobile industry;[98] Carrefour had become China's second largest retailer only five years after entering the market;[99] and Proctor and Gamble had more than half of what is undoubtedly the world's biggest shampoo market.[100]

A further reflection of the improving investment environment in China in this period was the continued diversification of both the geographical distribution of FDI and its sources.

In terms of geographical distribution (see Table 23), there was evidence that FDI began to meander increasingly into the interior regions of the country. In fact, with the adoption of more broadly based economic reforms and open-door policies in the 1990s, FDI inflows into China have started to spread to other provinces.

Evidence of such is the behavior of FDI in Guangdong province. In fact, among the eastern region provinces, Guangdong's performance as a percentage of the total realized FDI has declined from around 40 percent in the late 1980s to around 27 percent in the late 1990s. In contrast, the shares of other coastal provinces, such as Jiangsu, Fujian, Zhejiang, Shandong, Tianjin and Hubei, have increased steadily. Furthermore, the share of central provinces has also increased during this period, from 6.9 and percent to around 9.5 percent. These figures suggest that the provincial distribution of FDI inflows has spread somewhat from the opened coastal provinces into the inland provinces.

Notwithstanding this fact, the western less developed provinces received a very small amount of FDI inflows. Their share in the national accumulated FDI stocks has been even declining from 5.1 percent in the late 1980s to about 3 percent in the late 1990s.

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[94] Landler (2000).

[95] Coca-Cola, Sprite and Fanta, the leading Coke brands, had a combined 60.4 percent market share in 2000. The leading domestic brand, Jian Li Bao, had a market share of only 3.6 percent. Shen (2001).

[96] "Starbucks in China," *Economist*, October 6, 2001, p. 62.

[97] "The Kodak Moment," *Business China*, vol. 26, November 6, 2000, pp. 3-4.

[98] In 1999 Volkswagen sold 336,000 cars in China. Total market passenger car sales were 600,000, giving Volkswagen a 54 percent market share. Agence French Press, "WTO Inspires Investment Surge," *South China Morning Post*, February 8, 2001.

[99] Kynge (2001).

Table 23: Geographical Distribution of Realized FDI in China, 1995-1999 (%)

Year	1995	1997	1998	1999
Eastern Regions	**87.7**	**85.9**	**87.2**	**87.8**
Beijing	2.9	3.5	4.8	4.9
Tianjin	4.1	5.6	4.7	4.4
Hebei	1.5	2.5	3.2	2.6
Liaoning	3.8	4.9	4.8	2.7
Shanghai	7.8	9.4	8.0	7.1
Jiangsu	13.9	12.1	14.6	15.2
Zhejiang	3.4	3.3	2.9	3.1
Fujian	10.9	9.3	9.3	10.1
Shandong	7.2	5.6	4.9	5.7
Guangdong	27.6	26.1	26.5	29.2
Hainan	2.9	1.6	1.6	1.2
Guangxi	1.8	2.0	2.0	1.6
Central Regions	**9.2**	**10.7**	**9.8**	**9.4**
Western Regions	**3.1**	**3.5**	**3.0**	**2.8**
Total	**100**	**100**	**100**	**100**

Source: Adapted from Wei (2003), p. 41.

Overall, FDI inflows in the 1990s have diffused from the initially concentrated southern coastal areas towards the southeastern and eastern coastal areas as well as towards inland areas. However, the three provincial groups of the eastern, central and western regions experienced different patterns in FDI inflows.

Indeed, for the eastern region provinces FDI inflows have been increasing steadily with a remarkably high growth rate. For the other two provincial groups, the inflows of FDI have been much less, especially for the western region provinces.

As a result, the gap between the eastern regions and the central and western regions in terms of the absolute magnitude of annual FDI inflows has actually broadened since 1992.

As said, the diversification of the geographical distribution of FDI in China during this period was accompanied by a rapid multiplication of investment sources. Indeed, there were reports that the number of FDI sources, which had been 21 in 1983, 47 in 1988, 80 in 1991, 122 in 1992, and 146 in 1993, surpassed 150 as of 1995 onwards.[101]

Striking in this period is the emergence of Taiwan as one of the main sources of FDI in China. In fact, following the establishment of the semi-official bodies (the Straits

[100] Jia (2001).
[101] *People's Daily*, overseas edition, 7 April 1995, p. 1.

Exchange Foundation and the Association for Relations Across the Straits) in 1991, the growth of FDI from Taiwan underwent a sharp increase in following years, transforming Taiwanese investors in one of the most important source of foreign capital in China.

Nevertheless, while the FDI sources were many, in truth a small number of countries alone accounted for the bulk of the sums invested, and as before, Hong Kong comes first as main source of FDI in China (see Table 24).

Table 24: Sources of FDI, 1992-1999
(% of total Realized FDI inflow per year)

	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Hong Kong	68.2	62.78	58.24	53.47	49.56	45.59	40.71	40.58
European Union	2.2	2.4	4.6	5.7	6.6	9.2	8.8	11.1
United States	4.64	7.5	7.38	8.22	8.25	7.16	8.58	10.46
Japan	6.45	4.81	6.15	8.28	8.82	9.56	7.48	7.37
Taiwan	9.54	11.41	10.04	8.43	8.33	7.27	6.41	6.45
Total	91.03	88.9	86.41	84.1	81.56	78.78	71.98	75.96

Source: MOFCOM FDI Statistics (web site).

In 1999 the Chinese leadership undertook the decision to make the broad commitments to opening the domestic market that were required to conclude the agreement to join the World Trade Organization. With this step, at the end of the century, the grounds for a new phase of the story of FDI in China have been laid. In fact, the late 1990s policy of macroeconomic stimulus combined with China's accession to the WTO resulted in a new wave of foreign direct investment inflows to the country, which would transform China in the world's leading destination for foreign direct investment for the first time in history.

Phase Four: Beyond 2000

The WTO Decision

On the 10th November 2001 at the Doha Ministerial Conference and after fourteen years of arduous negotiations, China finally became a member of the World Trade Organization in an event expected to exert broad and far-reaching influence on every aspect of Chinese social and particularly, in its future economic development.

In fact, China's leaders expect to leverage the increased foreign competition inherent in its WTO commitments to improve the productivity of its inefficient, money-losing state companies. Also, they hope to hasten the development of a much needed commercial credit culture in the Chinese banking system.

Nevertheless, although more competition may eventually help improve productivity, in the short run unemployment will almost certainly increase potentially contributing to social unrest.

In fact, viewed under this perspective, China's adherence to WTO constitutes a gamble of historic proportions.

Perhaps the most important background factor to explain China's decision to submit itself to this challenge is that the regime, since the beginning of the reform process, increasingly has staked its legitimacy on its ability to deliver sustained improvements in consumption and living standards to the Chinese people. Indeed, although China's leaders have hotly debated many of the details of economic reform, the view that economic growth is the *sine qua non* for retaining political power seems almost unanimous.[102] Following this line of reasoning, if China's top Communist Party leadership believe that increased international competition will sore up the medium- and long-term performance of the economy, it may have become more willing to incur the short-term economic and political cost of restructuring associated with WTO accession as a way to insure its long-term political future.

[102] Lardy (2002), pg. 11.

WTO Commitments on FDI

China has made substantial commitments in trade and investment liberalization upon accession to the WTO.[103] Indeed, to secure accession, China signed treaties with a number of countries guaranteeing not only further lowering of trade barriers but also increased market access for foreign investors. In fact, WTO accession necessitated progressively opening up a range of services sectors, the removal of trade-relates investment measures and the implementation of trade-related intellectual property rights in compliance with WTO rules.

As a result, a wide range of service sectors is being progressively opened to foreign investors, with geographical, business scope and ownership restrictions generally being phased out over a period of not more than five years. The level of market access to foreign investors already available at the date of WTO accession was guaranteed by grandfathering clauses in the accession agreements.

The service sectors being open include financial services (banking, securities and insurance), distribution (wholesalers, retailers and franchising), business services (legal services, accounting, auditing and bookkeeping, management consultancy and tax services, architectural, engineering and business planning services, oilfield services, computer services, advertising, translation and interpreting), communications (courier services, telecommunications and audiovisual), travel and tourism (travel agencies and tour operators, hotels and restaurants), healthcare (medial and dental), environmental services and education (schools and educational services).

Furthermore, in addition to the opening up of specialized distribution services to foreign investors, China is also committed under its WTO accession agreements to phase out all restriction on distribution of most products by FIEs within three years after accession. This means that foreign-invested manufactures are now able to distribute their own products throughout China and do not have to depend on local intermediates. They are also able to provide a full range of after-sales services.

Moreover, FIEs were previously denied full rights to import and export goods of all kinds (although they could always import machinery and production inputs for their own use and import their own products) by the imposition of such requirements as export performance, trade or foreign exchange balancing and prior experience as criteria for

[103] China's commitments are outlined in the Protocol of Accession of China and the Report of the Working Party on the Accession of China. The protocol includes nine annexes as well as China's schedule of tariff and services commitments. All of these are legally binding. The accession documents are available on the WTO web site www.wto.org.

obtaining or maintain the right to import and export. Since accession to the WTO, they are no longer subject to such import and export restrictions.

Also, FIEs are now accorded national treatment, or in other words, treatment no less favorable than that accorded to domestic individual and enterprises, which respects to the procurement of production inputs and the conditions under which goods are produced, marketed or sold in the domestic market and for export. It respects also to prices and availability of goods and services supplied by national and subnational authorities and public or state enterprises. Furthermore, the national treatment of FIE is to occur in a vast array of areas, namely transport, energy, basic telecommunications, other utilities and factors of production. Discrimination against FIEs or against imports in the making of purchases and sales by state-owned and state-invested enterprises is also not permitted, nor may the Chinese government influence, either directly or indirectly, commercial decisions of such enterprises, including decisions on quantity, value or country of origin of any goods purchased or sold, in a manner inconsistent with WTO rules.

Complying with WTO Rules

After China's accession to the WTO, the Chinese government's efforts to improve the FDI legal framework and overall foreign investment environment continued, but now, taking in consideration the organization's basic principles and its relevant rules.

These basic principles - the principle of non-discrimination, the principle of transparency and the principle of trade liberalization - called for Chinese foreign investment legislation to be reformed in a rather fundamental way. Also, the specific rules of relevant agreements under the WTO, such as TRIMs, general agreements on trade measures (GATs) and TRIPs brought about very definite challenges to the relating provisions of the existing legislation.

As a result, the Chinese government had to take special efforts to sort out all the laws, regulations and other regulating documents concerning foreign trade and economic co-operation in order to clear away those not compatible with the WTO rules.

Following the requirements of the TRIMS under the WTO, the Chinese government has revised the Chinese-foreign Equity Joint Ventures Law, the Chinese-Foreign Contractual Joint Ventures Law, and the Wholly Foreign-Owned Enterprises Law, as well as its respective Implementing Rules.

As these underlying laws and regulations directly govern the establishment and management of the foreign-invested enterprises, the amendments meant to get rid of the contents concerning the requirements of balance of foreign exchange payments, local content, export performance as well as the report of the production plans. The former three requirements were considered to limit or distort the normal trade, which under WTO is forbidden by the TRIMS. The last item was considered to be no longer appropriate or necessary because of the ongoing establishment of a market economy system.

China is also seriously carrying out its undertakings under GATs. Accordingly, Chinese government has promulgated administrative regulations and departmental rules for specific sectors in the service trade areas. Just to name a few, the Administration Provisions for Foreign-Invested Telecommunications Enterprises, the Administration Regulations for Foreign-Invested Insurance Companies, the Administration Regulations for Foreign-Invested Financial Institutions, and the Administration Regulations for Representative Offices of Foreign Law Firms in China.

Further, in April 2002 the Chinese government has newly issued the Provisions for Guiding the Directions of Foreign Investments and the Guiding Catalogues of Foreign Investments, or the 2002 FDI Guideline. This aimed not only to make the foreign investment policies coherent to the WTO rules, but also to fully tap the advantages of the international industry structure adjustment by utilizing foreign investment in combination with the strategic adjustment of national economic structure and the reform of state-owned enterprises.

It should be noticed that in contrast with the FDI Guideline issued in 1997, the 2002 version has four changes in terms of the contents. Firstly, the items under the classification of encouragement increased from 186 to 262, while those under the heading of restriction decrease from 112 to 75. Also, the municipal networks of gas, heat and water supply and drainage have unprecedentedly been classified as open for foreign investment. Secondly, in line with the promises made by the Chinese government upon WTO entry, the sectors of banking, insurance, commerce, foreign trade, tourism, telecommunication, transportation, accounting, auditing and legal service have all been open in a more widely and deeply manner, not only in terms of territory, but also in quantity, business scope, requirement for share ratio, and timetable. Thirdly, in order to promote industries and products improvement through market competition, FDI has also been permitted in the production of general industrial products. Finally, foreign investments in the preferential industries of the Western Areas are now greatly

encouraged by the loosening of restrictions concerning both share ratio and allowable industries.

As seen previously, China had already legislation in place governing copyrights, patents and trademarks. Nevertheless, to fully comply in terms of legislation with the requirements made by TRIPs under WTO, China has enlarged the scope subject to the intellectual property right protection, prolonged the protection terms and intensified the steps for protection. Accordingly, China revised the Patent Law, the Trademark Law, the Copyright Law and the Computer Software Protection Regulations, as well as the respective Implementing Rules. Integrated Circuit Layout and Design Protection Regulations were also promulgated.

It should be noted that, from the Chinese government standpoint, making new regulations and amending the existing ones relating to this matter is not only needed to meet the TRIPs requirements, but perhaps more important, it is mandatory to assure that post-WTO China successfully continues to attract high-quality FDI.

Along with the legal environment improvement in China, presently the Chinese government is also taking measures to better the administrative environment being the most conspicuous one of these the launching of an administrative approval system reform. Indeed, the traditional administrative approval system was an old practice to allocate resources and manage economy under the planed economic system, and although the WTO system itself contains few rules directly relating the administrative approval, the foundation of market economy upon which the WTO system is established strongly challenged the Chinese traditional administrative approval system.

In conclusion, after three decades of reform, and particularly after WTO accession, China has ended the experimentalism and regional particularism that has characterized FDI policies throughout the reform years, and is moving rapidly towards international practices, open market economic rules and international integration.

FDI Behavior

Foreign direct investment inflows were strong throughout the period 2000-2003, with an annual average of 30,935 projects signed. This corresponded to an amount of US$82.354 billion and US$48.461 billion in contracted and actual FDI, respectively (see Table 25).

Table 25: China's FDI Growth, 2000-2003

Year	Projects (number)	Growth (%)	Contracted (US$ million)	Growth (%)	Realized (US$ million)	Growth (%)
2000	22 347	32%	62 380	51%	40 715	1%
2001	26 140	17%	69 195	11%	46 878	15%
2002	34 171	31%	82 770	20%	52 740	13%
2003	41 081	20%	115 070	39%	53 510	1%
Cumulative	123 739		329 415		193 843	
Annual	30 934.75		82 353.75		48 460.75	

Sources: MOFCOM FDI Statistics (web site).

Indeed, FDI inflows during this period reflected foreign investors expectations surrounding new market openings tied to China's WTO entry, new opportunities related to the preparations for the 2008 Beijing Olympics as well as the government's push to build up the nation's infrastructure. These numbers also reflect foreign investors' confidence in China's lone significant growing economy during the global economic downturn.

During the year 2000 and in comparison with the previous year, China witnessed an increase of 32 percent in newly signed projects. The rise for contracted FDI was of 51 percent, reaching US$62.380 billion, while actual FDI amounted to US$40.715 billion, only 1 percent higher than the number for the previous year. Nevertheless, as a consequence of several multibillion-dollar deals signed in 2000[104], in 2001 a new record level of $US 46.878 billion was reached in utilized investment, surpassing even the US$45.463 billion record set in 1998. Also, during 2001, the value of new contracts rose to the highest level of commitments since 1996 reaching US$69.195 billion.

It should be noted that these gains occurred despite the fact that the growth of utilized investment slowed in mid-2001 and particularly after September 11. In fact, utilized investment rose more slowly in the fourth quarter of 2001 than in the first three,

[104] In these were included companies such as Motorola, Nokia Corp., Royal Duch/Shell Group and Basf Group.

reflecting both the high level of utilized investment that occurred in the fourth quarter of 2000 (which provided a higher basis for comparison) and the post-September 11 environment.

In 2002, as previously noted, China's FDI inflows surpassed those of the United States, making China the world's leading destination for foreign funds for the first time in history. The 2002 annual increases in both contracted and utilized FDI, of 20 percent and 13 percent, respectively, were particularly striking in light of the fact that overall world FDI flows declined in 2002 for the second consecutive year.[105]

In 2003, China actually utilized US$53.510 billion of FDI, up only 1.44 percent from the previous year, was much lower than the growth achieved in 2002 (as said, 13 percent). It was also much lower than the expected figure of US$57 billion.

It should be noted, however, that in the first half of 2003, despite the onset of SARS, China's actual use of FDI was US$31.172 billion, up 32.87 percent from the previous year. On average China received more than US$5 billion of FDI for each 2003 first semester month. A calculation based on this rate of growth shows that the amount of FDI that China used for 2003 was likely to exceed US$60 billion. Nevertheless, investment growth rates in China began to rapidly plummet in August 2003. The amount of FDI in China for August 2003 was only US$3.32 billion, down 28.28 percent from same period of the previous year. This decline continued through September to November. The amount of FDI in China for these months was US$3.568 billion, US$3.318 billion and US$3.598 billion. This has even led to public concerns that the annual growth of FDI in China would become a negative figure, which at the end didn't happen.

There are some reasons that not only explain the 2003 disappointing figures, but that also show that they do not represent a tendency considered expectable in the near future. First, the outbreak of SARS created a severe economic and social aftermath. Indeed, it dampened the progress of all FDI projects on the agenda and has postponed the implementation of ongoing FDI construction projects in a process that affected more than 500 such projects, which exceeded US$10 billion in total. Second, international investment still remained at low levels. Indeed, the global FDI for 2003 was US$653 billion, US$2 billion up from 2002. However, the global FDI for 2000 was US$1.49 trillion, more than double the figure for 2003. Third, the growth in FDI in the US began to recover. The annual FDI in the US for 2003 jumped to US$86.6 billion, nearly double the figure for 2002. In 2003, FDI flew into the US faster than any other country. Finally, the overall world

[105] Global FDI fell 50 percent in 2001 and 25 percent in 2002.

competition for FDI has become increasingly fierce. China's neighboring countries have done all they can to divert as much FDI from the country as possible.

Regarding modes of investment, throughout the 2000-2003 period WFOEs remained the vehicle of choice for foreign investors (see Table 26).

In annual average, WFOEs made up 62 percent of the number of newly signed contracts, 66 percent of the contracted FDI, and 56 percent in actual FDI. Nevertheless, as foreign investors, to access the WTO-induced market openings in services, must take on Chinese partners, EJVs during this period maintained an average share of 33 percent of the newly FDI inked projects, 25 percent of the contracted capital, and 31 percent of the actual amount utilized.

Table 26: FDI by Type, 2000-2003 (US$ million Realized FDI)

Year	EJV	%	CJV	%	WFOE	%	JE	%
2000	14 343	35.23	6 596	16.20	19 264	47.31	382	0.94
2001	15 754	33.61	6 212	13.25	23 873	50.93	511	1.09
2002	14 992	28.43	5 058	9.59	31 725	60.15	272	0.52
2003	15 392	28.76	3 836	7.17	33 384	62.39	330	0.62
Cumulative	60 481	31.20%	21 702	11.20	108 246	55.84	1 495	0.77
Average	15 120	31.20%	5 426	11.20	27 062	55.84	374	0.77

Sources: MOFCOM FDI Statistics (web site).

Regarding the sources of investment, during the period 2000-2003, Asia continued to account for the overall bulk of FDI into China (see table 27).

Table 27: Sources of FDI, 2000-2003
(% of total Realized FDI inflow per year)

	2000	2001	2002	2003
Hong Kong	38.07	35.66	33.86	33.08
European Union	11	8.92	7.03	7.35
United States	10.77	9.46	10.28	7.85
Japan	7.16	9.28	7.94	9.45
Taiwan	5.64	6.36	7.53	7.35
Singapore	5.14	4.63	4.45	3.85
South Korea	3.70	4.21	5.18	8.39
Virgin Islands	8.77	10.80	10.90	10.80
Total	90.25	89.32	87.17	88.12

Source: MOFCOM FDI Statistics (web site).

But particularly worthy of mention during this period is the behavior of investment from free ports such as the British Virgin Islands and Cayman Islands. Indeed, actual investment from these tax heavens rose to unprecedented levels during 2001 to reach US$6.548 billion, up by nearly half from figure of the previous year (US$4.427 billion) continuing to be responsible for more than 10 percent of the total FDI into China during the following years.

Although it is impossible to track the original sources of these funds, most analysts point to two probable main origins. First, the longstanding phenomenon of PRC round-tripping of funds. Second, the ever-increasing investment by Taiwan high-technology firms that appear to be using the tax havens to flout Taiwan's restrictions on its firms' investment in the Mainland. Nevertheless, the fact is that free ports also appeal to other investors for the flexibility they offer in investment structure and exit strategy.

It should also be noted the growing share of FDI from South Korea. Indeed, in 2003 South Korean firms invested more in China than in the European Union, the United States or even Taiwan for the first time in history. Some of this investment reflects the relocation of some manufacturing facilities from South Korea to China.

But South Korea was not alone in its strategy of expanding investment in China during this period. Among many others were also Japan and US. In fact, examples of higher-profile expansions of existing foreign investments in 2002 were Eastman Kodak Co.'s move to increase its number of photo outlets in China, the formation of a chemical holding company by Japan's Kao Co., Toshiba Corp.'s buyout of its partner's remaining stake to establish a WFOE, and Exxon Mobil Corp.'s refinery expansion in South China.

In what concerns geographical distribution of FDI in China, during this period and as with the previous periods, the coastal areas were responsible for almost 90 percent of the total FDI in China. Nevertheless, as Table 28 shows, in 2003 FDI was already noticeable in the large majority of China’s provinces.

Table 28: Geographical Distribution of FDI in China, 2003 (%)

Locality	Projects	Contracted FDI	Realized FDI
Eastern Regions	**88.02**	**87.36**	**85.88**
Jiangsu	17.48	25.88	19.74
Guangdong	17.13	11.72	14.62
Shandong	12.68	10.80	11.24
Shanghai	10.86	9.34	10.22
Zhejiang	10.86	10.68	9.31
Fujian	5.53	3.72	4.86
Liaoning	5.43	5.62	5.28
Beijing	3.75	2.78	4.10
Tianjin	2.33	2.65	2.87
Dalian	2.12	1.98	1.52
Hebei	1.48	1.45	1.80
Hainan	0.40	0.20	0.79
Central Regions	**7.73**	**8.3**	**10.9**
Jiangxi	1.85	2.01	3.01
Hubei	1.24	2.02	2.93
Hunan	1.24	1.16	1.90
Anhui	1.03	0.84	0.69
Jilin	0.83	0.57	0.36
Henan	0.74	0.92	1.01
Heilongjiang	0.58	0.42	0.60
Shanxi	0.22	0.34	0.40
Western Regions	**4.25**	**4.33**	**3.22**
Guangxi	0.81	0.56	0.78
Sichuan	0.79	0.78	0.77
Shaanxi	0.59	0.66	0.62
Chongquing	0.50	0.37	0.49
Yunnan	0.40	0.39	0.16
Inner Mongolia	0.34	0.34	0.17
Xinjiang	0.21	0.18	0.03
Guizhou	0.16	0.17	0.08
Gansu	0.14	0.22	0.04
Qinghai	0.11	0.17	0.05
Ningxia	0.07	0.47	0.03
Tibet	0.12	0.04	0.00
Total	**100%**	**100%**	**100%**

Sources: MOFCOM FDI Statistics (web site).

In term of distribution by sectors, as before, investment in manufacturing continued to dominate, with more than two-thirds of China's incoming FDI flowing into manufacturing investments (see Table 29).

Table 29: Sectoral Distribution of Contracted FDI in China, 2001-2003 (%)

Sector	2001	2002	2003
Agriculture, forestry, animal husbandry and fishing	2.55	2.04	1.98
Manufacturing	70.59	71.61	70.17
Construction	2.63	1.28	1.46
Transport, warehousing, post and telecommunications	1.28	1.85	4.36
Wholesale and retailing, catering	2.02	2.01	2.07
Real estate	7.27	8.72	7.91
Health care, sports and social welfare	0.19	0.31	0.23
Education, culture, arts, broadcasting, film and TV	0.10	0.13	0.11
Scientific research and technical services	0.95	0.64	0.25
Others	12.42	11.41	12.6
Total	100	100	100

Source: MOFCOM FDI Statistics (web site).

However, it should be noted that from the previous 58.63 percent average of FDI in manufacturing (for the period 1992-98) now the equivalent share has risen to about 70 percent, in an increase of more than 10 percent.

Indeed, foreign manufacturers were positioning themselves to take advantage of the broader improvements in the business climate they expected from China's WTO accession, as falling tariffs and the removal of local content restrictions make producing in China relatively cheaper.

A larger proportion of this investment flowed into higher value-added sectors than in past years, though most investors continue to resist transferring their highest value-added operations to China. But investment increased most strongly in the electronics, telecom equipment, and chemicals sectors. Indeed, projects in telecommunications and electronics together made up the largest component of FDI in manufacturing and represented 10 percent of all utilized FDI and 12 percent of new commitments during this period. Nevertheless, growth was evenly spread among other manufacturing sectors, such as special equipment manufacturing, chemicals, and general machinery.

Another contributor to the rise in manufacturing investments has been the already mentioned relocation to China of production facilities from Japan, Taiwan, South Korea, and other parts of Asia. Indeed, Japanese companies alone moved 22 facilities in 2002 from Japan and other parts of Asia to China. Furthermore, foreign investment in the production of raw materials and intermediate inputs also picked up as foreign component

suppliers moved into the market. With this trend came the emergence of FDI-led integrated supply chains in certain regions of the country, particularly in and around Shanghai and Shenzhen.

It should also be noted that, in 2000 only, foreign companies established more than a dozen research and development (R&D) centers. In fact, at the end of that year, 110 of the Fortune 500 companies active in China had established R&D centers. However, they were not alone - Indian, South Korean, and Japanese companies were also stepping up their investment in R&D facilities.

Moreover, the scope and locations of such centers were expanding. Indeed, although most new R&D facilities were still concentrated in the telecom and software sectors, companies were also investing in auto- and food-related R&D projects. Also, more facilities were popping up outside of the traditional Beijing-Shanghai corridor, in places such as Chengdu, Sichuan and Shenzhen.

Also, as of year-end 2002, Shanghai was home to 70 regional headquarters and 37 international purchasing centers of foreign companies. Shenzhen and Beijing are also witnessing a boost in foreign companies' regional headquarters and purchasing and logistics centuries.

It should be noted that preferential policies adopted by the Chinese government have prompted some of these moves. For example, in Shanghai, transnational procurement or logistics centers set up by regional headquarters are eligible to trade internationally. Also, those with R&D functions are eligible for preferential treatment designated for the high-technology sector.

All in all, in 2003, the already 230 thousand registered and operating foreign-invested enterprises in the country continued to contribute actively to the country’s economic development.

PART III: Conclusion

As evidenced in this study, since the very beginning of the reform period, foreign investment absorption was considered to be a key component for the success of China's basic state policy of opening to the outside world. FDI was also expected to develop China's export sector and to introduce the technologies, know-how, and capital so needed for the country's long term economic development.

Accordingly, China has steadfastly adhered to its opening-up policy and has actively promoted foreign investment inflows in what have been considered to be world-renowned achievements. Indeed, as seen throughout this study, the long-term devotion of Chinese government to improving the overall China's environment for foreign investment in order to enhance its appeal to foreign investors has been a decisive contributing factor to the sustained and rapid growth in the foreign investment absorption.

As analyzed, the commitment of the Chinese government to the open up policies was translated in a positive although gradual FDI reform approach. This can been seen, first, in the shift from the establishment of the four initial Special Economic Zones to the nationwide implementation of the open policies; second, in the cautious initial permission of joint ventures to the authorization of wholly foreign-owned enterprises; third, in the initial tight foreign exchange control to ren min bi convertibility on current account; fourth, in the initial offering of tax incentives to attract FDI to the experimentation with national treatment; and finally, in the evolution from an patchy legal FDI framework to the compliance with international standards.

As also documented in this study, the gradual FDI reform approach was often defined by the leaderships' necessity of overcoming internal opposition to the reforms from the most conservative sectors of the establishment. As seen, at the beginning of the reform process and in order to nurture nationwide support for the open up policies, the political leadership limited the opening to FDI to only a few localities in which it allowed a market-based economy to develop alongside a centrally planned system. In parallel, it developed a legal framework that provided local governments with a great deal of autonomy in economic decisions in a political strategy that has created in local authorities strong incentives to grow and develop their economies. As documented, as the success of the initial experiments resulted in strong demonstration effects, support for reform became more widespread. In fact, as the reforms were implemented and started to produce fruits, even the most conservative factions of the establishment - which at first strongly opposed the entry of foreign capital in the country - were fiercely fighting for their share of foreign

investment as it was starting to be seen as indispensable for achieving the much wanted economic development of their particular economies. By this time, it was clear that China was increasingly moving forward towards a market-oriented economic structure. Indeed, a steadily building consensus within both the policy-maker circles and society at large concerning the advantages of a fuller market-driven economy had significantly reduced the potential for disruption of the reform process. The policy-makers had recognized that China's rapid economic development was a direct result of economic reform and policies of openness, and that deepening reforms and widening openness would be crucial to achieving sustained long-term growth. The policy-makers had also understood the extent to which China's power on the world stage depended upon continued economic strengthening and improved national wealth. Moreover, as the majority of the people have benefited greatly from the country's impressive economic development, a strong supportive base has been formed for pushing ahead with further reforms and openness. In fact, although this process is far from completion, the trend is irreversible as the signing of the WTO agreements testifies.

As said, today is widely recognized that China's rapid economic development was a direct result of the open up policies and economic reform. But what has been FDI's particular contribution for this amazing development?

The answer to this question in itself explains the significance of China's success in attracting FDI. Indeed, the contribution that foreign direct investment has made to the Chinese economy during the period since 1980, and especially since 1992, has been impressive:[106] FIEs have made a very tangible and significant contribution to China's economy through investments, industrial output, exports, foreign exchange, tax revenues, and employment (see Table 30).

Regarding fixed asset investment, in 1991, FDI was responsible for 4.15 percent of China's total fixed asset investment. In 1994, this proportion had risen to an astonishing 17.08 percent. In average, from the beginning of the 90's to 2003 the annual share of FDI as a proportion of total fixed asset investment in China was 11.5 percent.

In what industrial output is concerned, the share of industrial output of FIEs as a proportion of total Chinese industrial output increased from 5.29 percent in 1991 to about 35.81 percent in 2003. In addition, the value-added of FIEs as a percentage of China's industrial value added increased from 11.0 percent in 1994 to 27.22 percent in 2003.

[106] For an in-depth analysis of this issue, see for example Sun (1998) and OECD (2000).

Table 30: FDI's Contribution to China's Economic Growth, 1991-2003

Year	Fixed Asset Investment by FIEs (%)	Industrial Output by FIEs (%)	Chinese Exports by FIEs (%)	Total Foreign-Related Tax Revenues (%)	Employment in FIEs (% of total urban employment)
1991	4.15	5.29	16.8	-	0.6
1992	7.51	7.09	20.4	4.25	0.8
1993	12.13	9.15	27.5	5.71	0.8
1994	17.08	11.26	28.7	8.51	1.1
1995	15.65	14.31	31.5	10.96	1.3
1996	15.10	15.14	40.7	11.87	1.4
1997	14.49	18.57	41.0	13.16	1.5
1998	13.23	24.0	44.1	14.38	1.4
1999	11.17	27.75	45.5	15.99	1.5
2000	10.32	22.51	47.9	17.5	1.6
2001	10.51	28.05	50.1	19.0	-
2002	10.10	33.37	52.2	20.52	-
2003	8.03	35.81	54.83	20.86	-

Sources: MOFCOM FDI Statistics (web site).

FDI has also built a highly competitive and dynamic manufacturing sector for exports. Indeed, the value of goods exported by FIEs in 1993 was US$91.7 billion. In 2003, it had increased to US$240.341 billion (in an increase of 41.43 percent over the previous year alone).

In foreign exchange terms, in 2003, foreign exchange balances held in China's banks by FIEs amounted to US$65.414 billion, which accounted for 53.74 percent of the total nationwide balance (US$121.722 billion).

Regarding tax revenues, in 1992, FIEs represented 4.25 percent of China's total tax revenues. Up to 2003, this proportion had risen to an impressive 20.86 percent of China's total revenues.

Finally, FDI in China has had a tremendous impact in the creation of employment opportunities. Indeed, the creation of job opportunities - either directly or indirectly – has been one of the most prominent of FDI impact on China and particularly important in ameliorating unemployment pressures stemming from ongoing reforms of state-owned enterprises. In the coastal provinces of Guangdong, Fujian, Shanghai, and Tianjin, FIEs were responsible for over 10 percent of urban employment as of 1999.[107] Nationwide, at the end of 2000, employment in FIEs as a percent of total urban employment already represented 1.6 percent of China's urban workers.

Overall, empirical research has found that FDI direct contribution to GDP growth through capital formation is estimated to have been about 0.4 percent points to annual GDP growth in the 1990s. It also suggests that FDI has raised total factor productivity growth in China by 2.5 percent points per year during the same period. Thus, in sum during the 1990s FDI has contributed nearly 3 percentage points to potential GDP growth for China.[108]

Indeed, there is no doubt that foreign direct investment has played an increasingly important role in China's economic development in the reform era. It has contributed to investment, to output, to exports, to employment and to the coffers of central and local governments. FDI has stimulated the creation of many thousands of enterprises, often export-oriented and has thus contributed significantly to growth. It has helped forward the modernization drive by introducing new technologies and management techniques. It has introduced and spread concepts of competition and marketing and helped Chinese products to find markets abroad. It has arguably fostered the development of a more demanding and discriminating domestic consumer market, which has in turn helped to stimulate a response among Chinese enterprises. Furthermore, the investing firms enhanced China's efficiency in production and competitiveness in the world marketplace. Also, as seen, the improved openness has reinforced the efforts in system reforms, deepening and accelerating the process of economic transition.

Notwithstanding the enormous benefits that FDI brought to China, it should be noted that it as also embedded several serious negative impacts.

To start with, FDI has contributed to increase inter-regional economic disparity within China. Indeed, as a result of coastal-oriented distribution supported by government policies, FDI has reinforced factors behind the existing inter-regional economic disparity, such as divergent capital formation, technology gap, and the differences in industrial structure and human capital.[109] In this sense, by focusing on specific regions, China's FDI policy has contributed to a growing income disparity between the coastal and inland provinces and although the disparity of regional FDI distribution has been somehow reduced in the past few years, wealth differentials have continued to widen.

It should be kept in mind that China is authoritarianism's last stand. Although, for such a large developing nation, and at a first sight, the Communist Party seems to be standing up well to the stresses of an increasingly market-oriented economy, the reality is far from it. Indeed, China is under tremendous grassroots pressure for change and its

[107] Tseng and Zebregs (2002), p. 20.
[108] Ibid, p.19.

leaders are trying to keep the dikes from collapsing. As a matter of fact, Communist Party leaders are so jittery that they prevented visitors in April 1999 from laying flowers at the grave of late reformist leader Hu Yaobang on the tenth anniversary of his death for fear that the tribute could swell into anti-government protests. Also, citizens who take petitions to important government meetings are hustled away by police. Furthermore, corruption and wasteful investment run rampant, the press remains cowed and the Internet police frantically try to shut down dissident web sites as soon as they appear. Indeed, the regime is so afraid of unsupervised public gatherings that it doesn't even allow independent chambers of commerce. That a nation of 1.3 billion can afford to brook so little dissent testifies to the party's somehow fragile public support.

Under this perspective, the widening income disparity aggravated by the FDI policy followed is indeed a serious problem as it constitutes a factor potentially able of degenerating in severe social unrest and political turmoil.

Also, as seen, in its unparalleled march to the market, Chinese government has implemented economic reforms that strongly favored foreign investment. But, deeply afraid of a politically independent private sector, Chinese government has also given state firms privileged access to capital, technology and market. In result, China has today tens of thousands of randomly located small-scale state firms that possess limited production capacity and that rely on the usually illegal protectionism policies and regional protectionism adopted by their local or regional government authorities. As pointed out by official media, "prompted by self-interest, some regions have blocked the inflow of resources in great need in other areas".[110]

Indeed, based on a survey of 10,000 state-owned enterprises, the China Economic and Analysis Center under the State Statistics Bureau pointed out the "regional competition within China is far more intense than on the international market". The competition however, is "not the healthy competition of a free market".[111]

As a consequence of such regional protectionism, the existence of a large number of inefficient small-scale enterprises has restrained the growth of potentially more vigorous large-scale enterprises. In fact, and regardless of its impressive economic development, China failed to develop significant and competitive global players. In this way, the overall result of China's path to a market structure economy is a Chinese corporate landscape of a few big private companies, a mass of inefficient but still very powerful and significant state-owned enterprises and increasingly dominant foreign multinationals.

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[109] See Sun (1998).
[110] A commentary in *China Daily*, Beijing, 19 December 1996.

China's unreformed political system had a second unintended consequence: the business risks inherent in China's unreformed political system have bred a response among many Chinese managers that encourages them to pursue short-term returns, local autonomy, and excessive diversification rather than invest in long-term technological development. Indeed, most are unwilling to develop "horizontal" networks with customers, suppliers and trade-bodies – which in other countries establish technological standards and foster confidence in long-term research. It seems that, in China, a company's best defense against corruption and the direct political linkages that benefit rivals is often to avoid business collaboration entirely and instead build vertical links up to the Communist Party hierarchy and curry favor with local bureaucrats.

It should be noted that, when Chinese government permitted a new FDI trend to develop in 1990 - a shift away from joint ventures and toward WFOEs, it set the grounds for China's increasing dependence on foreign technology and investment. Indeed, although WFOE increasingly started to dominate high-tech exports, they were much less inclined to transfer technology to Chinese firms than were joint ventures, for unlike these, they were not contractually required to share knowledge with local partners. Moreover, WFOEs had increasingly more incentives to protect their technology from both domestic and other foreign firms, in order to capture a greater share of China's domestic markets.

Furthermore, the government continues to direct research spending, focusing on risky "big bang" projects (like sending a man to space). In fact, China's low wages actually provide a disincentive to such investment, since Chinese firms can often boost short-run profits by replacing capital with additional labor.[112]

Not surprisingly, therefore, foreign companies today control virtually all the intellectual property in China and account for 85 percent of its technological exports.

China has, in this way, joined the global economy on terms that reinforce its dependence on foreign technology and investment and restrict its ability to become an independent industrial and technological superpower.

Nevertheless, the outlook for China's future development potential seems quite promising, given its strong agricultural foundation, considering its long tradition of high savings and investment, its ample labor force, its continuing improvement in productivity,

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[111] AFP, *Straits Times*, Singapore, 28 January 1997 cited in Ding and Zhimin (1997), pp. 112-113.

[112] Arthur Kroeber, managing director of the *China Economic Quarterly* argues that China's "unique combination of first world infrastructure and third world labor costs" and its focus on capacity building rather than technological innovation means that corporate success are more likely to be component manufactures or processors of intermediate goods than global consumer brands such as South Korea's Samsung. Cited from *The Economist*, 8th January 2005, p. 59.

its vast market size, its improved legal and institutional base, and the enhanced capability of the Chinese policy-makers in economic management.

As said in the beginning of this study, China's success in transforming itself from an impoverished country into a leading player in the international economy is one of the most extraordinary economic development stories in the world. Indeed, nothing on this scale and within such short a time period had ever been accomplished.

Under this perspective, no matter how big are its forthcoming challenges, China's economic future looks bright.

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China Securities Regulatory Commission web site: www.csrc.gov.cn

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Shanghai Foreign Investment Commission web site: www.investment.gov.cn

U.S.-China Business Council web sites:

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Word Trade Data Base web site: www.wtdb.com

Word Trade Organization web site: www.wto.org

Abbreviations

BITs	Bilateral Investment Treaties
BOT	Built–Operate-Transfer
CCP	Chinese Communist Party
CJV	Contractual Joint Venture
EJV	Equity Joint Venture
EOE	Export-Oriented Enterprise
ETDZ	Economic and Technology Development Zone
EU	European Union
FDI	Foreign Direct Investment
FIE	Foreign-Invested Enterprise
FX	Foreign Exchange
GATs	General Agreements on Trade Measures
GATT	General Agreement on Trade and Tariffs
GDP	Gross Domestic Product
IMF	International Monetary Fund
IPR	Intellectual Property Rights
JE	Joint Exploration (Project)
MOFCOM	Ministry of Commerce
MOFTEC	Ministry of Foreign Trade and Economic Co-operation
MOFERT	Ministry of Foreign Economic Relations and Trade (previous designation of MOFTEC)
NPC	National People's Congress
OECD	Organization for Economic Co-operation and Development
OUD	Old Urban District
PRC	People's Republic of China
REITC	Regulations on Encouraging the Investment of Taiwan Compatriots
RMB	Ren min bi
SEZ	Special Economic Zone
TAE	Technologically Advanced Enterprise
TRIMs	Trade-Related Investment Measures
TRIPs	Trade-Related Intellectual Property Rights
US	United States (of America)

USCBC	U.S.–China Business Council
WFOE	Wholly Foreign-Owned Enterprise
WIPO	World Intellectual Property Organisation
WTO	World Trade Organisation