

## INTERNAL AND EXTERNAL REFORMS: EXPERIENCES AND LESSONS FROM CHINA

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In 1999, foreign direct investment in China was \$40.4 billion, a sharp drop from the \$45.6 billion of FDI in 1998. Government officials and economic analysts have voiced concerns about a further contraction of FDI and about the economic consequences associated with such a contraction. The substantial concessions—for example, over foreign equity holdings in the service sector—the Chinese government has made to the United States and European Union during the recent negotiation over its World Trade Organization accession were in part motivated by a desire to stem the contractionary trend of China's FDI inflows. Also recently, the central government has permitted local governments in the interior regions to offer greater tax benefits on foreign investors wishing to invest there. Since the coastal regions already have various tax benefit programs in place, such a measure would have the effect of bringing down the average tax rates on foreign investment activities.

The main point of this paper is to argue that attracting FDI, as a policy stance, should be of secondary importance to those domestic microeconomic and institutional reforms that seek to improve the allocation of resources in the Chinese economy. These domestic reforms would encompass, for example, removing the political, legal/regulatory, and financial constraints on China's truly private firms and tackling the state-owned enterprise (SOE) problem not as a management issue but as an ownership issue. FDI is never a goal in and of itself but a means to promote economic growth and development and, to that extent, the benefits of undertaking domestic reforms may be far greater than any policy measures that are designed to attract more FDI.

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Arguably, China's internal reforms have lagged behind its external reforms. A key measure of the extent of internal reforms is the development of private firms. Observers of the Chinese economy often use the shares of nonstate firms (in terms of output value, employment, or investment) as a proxy and short-hand measure of the destatization of the Chinese economy. Equating nonstate firms with private firms, however, runs into a serious conceptual and measurement problem. The conceptual complication arises because an accurate definition of ownership of a firm would need to address the issue of control. The World Bank and European Development Bank define the newly emerging private or privatized firms in transitional economies as those firms whose control rights are lodged in private hands. Private claims on a portion of an equity stake of a firm is a necessary but not a sufficient condition to establish the firm as a private entity because control rights can still belong to the state. Many of the nonstate firms in China—for example, those listed on the two stock exchanges in Shanghai and Shenzhen—are essentially firms in which private entrepreneurs are minority shareholders but whose control rights rest firmly with the state. In this situation, private entrepreneurs are viewed as sources of capital—either to rescue poorly performing SOEs or to finance business expansions of state-owned monopolies (such as China Telecom)—rather than as sources of sound judgment, discipline, supervision, and business acumen.<sup>1</sup>

Measurement problems are even more tangled. For example, in the official classification of firms, collective firms are often counted as nonstate firms. Yet, many of the collective firms are wholly owned subsidiaries of either SOEs or township enterprises. Thus, an entire category of nonstate firms would disappear if firms were required to release their consolidated financial statements. In 1998, industrial collective firms accounted for about 53.5 percent of the gross industrial output value of the nonstate sector.

Compared to the timid pace of internal reforms, China has pushed forward external reforms more aggressively. By a number of conventional measures, China's economy in fact is quite open. On the trade side, a large portion of China's GDP is accounted for by foreign trade. Using official exchange rate conversion, the ratio of trade to GDP is 40 percent, an extremely large share for an economy of China's size.<sup>2</sup>

<sup>1</sup>The Chinese legal regime recognizes far more rights to minority shareholders in joint ventures. The PRC joint venture regulations require crucial decisions be made by the board on a unanimous basis and gives the first right of refusal to the joint venture partner when the business is put up for sale.

<sup>2</sup>Using the purchasing power parity conversion would yield a lower ratio, but the purchasing

The extent of China's dependency on FDI is already extraordinarily high. Moreover, the gains associated with large FDI inflows have already been reaped to a far greater extent than the potential gains associated with, for example, a privatization program and the creation of a business environment that is friendly to Chinese private firms. The recent alarm over the FDI contraction notwithstanding, it is worth noting that since the early 1990s, China has been one of the largest FDI recipients in the world. In 1994, for example, China alone accounted for 49 percent of the total FDI flows to developing countries and 15 percent of the worldwide FDI flows. Not only is the absolute size of FDI large, its relative size—measured by the ratio of FDI to capital formation—surpassed that of many countries in the world. Furthermore, foreign-invested enterprises (FIEs)—i.e., joint ventures between Chinese and foreign firms or wholly owned foreign subsidiaries—have established a sizeable presence in the Chinese economy and, in a number of industries, have come to command a dominant position.

Chinese officials and the foreign business press hail China's large FDI inflows as one of the most celebrated achievements of the reform era. International agencies such as the World Bank have credited FDI as a main driver of China's economic success. International rating agencies routinely use FDI flows as an important macroeconomic indicator to assess China's creditworthiness. Standard & Poor's, for example, in its most recent report on China's credit rating, cited "strong inflows of foreign direct investments" as one of the factors to justify a triple-B long-term and A-3 short-term foreign currency sovereign and senior unsecured credit ratings on the PRC.

This paper challenges conventional wisdom on China's FDI. The central claim of this paper is that the large absorption of FDI by China is not a sign of the strengths of its economy but of its fundamental weaknesses.<sup>3</sup> There are two complementary components to this claim. First, much of the export-oriented FDI—mainly originating from ethnic Chinese firms in Hong Kong and Taiwan—materializes because of the severe liquidity constraints on the part of export-oriented Chinese firms. These liquidity constraints arise not because export-oriented Chinese firms are inefficient but because

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power parity measures are plagued by the uncertainty of exactly what constitutes the right purchasing power parity rate. If the "true" trade/GDP ratio is half of the ratio based on the official exchange rate, 20 percent of the GDP in foreign trade is still quite large.

<sup>3</sup>The argument of this paper is based on the research for a book I am currently working on. The book is tentatively entitled *Selling China: The Institutional Foundation of FDI during the Reform Era* (Huang 2001, forthcoming).

they are private and for years Chinese banks were explicitly prohibited from lending to private firms. Private firms have no choice but to raise financing in the only way they can—selling their claims on the future cashflows to foreign firms. FDI rises as a result.

Second, much of the domestically oriented FDI—mainly in capital-intensive industries—does not go toward financing the creation of new capacity but toward financing the acquisition of existing assets from SOEs, which have accumulated massive financial losses and have huge unfunded explicit and implicit liabilities on their balance sheets. The insolvency of the SOEs is a familiar story. What is not familiar is the fact that SOEs have built up a potentially valuable asset base during the reform era, which was financed by a generous infusion of subsidized credit from the banking system. On top of a good asset base, SOEs have generated a thin or close to negative cashflow, rendering them potential acquisition targets. To make my account complete, because the government explicitly shuns a privatization stance, the only viable acquirers end up being foreign firms. FDI rises on this account.

A complete account of FDI in China has to consider the fundamental failures of China's financial institutions to allocate capital efficiently. To be blunt, these failures do not stem from those constraints commonly cited by some of the leading scholars on the Chinese economy, such as underdevelopment of a social safety net, poor risk assessment capabilities of Chinese banks, lack of experience, or unintended policy mistakes. They stem, instead, from a deliberate choice the regime has made to support SOEs as both the ideological foundation of the state *and* as economically viable firms.

The paper starts with an empirical section documenting some of the salient features of China's FDI activities. It is then followed by a discussion on a number of anomalies plaguing the existing explanations of FDI in China. The third section offers what I call an institutional foundation hypothesis, which argues that FDI rises in China because of the fundamental problems in the way the Chinese financial system allocates resources that have created the liquidity constraints of private firms on the one hand and insolvency of SOEs on the other. Finally, the paper concludes with offering some policy implications.

## FDI in China

Foreign investment is most commonly defined as “direct” when the investment gives rise to “foreign control” of domestic assets. Thus, according to the International Monetary Fund, FDI “is made to ac-

quire a lasting interest in an enterprise operating in an economy, other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise." In the United States, FDI occurs, according to the Department of Commerce, when a foreign investor's stake exceeds 10 percent. In China, the legal and definitional hurdle is set at 25 percent.

Between 1979 and 1997, the cumulative FDI was \$220 billion on the materialized or paid-in basis. Much of this FDI stock was invested since 1992. Between 1992 and 1997, the total FDI inflow was \$196.8 billion, which made China the largest FDI recipient among developing countries and second only to the United States. By the mid-1990s, FIEs have become a significant force in the Chinese economy. The importance of their role is first seen in the growth of FDI: between 1990 and 1997, the compound annual growth of FDI was 44 percent; the most dramatic increase occurred in 1992 and 1993, when FDI grew by 142 percent and 146 percent, respectively.

Many foreigners complain about restrictions on FDI in China but in fact China takes in more FDI as compared with many countries in the world. In 1994, FDI accounted for 6 percent of the Chinese GNP, but in the United States, by comparison, in the early 1990s, FDI investment accounted for about 1 percent of GNP. The financing role of FDI is also more important for China when compared to its role in other East Asian countries. In the early 1990s, FDI accounted for less than 5 percent of fixed asset investments in Korea and Japan, although in the wake of the Asian financial crisis, FDI increased substantially in Korea where asset values have fallen sharply.

The absolute size of FDI, however, is misleading. Countries vary in their economic and market size, so the size of FDI flows ought to be gauged relative to the size of the host economy. The absolute size of FDI flows for the United States in 1996 is twice as large as the Chinese FDI, but the U.S. economy is roughly seven times as large (on the basis of official foreign exchange conversion). In that sense, the United States is less "dependent" on FDI than China is even though the absolute size of FDI flows is much greater in America. A more useful measure is the ratio of FDI to capital formation, where capital formation is defined as the total fixed asset investments made by foreign and domestic entities in a given year. Empirically, this ratio indicates the relative importance of FDI to a country's economy. Conceptually, the FDI/capital formation ratio is driven by the willingness on the part of foreign investors to invest in a country relative to the willingness on the part of domestic investors to do the same. If the FDI/capital formation ratio increases within a short period of time (as it did in China in the 1990s), this would raise an interesting

TABLE 1  
RELATIVE FDI SIZE AND OTHER MACROECONOMIC  
VARIABLES, 1993–97

	Ratio of FDI to Gross Fixed Capital, 1993–97 (%)	Gross Domestic Savings Rate, 1994–97 (%)	Current Account Relative to GDP, 1994–97 (%)
China	14.56	41.76	2.74
Brazil	5.32	20.13	-0.765
Mexico	15.32	21.35	0.53
India	2.40	21.15	-2.64
Singapore	27.04	50.92	16.4
Thailand	3.76	37.97	-6.28
Hong Kong	10.24	31.92	-1.35
Taiwan	2.78	—	—
Korea	1.06	35.71	-1.78
Malaysia	14.12	39.98	-0.75
Chad	20.42	-5.2	-17.83
Uganda	13.12	5.94	-9.37
United States	6.38	15.57	-1.61
Canada	8.28	20.37	1.71
United Kingdom	12.4	14.71	-0.943
Hungary	27.94	21.94	-2.52
Ireland	15.5	29.8	14.91

SOURCES: FDI data are from the United Nations Centre on Transnational Corporations (1998); economic data are from World Bank (2000).

research question about why foreign and domestic investors should view the same market dynamics differently.

Table 1 presents data on FDI/capital formation ratios of China and a number of other countries for a comparative perspective. Between 1993 and 1997, FDI flows accounted for about 15 percent of China's total capital formation. Only Singapore, Chad, and Hungary have a substantially higher ratio. Even though the United States attracted a greater amount of FDI, the relative importance of FDI in the case of the United States is far smaller than it is in the case of China. For the United States, FDI only accounts for some 6 percent of total investment; China's FDI dependency is almost three times as large. It is worth noting that China is commonly viewed as a closed and controlled economy, yet its FDI dependency is higher—and in some cases substantially higher—than the completely open economies such

as the United States (6.38 percent), United Kingdom (12.4 percent), Hong Kong (10.24 percent), Thailand (3.76 percent), and Malaysia (14.12 percent).

To a large extent, the FDI/domestic capital formation ratio at the national level belies the true extent of China's dependency on foreign capital. FDI dependency is deep in pockets of China, especially in the coastal areas. In the 1990s, FDI inflows contributed to a quarter of Guangdong's capital formation; for Fujian province, the figure was 20 percent. In parts of Guangdong, such as Shenzhen, capital inflows exceed 50 percent of the capital formation (Kueh 1992). FIEs have played a unique role in China's reform process. Much of the economic studies of Chinese reforms focuses on the entry of nonstate firms such as TVEs, and the idea is that China will "grow out of the plan" without explicit privatization by allowing the creation of new, private firms (Sachs and Woo 1994, Naughton 1996). However, the role of FIEs is arguably more significant, for two reasons. One is that ownership patterns of the Chinese economy are diversified at the firm level in the case of FIEs, not just at the industry or regional level as in the case of TVEs. By definition, many FIEs—which are joint ventures—are owned by separate legal entities and many of the Chinese shareholders are traditional SOEs. As such, state ownership is directly diluted and managerial practices of foreign investing firms have a stronger impact on the traditional SOEs while the effect of the TVEs on the SOEs is mainly via competition on product, labor and, to some extent, asset markets.<sup>4</sup>

### Why Conventional Wisdom Is Wrong

Most of the explanations about why China has absorbed so much of the FDI are of two stripes. The first type of explanation focuses on the motivations of foreign investors investing in China. Both academic and business analysts tout China's attractive economic fundamentals as drivers of FDI inflows. These fundamentals include a fast growing market and relatively cheap—but skilled and disciplined—labor force. The second type of explanation focuses on China's motivations for seeking FDI. Many analysts have taken as given the benefits to China associated with large FDI, such as an alleviation of capital

<sup>4</sup>Take Guangdong Provincial Freeway Development Company (GPFDC) as an example. GPFDC was formed by the Guangdong Provincial Freeway Company, an arm of the provincial authorities, with the intention to attract foreign and private capital. GPFC injected its operating assets—bridges and expressways—as its equity contribution to GDFDC, and 5 percent of the equity stake was placed with a Malaysian company and another 31 percent was sold as "B" shares to foreign investors at the Shenzhen Stock Exchange. As of 1996, the GPFDC's equity stake was 45 percent (World Bank 1997).

shortage and technology and know-how transfers. However, these two explanations are insufficient to explain the full scale of China's FDI situation.

Foreign investors' motivation is an inadequate explanation for two reasons. One is that while good economic fundamentals may drive up the absolute size of FDI inflows into China, it is not a good explanation as to why the relative size of FDI, as measured by the FDI/capital formation ratio, has also grown over time. The reasoning is straightforward. Suppose the Chinese market for washing machines has grown exponentially because of strong income growth. This market strength should be an alluring factor to both foreign and domestic firms—that is, domestic firms should be as motivated as foreign firms to invest, leading to a surge in total investment. The ratio between foreign and domestic investments should not change as much, at least not as drastically as it did in China in the 1990s, when the FDI/capital formation ratio rose from nil at the beginning of the decade to about 18 percent in 1994, and to around 12 percent in 1999. Investment is money a firm puts down today in the belief that it will yield a greater payoff in the future. If, in the 1990s, foreign investors put down more money for investment in China than domestic investors, it would imply that for some reason foreign investors believed that they were better positioned to take advantage of China's market growth opportunities and that domestic investors were somewhat less optimistic than foreign investors about future market potentials. In fact, during the 1990s, not only did domestic investors invest at a lower rate, many domestic firms were divesting from their existing product lines, such as washing machines, autos, and refrigerators—the kinds of products closely linked to income growth. A rigorous explanation ought to address this apparent divergence in beliefs between foreign and domestic investors.

China's cheap labor supply is putatively another motivating factor, according to many of the accounts, but this explanation is equally flawed. The reason is that there are many forms of relationships (commonly called alliances in the academic literature) foreign firms could use to take advantage of the cheap labor in China other than FDI. As an equity arrangement, FDI is simply one in the universe of numerous alliances between foreign and domestic firms. Other alliances include subcontracting, licensing, and asset leasing. A firm based in Hong Kong or Taiwan can take advantage of China's cheap labor by subcontracting out manufacturing operations to Chinese firms. There is nothing about cheap labor per se that requires foreign firms to take an equity stake in an operation located in China. Indeed, in the area of labor-intensive production, contractual alliance is a

common business method in cross-border economic activities in other developing countries. Garment firms in India, Turkey, Thailand, and Columbia supply their output to MNCs such as Adidas, Nike, Laura Ashley, which, over the years, have all but subcontracted out their manufacturing operations in order to specialize in marketing and brand management. Contractual alliance is a standard practice in labor-intensive industries elsewhere, but for some reason equity alliance is the norm in China. This difference needs to be explained and a good explanation has to address why an equity arrangement is a more viable business alliance to take advantage of cheap labor than a contractual alliance in China.

It is important to ask what the Chinese get from FDI. Again, the conventional explanations that FDI brings capital and technology to China should not be accepted at their face value. There is no evidence that shortage of capital is a driver of FDI inflows because China is not short of capital. In the 1990s, China has had one of the highest savings rates in the world, at 41.76 percent between 1994 and 1997. The puzzle is that China's reliance on FDI deepened at a very time when the capital shortage was being alleviated. By all indications, China should be awash in capital. China's savings rate rose from an initially high level throughout the reform era. Between 1986 and 1992, the savings rate hovered around 36 percent but between 1994 and 1997, the savings rate rose to 42 percent, second only to Singapore's 51 percent.<sup>5</sup> The acceleration of the savings rate coincided closely with an explosive growth of FDI. Thus, China imported more capital when it saved more and imported less capital when it saved less! As Table 1 shows, on average between 1994 and 1997, China exported capital to the rest of the world to the tune of almost 3 percent of its GDP. The large FDI inflows, on top of large current account surpluses throughout much of the 1990s, led to a huge accumulation of foreign exchange reserves, to the tune of \$168.3 billion as of December 2000.

Foreign exchange reserves are China's claims on dollar assets. When FDI inflows are financing the growth of China's foreign exchange reserves, that amount of FDI is not used productively to develop the Chinese economy. According to the *Wall Street Journal*, China invested about an estimated 40 percent of its foreign exchange reserves in U.S. Treasury bonds (Smith 1998). This is surely a strange outcome. The Chinese are striving to give up the ownership of their economy only to use the capital surpluses to invest in low-yielding government bonds in America. In a country of poor peasants, China

<sup>5</sup>The savings rate is defined as the difference between GDP and final consumption divided by GDP. The data are reported in State Statistical Bureau (1998).

borrowed heavily from the rest of the world—and, as will be illustrated later, lends sparingly to domestic private firms—so that it can finance government spending in the industrialized countries.

The technology rationale is also problematic. To be sure, some FDI projects bring technology—broadly defined to encompass not just hardware technology but also organizational and managerial know-how—to China but it is important to distinguish between hardware know-how and organizational/managerial know-how. Hardware know-how refers to the technical knowledge about operating and utilizing advanced machinery and equipment, while organizational/managerial know-how refers to the knowledge to operate a firm efficiently. The industries in China with the largest share of FDI are often those with a low capital content and low “knowledge worker ratios” (i.e., engineers to blue collar worker ratios). In the 1990s, FDI originating from Hong Kong and Taiwan accounted for between 50 to 70 percent of China’s total FDI inflows and much of this kind of FDI contains a low content of the hardware know-how. Many Hong Kong and Taiwanese simply capitalized their standard and mature equipment and machinery as equity stakes in FIEs in China. In the standard account, FDI materializes only when the know-how needed to operate the capital assets cannot be disembodied from the capital itself. Given the high degree of maturity and standardization of the capitalized equipment, it is a mystery why Chinese firms could not simply import these items. It would have been a win-win situation for both sides. For the Hong Kong and Taiwanese firms, their equipment and machinery had been rendered increasingly uneconomical because of rising labor costs since the late 1970s, and the opening of China would have provided an opportunity for these two economies to transition very quickly to service economies.<sup>6</sup> Not only is there thin evidence of “hardware technology transfer,” some researchers have reported on “negative technology transfer” associated with FDI—that is, Chinese firms possessed more advanced hardware than the investing firms from Hong Kong and Taiwan (Young and Lan 1997). Thus, the overseas Chinese firms invest in China not to transfer technology

<sup>6</sup>Despite the image of Hong Kong as one of the most important financial centers in the world, manufacturing and its ancillary operations were still an important part of Hong Kong’s economy until quite recently. In 1993, manufacturing employment accounted for 22.6 percent of the total employment. Thus, at a per capita income greater than that of Great Britain and at a rental price several times that of Manhattan, Hong Kong still retained a substantial tie to labor-intensive manufacturing activities. I argue in my book that this is strongly related to the fact that investing in China was made cheaper for Hong Kong manufacturing firms because of the institutional configuration of the Chinese economy. This allowed Hong Kong firms to retain their labor-intensive manufacturing operations in the territory longer than it would have been economically feasible.

but to exploit the strong research and development capabilities of the Chinese firms.

Organizational know-how transfer is harder to document because of its intangible nature, but again anecdotal and piecemeal evidence suggests that it is implausible to argue that the organizational know-how is present in all the FDI projects (numbering over 80,000 in 1993, and declining to about 20,000 in recent years).<sup>7</sup> For relatively simple and standard organizational know-how, a contractual arrangement is entirely feasible. For example, a Chinese firm can hire a retired foreign manager at a cost that would be a fraction of the present value of the future cash flows on the sold equity. For years, Korean firms did exactly that to build up their organizational and managerial expertise when the economy was shifting from light and labor-intensive industries to capital and technology-intensive industries in the 1970s.

As any business owner would know, ceding equity is an expensive way to access managerial expertise and usually one only gives up equity in the absence of alternative sources of financing. In venture capital projects, for example, debt financing is usually unavailable because banks value a stable source of cash flow while the technology entrepreneurial start-ups entail high risks (defined as high variance of their cash flows). Therefore, they have to rely on equity capital from venture capitalists who are seeking to reap the huge upside if the project succeeds. In other situations, stock options are given to managers when these managers possess hard-to-measure and intangible attributes or when the owners use stock options as a monitoring device. None of these conditions readily applies to the Chinese firms in labor-intensive and mature industries actively seeking FDI. And even if some of these conditions apply, there is no reason why foreign suppliers of capital should disproportionately be sought out at the expense of domestic capital suppliers in many situations. What is also unusual in the Chinese case is that FDI is quite prevalent in those industries in which China possesses a huge comparative advantage (such as garment and shoe making) and in those industries in which China has accumulated years of manufacturing experience and in which China should possess a deep competitive advantage at the firm level. For example, there are almost a thousand FIEs in China's handicraft industry (such as jade carving), an industry the Chinese have practiced for thousands of years. The average foreign share of

<sup>7</sup>It is interesting that, in interviews, SOE managers typically invoked importing organizational know-how as a motivation to seek out foreign joint venture partners. Often in the same conversations, they also described their reluctance to spend money on training and human resource development.

the equity of FIEs in this industry amounted to 88 percent. It is thus puzzling why China possesses deep comparative advantages in labor-intensive industries but its firms are shockingly short of competitive advantages.

### Explaining FDI in China: Institutional Foundation Hypotheses

The many anomalies identified in the previous sections of this paper call for a more rigorous explanation. I will outline a number of hypotheses below, which fit better with many of the empirical attributes of the FDI situation than the conventional explanations. The central idea of this new approach is that FDI plays such an important role in the Chinese economy not because all of these foreign firms are the world's best-practice firms but because they are uniquely positioned to exploit many of the business opportunities in China created by China's inefficient economic and financial institutions. Fundamentally, FDI is a microeconomic, not a macroeconomic, phenomenon. Whether a country gets more or less FDI depends on the competitiveness of its firms vis-à-vis foreign firms.<sup>8</sup> Firm competitiveness is a relative concept. To say that Chinese firms are uncompetitive relative to foreign firms could mean one or both of the following scenarios. First, foreign firms possess a deep capital base and a superior technological edge over Chinese firms. Chinese firms cede equity or market controls to foreign firms simply because foreign firms are too strong. The likes of foreign firms here would be, for example, those on the *Fortune* 500 list. The second scenario, however, envisages that Chinese firms themselves are fundamentally uncompetitive, either because efficient but private firms are denied access to the country's vast savings pool or because SOEs, heavily favored by the state, lack appropriate market-oriented incentives to perform. Both of these possibilities are observationally equivalent in that both of them would predict an important role of FDI in the Chinese economy. But they hold vastly different analytical and policy implications. Let me borrow an example from military history to illustrate the fundamental difference between these approaches toward FDI.

In 1941, Nazi Germany launched a surprise attack on the Soviet Union. The Soviet forces were woefully unprepared for this attack and suffered extremely heavy losses. German forces advanced quickly, decimated almost the entire Soviet airforce, and, in a short

<sup>8</sup>This way of analyzing FDI is more consistent with the standard academic approach toward explaining FDI. The standard approach is called industrial organization theory of FDI, which explains FDI as a function of competitive attributes of firms from a home economy over those in a host economy. For a standard illustration, see Caves (1996).

period of time, seized controls over the most productive territory of the country—accounting for 60 to 70 percent of Soviet coal, steel, pig iron, and aluminum production (Nove 1986). One line of explanation for such a devastating outcome for the Soviet Union would point to the stealth strategy of the German military, the precision of its planning and execution, the lightening speed of its tank formation, the perfect coordination between land and air assaults, and the vast superiority of its attack tactics (for example, the much-feared *blitzkrieg*).

An alternative line of inquiry would focus on the reasons why the Soviet forces were so unprepared for the German assault in the first place. To be sure, one might argue, the Soviet army might have been unable to repel the German forces at the border, but the speed and the totality of its defeat were an indication of something else at work. The fact was that the Soviet army was not only weaker than the Germans but it was completely unprepared for the German attack. What is more, this state of unpreparedness was largely self-inflicted. Between 1937 and 1938, during Josef Stalin's Great Purge, 70 percent of the Central Committee were arrested and 90 percent of the Red Army's generals were purged. The low morale and the poor training placed the Red Army in a state of paralysis on the eve of Hitler's "Eastern Campaign."

This historical analogy readily extends to our analysis of FDI in China. Some of the FDI materializes in China because the investing firms are globally competitive firms with proprietary assets, a deep capital base, and technological dynamism. (These are the commercial equivalents of the well-equipped and efficient German army.) But Chinese firms have ceded market and equity positions not only to *Fortune* 500 firms but to small and medium firms from overseas Chinese areas in highly competitive industries (thus no technological proprietary edge on the part of investing firms) and in industries—such as traditional handicraft, garment and shoe-making—in which Chinese firms ought to be quite competitive. To further extend our historical analogy, this situation, to a large extent, is self-inflicted. Domestic firms—mostly private firms—are denied access to capital and therefore they either do not pose a formidable competitive threat or they access capital from Hong Kong and Taiwanese firms via ceding their equity stakes. The fact that China gets so much FDI is a *prima facie* indication that Chinese firms are uncompetitive vis-à-vis foreign firms and an important reason why Chinese firms are uncompetitive is because of the poor allocative decisions of China's vast savings pool.

One of the most notable inefficiencies of the Chinese economic system is the inefficiency of its financial market. This inefficiency

arises from two main sources. First, assets are owned by disparate *political* rather than economic units. The first and foremost manifestation of the political control is that a vast majority of SOEs are under the direct controls of regional governments. “Control” here means broadly *de facto* ownership rights—the rights to make crucial decisions, to receive residual cash flows, and to dispose of assets. In 1995, there were 87,905 industrial SOEs, of which 83,167 were owned by the regional governments. The locally owned SOEs accounted for 65 percent of the total SOE assets and 64 percent of sales.<sup>9</sup> The ownership functions of the regional governments are complemented by the broad regulatory power in their hands. Despite central policy prohibitions, it is widely known that local governments set up trade barriers against interregional trade as well as to curtail capital exports. This means that often it is difficult for a firm located in province A to invest in province B because of the capital restraints.

This political control implies that assets are not transferable across different jurisdictions and that domestic firms are unable to engage in cross-regional investments. In effect, there is a capital control restricting capital export from one region of the country to another region of the country. The combination of the ownership and regulatory functions in the hands of regional governments has a strong impact on interregional investment patterns. Consider the contrast between Shanghai Automotive Industrial Corporation (SAIC) and First Automotive Work (FAW) in Changchun, Jilin province. In 1997, SAIC had 40.4 billion yuan in sales, a bit larger than that of FAW (34.1 billion yuan). Yet all of SAIC’s 38 subsidiaries and affiliates are located in Shanghai. FAW, despite its smaller size, made active acquisitions outside Jilin province. Its subsidiaries and affiliates are located in Beijing, Xinjiang, Shandong, Qinghuai, etc. The fundamental difference between SAIC and FAW is that SAIC is controlled by the Shanghai municipal government whereas FAW is controlled by the Ministry of Machinery Industry in Beijing and thus it is not tied to the Jilin province.

The local ownership arrangement means that foreign capital plays a unique role that would be absent under an alternative ownership arrangement. Because there are no similar constraints on the mobility of foreign capital, foreign firms are free to fund operations wherever there is a capital shortage, but domestic firms are constrained from doing the same. This means that foreign firms have many more projects to choose from than domestic firms and that, for any given

<sup>9</sup>The data are from the 1995 industrial census (see Office of Third Industrial Census 1997).

fundable project, foreign firms are essentially competing with each other rather than having to compete with domestic firms as suppliers of capital. This dynamic plausibly explains why China can have high FDI inflows while having the world's highest savings rate. Capital-rich regions or firms export capital to foreign countries via large trade surpluses because domestic investment opportunities are limited by regulations and policies. Capital-poor provinces import capital from foreign countries to make up for the shortage. The overall effect is that foreign companies have come to play an arbitrage role that is lacking in the domestic financial market and thus have acquired a greater financing role in the Chinese economy given the enormous financial market inefficiency in the form of financial segmentation along the regional lines.<sup>10</sup>

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

Another source of financial market inefficiency has to do with the well-known failure on the part of the Chinese banks to channel credits to their most productive uses. The lending bias operates in two ways. One is that an overwhelming proportion of the credits is directed toward SOEs, which account for over 70 percent of the bank lending—even though their output shares have declined to 40 percent. Nonstate firms, while more productive and profitable, were starved of credit financing during the entire reform era, until recently when the government removed credit quotas in late 1997 (McKinnon 1994). Lending bias also means that banks are serving a heavily re-

<sup>10</sup>There are specific examples of foreign companies playing this arbitrage role. China Strategic Investment's typical approach is to finance its acquisitions from the proceeds from revenues generated by the previous acquisitions. This strategy enabled it to acquire some 200 companies between 1992 and 1994 even though its sale revenue in Hong Kong amounted to only \$80 million.

distributional function across regions that the budget of the Chinese central government inadequately provides for. There is strong evidence that the central bank's refinancing—enforced via the excess reserve requirements on the specialized banks—redistributes financial resources from deposit-surplus regions to deposit-deficit regions. Deposit-deficit regions—i.e., regions that lend more than they have deposits for—are northeastern provinces that are the strongholds of large and heavily loss-making SOEs. Deposit-surplus regions are typically liberal southern provinces, such as Jiangsu, Zhejiang, and Guangdong, that have a fast-growing nonstate sector. The unfortunate result of this arrangement is a substantial financial disintermediation on the part of the Chinese banks. The banking system owes huge liabilities to the efficient and thrifty private sector. The funds are then channeled to finance not just maintenance but also expansion of the state sector. Given that the funds are flowing from an efficient to an inefficient sector, it is not surprising that the banking system has accumulated a huge amount of nonperforming loans (variously estimated between 25 to 40 percent of the total loan portfolio).

One of the consequences associated with this lending bias is that efficient but private firms are denied access to China's vast savings pool and are too liquidity-constrained to finance their business expansions. Spotting a potentially profitable opportunity, foreign firms, especially those from Hong Kong and Taiwan, become the suppliers of capital to the liquidity-constrained but fundamentally sound business operations. This is one of the most important reasons why FIEs dominate China's labor-intensive industries. In industries such as garment and shoe-making, Chinese private firms ought to have possessed strong competitive advantages, but the poor allocative decisions of the Chinese financial institutions imply that a severe mismatch between human and financial capital exists—that is, efficient private firms cannot get financing whereas inefficient SOEs are favored. The outcome of this allocative pattern is that private entrepreneurs access capital—sometimes short-term capital—by selling their own equity shares to MNCs based in Hong Kong and Taiwan.<sup>11</sup>

Another inefficiency has to do with foreign exchange allocation. In the 1980s, Chinese firms could not get foreign exchange because there was no foreign exchange market. There is the beginning of one

<sup>11</sup>One nonstate company I interviewed in Suzhou possessed very advanced know-how to make precision machinery and its products were exported to many countries. Because of its nonstate status, it could not secure any credit financing from Chinese banks. Thus, it formed a joint venture with a Hong Kong trading firm, which had marketed its products abroad but had little technical know-how, in order to secure the needed capital.

now, but it still has a lot of restrictions. A good firm that is producing for the domestic market, that is making lots of money and has good profits, might need foreign exchange to import equipment. Apart from the illegal black market, a common method for Chinese firms to access foreign currency outside the bureaucratic allocation is to go to a foreign investor, who would demand an equity stake. Although the original need is a short-term need, once the company has given up part of its ownership, it has, in effect, relinquished its control over its assets in perpetuity. To put it differently, the absence of an efficient foreign exchange market artificially reduces the present value of the assets of Chinese firms. Because foreign exchange is allocated administratively, much of the official allocation has gone to SOEs to satisfy their import needs. Export-oriented private firms find it extremely difficult to access foreign exchange as result. Since foreign exchange is a critical resource for export-oriented firms, as they need to source quality components and machinery from abroad in order to produce quality products, domestic private entrepreneurs need to cede their equity stakes to firms based in Hong Kong and Taiwan to access foreign exchange. In these two illustrations, the financing roles of foreign firms arise not because China is short of capital but because its financial allocation is hugely inefficient. And it is this type of inefficiency that has prevented production linkages between Chinese and foreign firms based on a contractual arrangement. A contractual arrangement brings forth a business opportunity to a Chinese entrepreneur but not resources and machinery necessary to convert that opportunity into profits. FDI is then favored because it brings forth both a business opportunity and necessary resources. An equity arrangement, FDI, is favored not because it is intrinsically superior but because the contractual alternative is rendered unviable.

Probably, the most profound failure of the Chinese financial institutions is that they systematically favor the least efficient firms, SOEs, at the expense of the most efficient firms, such as private firms. This lending bias creates two sources of demand for FDI. First, as already pointed out, private firms, faced with severe liquidity constraints, seek capital by selling out equity claims to foreign firms. Second, SOEs, while holding the country's most valuable assets, cannot generate any cash flow benefits and they therefore have become acquisition targets. In the 1980s and during much of the 1990s, the Chinese government began to adopt a very aggressive investment strategy of revitalizing the large and medium-size SOEs by building up their asset base and capital stock. The government thus allocated a lot of foreign exchange to these companies to finance the importation of advanced technology from abroad, especially from OECD countries.

The underlying idea behind these “big-push” type of projects is that SOEs are losing money because they do not have good fixed assets. (Or to put it differently, SOEs lose money because they do not have money.) However, many of these projects have ended in financial disasters. SOEs are very effective at building assets but are very poor at operating them. After the assets were in place, the SOEs could not derive any beneficial cash flows from these assets. Chinese managers have always been rewarded on the basis of technology and the size of their assets, not profits. Most of the key SOE managers cannot reorient their goals or change the way they manage, with the result that they cannot match products and production to market demand or work to create a strong bottom line.<sup>12</sup>

The value of assets is not determined by their purchase price but by their ability to generate cash flows. Because some of the SOEs can have reasonably good assets but poor cash flows, a curious outcome results for a poor country. Assets are actually quite cheap in China and sometimes the fixed assets in the hands of SOEs are sold at a fraction of their replacement cost. Unlike Korea and Indonesia, countries that experienced a debilitating financial crisis, the value of SOE assets is depressed at a time when economic growth is quite strong. Indeed, foreign companies have been coming into China, not so much to build new plants but to acquire existing plants at bargain prices. Foreign companies also continue to buy out the shares of their Chinese partners, meaning that more and more foreign companies are becoming majority shareholders in Chinese firms. Because FDI activities increasingly take on an acquisition flavor, academic research has shown that the large inflows of FDI since the early 1990s have not contributed to capital formation. It is also worth noting that the large FDI inflows have coincided with a severe overcapacity in the Chinese economy.

Many analysts refer to FIEs, created by joining a foreign firm, and a SOE as joint ventures and the investments made by foreign firms as “green-field” investments. In reality, these terms are misnomers. In the standard usage of the term, joint venture is used to refer to a joint

<sup>12</sup>It is important to distinguish between financial losses associated with *maintaining* the state sector and financial losses that have arisen from *expanding* the state sector. Many analysts of the Chinese reforms implicitly attribute all the financial losses to the maintenance of the state sector when in fact expansion of the state sector has also contributed to the insolvency of Chinese banks. This distinction is critical because the conventional justification of Chinese gradualism holds that it is politically expedient to support the state sector as a way to finance political stability. I believe that the Chinese reform strategy is in fact based on a very different philosophical foundation—it is a belief that SOEs can be turned into viable and competitive firms.

equity arrangement between two independent firms to launch a new product and to cooperate on a product development. The rationale for such a joint effort is that risks are often too high for one firm to bear and that each firm possesses unique expertise that can be leveraged to a greater effect in a joint endeavor. In many of the joint ventures involving Chinese SOEs and foreign firms, the goal of the venture is not to develop a new product but to shift an existing product line from one partner (Chinese firm) of the venture to another (foreign firm). In numerous creations of such “joint ventures,” the Chinese SOEs contributed and capitalized their product lines and distributional networks as equity investments in the newly created FIEs. More often than not, Chinese firms had earlier imported these product lines from abroad on a turnkey basis and sometimes from the same foreign firm that was seeking to acquire these assets. Thus, the field is not green but yellow, and often it is not really a field but facilities emptied of the personnel belonging to the Chinese parent firms.

### Policy Implications

Across China, the FDI phenomenon is associated with transferring assets and managerial control from SOEs into the hands of foreign firms. The parent SOEs are increasingly specializing in provisions of social services, funded in part from the dividend payouts from their stakes in these FIEs. Another effect associated with the FDI phenomenon is that many SOEs with equity interests in FIEs are shedding their operating and managerial functions but are transitioning into quasi investment funds. On the asset side of their balance sheet, a growing portion of their assets consists of equity claims on FIEs and their income consists more and more of nonoperating sources such as dividend payments from their affiliated firms.

All things considered, SOEs are probably better at providing social services than providing commercial services and products. Asset acquisition by foreign firms, in all likelihood, has the effect of improving allocative efficiency. There are, however, a few caveats. First, because the private firms have been systematically suppressed, they cannot bid for the assets of SOEs as effectively as they otherwise could. As a result, foreign firms are more successful bidders. Second, and probably more important, because the government still forbids a large-scale privatization program, only foreign firms can launch bids for SOE assets. Thus, the acquisition by foreign firms of SOE assets takes place on an asset market that lacks fundamental contestability. This is a net welfare loss for the country because it means that foreign firms

are able to acquire Chinese assets at prices lower than what they could have commanded otherwise.

It is high time to evaluate the benefits and costs of China's reform strategy. Recently, China's reform strategy has been touted as one that is both more economically and socially successful. The Chinese gradualist approach allegedly has produced winners but no losers. The Chinese "third way" is even acquiring normative and policy significance as it has been used to challenge the intellectual pillars of the "Washington consensus" by such influential figures as Joseph Stiglitz.

Such a conception of the Chinese reform experience is debatable. There have been huge losers in the Chinese reform process, notably private entrepreneurs who have foregone business growth opportunities and lost control over their businesses because of the systematic legal and financial discrimination against them. These foregone benefits are financially equivalent to actual losses. Thus, the argument for gradual reform is a political one, not an economic one. The political rationale is that foregoing future benefits is more politically palatable than incurring actual losses because people naturally react more strongly to actual losses than to foregone benefits. There is another rationale why the regime has sacrificed the interests of private entrepreneurs: they are politically powerless. It is, however, important to point out that there is a huge cost to gradualism and that the fact that gradualism may be the best political strategy is qualitatively different from arguing that a gradualist strategy is actually a *better* economic strategy.

Furthermore, it is quite dangerous to preach gradualism to countries that simply lack the basic conditions that would enable the countries to avoid incurring actual losses associated with this strategy. The reason that the Chinese economy was able to grow despite its massive institutional imperfections is, to some extent, a function of its developmental stage and a function of luck. China was and still is a large agrarian economy, which means that the agricultural sector is essentially able to supply surplus labor to fuel the growth of the nonstate sector as an input, a condition that cannot be repeated elsewhere (see Sachs and Woo 1994). China is lucky because it is situated close to Hong Kong and Taiwan, the two sources of ready capital suppliers to the liquidity-constrained private firms.<sup>13</sup> Without these ties to ethnic Chinese capital suppliers, the nonstate firms would have atrophied

<sup>13</sup>It is important to note that another attribute of the gradualist strategy—underdevelopment of the rule of law—would have deterred foreign investment if not for ethnic Chinese firms that possess relationship capital and cultural know-how that help foreign firms navigate China's murky business environment.

under the weight of the lending bias in the system. Again, this is a China-specific factor that cannot be easily replicated elsewhere.

In many ways, the Chinese economic miracle in the last 20 years happened in a most paradoxical fashion: China's economy took off but none of its firms did. On the eve of entry into the WTO, China again is about to cross a critical juncture in its reform course. Government officials, managers, and workers in China worry about the devastating impact on domestic businesses once the tariff and nontariff protection is lifted and foreign firms compete with domestic firms in full force. To some extent, that concern is puzzling because the scenario that is the source of this anxiety has already happened, several times over in China. Chinese manufacturing firms have already lost the war to foreign firms and it seems strange that one should worry now about who is going to win the battle. Many of the export channels are in the hands of foreign firms already; so is the control of the most dynamic firms in the electronics, garment, machinery, and automobile industries. What the WTO is going to bring about is foreign encroachment on state-owned service monopolies, notably in banking and telecommunications, which the state has fiercely resisted opening up until now. Had the government chosen an entirely different reform sequence, by first opening up the financial service providers to both foreign and domestic private entities, it is quite plausible that Chinese control over its manufacturing operations would have been greater. Had the financial resources and corporate opportunities been allocated to firms with good business acumen and the right mix of performance incentives, there would have been world-class Chinese private firms, most likely in household appliances and electronics, such as those in Korea and Japan emerging from their economic takeoff eras.

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