

Why is there so much demand for foreign equity capital in China? An institutional and policy perspective

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Abstract

Foreign-invested enterprises (FIEs) are now a significant force in Chinese economy, as measured by their size, performance, and their encroachment on China's most important industries. This paper challenges many of the conventional views on the factors behind this growth of FIEs. The paper offers an institutional and policy perspective explaining the high Chinese demand for foreign equity capital. The basic contention is that FIEs' advantages over domestic firms exceed the capital and technological advantages in their possession and these extra-ownership-specific advantages arise from the way the Chinese economic institutions are organized. There are two sources of these advantages. One is that foreign firms provide a range of functions that are under-provided by domestic firms due to regulatory and institutional factors. Another source arises from the fact that premium is conferred on FIEs' form of organization. Certain advantages, by regulations and policies, are granted to FIEs and thus domestic firms have incentives to acquire these advantages by a process of corporate conversion into FIEs. These two sources of extra-ownership-specific advantages create a higher Chinese demand for foreign equity capital than would otherwise be the case under an alternative institutional and policy context.

Why is there so much demand for foreign equity capital in China?¹

In 1997, the Chinese government reported a foreign capital inflow of 64.4 billion dollars and an FDI inflow of 45.3 billion dollars. In 1998, despite the widespread financial turmoil in East and Southeast Asia, FDI inflows into China continued at a strong pace, defying the growing pessimism about China in the Western business community. For the first nine months in 1998, the FDI inflows stood at 31.4 billion dollars, unchanged from the year before (Smith 1998).

Starting de novo in 1980, foreign-invested enterprises (FIEs) have become a sizable player in the Chinese economy. The FIEs have accumulated a large capital base and their investment activities account for an increasing share of China's capital formation. They are a large employer of China's labor force and their superior pay and flexible employment structure have drawn the best educated of the Chinese workforce. Their ability to raise funds and to import and export capital quickly has a strong influence on China's macroeconomy. Increasingly, FIEs are making China the manufacturing base of Asia. They can be found in virtually every part of China and in every economic sector. In a number of sectors, FIEs have established dominant positions in Chinese industry, especially in soft drinks, toys, cosmetics, automobiles, etc. FIEs' foreign trade activities account for a large share of China's overall trade balance; in 1996, they accounted for 40 percent of China's foreign trade and for 30 percent of Chinese export.²

The growing financing and economic roles of FIEs in the Chinese economy can be described as an "FIE phenomenon." This paper explains this phenomenon in two ways. One is to show that much of the existing explanation does not hold up to a close scrutiny and that there is a need for a more vigorous perspective on this issue. The other is to lay out an analytical framework that stresses the importance of China's institutions and policies in understanding the FIE phenomenon. I call this framework "institutional and policy factors" approach (or IPF approach). There are two main differences with conventional explanations. One is that the IPF approach aims at uncovering the alliance motivations and the characteristics on the part of the Chinese shareholder firms, as opposed to the motivations and characteristics of the foreign investing firms. I argue that Chinese motivations and their operative constraints are a critical part of the story underlying the FIE phenomenon. The

¹ In writing this paper, I have benefited from discussions with Professor David Li at University of Michigan.

other difference is that the IPF approach constructs a micro story explaining growth and performance of FIEs. The typical approach is to rely on macro factors such as economic fundamentals and evolution of FDI regulations as explanations.

This paper consists of four parts. The first section gives a more detailed delineation of what is meant by “FIE phenomenon” in China during the reform era and especially in the 1990s. The second section sketches a number of conventional explanations and describes their problems. The third section presents the IPF approach and discusses some empirical evidence. The fourth section concludes and offers some policy implications.

The FIE phenomenon

Foreign investment is most commonly defined as “direct” when the investment gives rise to “foreign control” of domestic assets. Thus according to IMF, FDI “is made to acquire a lasting interest in an enterprise operating in an economy, other than that of the investor, the investor’s purpose being to have an effective voice in the management of the enterprise.” In the United States, the Department of Commerce defines inward FDI when a foreign investor’s stake exceeds 10 percent. In China, the legal and definitional hurdle is set at a higher level—25 percent. The ostensible purpose is to preclude “fake” FIEs from enjoying many of the policy benefits granted to FIEs but to establish “an effective voice in the management of the enterprise” also requires a higher foreign equity stake in China as most of the Chinese joint venture partners are SOEs, whose shares, like closed corporations, are not traded.

FDI inflows are the most widely cited and watched measure of FDI. As the name suggests, FDI inflows connote the quantity of FDI received by the host country during a given period of time. This is to be distinguished from FDI stocks, which refer to the accumulation of FDI inflows at a given point in time. Table 1 reports FDI inflows as measured by the number of approved applications and the dollar values of approved and actual inward FDI inflows.

Table 1 about here.

Between 1979 and 1997 the gross FDI stock was US\$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 a whopping US\$196.8 billion, which put China as the largest FDI recipient among developing countries and second only to the United States. By the mid-1990s, the foreign-invested enterprises (FIEs) have become a significant force in the Chinese economy. The importance of their role is first seen in their growth. The compound annual

² Calculated from (State Statistical Bureau 1997).

growth rate of FDI between 1990 and 1997 was 44 percent; the most dramatic increase occurred in 1992 and in 1993 period when the FDI grew by 142 percent and 146 percent respectively.

The rapid FDI growth implies that FIEs have become a significant source of investment financing in the Chinese economy. In 1981, FIEs in China only accounted for 3.78 percent of China's fixed-asset investment; by 1997, the share rose to 12 percent. In 1992, FDI was about 2 percent China's GNP and it rose to 5 percent in 1997.³ It is noteworthy that the financing role of FDI in the Chinese economy is more significant than that in most other East and Southeast Asian economies, with Singapore being a notable exception. In terms of GNP shares, in the early 1990s, FDI was only 0.2 percent in the case of Korea; 2 percent in the case of Thailand and 1.5 percent in the case of Indonesia.⁴ In the 1980s during a period of increasing supply of direct investment capital, China's FDI share of gross domestic capital formation increased by more than fivefold, while the Korean and Taiwanese shares increased threefold and the Indonesian share increased by about 30 percent.

To a large extent, the FDI/domestic capital share ratio at the national level belies the true extent of Chinese dependency on foreign capital. Investment integration is deep in pockets of China, especially along China's coastal area. 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.⁵ FIEs have become industrial leaders in a number of areas in the Chinese economy. The following table lists a number of such sectors and firms. The information is based on a study by the State Planning Commission (SPC). The FIEs' encroaching market share is still a sensitive issue in China. The SPC presents the statistics in Table 2 in a sharply critical manner. In addition, the same report notes that in light industries, electronics, and the chemical industry, the FIEs' shares in sales have already exceeded 30 percent.

Table 2 about here.

The FDI/domestic capital formation ratio can understate extent of China's reliance on FDI in another way. The reason is that foreign and domestic investment activities can interact with each other either as substitutes or as complements. A cross-country comparison of FDI inflows as shares of total capital outlays can be misleading because FDI inflows can

³ Calculated from (State Statistical Bureau 1988) and (State Statistical Bureau 1998).

⁴ See (Huang 1998) for a more detailed comparison between China and a number of East and Southeast Asian economies in terms of the importance of FDI.

⁵ See Kueh (1992), pp.656-661.

substitute domestic investments in some countries but induce domestic investments in others. Thus the value of the denominator is some function of the numerator. The substitution effect can make the FDI/capital outlays share appear larger, whereas in the case of complementarity between the two activities the shares can appear to be smaller.⁶ To make a judgment about whether one effect prevails over the other requires some knowledge about how domestic and foreign investment decisions interact with each other. It is plausible to argue that the Chinese FDI/domestic investment share somewhat understates the importance of the FDI inflow. The considerable fiscal, monetary, and operational incentives associated with FIE status should induce a portion of domestic investments that would not otherwise materialize. Also the crowding-out effect is likely to be small because state-owned firms operate under soft-budget constraints and the investment hunger in the state sector dilutes some of the suppressive effects of the large FDI inflows

FIEs have played a unique role in China's reform process. Much of the economic studies of Chinese reforms focuses on the entry of non-state firms such as township and village enterprises (TVEs) and the idea is China is able to "grow out of plan" without an explicit privatization program by allowing creation of new, private firms.⁷ 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 the TVEs. By definition, FIEs are owned by separate legal entities and a vast majority of the Chinese shareholders are traditional SOEs. As such, the state ownership is directly diluted and the 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.⁸

⁶ Whether substitution or complementarity effects are stronger depends on the complex manner with which domestic firms finance their shares of capital contributions and on the institutional relationship between foreign investors on the one hand and the host governments on the other.

⁷ See (Sachs 1994) and (Naughton 1996).

⁸ Take Guangdong Provincial Freeway Development Company (GPFDC) as an example. The 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 GPFC's equity stake was 45 percent. See (World Bank 1997).

The second reason is that FIEs compete directly with the largest and the most prominent SOEs. From a competitive perspective, the rise of the FIEs is arguably a far more important economic phenomenon than the rise of TVEs and other non-state firms. FIEs are clamoring to enter into those sectors which will put them in head-on competition with some of China's most famed state firms, in auto, telecommunication, petrochemicals and machine building. In contrast, TVEs and others mainly compete with SOEs in what the state has traditionally viewed as rather marginal product segments, mainly in light industry and their dynamic growth has been achieved at the expense of the small and medium-sized SOEs.

In China, no less than in other countries, foreigners' growing presence in industries steeped in national and political symbolism can be an emotionally wrenching experience. It is no longer a normal business competition, proclaimed one worried Chinese official from the auto industry; it is nothing short of a geopolitical war. Of the four so-called pillar industries designated by the Chinese government, FIEs have a significant presence in two of them. In electronics and telecommunication, FIEs' equity stake has already exceeded that of domestic firms, at 53 percent in 1997. FIEs accounted for 47 percent of the assets and 63 percent of pre-tax profits. In the auto industry, where SOEs are more entrenched than those in the electronics and telecommunication and the government has attempted to tailor and limit foreigners' equity participation, by 1997, foreign firms have accumulated a significant stake in this industry, at 21 percent, as compared with 63 percent held by the government and only 3 percent held by the Chinese private firms. Foreign shares of the seven largest auto firms came to 16 percent; the rest is exclusively held by the state.⁹

FIEs are also enormously profitable. In 1996, China's balance of payment account recorded a profit expenditure figure of 11.6 billion dollars, a sharp increase from years before. Profit expenditure represents profit distribution due to foreign investors. The profit figures look even more impressive if one is to look beyond FIEs themselves and compare their performance with China's main form of corporate organizations—the state-owned enterprises (SOEs). The story about the sharply differing fortunes of the FIEs and SOEs can be told in a number of dimensions. The simplest dimension is the rise of FIEs as a significant force in China's economy from a de novo presence only 18 years ago. As of 1996, there were 43,542 industrial FIEs and 240,447 FIEs in the entire economy. Industrial FIEs accounted for 16 percent of the industrial value-added and 17 percent of assets.¹⁰

⁹ These data are reported in (State Bureau of Machinery Industry 1998).

¹⁰ All these figures and the figures reported below only cover enterprises that are independent accounting units.

Probably, the thing that distinguishes the FIEs most from the SOEs is their financial performance. In 1996, 43,542 industrial FIEs reported a post-tax profit of RMB 40.79 billion, whereas some 86,982 SOEs managed to churn out a paltry 500 million more, at RMB 41.26 billion. Other financial measures tell exactly the same tale. In all likelihood these figures under-state FIEs' success and SOEs' woes. FIEs are suspected of using transfer pricing to hide profits; SOEs, on the other hand, exaggerate their profit and sale figures to make their income statements look attractive to banks.

Existing explanations

Despite the growing importance of FIEs in the Chinese economy, most of the academic literature has not attempted to explain the FIE phenomenon as defined here, i.e., the factors that account for the growth of FDI over time and the increasing importance of FIEs in the Chinese economy. Academic writings on FDI in China have focused on relatively targeted subjects.¹¹ For example, economists have focused on the economic effects of FDI in China such as export performance and economic growth via impact on productivity and competitiveness of markets. The economic writings thus approach FDI from a developmental perspective and focus on an issue that all the developmental economists care about—economic growth. Exactly how FDI gets to be so important is usually left out in this discussion; instead the financing and economic roles of FIEs are taken as a starting point of analysis and the interest is to explore their implications. Political scientists have approached the study of FDI from a totally different perspective. The principal focus there is on the effect of increasing FDI on the ability of the state to maintain control over its own economic and political agenda. This approach is rooted in the bargaining literature on FDI. Again why there is a high demand for FDI in the Chinese economy and why the FIEs have grown so quickly are left out in this account.

Outside Chinese studies and in economics, by far, the most dominant theory of FDI is that of industrial organization (IO) perspective. The starting point of the IO perspective is that foreign firms incur costs that domestic firms do not. These costs range from the intrinsic difficulties of managing cross-border operations to the costs attached to investing abroad such as operating in linguistically and culturally unfamiliar environments and with legal and political uncertainty. To offset these extra costs, a foreign firm must possess internal, ownership-specific advantages over its domestic rival firms. These advantages can

¹¹ See (Kamath 1990) and (Pomfret 1991) in economics and (Pearson 1991) in political science. In addition, (Shirk 1994) tangentially addresses the issue of state control, although the subject matter is not limited to FDI.

take the form of both hardware and software, such as technology, organizational skills and marketing expertise, etc. that are unavailable to domestic firms.¹²

It is critical to recognize an unstated premise of the IO reasoning: There is a competitive asset market that allocates financial resources efficiently. This premise then enables the IO perspective to make two claims. One is the ownership-specific advantages, rather than other factors, enable foreign firms to outbid domestic firms, for example, by paying a premium price to acquire domestic assets. The second claim is that the ownership-specific advantages are well-defined and they refer to those assets that cannot be transacted costlessly via an arms-length arrangement. These assets are, for example, trademark, patents or critical know-how. The IO reasoning predicts MNCs to be prevalent in those industries that involve a heavy use of these assets.

The efficient asset market premise is simply not met in many developing countries and in a reforming centrally planned economy such as China. Asset acquisitions by firms are a heavily bureaucratic process and institutional and policy factors can magnify or reduce these ownership-specific advantages. The implication is that the patterns of FDI can depart sharply from the ones as predicted on the basis of an IO reasoning and that MNCs can acquire extra-ownership-specific advantages or disadvantages that either increase or attenuate the narrow ownership-specific advantages as posited by the IO theory.

In China two empirical FDI phenomena seem at conspicuous odds with the IO perspective. First, an important component of FDI inflows consists of the so-called “round-trip FDI.” Round-trip FDI refers to the capital that is first exported to acquire a foreign domicile and then imported to establish an FIE in China. Round-trip FDI in all likelihood does not result in any net increase of capital inflows and probably a minimum degree of technology transfer. Yet by all accounts, round-trip FDI is a significant phenomenon. The large negative errors and omissions terms in China’s balance of payment statistics provide a hint of its magnitude; using regression analysis, I estimated the round-trip FDI to be around 20 percent of China’s FDI inflows in 1992 and the World Bank has estimated it to be around 25 percent.¹³

The IO perspective would predict, all else being equal, MNCs to dominate in those industries that use capital intensively because financial and physical capital is supposed to constitute one of the very important ownership-specific advantages of the MNCs. However,

¹² The pioneering work in this field is found in (Hymer 1976). For a good summary of this large body of literature, see (Caves 1996).

¹³ See (Huang 1998) and (World Bank 1996).

this is not immediately clear in the Chinese data, when asset intensity is measured by the fixed asset turnover ratio. If anything, there is a negative correlation between FIEs' equity shares and asset intensity. Fixed asset turnover ratio is the ratio of sales to the net fixed assets. It measures the sales generated by the per unit of net fixed assets deployed and measures capital intensity of an industry, with a high ratio denoting low capital intensity and a low ratio denoting high capital intensity. Table 3 shows the equity ratios of FIEs and the fixed asset turnover ratios of eight industries, in four of which FIEs have the highest equity shares and in four of which FIEs have the lowest equity shares. The average asset intensity levels of the high FIE equity group is actually higher than that for the low group, 3.17 compared to 2.09. Tobacco processing and petroleum processing are heavily capital-intensive activities and yet FIEs have almost no presence.¹⁴ This suggests that FIEs are more dominant in industries of low capital intensity. The same pattern holds when one is to look at the data for all industries. The simple bivariate correlation between fixed asset turnover ratio and FIEs' industrial equity shares for 1996 was not only positive but large, at 0.70.

Table 3 about here.

Many of the China-specific accounts for the FIE phenomenon and for the Chinese motivations to form alliances with foreign firms comes from China's policy statements and from business press and in general they do not hold up to a close scrutiny.¹⁵ To understand Chinese motivations, it is necessary to look at the benefits of forming FIEs from a Chinese point of view. At first blush, the question about the benefits associated with FDI seems both obvious and pedestrian. The most obvious benefits are capital and technology that are purportedly associated with FDI inflows, as Chinese officials often proclaim.¹⁶

The official rationale dovetails well with what is known as "savings-investment" gap theory of foreign capital in development economics. Both the official and the savings-investment gap rationales are rationales for importing *foreign capital*, not necessarily for importing *foreign equity capital*. A country, like a firm, can issue bond or stock on

¹⁴ It is likely that government's restrictions on FIEs explain this outcome as well.

¹⁵ To the extent that academic writings address the issue of motivations, they typically accept the official justifications for FDI—i.e., China needs to import capital to deal with capital shortage and to upgrade technology.

¹⁶ See (Li Lanqing 1995). In an 1980 interview with journalists, Deng Xiaoping gave the rationale for establishing the four SEZs as follows: "Technology, science and even advanced production management, which is also a kind of science will be useful in any society or country. We intend to acquire technology, science and management skills to serve our socialist production"(Deng Xiaoping).

international capital market and the choice of one over the other is a function of a host of factors such as costs and riskiness of one form of capital vis-à-vis the other form. That the Chinese favor equity capital over debt capital is a statement not so much about the shortage or abundance of capital in China but about how the benefits and costs of debt and equity capital are perceived by the Chinese and about the various characteristics attendant to these two alternative financing sources.

It is important to note that there are important tradeoffs between absorbing FDI and making market concessions and ceding national control to foreign firms. Some governments, notably Korean and Japanese governments, have traditionally been unwilling to make this kind of tradeoffs in favor of FDI, while other governments--in Singapore and in China--have been more willing. Thus an appropriate question is not whether a government desires foreign capital and technology but whether a government is willing to pay the price for it in the form of ceding national markets and corporate controls. A more complete explanation needs to address the reason why the benefits of capital and technological import exceed whatever the costs the Chinese incur by permitting and actively courting FDI.

The savings-investment gap implies a capital shortage rationale for FDI. However, capital shortage rationale raises a number of empirical anomalies. If attracting FDI is motivated by a desire to increase investment rate, then it is more than mystifying why onerous restrictions are placed on Chinese domestic capital—especially non-state capital—in terms of their access to fundable projects. Numerous *de jure* and *de facto* regulatory constraints strongly bear on domestic non-state firms, including their access to China's banking system and to profitable investment projects while foreign investors are actively courted and are given attractive tax and other benefits. Thus there is a preference not just for any equity capital but for *foreign* equity capital. This preference for FDI cannot be explained by ideology, at least not in an obvious way. Foreign control no more or less undermines the socialist character of the Chinese economy as private but Chinese control. The international competition for capital is only a partial explanation. Although the mobility of foreign capital leads to a better treatment from policy authorities, it is puzzling why the fierce inter-regional competition for capital does not accord the same benefits to domestic capital. On the supply side, a foreign investor invests in China not because the government treats domestic firms badly as compared with foreign firms but because investing in China yields a higher level of benefits as compared with investing in an alternative location.

A further anomaly 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 1993 and 1997, the

savings rate rose to 40.6 percent.¹⁷ The acceleration of the savings rate coincided closely with an explosive growth of FDI and with a significant liberalization of the FDI controls. Thus China imported more capital when it saved more and imported less capital when it saved less! China's balance of payment statistics bear out this suspicion. In the 1990s, China ran a current account deficit only in 1993 and the simple economic logic would predict that in other current account surplus years China is a net capital exporter, not an importer. This is precisely what happened. The large FDI inflows, on top of a large current account surplus throughout much of the 1990s, led to a huge accumulation of foreign exchange reserves, to the tune of 140.9 billion dollars six months into 1998.

Foreign exchange reserves are Chinese claims on dollar assets. When the FDI inflows are financing the growth of China's foreign exchange reserves, that amount of FDI is not used productively to develop Chinese economy. According to Wall Street Journal, China invested about an estimated 40 percent of its foreign exchange reserves in US treasury bonds (Smith 1998). If 40 percent figure is a reasonable estimate, then in fact China is a net capital exporter. This outcome is rather strange from the point of view of the capital shortage rationale for FDI. The Chinese are striving to give up the ownership of their economy only to use the capital surpluses to invest in low-yielding government bonds in America. In a country of poor peasants, China borrows heavily from the rest of the world so that it can finance government spending in the industrialized countries, an outcome a former Chinese central banker calls "scandalous."¹⁸ By all indications, the Chinese are poor arbitrageurs. The country pays on average 8 percent on its foreign debt but only gets 5 percent returns on its investments abroad. One is hard pressed to think of an economic justification for this outcome but if there is, fund shortage is not one of them.

The technological import argument also rests on some shaky grounds. Equity investments are preferred when the technology cannot be disembodied from capital, as in the case of proprietary assets such as trademarks and patents or as in the case of critical managerial know-how. There is no doubt that importation of proprietary technology is involved in some cases in China and thus equity investments are inevitable there, as arms-length arrangements are difficult to design and enforce. The puzzle is the sheer magnitude of FDI cases in China relative to any realistic supplies of proprietary assets and the very large scale of concessions conferred on FIEs putatively to attract equity investments. It defies common sense that all of the FDI cases in China involve proprietary assets that cannot be

¹⁷ Savings rate is defined as the difference between GDP and final consumption divided by GDP. The data are reported in (State Statistical Bureau 1998).

¹⁸ Quoted in (Smith 1998).

obtained via alternative forms of firm alliances such as licensing. It is important to point out that a vast majority of FIEs in China are formed with small firms in Hong Kong and Taiwan that are often simple trading houses without any technological content in their economic activities. Although there may be managerial know-how transferred to the FIEs, it is not immediately clear why this form of managerial know-how cannot be separated from capital import per se.

The second popular explanation often invoked in business press for the growth of FIEs in China points loosely to the attractiveness of China's economic fundamentals—fast income growth on top of a large population and cheap and disciplined labor force, etc. The explanation focusing on the economic fundamentals is correct, by definition and default. It is not hard to imagine that FDI inflows would have to be modest if these economic fundamentals were not sufficiently attractive to the investing firms. However, it is important to recall that the rapid growth of the roles of foreign companies in China is of relatively recent vintage. The real surge in the FDI inflows took place after 1992; the cumulative FDI inflows between 1992 and 1997 accounted for some 89 percent of the FDI stock between 1979 and 1997. During the 1980s, the FDI grew steadily, but not at a spectacular rate, even though the Chinese economic growth was already quite impressive during this period. Thus if we accept the notion that economic fundamentals drive FDI inflows, this gap in timing needs to be explained.

The economic fundamentals explanation poses other puzzles. The good economic fundamentals themselves do not automatically drive up the FDI inflows. For one thing, foreign firms may prefer exporting to investing in foreign sites and overseas investments thus occur only when there are impediments to exporting. In addition, FDI policies of host countries can be promotional or restrictive and these policies have a big impact on the levels of the FDI. This is abundantly clear when one examines the history of FDI in the East Asian newly-industrialized economies (NIEs), countries that grew extremely fast in the 1970s and 1980s but without much foreign equity participation. (Amsden 1989) points out that the number of multinationals in Korea is smaller than any other late industrializing countries. (Hill 1985) shows that the Korea's share of FDI in the gross domestic investment is lower than most other developing countries. An important reason were the policy barriers against FDI. In a 1980 survey, 23 percent of the foreign executives in Korea listed "cumbersome bureaucratic procedures" as the number one impediment (Stallings 1990). Japan, the world's second largest economy, has a level of FDI inflows lower than the level of Greece (Graham 1994). Thus, the economic fundamentals explanation provides a *necessary* but not a sufficient account of the FDI growth, i.e., those countries with high levels of FDI must have good economic fundamentals but there can be countries with good economic fundamentals but

with low levels of FDI. This distinction between the necessity and sufficiency conditions of the FDI growth often gets blurred in the business press.

To a large extent, the economic fundamentals explanation asks the wrong question in the first place. Even if good economic fundamentals drive up FDI inflows, the core issue is not the growth of FDI inflows *per se*. The core issue is the growth of FDI inflows relative to the growth of domestic investments. To be sure, good economic fundamentals induce more investment, but why have there been more *foreign* investments? Do foreign firms have an edge in responding to the growth opportunities than domestic firms? Strictly speaking, an account of the FDI growth is not about FDI growth *per se* but is about why foreign firms have invested more than domestic firms (as the increasing share of FDI of domestic capital formation indicates). Thus our story has to start with explaining why, over time, foreign firms have gained advantages relative to domestic firms and the factors causing the advantages of foreign firms to rise over time.

Another common strand in the business press explanations stresses China's FDI liberalization over time. FDI inflows rose in the 1990s as the Chinese authorities shifted from a permissive FDI regulatory regime in the 1980s to a promotional FDI regulatory regime in the 1990s. The trouble with this explanation is that it is functionally indistinguishable from either the capital shortage or the economic fundamentals explanations and thus is afflicted with the same anomalies that bedevil those explanations. The surge of FDI inflows in the 1990s must imply that there was a latent but unsatisfied demand for foreign equity capital in a more controlled policy environment in the 1980s.¹⁹ Lifting policy restrictions in the 1990s thus had the effect of matching this latent demand with the actual supply of FDI. Put it this way, the FDI liberalization hypothesis tells us something about the mechanical process

¹⁹ An entirely different line of inquiry focuses on the total amount of "suppliable" FDI capital and its changes over time. It is entirely possible that China's FDI inflows in the 1990s could increase without any significant FDI liberalization if the total supply of FDI capital to developing countries increased. In reality, it is not so easy to cleanly separate the demand and supply sides of FDI capital. The supply of equity capital can be increased precisely because there is now a more demand for it induced by FDI liberalization. An article in *Economist* documents this dramatic change in the attitude toward multinational corporations (MNCs). MNCs were viewed as an embodiment of ruthless exploiters of poor countries in the 1970s but since the 1980s there was a complete reversal of the view. MNCs are now viewed as symbols of modernity and progress. "Governments all around the world," the article pointed out, "especially in the developing countries, are queuing up to attract multinationals." See (Emmott 1993).

whereby FDI demand and supply are matched but a truly interesting question is why the level of FDI demand is so high.

Ignoring the issue of FDI demand, the FDI liberalization hypothesis assumes an automatic connection between removing policy barriers against FDI and increasing FDI inflows. The connection may be there but the logic needs to be spelled out more fully. One can easily think of a situation in which this connection is not automatic. In Japan, there is hardly any barrier against FDI at the policy level after the significant capital market liberalization since the late 1980s but the FDI inflows for years remained at a low level. One econometric study suggests--and finds strong empirical evidence for--the hypothesis that *Keretsu* arrangement—inter-locking shares held by firms--inhibits FDI demand on the part of the Japanese firms (Lawrence 1993). This line of inquiry asks the right question and points to the right level of analysis. Structure of market and organization of firms can exert independent influences on firms' alliance decisions. A more complete explanation would attribute the FDI growth in the 1990s to the policy liberalization *at a given level of FDI demand*. The FDI liberalization hypothesis is not wrong but it is missing the critical middle step of explicating China's FDI demand.

IPF approach

My fundamental premise is that the growing roles of FIEs in the Chinese economy are driven not only by foreigners' supply of equity capital but also by the Chinese *demand* for foreign equity capital. The demand side story gets to the perceived benefits associated with foreign equity capital and to the Chinese motivations to form alliances with foreign firms. The central idea of this paper is that desire for capital and technology do not constitute the full universe of the Chinese alliance motivations and that the Chinese alliance motivations are a partial function of the Chinese economic institutions and policies. Thus I term this approach to studying FIEs the institutional and policy factors approach (IPF approach). In the following paragraphs, I look at four such IPFs—state ownership, economic decentralization, financial market inefficiency and policy benefits.

State ownership

An important feature of SOEs' behavior in China and in other reforming socialist economies is that they have an insatiable investment appetite. Despite the impressive results of its economic reforms, China remains a partially reformed CPE. In 1994, state-owned enterprises employed 67 percent of all urban employees and accounted for 57 percent of the total gross fixed capital formation. In comparison, as of the late 1970s, the state sector accounted for 32 percent and 23 percent, respectively, in the gross fixed capital formation in

Taiwan and Korea.²⁰ The investment demand of state-owned enterprises is viewed as inefficient and excessive in reforming or partially-reformed CPEs. Excess investment demand implies two kinds of behavior unique to SOEs in CPEs. *Ex ante*, excess investment demand means there are weak self-enforcing constraints on investment demand; *ex post*, it means that demand for investments constantly exceeds the potential supply of investible resources, such as capital, intermediate goods, or, as the case may be, foreign exchange. Excess investment demand arises because there is a fundamental asymmetry in the incidence of costs and benefits associated with undertaking investment activities in a CPE. Benefits -- enhanced reputation and higher financial rewards--accrue to the investors while investment costs are borne by society at large. This is a situation analogous to "negative externalities" in the market economies and the consequences are similar: the costs of the affected activities are lower than socially optimal; therefore incentives to undertake these activities are stronger than when the external costs are taken into account. As Kornai²¹ comments:

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

A second and closely related characteristic of SOEs has to do with the budgetary environment in which they operate. SOEs are said to face "soft budget constraints," which refer to a bureaucratic readiness to provide financial assistance and, ultimately, to prevent bankruptcy.²² Soft budget constraints, in essence, imply zero risks for the investment activities undertaken by a SOE. They are the second reason why restraints on investment demand are not self-enforcing on SOEs.²³

The lack of a credible threat of bankruptcy shapes alliance motivations and behavior profoundly. For one thing, it is entirely possible that forming joint ventures is an extension of the excess investment demand on the part of the SOEs. But there are more subtle connections. Launching joint ventures can be a costly proposition, especially for cash-

²⁰ Wade (1990), p.177.

²¹ Kornai (1992), p.163.

²² For further illustrations, see Kornai (1980 and 1986).

²³ One may object by pointing to a similar phenomenon in market economies--savings and loans institutions in the US economy. But this observation is a mere restatement of the same point. Savings and loans institutions are federally insured and hence face a similar budgetary environment as a normal CPE firm. The recklessness of their behavior then critically depends on the degree of government supervision; if government supervision becomes lax, as it did in the 1980s, behavior tends to be reckless.

constrained SOEs. There are two common funding approaches. One is that SOEs would inject their best performing fixed assets and workforce into the new ventures when they have low cash reserves. The other approach is that the SOEs would borrow heavily to finance their equity injections into the new ventures. This is evidenced by the fact that in sectors with a high foreign equity stake the SOEs tend to be highly leveraged, as measured by debt to equity and debt to asset ratios.²⁴ The simple bivariate correlation between SOEs' debt levels and FIEs' sectoral equity stake is very high. For debt to asset ratio, it was 0.74 and for debt to equity ratio, it was 0.72. The four sectors with highest foreign equity stakes are electronic and telecommunication equipment (55 percent), leather and related products (52 percent), garments and fiber (49 percent) and food manufacturing (47 percent). The SOEs' debt to asset ratios in these four sectors are, respectively, 0.76, 0.86, 0.71, and 0.77. The average debt to asset ratio for all the industrial sectors is 0.68.²⁵

There are both balance sheet and income statement implications from these equity injection methods. By forming joint ventures, SOEs essentially convert their fixed assets into long-term financial holdings on their balance sheet. In the extreme case, as in one SOE that I interviewed, the SOE could put itself in technical bankruptcy when all of its fixed assets were injected into a joint venture and it was unable to generate any revenue to service the existing debt. In less dramatic cases, because the shareholder SOEs are left with the least productive assets and workforce, their profits tend to plummet after joint ventures are created. Those SOEs that contributed cash became highly leveraged and heavily burdened with interest payments.

Here a critical driver of the SOE alliance behavior is the *ex ante* expectation of bailouts by the state and thus SOE managers tend to discount the costs and even the real bankruptcy prospects as a result of the aforementioned manners of financing joint ventures. Because the loan obligations are soft or the fiscal subsidy is readily available to SOEs in distress, SOE management may not feel constrained by the excessive burdens of asset conversion and expansions.²⁶

²⁴ It is important to note that this is one of a few possible interpretations. Another possibility is that FIEs tend to gain advantages in sectors in which SOEs are failing. Thus high debt levels are not *ex post* but *ex ante*.

²⁵ All the data here refer to 1996.

²⁶ Their *ex ante* expectations can turn out to be false *ex post* and it is highly likely in that case that conflicts between Chinese shareholder and foreign shareholder escalate, with the Chinese shareholders insisting on dividend distribution while the foreign shareholders would insist on profit retention.

SOEs are also motivated positively to launch projects. A World Bank study finds an “engineering” motive particularly strong among Chinese SOEs (Byrd 1987). An engineering motive can refer to a desire to produce an excellent product or to adopt the newest technology. The benefits are both psychological and tangible. A system of ranking enterprises and varying bonus, wage, and credit treatments according to their technological sophistication accentuate enormously the appetite for new technology.

The effect of a strong engineering motive on FDI can be illustrated by either the demand or supply sides of the story. On the demand side, it accentuates the demand for the type of capital closely bundled with technology. On the supply side, the high demand for technology on the part of the Chinese SOEs increases the owner-specific advantages possessed by the MNCs. Many foreign investors would readily confirm the constant demand for technology transfer from their Chinese partners and often such a demand is economically wasteful, as the Chinese often do not need or understand the newest technology. In my interviews with executives from the Chinese shareholder firms of joint ventures, an overwhelming response to the question why they wanted to form joint ventures with foreign companies is to get the latest technology. This is true even in cases where the SOE had invested heavily in upgrading and importing equipment and technology only a few years before forming an alliance with a foreign company.²⁷ A senior Otis executive reflected on this issue in a Harvard Business School case study (1997, p. 8):

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

A third connection between state ownership and demand for foreign equity capital has to do with the sharp differences in terms of operational autonomy granted to SOEs vis-à-vis that granted to FIEs. Although many foreign executives complain about governmental restrictions placed on their operations, FIEs enjoy a far greater autonomy as compared with SOEs. SOE managers are appointed by government and specifically by the Organization Department of the Chinese Communist Party. The appointment decisions can be often a

²⁷ In a number of cases, the foreign joint venture partner is the same company that exported equipment and technology to the Chinese firm a few years before and the Chinese firm used the purchased equipment and technology as assets injected into the joint venture with the expectation that the technology would be further upgraded.

politicized process. In addition, the SOEs are often subject to detailed and often discretionary bureaucratic interferences and to predatory taxes and fees. Herein lies a strong incentive to become a FIE on the part of the SOE managers: They acquire autonomy and protection from bureaucratic predatory practices. Many managers I interviewed invoked this explicitly as one of the many side benefits arising from changing their corporate status from SOEs into FIEs.

The arms-length relationship between government and FIEs is evidenced in a number of ways. First, the political control is much weaker in FIEs as compared with SOEs not only by default but also by a rather explicit regulatory design. None of the FIE laws makes any explicit references to the Communist Party and does not mandate the establishment of Party organizations within FIEs. To some extent, this is in contravention of the Charter of the Chinese Communist Party, which requires a Party organization where there are more than three Communist Party members. A brief reference to the role of the Party within FIEs is found in a manual prepared under the auspices of the Ministry of Foreign Economic Relations and Trade, which describes the role of the Party as monitoring illicit conduct and educating FIE workers on ideology. No managerial role is prescribed.²⁸ In contrast, the 1986 Factory Director Regulations governing the SOEs assigned broad and specific powers to the Communist Party, such as those ensuring the “socialist character of management,” compliance with laws, fair distribution of interests among state, enterprise and workers, etc.²⁹ These functions would directly impact managers’ production and wage/bonus setting policies. The reference to the Communist Party in the 1988 SOE Law was briefer, stipulating a monitoring and supervisory role to ensure compliance with Party and state policies and regulations (Article 8). Interestingly, almost exactly identical wording referring to the Communist Party also appears in the 1991 Collective-Owned Enterprise (COE) Law (Article 10), although there is no similar provision in the 1990 Township-Village Enterprise (TVE) Law.³⁰

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

²⁸ See (Li Lanqing 1995, pp. 178-179).

²⁹ [Article 16, 1993 [1986] #1812].

³⁰ See [, 1993 [1991] #1814] and [, 1993 [1990] #1813].

the Company Law, the SOEs acquired the set of organizational and corporate attributes that FIEs acquired 14 years earlier.

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

The differences in the *de jure* treatments of FIEs and SOEs do have a tangible impact on the actual operations of firms. In the 1980s and 1990s, several rounds of SOE reforms aimed at assigning significant fiduciary responsibilities to the SOE managers. The 1988 SOE Law gave broad powers to the SOE managers including asset disposals. However, a number of surveys suggest that the SOE managers are sharply constrained even in the areas of operations in which they have been given explicit autonomy. A World Bank survey of 156 SOEs in 1994 shows that more than 60 percent of the SOEs surveyed indicated that they did not have autonomy in decision making over trade, disposal of assets and mergers and acquisitions. The Communist Party wields considerable power over personnel issues. A State Council study, cited in the aforementioned World Bank study, indicates that most of the SOEs did not have full investment authority, personnel decision rights and the rights to set wages. The conclusion from the study was that most of the 14 rights specified by the 1988 SOE Law remained with the line bureaus.³¹

Survey data indicate that FIEs are more independent from government. In a 1995 survey, American firms in China ranked "bureaucratic interference" as the number three problem after inflation and rising accounts receivable,³² even though only a few years earlier, it routinely took years to negotiate an investment deal with the Chinese government. In the early 1990s, Shanghai pioneered in setting up "one-stop agency" to approve FDI applications, a practice copied by many regions. However, there is no similar agency for dealing with domestic investment applications. In 1995, ten government departments organized a comprehensive survey on managerial evaluations of their operational autonomy. Unlike the previous studies I cited, this survey included SOEs, COEs, FIEs as well as private

³¹ (World Bank 1997).

³² "Feeling upbeat" (1995)

enterprises, making a direct comparison possible.³³ The survey reveals, in a convincing fashion, that the non-SOE managers enjoyed a far higher degree of operational autonomy, at least in their subjective evaluations. When asked what were the difficulties of improving enterprise management, the top three impediments cited by the SOE managers were, in a descending order, 1) wrong managerial selection system, 2) incomplete delegation of authority over labor and personnel issues, and 3) too many surplus workers. All these three factors were fundamentally driven by the structure of the government-business relationships.

In contrast, the top three impediments cited by the FIE managers all focused on internal operations of firms. They were: 1) poor quality of managers, 2) lacking advanced managerial techniques, and 3) poor asset management.³⁴ Considering that many of the FIEs are affiliates of the SOEs, this ranking is remarkable in that it was almost exactly identical to the one given by the private enterprise managers, indicating that the FIEs have come to enjoy a similar level of operational autonomy as the private enterprises.³⁵ In the same survey, 67.3 percent of the SOE manager-respondents picked “Evaluation by the supervisory authorities” as their top concern while only 39.7 percent of the FIE manager-respondents did so. 15.4 percent of the SOE manager-respondents gave “coordinating relationship with government agencies” when asked to pick activities to which they devote most of their time and effort. Only 7.9 percent of the FIE manager-respondents did so.

Economic decentralization

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

³³ The survey is reported in (1996).

³⁴ The survey does not give the size breakdowns of the enterprises. The survey noted that 87.7 percent of the surveyed enterprises were large and medium sized. However it is not known whether the SOEs were larger than the FIEs. Size matters because government controls the large enterprises more tightly than smaller enterprises.

³⁵ The top three impediments cited by the private enterprise managers were: 1) lacking advanced managerial techniques, 2) poor asset management and 3) low quality of managers.

of the total expenditure. In 1995, after the 1994 fiscal recentralization, the regional share was 47.8 percent on the revenue side but was still 70.7 percent on the expenditure side.³⁶

The first and foremost manifestation of economic decentralization 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.³⁷ 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 inter-regional 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.

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

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

³⁶ This is calculated from SSB (1996), p. 235.

³⁷ The data are from the 1995 industrial census. See (Office of Third Industrial Census 1997).

role that is lacking in 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.³⁸

MNCs are not only multinational but they are, first and foremost, multi-regional in China. Motorola, Schindler, Otis, Volkswagen, Ford, Nabisco, etc. have all established operations across the country and increasingly Western MNCs are creating a holding company structure to coordinate their complex activities and interactions among their subsidiaries or affiliates and to economize on 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 dollars in 1992, acquired 200 companies in China during a span of two years between 1992 and 1994. Its joint ventures are located in more than nine provinces and its China Tires Holdings, via its acquisitions of tire plants in five provinces, emerged to be the largest tire producer in China in 1994 (Lim 1994).

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

The second effect is less direct. Import substitution strategy, as is well-known in economics, creates rents and induce rent-capturing activities (Krueger 1974). Rents accentuate domestic capital immobility; not only regional governments are loathe exporting capital to other regions they are also loathe importing capital from other regions lest the rents created in their regions are shared. This would mean that regional governments would demand something more than capital before agreeing to any rent-sharing arrangements

³⁸ There are specific examples of foreign companies playing this arbitrage role. The 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 dollars.

without outsiders. Foreign companies are the beneficiaries of this preference because they possess know-how and technology and because FIE status itself commands a premium.

Harvard Business School case on Otis in China provides a fascinating account of this dynamic. In 1984, Otis and Tianjing Elevator Company (TEC) entered an agreement to form a joint venture, China Tianjin Otis Elevator Company (CTOEC). As the business expanded, Otis felt increasing need to set up additional joint ventures in other parts of the country, because of the market segmentation. However, this attempt was frustrated by the Tianjin Municipal government. The Tianjin municipal government viewed such an attempt by Otis as fostering competition and in 1988, it rejected Otis' plan to set up another joint venture in Suzhou in Jiangsu province, even though CTOEC, in which TEC had a controlling stake at 65 percent, would have 50 percent stake in the new venture.³⁹ In another deal, Otis tried to set up a joint venture in Guangzhou to capture the booming market there. This time, the Guangzhou government rejected the original proposal because it would involve equity participation from TEC.

Both of these episodes illustrate the extent of local protectionism in China. Tianjin and Guangzhou governments viewed Otis' actions as shifting rents to other regions and as resulting in a pure financial re-distribution. Neither government is averse to Otis' participation but it is wary of either benefiting its competitors or allowing its competitors to share a portion of its market growth. The Guangzhou episode illustrates how strong this consideration is. The government was willing to accept a minority stake in the joint venture with Otis on the condition that Otis would drop TEC's participation.

Thirdly, regionally-based capital competition erodes barriers against FDI at the national level. It is well-known that Chinese localities compete with each other to attract FDI by reducing taxes, land-use fees and provisions of infrastructure. To some extent, this is similar to the expensive bidding war among Ohio, Pennsylvania and Ontario for a Honda plant in 1987. In the United States, this kind of bidding war changes the regional distribution of FDI without necessarily increasing the level of FDI in the country.⁴⁰ In China, it does increase the FDI inflows at the national level, due to two critical differences with the United States. One is that the policy resources under the command of the Chinese regional governments are much greater as compared with those of the American counterparts. Regional governments can offer far greater inducements as compared with their counterparts in the United States. The other difference is that unlike the United States China started from

³⁹ The original agreement has given TEC the approval power for business expansion plans in China. See

⁴⁰ See (Graham 1994) for an analysis of this episode.

a position of tight restrictions and controls on FDI inflows. The effect of regional bidding for capital is that it brings down the nationwide barriers against FDI by equalizing policy and tax treatments to the level of the most liberal region. This is easily illustrated by the example of the four Special Economic Zones (SEZs) and the fourteen coastal cities which were initially given greater power to approve FDI projects at far higher dollar thresholds than other provinces. As these privileged regions began to attract large FDI inflows, other regions began to demand the same approval authority. Gradually, the central government extended the approval authority to other regions as well. It is also true that many of the FDI liberalization measures have been adopted by the central government after they have been implemented at the local level, such as permitting FDI in retail, telecommunications, and real estate, etc.

Financial market inefficiency

One of the sources of financial market inefficiency has already been alluded to—segmentation of supply of capital along regional lines—and it induces a level of demand for foreign capital that would not materialize if domestic capital had been permitted to move more freely. Another source of financial market inefficiency has to do with the well-known failure 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; SOEs account for over 70 percent of the bank lending even though their output shares have declined to 40 percent. Non-state 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 1997.⁴¹ Lending bias also means that banks are serving a heavily re-distributional function across regions that the budget of the Chinese central government inadequately provides for. There is strong evidence that the central bank's re-financing—enforced via the reserve requirements on the specialized banks—re-distributes 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 typically northeastern provinces with large and heavily loss-making SOEs. Deposit-surplus regions are typically southern provinces, such as Jiangsu, Zhejiang and Guangdong, that have a fast-growing non-state sector.

Given this lending bias, foreign firms become suppliers of capital to firms that are fundamentally sound but suffer from an externally-imposed liquidity crunch. This explains well the demand for foreign capital from dynamic non-state firms. One non-state 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 non-state status, it could not secure any credit financing from the Chinese banks and thus it formed a joint venture with a Hong Kong trading firm—which had marketed its products abroad but had little technical know-how—in order to secure the needed capital. Another example is that foreign companies became a source of foreign exchange supply to those domestic firms with import needs but no export revenue. Because there was no foreign exchange market to match the foreign exchange demand with supply, at least in much of the 1980s, the FIEs became a vehicle to access foreign exchange. This kind of financing roles of foreign firms is purely a function of the financial market inefficiency and would not materialize in its absence.

Policy benefits

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

This account is plausible but it is by no means complete and it is even slightly misleading. For one thing, beginning in 1993, the Chinese authorities have moved to equalize tax treatments of domestic firms and FIEs and thus the tax benefits have declined in

⁴¹ See (McKinnon 1994).

importance as a driver of investment behavior. International evidence suggests that tax treatments in general have a weak effect on the distribution of FDI across countries. In the case of US corporations, the US government taxes their profits on a global basis and thus the tax saving effect of investing in China will be offset by a tax increasing effect in the United States. It is worth emphasizing that the benefit of lower taxes primarily falls on the Chinese shareholders and thus increases their incentives for a corporate conversion into FIEs to qualify themselves for a better tax treatment. Thus demand for foreign equity capital is higher than otherwise and it may result in a more accommodating stance toward demands made by foreign firms than otherwise would be the case. For example, it is plausible to imagine that without the tax benefits the Chinese shareholders may resist foreign requests to take a controlling stake in the joint venture.

There are also less publicized policy benefits conferred on FIEs. During much of the reform period, foreign exchange constituted a valuable asset to firms in its possession in part because RMB was over-valued for many years and in part because under a protectionist trade regime access to imports was highly valued. Here there are critical differences between FIEs and domestic firms. First, exporting FIEs could retain 100 percent of their foreign exchange earnings while domestic firms could only retain a portion and had to sell the balance to the central bank at the official rate. Thus for each export transaction, the FIEs made a surplus equivalent to the amount the RMB was overvalued. This situation began to change since the early 1990s and it was a more relevant factor in the 1980s.

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

Conclusion

The IPF approach produces different interpretations of the so-called “FIE phenomenon” from ones that are widely circulated. Take the performance aspect of the FIE phenomenon. FIEs and SOEs are often viewed as polar opposites in China’s impressive economic transformation in the last 20 years. FIEs are forward looking, efficient, market-oriented and are formidable business competitors. SOEs, on the other hand, are the relics

from China's seemingly distant past of central planning. Not only are they inefficient they are also fiercely resistant to changes. Despite numerous rounds of corporate reform efforts, the SOEs have kept floundering and have wasted untold amount of capital in a country with a per income of only several hundred dollars.

A slightly more charitable view of the SOEs is that they have played a vital role in creating and financing the FIE growth and such a financing function produces a severe strain on their performance. SOEs in the Chinese economy are increasingly specializing in social and welfare functions of the society and they are shedding their economic roles. In the process of creating joint ventures, SOEs are saddled with the worst of fixed assets, an unproductive workforce and a highly leveraged capital structure. Thus divergence in performance between SOEs and FIEs over time is not due purely to the internal characteristics of these two forms of corporate organizations and indeed it is plausible that their differing fortunes are in fact mirror images of the same phenomenon.

The basic contention from the IPF approach is that FIEs' advantages over domestic firms exceed the capital and technological advantages in their possession and these extra-ownership-specific advantages arise from the way the Chinese economic institutions are organized. There are two sources of these advantages. One is that foreign firms provide a range of functions that are under-provided by domestic firms because domestic firms are restricted by regulations and policies from performing these functions. Capital provision to capital-importing regions is but one of these functions. Another source arises from the fact that premium is conferred on FIEs' form of organization. Certain advantages, by regulations and policies, are attached to FIEs and thus domestic firms acquire these advantages by a simple process of corporate conversion. The premium consists of, for example, better property rights over foreign exchange, greater operational autonomy and protection from bureaucratic predation. This view of FIEs, for example, will depart sharply from the conventional economic studies that explain the export performance of the FIEs only in firm-level efficiency terms.⁴² The conventional wisdom attributes this to the efficiency and the competitiveness of FIEs. The IPF view would argue that Chinese export-producing firms have a strong incentive to be converted into FIEs as a way to maximize the option value and to protect the security of their foreign exchange holdings. Probably, the best evidence for the existence of such premium is the so-called round-trip FDI—the FDI that does not bring in any net inflows of capital or technology.

The IPF approach has important policy implications. Among Chinese policy makers and advisors, there has been a noticeable rise of economic nationalism in recent months.

⁴² See (Pomfret 1991).

Chinese are concerned about ceding undue control to foreigners and have taken actions to limit foreign companies' ability to sell their goods directly to the Chinese and in a number of sectors, such as telecommunication, the government has banned a number of innovative schemes designed to get around government's entry restrictions. Some Chinese policy advisors are complaining about market power of the FIEs and losses of policy sovereignty.

It is worth noting that some of undisciplined demand for FDI should be understood in the context of the soft-budget constraints of SOEs and their effort to clarify their ownership status vis-a-vis the government. The distortions of China's financial market and institutions are the root cause behind the apparent gaining of advantages on the part of the foreign firms in areas where domestic firms could have an advantage. The correct course of action is to deepen reforms, including an explicit privatization program, streamlining the regulatory functions of the local governments and effecting national treatment, in order to remove some of the "excessive" incentives for corporate conversions.

Policy makers should also recognize an often hidden benefit of FDI—its diluting impact on the state ownership at the firm level and its creation of a corporate governance structure broadly similar to the one in market economies. This policy payoff primarily comes from the entry of foreign firms, not of domestic, non-state firms. From that perspective, one should not underestimate the contributions of the FIEs in terms of software technology the FDI embodies—organizational and managerial skills. It is likely that this will be a more lasting legacy of the surging FDI inflows in the 1990s.

Tables and Figures

Table 1 Measures of FDI inflows: Number of projects, values of approved and paid-in FDI, 1979-1997

	Number of approved FDI applications	Approved FDI inflows (\$ billion)	Actual FDI inflows (\$ billion)
1979-1982	922	6.01	1.17
1983	470	1.73	0.64
1984	1856	2.65	1.26
1985	3073	5.93	1.66
1986	1498	2.83	1.87
1987	2233	3.71	2.31
1988	5945	5.30	3.19
1989	5779	5.60	3.39
1990	7273	6.60	3.49
1991	12978	11.98	4.37
1992	48764	58.12	11.01
1993	83437	111.44	27.52
1994	47549	82.68	33.77
1995	37011	91.28	37.52
1996	24556	73.28	41.73
1997	21001	51.00	45.26

Sources: (State Statistical Bureau 1998), p. 138.

Table 2 Estimates for the Share of Foreign-Invested Enterprises (FIEs) of the Total Domestic Sales and of the Number of Firms (Percent)

	Shares of Domestic Sales	Shares of Firms
<u>Industries</u>		
Baby Food	20	
Cosmetics	30	18.8
Glassware	30	3/5 ^a
<u>Firms</u>		
Xerox	42	
Motorola	70	

^a: Three out of the five largest firms are FIEs.

Sources: (State Planning Commission 1994).

Table 3 FIEs' equity shares and asset intensity of eight industrial sectors, 1996

Industries	FIEs' equity shares	Fixed asset turnover ratio
<u>Top four industries</u>		
Electronics and telecommunications	0.55	3.21
Leather products	0.52	3.87
Garments	0.49	3.64
Food manufacturing	0.47	1.94
Average	0.51	3.17
<u>Bottom four industries</u>		
Tobacco processing	0.02	2.69
Petroleum processing	0.03	1.36
Smelting and pressing of ferrous metals	0.03	2.28
Special purpose equipment	0.10	2.03
Average	0.05	2.09

Note:

Industries selected for this table refer to those in manufacturing only; FDI is restricted in mining and public utilities.

FIEs' equity shares are calculated as the ratio of FIEs' equity in a sector to the value of equity of that sector.

Fixed asset turnover ratios equal to sales divided by the net fixed assets.

Source: Based on the data in (State Statistical Bureau 1997).

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