China's Modernization and its Implications for Foreign Investment

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Declaration

Except where otherwise indicated
this thesis is my own work.

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CHAPTER 1
Introduction

In 1978 at the third plenum of the 11th Central Committee, the leaders of the People's Republic of China adopted a program of economic reforms which altered China's development strategy from one of isolation to active participation in the world. The drive to achieve Four Modernizations by the end of this century calls for changes in China's agriculture, industry, national defense, and science and technology. The Four Modernizations were first proposed by the late Zhou Enlai in 1975, but were vigorously opposed by China's ultra-leftists, hereafter in this paper also referred to as conservatives and oppositionists. It was not until the death of Mao in 1976 and the arrest of the Gang of Four that the reformers were able to begin to implement their changes; the time was ripe for change in China. The excesses of the Cultural Revolution (1966-1976) created a domestic political atmosphere which made it possible for the post-Cultural Revolution government to introduce drastic new programs.1

During the Cultural Revolution, the slow growth in agricultural output resulted in a per capita income growth of only 0.5% per annum.2 In the industrial sector, gross output grew at a rate of 10% per annum, but this was also accompanied by great waste and inefficiency.3 In addition, the Cultural Revolution intensified political tensions and conflicts between society and the State, and undermined official legitimacy.4 As a result, efforts to improve living standards and to reduce the State's control over people's lives were welcomed by the majority of Chinese.

The first efforts of the reform began in the rural sector in Sichuan Province. Experiments in industrial reform followed which introduced market factors into economic planning and expanded decision making powers for various enterprises.

Throughout these initial experimental years, there ensued a continuous political

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3ibid., p. 3.
4Huan, op. cit.
power struggle between the reformers and the remaining conservatives. Finally, in 1980, four key leaders of the remaining Maoists were removed from their State and Party posts, including Hua Guofeng. Although Mr. Hua participated in introducing the reforms, he did not favor a substantial departure from the old methods. Rather, he desired to simply make a few changes, such as removing the suppression of material incentives while strengthening centralized control. Mr. Hua was replaced as Premier by Zhao Ziyang and as Party Chairman by Hu Yabong.

The strengthened reformers coalition, headed by Deng Xiaoping, expanded their experimental management style to other aspects of China's economy. Since then, the economic program has progressed on three fronts, commonly referred to as rural reform, urban reform and the open door policy.

Rural reform is the decollectivization of agriculture, returning to the family as the essential economic unit, and lifting controls to allow peasants to market their surplus production.

Urban reform includes efforts to expand the autonomy of enterprises, provide material incentives to workers and enterprises, and allow market forces to partially replace state planning in the distribution of commodities and materials.

The open door policy refers to the opening of China to foreign investment, technology, and increased foreign trade. These are the changes which most dramatically affect foreign business interests in China. Consequently, this paper will analyze China's open door policy and its ramifications for foreign businesses. Specifically, four aspects of the open door policy will be reviewed: China's changing trade system; China's changing banking system; foreign investment in China and China's legal framework; and finally, potential obstacles to the continuation of China's modernization process. The chapters will cite current developments in each of these areas in an effort to generally assess whether investment in China is indeed an attractive business proposition for foreign businesses.

This paper will attempt to determine the extent to which the current Chinese leadership is committed to economic transformation and to attracting foreign investment, and whether their level of commitment is likely to be maintained under future leaders. Also, this paper will attempt to ascertain whether China's current leaders can maintain and advance the open door policy, in view of the numerous obstacles which are predicted by some to portend its demise.

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5Perry and Wong, op. cit., p. 9.
First, however, the term modernization, which is an elusive term, must be defined. Social scientists widely disagree on the definition of modernization. Concurrence might be extensive for a very loose, general attempt to define it, but the effort is hardly worthwhile. The result becomes a mere listing of the elements of contemporary life, such as urbanization, political participation and mass education, and provides no specificity or insight.

Part of the reason for the inability to agree on the term is because each of the social sciences differs in its approach to the definition and analysis of modernization. Generally, economists see modernization primarily in terms of man's application of technology to nature's resources in order to produce an increase in growth of output.

Sociologists have explored an approach, known as the differentiation approach, which holds that when external conditions change, societies adapt through differentiation. Between the moment of initial external stimulus and that of a fully adapted response, in which functions and duties have shifted, there is a period of turbulence and productivity, and that interval is modernization.

Finally, political scientists have focused on the ways in which governments increase their capacity to adapt to change and make policies in response. Since this assumes that the populace
views the government as legitimate, political scientists are often interested in how this view of legitimacy was established.

Because of these varying interests in and approaches to the analysis of modernization, definitions of the term are similarly varied. Often a definition provided by one source is not only dissimilar to another, but is contradictory. For example, in his book, *Social Change*, Wilbert E. Moore states that modernization is considered in terms of economic growth and equates it with industrialization which is defined as the extensive use of inanimate sources of power for economic production.

Others, however, while agreeing with Moore's definition of industrialization, do not find the term to define modernization. Rather, they propose that industrialization is one of many processes that occurs within modernizing societies. Industrialization is merely an aspect of modernization.

What, then, is the definition of this term modernization? Is it possible to define the term without simply resorting to a list of activities that is widely considered to occur during modernization? This author views modernization as the process by which societies have been and are being transformed under the impact of the scientific and technological revolution. It is a process that affects all aspect of society. Some elements are changed directly, while others may be changed indirectly by the emergence of new and apparently unconnected elements. Clearly,
this is not a definition which merely equates modernization to industrialization, which is a very narrow glimpse of the modernization process and all that it affects in a society.

Similarly, it is not a definition which is equivalent to the differentiation definition provided by many sociologists. Although it is admittedly similar, it is not as vague. My criticism of that definition is that the process of differentiation can be found in varying degrees in different periods of history. The definition utilized in this paper, however, refers to an important and novel attribute of a historical period.

Obviously there has been technological progress before, as well as scientific discovery, though never on such a scale. What does seem to be new, especially in reference to the People's Republic of China, is the application of these discoveries to the economy, government and education. Unlike the differentiation definition, this definition of modernization points to a narrower application of knowledge to practical affairs.

Consequently, the Chinese themselves have titled their efforts to apply scientific and technological knowledge to the practical affairs of their society as the Four Modernizations. Throughout this process, there will be extensive change as responsibilities and functions shift, and there will be problems resulting from these changes. Nevertheless, this process of
change has captured the attention of the world and is being closely monitored with widespread speculation regarding its outcome.

A crucial question that must be answered in order to make a prognosis as to whether or not a society will sustain its direction towards modernization is: how do people see their past? Are the values and practices of the past to be preserved or adapted? This is an especially relevant question in the case of the People's Republic of China which had a past that held the outside world and change in disdain.

When people refuse to break ties with their past and will not adopt new practices that modify past behavior, there is a hostility to innovation which is clearly antithetical to the development of modernization. However, if people view their past practices and traditions as being constantly subject to reinterpretation and modification, views of the past do not constitute a barrier to modernization.

This attitude of reinterpreting the past so that change can be ushered in is one of the attributes of current Chinese society that has permitted introduction of the Four Modernizations and the Open Door Policy. While this attitude is not unanimous, as will be discussed later in this paper, it does seem that it is penetrating beyond some members of the leadership to the masses. This is considered, by this author, to be a significant and self-
sustaining development for the process of modernization in China.

China has been stimulated by the impact of the scientific and technological revolution and is subsequently adapting and changing in response to that stimulus. This paper attempts to describe some aspects of that modernization process by examining the changing responsibilities of some structures and the establishment of new structures in order to gain some insight into the scope and breadth of the process.
CHAPTER 2
The Changing Trade System

One of the major changes in the People's Republic of China since the announcement of the open door policy in 1978 is witnessed in China's increasing interest in, and changing attitudes toward, international trade. Although it cannot be said that Chinese officials are in complete agreement regarding the role of international trade in the development of China, this chapter will review the changing environment in China beginning with a discussion of the Chinese perspective regarding international trade and its philosophical and practical compatibility within the framework of Marxian economics. This chapter will proceed to discuss the internal developments surrounding the advent of decentralization, including the emergence of the Special Economic Zones (SEZs) and their uses in the promotion of international trade, as well as the planned and potential uses for Hong Kong in China's overall strategy. Finally, this chapter concludes with an analysis of the role of international trade in the future development of China.

Both the composition and value of international trade in China have changed dramatically in recent years. The most significant change in the composition of China's import-export trade has been the decrease of agricultural products as a component of imports and their growth as a component of exports. Machinery and technical products now comprise the bulk of China's imports, and China, once a major market for farm products from the United States, has transformed into a competitive exporter of agricultural products.\(^1\) In addition, both the value and volume of China's trade have increased substantially. The total value of China's imports and exports grew from U.S.$10.9 billion in 1973 to U.S.$50 billion in 1984. An analysis of the changes in the volume as a proportion of national income and as a proportion of world exports shows an increase by both measures. In 1978, exports totalled 5.6% of national income and .81% of world exports; whereas in 1984, exports increased to 10.6% of national income and 1.46% of world exports.\(^2\)

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The growth in foreign trade since the formal approval of the open door policy in 1978 is significant not only quantitatively, but also because it represents an obvious departure from Mao's stated policy of self-reliance. According to China's policymakers during the Mao era, the world was divided into two groups, rich countries and poor countries, including China in the latter. It was their belief that the rich countries sought to exploit the poor through trade; therefore, trade was to be avoided. Since China had struggled to gain its political independence, it was imperative to maintain economic independence, since without it, political independence would be short-lived. According to Mao, "We emphasize self-reliance. We can rely on our self-organized strength to defeat all domestic and foreign reactionaries." This policy produced an isolationist China, with China's exports as a proportion of world exports falling to an all time low of .73% in 1977, near the end of the Cultural Revolution when the emphasis on self-reliance was at its peak.

How, then, does China, a socialist country, move from a policy of viewing international trade as an exploitative practice to be avoided to a policy which places a high premium on the growth of international trade? Under Mao's philosophy, China's current leaders are subjecting China to possible exploitation, and are in turn undertaking to exploit other countries through trade. To reconcile the disparities in the two policies of self-reliance and expanding trade, China's contemporary trade theorists describe international trade as a mutually beneficial arrangement, and not as a practice in which trading partners relate as victor and vanquished.

The justification for this change in policy can be found in China's reassessment of the theory of comparative advantage, which demonstrates the mutual benefits of trade. The initial result of this reassessment was the ideological separation of international trade from imperialistic exploitation. Through trade, poorer countries can simultaneously benefit, making the gains of trade available to them as well.

China's contemporary view of trade is also a result of an evolving perspective on Marx's idea that the intrinsic value of goods can be separated into two concepts, each of which has its own method of realization. First, Marx stated that the utility of a product gives it use value, which is realized through consumption. Second, Marx held that exchange value is a quantitative relationship whereby values in use of one sort are exchanged for values in use of another sort, which is realized through trade.

Some Chinese theorists believe that an increase in value as a result of international

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4 Watson, Luolin, op. cit.
5 Ma, op. cit., ibid., p. 294.
trade only applies to use value. For example, if two countries each possess different goods in excess of their needs, their respective surpluses have limited value. But, if the surplus goods are exchanged, effectively satisfying deficit needs in the trading countries, the total use value has increased. Regarding exchange value, these theorists believe that the value of a good is measured by the amount of socially necessary labor required to produce the good, which is known as the Labor Theory of Value. When two goods are exchanged, the total amount of value is merely the sum of the labor involved in the traded goods, and there is no net increase in the gross amount of value. Consequently, in this scenario, since no extra value has been created, mutual gain from trade is not possible; the gain of value by one side necessitates loss of value by the other, an ideologically unpalatable circumstance for China. The implications of this view that use value can justify mutually beneficial trade whereas exchange value cannot, are such that, if implemented into trade policy, China’s trade options would be severely limited. Trade would be required only as a means of disposing of excess products and acquiring needed ones; only material imbalances in the national plan would justify foreign trade, and trade would therefore remain as an appendage to economic planning.7

However, another group of theorists argue that both use value and exchange value can be increased by international trade. They believe that labor can be saved by importing certain products, and the saved labor can then be used to produce new exchange value, the effect being a net increase in exchange value. This view of the dual beneficiality of trade immeasurably increases the importance of foreign trade for China. If an imported product can save on labor, and the labor can be allocated to other goods, then the country’s productivity will necessarily benefit. Thus, the role of foreign trade would be integral to the national plan, and not merely a reaction to perceived imbalances. At present, this exchange value approach to foreign trade seems to be gaining increasing support in China.8

Although the general consensus in China today seems to be that international trade is mutually beneficial and that self-reliance is both unwise and unnecessary in order to protect political independence, the issue of self-reliance has re-emerged in relation to the types of goods which China should import. An article by Lin Zongtang in the Peoples Daily on August 19, 1985 warns that the old principle of self-reliance remains truer than ever if correctly understood in light of today’s circumstances.9 He suggests that foreigners will never sell to China their most advanced technology, nor technology that is

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7 ibid., p. 295.
8 ibid., p. 296.
9 Cited in China News Analysis, July 1, 1986, No. 1315, p. 5.
necessarily best suited for China’s needs. Mr. Lin concludes that China cannot depend on
the importation of goods to bring it into the modern age. He believes that China must
selectively import products which can be developed and transformed into goods well
suited for China’s needs. In other words, Chinese innovation will ultimately modernize
China.\textsuperscript{10}

This recognized need for the introduction of modern technology to spur Chinese
technological innovation is but one of the reasons that China’s trade system has
undergone a striking metamorphosis evolving from a centralized structure to a
decentralized one.

Prior to 1975, China’s imports and exports were governed by a few high level
bureaucrats in Beijing. There were twelve state owned import and export corporations
and another seven corporations charged with overseeing transportation, insurance and the
financial aspect of China’s trade. These corporations functioned according to plans
approved by the State Council, the highest executive organ in China, which is headed by
the Premier and includes various state commissioners and ministers. The plans by which
the foreign trade corporations were directed reflected overall foreign policy and the then
current Five Year Plan and were implemented by the Ministry of Foreign Trade.

Essentially, the corporations stood between the Chinese end user or supplier and the
foreign corporation making the sale or purchase. Even when the foreign corporation knew
which enterprise was supplying the product it was trying to market abroad, it could not
work directly with the supplier to ensure that the product met its standards.\textsuperscript{11} To
complicate matters, meetings between foreign business representatives and representatives
of the state owned corporations were usually only held twice a year at the Canton Fair.
Under this centralized system, there was no competition between the state owned
corporations because product lines did not overlap, and competition between branches of
the same corporation was prevented by unified pricing guidelines and internal restrictions.

The process of decentralization of this trade bureaucracy was slow and gradual
beginning in the late 1970s and gaining momentum in the early 1980s. It closely
paralleled other major policy changes, including the opening of China to foreign
investment and the creation of Special Economic Zones.\textsuperscript{12}

The first phase of decentralization left the twelve state owned foreign trade

\textsuperscript{10}ibid., p. 6.
N. Clough, eds., \textit{Modernizing China Post-Mao Reform and Development} (Boulder: Westview,
\textsuperscript{12}SEZs will be discussed later in this chapter and the changing investment climate will be
discussed in chapter 3.
corporations intact, but gave more authority for import and export decisions to their regional branches while still maintaining a unified central plan. The Ministry for Foreign Trade still played a dominant role in the planning and implementation of foreign trade, remaining directly responsible to the State Council.

This first phase lasted from 1978 to 1981 when the traditional, monopolistic structure of the Ministry of Trade began to break down as a result of the dissatisfaction with the performance of the traditional trade corporations. New "end-user" corporations were formed specializing in the import of a particular commodity. Although they were state owned, they did not come under the direction of the Ministry of Foreign Trade. Rather, they were controlled by the various other industrial Ministries. By 1982, thirty-two such entities had been established. A well known example is the China National Offshore Oil Corporation, which has been heavily involved in negotiations with foreign companies for offshore oil drilling.13

This change was closely followed by the formation of corporations by cities and provinces, and the emergence of new rules which allowed local authorities to conduct business dealings directly with foreign corporations without prior approval from the central government. In fact, most provincial governments now have trade representatives in Hong Kong, Japan, the United States and Europe. These representatives are responsible to their provincial authorities and not the Ministry of Foreign Trade.14 At the same time, local authorities were held accountable for their own foreign trade profits and losses and were permitted to retain a percentage of the hard currency earned from their exports for use in importing needed products and technology. The authorities were required, however, to keep their foreign exchange in balance.15

Enterprises were also given access to foreign businesspersons for the purpose of direct negotiations regarding their own deals and were allowed to retain a percentage of foreign earnings. But some key industries, such as energy and mining, are still completely controlled by the central government.16

In addition, the Chinese government initiated a system of double exchange rates in an effort to provide incentive to exporting companies, and in an attempt to ameliorate the problems presented by the price differential between China’s domestic market and the international market. For domestic accounting purposes, this established the exchange

13Ellman, op. cit., p. 430.
14Huan, op. cit., p. 5.
16Huan, op. cit., p. 5.
rates between the renminbi (the Chinese currency) and foreign currencies at roughly one half the official exchange rates.\textsuperscript{17}

For foreign buyers of Chinese goods, the decentralization of the trade apparatus meant an explosive increase in the potential number of suppliers, depending on the commodity line, and the competition between regions meant potentially attractive pricing. For sellers of goods to China, the impact was similar since more Chinese buyers had both the authority and the hard currency for purchases. However, for both buyers and sellers the change meant that a great deal more effort was required for identification of the appropriate officials with the necessary authority to conduct transactions. Not only were there numerous new individuals involved at the local level, but some decisions were still reserved for Beijing decisionmakers and the division of authority was not always clear, often changing from one year to the next without regard to the status of pending negotiations.\textsuperscript{18}

Concurrent to these changes in the trade bureaucracy, was the emergence of Special Economic Zones (SEZs). The SEZs are similar in concept to many Export Processing Zones established elsewhere in Asia which were designed to promote manufacturing development through such incentives as custom free manufacturing.\textsuperscript{19} In China, the SEZs provide increasing decision making power and preferential treatment to foreign entrepreneurs.

The first SEZ was established in 1979 in the border town of Shenzhen, adjacent to Hong Kong. Its stated purpose for its creation was to promote the development of high technology and capital intensive industrial projects in China, through Chinese and foreign partnerships, with the risks and benefits to be shared accordingly.\textsuperscript{20}

Following the establishment of Shenzhen came the Zhuhai SEZ at the mouth of the Pearl River, adjacent to Macao and Shantou, 180 nautical miles northeast of Hong Kong, and finally Xiamen on the coast of Fujian Province opposite Taiwan. It is said that the Xiamen site was chosen for two reasons: to demonstrate China’s development commitment to the Taiwanese, and to attract investment funds from the millions of

\textsuperscript{17}ibid.


expatriate Chinese with roots in the Fujian Province.21

In August 1980, the 15th Session of the Standing Committee of the National People’s Congress adopted Regulations on Special Economic Zones in Guangdong Province (commonly referred to as the 1980 Regulations).22 The 1980 Regulations set the framework for the SEZ concept by establishing the principle that the zones were to provide a favorable environment for foreign investment by making the local government responsible for the necessary infrastructure, but that all business activities would be subject to the laws of the People’s Republic of China.23

The 1980 regulations contained a number of business incentives which made the SEZs unique within China. Some of the incentives designed to attract outside investment included import tax exemptions for supplies, equipment and raw materials, export tax exemptions for some semi-finished and finished products, and a 15% corporate profits tax (compared to 33.3% outside the SEZs) with various tax holiday plans favoring projects with higher capital investment, more sophisticated technology and a longer capital turnover cycle.24 In addition, foreign firms were permitted to establish their own wholly owned enterprises in the zones, subject to local approval, and to enter into joint ventures with Chinese enterprises. Also, while the goal of the SEZs was clearly export oriented, local approval could also grant permission to sell a portion of an enterprise’s goods on the domestic Chinese market.25

By 1984, the SEZ concept was being heralded as a great success. Reports suggested that foreign investment in the Shenzhen Special Economic Zone alone totalled $540 million by the end of that year.26 This apparent success lead to an expansion of the SEZ concept when, in the spring of 1984, 14 coastal cities were opened to foreign investment, in an attempt to further attract high technology and productive enterprises for the purpose of increasing foreign exchange earnings. The cities included Dalian,


22 See chapter 3 for a detailed discussion of the 1980 Regulations and their impact on foreign investment.


24 Huan, op. cit., p. 6.

25 See chapter 3 for a complete discussion on investment options available to foreign businesses in China.

26 Far Eastern Economic Review, May 9, 1985, p. 70.
Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai. The coastal cities adopted many of the same laws and incentives that already existed in the SEZs, but with one striking difference; whereas the SEZs were each established in relatively underdeveloped areas, the coastal cities were already established manufacturing and commercial centers. The selection of these fourteen cities also addressed the southern geographical bias of the SEZs, as eleven of the cities were located in the north.27

The decision to expand the SEZ program to the coastal cities was thought by many to be one of the most pragmatic of Deng’s policies.28 However, the future of the SEZs was put in great doubt when, in June of 1985, Deng referred to the SEZs as experiments which may or may not ultimately be considered as successful.

Also that year, Beijing decided to limit the fourteen coastal cities to four; Shanghai, Dalian, Tianjin and Guangzhou. While some interpreted this change to be a major policy reversal justifying doubts about the government’s commitment to attract foreign investment, the more accurate assessment was that it was a prudent decision reflecting the cities’ development disparities. Implicit in the decision was the recognition that rapid industrial development had already strained the transportation system and had created raw material and energy supply shortages. It was concluded that the infrastructure must be allowed to mature to meet the increasing demands. Of the original fourteen cities, only the four were well enough developed to permit significant and immediate new foreign investment. The other cities were relegated to more long-term rather than short-term priority.29

In assessing the performance of the Special Economic Zones, which has recently been criticized, it is important to first identify their objectives. Although Western writers on the topic often disagree on the specific objectives, most seem to agree, as does this author, that the general objectives are as follows: the most important goal is to attract relatively advanced technology, which would be absorbed and transferred to other parts of the country, and the secondary objectives are to generate foreign exchange and to increase skilled labor.

In regard to the first objective, the SEZs have not, by and large, lived up to their goal of acquiring advanced technology. Most investments have consisted of relatively low-technology, such as land and labor intensive projects, freight transportation, or

28Ibid.
However, in regard to the goal of increasing skilled labor and introducing outside management techniques the SEZs have fared somewhat better. Some have been successful in several respects, leading to the development and training of a fairly large semi-skilled labor force in previously agricultural areas, as in the case of Shenzhen, which was the first SEZ to encourage incentive-based labor management, paying workers on the basis of how much they produced and giving management more leeway in hiring and firing.

But, the SEZs are most often criticized for their dismal performance in attracting foreign investment to develop major industries for export. The problem is partly due to the fact that producing goods for export was not what many foreign investors had in mind when the SEZ policy was announced. They found the problems of investing in China, ranging from soaring costs, arbitrary taxes and an initially unmotivated labor force, as outweighing any benefits such as cheap sites for the production of exports. China was a nation in need of almost everything and foreign businesspersons primarily wanted access to its vast domestic market.

Critics are quick to cite that in Shenzhen, after spending almost $U.S. 1600 million on infrastructure and construction, with less than half that amount coming from outside China, direct foreign investment was only $U.S. 840 million by mid-1985. Moreover, as much as two thirds of the goods produced in the SEZs were being sold domestically. An article in *Beijing Review* in August, 1985 remarked on the mere 20% of Shenzhen's production entering the international market, "the economic foundation of the special economic zones is still not as solid as desired, and foreign exchange income and expenditures are unbalanced."

There are several reasons for the imbalance. The problem began in 1984 and early 1985 when local Chinese officials, with their newly acquired authority, bought imports excessively to boost the living standard of the masses who flocked to the SEZs. With incomes having risen in China, particularly in the rural areas, as a consequence of the agricultural reforms and increased output, and an appetite for Western goods, the SEZs provided one of the few channels for obtaining these goods, either as direct imports or as products of the zones. In fact, the country imported so many goods, including such consumer products as televisions, refrigerators and automobiles, that its trade deficit

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30 ibid., p. 46.
ballooned from $U.S. 1 billion in 1984 to $U.S. 7.6 billion in 1985, and foreign reserves plunged.34

In response, there were several actions taken by the government, including the removal of the mayor of Shenzhen in August of 1985 for not expanding aspects of the development of Shenzhen to the rest of the country.35 Additionally, there was a partial rescinding of the decentralization policies. Local entities negotiating deals were no longer given carte blanche authority for approval, even if they drew upon local foreign exchange reserves. The government also imposed some new import tariffs and restrictions and levied an import regulatory tax on a range of consumer goods.36 Measures were also taken by the the central government to conserve foreign exchange, including new restrictions on the granting of export licenses, to reduce overseas sales at prices below official export prices.37 In addition, it tightened central control over foreign exchange allocations, requiring enterprises applying for access to their funds to demonstrate that their expenditures would ultimately generate exports.38 It gave the People's Bank of China more authority requiring its approval for all international borrowing.39 Finally, it continued to devalue the renminbi, leading to a decrease of about twenty percent between late 1984 and late 1985. This was part of a long-term plan to rationalize China's foreign exchange policy, and was intended to reduce the widening trade deficit, offset the effects of domestic inflation, stimulate foreign investment in China and discourage use of the country's foreign exchange reserve for imports.40

In spite of this partial retreat to centralization and the new restrictions, it is the opinion of this author that the door to China is indeed still open and the SEZs are and will continue to be an integral part of that policy.

Another vital role in the open door policy, particularly in relation to trade, is played by Hong Kong, a role which has increased in importance and attracted much speculation over the past several years. The history of the relationship between Hong Kong and the People's Republic of China spans forty years and includes cooperation on a number of issues ranging from water supplies to immigration.41 When China announced

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34 China Trade Report, October 1985, p. 4.
37 ibid., p. 7.
38 These measures were cited in an unclassified telegram from the American Embassy in Beijing to the Department of Commerce.
39 See chapter 2 for a full discussion of the banking system in China.
40 American Embassy telegram, op. cit.
41 Jacobs, op. cit., p. 63.
its open door policy, many observers predicted that the impact of China’s direct contact with the rest of the world would diminish Hong Kong’s role as a foreign trade partner with the People’s Republic of China.\textsuperscript{42} However, the policy has had the opposite effect.

For many years, the People’s Republic of China had fluctuated between being the largest and second largest supplier of goods to Hong Kong, and Hong Kong had been China’s largest export market. But the pattern of trade has changed in the last few years. China now imports a substantial quantity of products from Hong Kong, and has overtaken the United States to become Hong Kong’s largest trading partner. Also, since 1980, China has been the largest market for Hong Kong’s re-exports, as well as Hong’s largest source of goods re-exported through to other countries. In 1984 re-exports to China accounted for 34\% of Hong Kong’s total re-exports, and re-exports of products originating from China also accounted for 34\% of the total.\textsuperscript{43}

The growing visible trade links between China and Hong Kong are attributed to Hong Kong’s possession of what China is lacking; an advanced business and communications center and a developed infrastructure. Since Hong Kong has both efficient air and shipping links with the rest of the world and the best harbor on the coast of China, it is a logical and vital link in China’s foreign trade system. Furthermore, China has consistently run a significant visible trade surplus with Hong Kong, which makes Hong Kong a primary source of the foreign exchange earnings which China so desperately needs to purchase the technology necessary to achieve its modernization goals.\textsuperscript{44} Economic analysts suspect that China has now invested more than $\text{U.S.}\ 6 billion in Hong Kong, although there are currently no hard statistics available to precisely compute the figure. Nevertheless, if this figure is accurate, it would mean that China has replaced the U.S. has the largest source of investment in Hong Kong, yet another indication that China views Hong Kong as a primary link in its bid to attract foreign investment and trade.\textsuperscript{45}

Another issue in the China-Hong Kong trade relationship is the question of the impact on Hong Kong’s trade after sovereignty returns to China in 1997. A detailed discussion of this issue will not be provided in this paper. However, many believe that the answer was provided in April, 1986 when Hong Kong became the 91st member of the General Agreement on Tariffs and Trade. Its membership was part of the Sino-British Agreement on Hong Kong’s future and ensures its independent status. Membership will

\textsuperscript{42}Phillips, ‘Fourteen Coastal Cities Opened Up to Foreign Investment’, op. cit., p. 65.
\textsuperscript{43}Jacobs, op. cit., p. 65.
\textsuperscript{44}Lydia Dunn, ‘Hong Kong After the Sino-British Declaration’, \textit{International Affairs}, Vol. 61, No. 2, Spring 1985, p. 204.
also facilitate the pursuit of its own trade policies after 1997, which Hong Kong will continue to direct according to repeated statements by Chinese officials.\textsuperscript{46}

Visible trade is not the only financial link between Hong Kong and China.\textsuperscript{47} With Shenzhen SEZ in close geographical proximity to Hong Kong, the high level of interaction between the two is inevitable. In fact, Hong Kong investors dominate investment in Shenzhen. Although the majority of the investment is not in high technology, capital intensive industrial projects as the Chinese officials had hoped, there are a large number of subcontracting arrangements. These provide for the manufacture of some products to start in Shenzhen and finish in Hong Kong. Furthermore, it is logical to predict that Hong Kong investors will in the future play a major role in the continued development of not only Shenzhen, but also of the remainder of China. With the increase of incentives to invest in high technology, capital intensive projects, it is also logical to predict that much of the investment from Hong Kong will be in those areas.\textsuperscript{48}

The importance of foreign trade to the development of China’s four modernizations is reflected in the \textit{Proposal of the Central Committee of the Chinese Communist Party for the Seventh Five Year Plan for National Economic and Social Development 1986-1990} which was adopted in September of 1985. The plan states, (paras. 41-42)

"The key to implementing the open policy with an increased use of foreign funds and imported technology is to increase foreign exchange earnings through exports. To accomplish this, which is of paramount importance in our modernization programme, we must adopt strategies which meet the demands of the international market and correspond to China’s domestic conditions...Except for a few major commodities vital to the national economy and the people’s daily life, whenever there are conflicts between export and domestic sales, priority should be given to the needs of exports."\textsuperscript{49}

Specifically, trade volume is pegged to rise to $U.S. 83 billion in 1990 (40\% more than 1985) of which $U.S. 45 billion will be in imports and $U.S. 38 billion in exports. The importance of China developing its exports to earn foreign exchange is recognized by many outside the Chinese leadership. Policy makers have been under pressure from the World Bank to diversify their exports, particularly with expansion in the machinery and metal products sectors, so as not to rely so heavily on petroleum and on textiles where market growth is likely to slow in the future.\textsuperscript{50} These two categories currently account

\begin{itemize}
\item \textsuperscript{46} \textit{Far Eastern Economic Review}, May 8, 1986, p. 129.
\item \textsuperscript{47} Another link between the two, that of financial services, will be discussed in chapter 2.
\item \textsuperscript{49} Cited by Ellman, op. cit., p. 430.
\end{itemize}
for roughly one half of China’s total exports. Regarding imports, emphasis will be placed on computer software and advanced technology, while consumer durables and assembly line products will be restricted.\textsuperscript{51}

Can China attract the type of imports it needs and can China’s exports compete on the international market? This remains to be seen, as there are obstacles to both China’s desired imports and current exports. Textiles, a major Chinese export, brought China into competition with the Newly Industrialized Countries (NICs). But, textiles are a declining source of exports for the NICs. As their per capita income increases and their labor costs rise, they are moving into higher-value added exports such as semi-conductors and electronics.\textsuperscript{52} Nevertheless, in the area of labor-intensive manufactures, such as textiles, China’s problem does not lie in competition with the NICs, but in coping with the international trend toward protectionism, particularly in the United States and the EEC, which are both increasingly concerned about textile imports.\textsuperscript{53}

On the import side there exists an obstacle of even greater concern, namely Western government restrictions on the transfer of technology to China, which has been the subject of complaint by Chinese officials and Western businesspersons for many years.\textsuperscript{54} The Coordinating Committee for Multilateral Export Controls (COCOM) brings together the United States, Japan and NATO countries to coordinate the East-West trade policies of the Western Allies and Japan. The primary purpose is to prevent leakage of state-of-the-art technology which could compromise Western security. Until recently, as much as 80\% of the Council’s backlog of cases to be reviewed involved technology exports to China which were on the embargoed list and therefore required multilateral review. This mostly involved dual use items, which are items with civilian as well as potential military uses. However, in February of 1986, COCOM relaxed the regulations allowing 27 categories of items to be exported without review. This permits national authorities to license at their own discretion. As a result of the changes, the U.S. Department of Commerce announced that it would be able to clear 75\% of its license applications for technology exports to China in thirty days.\textsuperscript{55} Despite this progress, Chinese officials and the U.S. business community want to see export controls further relaxed. There are still delays of ninety days in the U.S. on some items and a complete ban on others.

\textsuperscript{51}China Trade Report, May 1986, p. 4.
\textsuperscript{55}China Trade Report, June 1986, p. 1.
In light of these obstacles, China’s goals of attracting foreign investment in high technology industries and expanding its exports seem quite ambitious in the short term. To achieve the nation’s objectives, the SEZs will retain a primary role. Some believe that expectations for their success in the first five years were too high, but for the next five years, high expectations are justified. The next five years will be the real test for the SEZs because they must now build upon a reasonably well developed infrastructure and semi-skilled labor force to achieve their goals.

Shenzhen’s proximity to Hong Kong and its advanced facilities should facilitate a growth in manufacturing ventures in which the production is started in one site and finished in the other, to take full advantage of the benefits offered by each. Zhuhai’s future holds great promise in the search for oil in the South China Sea. But, even if large discoveries are not made, it is also strategically positioned at the mouth of the Pearl River, which is the gateway to the rich counties of the Pearl River delta and is a traditional trade route. Zhuhai is also very close to Macao and is expected to benefit from its proximity to this established trade center, much as Shenzhen has and will continue to benefit from Hong Kong. In the early years, both Xiamen and Shantou benefitted greatly from the investment of overseas Chinese. For the future, Xiamen is geographically well positioned to develop as an export processing zone for the agricultural and fisheries production of Fujian. Shantao is located at the northern reach of the South China Sea oil search and would greatly benefit from a find in that area.

Despite recent criticisms, there is still an abundant potential for the SEZs to contribute to China’s continued rapid expansion into the important arena of international trade. Although some modifications have been made to the initial decentralization policies, local authorities, especially in the SEZs, still enjoy a good deal of autonomy. According to Paul Speltz, a Citicorp official involved in negotiating deals with China, "Negotiations often fail because Western businessmen think they can deal directly with Peking and not include municipal and provincial authorities in their talks. It’s still very prudent to keep everyone informed." Ellen Eliasoph, an attorney with Paul, Weiss, Rifkind, Warton & Garrison in Shanghai, says much the same thing, "In Shanghai the city government has extensive powers of self regulation. It doesn’t always listen to Peking. It competes."

In addition to the further development of the SEZs, China’s economic environment continues to change in a number of other ways. Of considerable importance are the

56 See footnote #18.
58 ibid.
changes occurring in China’s banking system, as well as China’s attempts to develop and reform its ancient legal system, a process which began in earnest a few years ago and which Chinese officials hope will have a positive impact on foreign investment. These topics will be discussed in chapters two and three of this paper respectively.
CHAPTER 3
Changes in the Banking System

Similar to the changes in the foreign trade system, China’s banking system has also been significantly affected by China’s modernization efforts and open door policy. It, too, has become decentralized in an effort to more efficiently, and competitively, handle its increasing responsibilities. This chapter begins with a brief discussion of the functions of China’s banks prior to 1979, in order to fully appreciate and understand the changes that have taken place in recent years. A description of the current functions of the established banks will then be provided as well as a summary of the facilitative role envisioned for newly established banks in China’s modernization process. Finally, the chapter will review the role of foreign banks in China.

In the pre-1979 period, the banking system in China was a centrally controlled bureaucracy with little leverage vis-a-vis the other Ministries. The People’s Bank of China maintained authority and control over two specialized banks; the Bank of China and the People’s Construction Bank of China.

During this period, the banking system performed six basic functions. First, the banks accepted deposits and advanced loans to channel any idle funds to the productive sectors. This credit was normally pre-arranged and was for the sole purpose of an enterprise fulfilling its plan from the central authorities. Second, the People’s Bank monitored and controlled the amount of circulating currency. Chinese monetary authorities considered the control over the volume of cash in circulation, which was mostly held by individual consumers, to be the most important means of maintaining short-term monetary stability; too much cash in circulation would have raised the demand for scarce goods and produced inflationary pressures.\(^1\) Although such demand pressures would not necessarily have led to actual price increases, since most prices were centrally administered. Thus, an overall target for the amount of currency in circulation was set by authorities. It was the responsibility of the banking sector to keep within that target by placing strict limitations on all state enterprises and many large organizations.

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They were required to deposit all idle cash in the People's Bank and to limit cash payments to the short list of permissible activities. Because enterprises were restricted in their cash transactions, all collections and transactions had to be carried out by means of transfers between banking accounts. Essentially, this highlights the third function of the banking system, to serve as a national accounting system. This ideally positioned the banks for monitoring the fulfillment of the State's plan, its fourth function, enabling action to be taken when enterprises fell short of their goals. In reality, however, the banks were unsuccessful in curbing unplanned investment. The fifth function had the People's Bank operating as a conduit for revenues and expenditures for the government, and the sixth function involved the limited foreign exchange transactions.²

With the reforms of 1979 came the recognition by the leadership in Beijing that the banking system could play an important role in the efficient allocation of funds, the promotion of economic activities, and the maintenance of price stability through non-administrative means.³ The initial reforms to the banking system began with the 1983 decree by the State Council that the People's Bank should become solely a central bank, directly accountable to the State Council. Its responsibilities now include formulating and implementing monetary policy, issuing currency, controlling credit, setting interest rates, acting as state treasury, and overseeing the operations of the specialized banks.⁴ In addition to the Bank of China and the People's Construction Bank this includes two new banks; the Industrial and Commercial Bank of China and the Agricultural Bank which was re-established after being abolished more than twenty years ago. In addition to these specialized banks, there are two additional members of the China Banking System but they do not come under the sole authority of the People's Bank. They are the China Industrial Trust and Investment Corporation and the China Investment Bank.

In 1985, the head of the People's Bank, Lu Peijian was removed and replaced by Chen Muhua who came not from the bank itself but from the political arena. This was a confusing change to most Western observers, but the impact of the change has been a significantly expanded role for the People's Bank.⁵ This is particularly true in its international operations. It controls all public bond issues abroad, and is ultimately responsible for the foreign exchange regulations. In addition, the People's Bank is involved with the International Monetary Fund (IMF) and the World Bank as well as the Asian Development Bank. Its involvement with the Asian Development Bank is

² ibid., p. 453.
⁵ ibid.
particularly revolutionary because Taiwan, which is also a member, was not expelled upon the inclusion of China, nor did China demand such an expulsion.\(^6\)

In addition to the new role of the People's Bank, other changes involve increased authority and independence for the other member banks, which involves limited competition with the People's Bank of China, particularly in attempts to attract business from abroad. However, it remains clear that the People's Bank of China possesses the final authority.\(^7\) As the People's Bank has become more important, so, too, have the specialized banks. They monitor and administer credit applications, signalling the People's Bank on market trends in their sectors. They are also encouraged to compete with each other but when the competition results in lending practices that are considered too aggressive and risk laden, the People's Bank intervenes.\(^8\)

The role of the Bank of China, one of the four specialized banks, has changed substantially in the last several years as China has increased its links with the outside world. Domestically, the bank has taken over the provision of finance to the foreign trade network inside China giving loans for production and commercial transactions related to exports.\(^9\) The bank also offers financial assistance to enterprises with foreign investment in the form of overdrafts, preferential loans and short to medium term credit.\(^10\)

Today, the Bank of China has branches both within and outside the country, but it is its activities in Hong Kong and overseas that are the most impressive. In its 1985 annual report, the Bank of China's total assets worldwide had increased by 30% over the previous year, and its overseas offices including those in Hong Kong, Macau, Tokyo, London and New York totalled 310. In Hong Kong it has attracted a substantial deposit base, and it has been involved in merchant banking and securities brokerage. The Bank of China's merchant banking subsidiary, China Development Finance, has been very involved in loan syndications for Chinese projects and the underwriting of bond issues. Its other overseas branches have been trading in international money markets and bond markets, successfully issuing paper in Tokyo, London and Hong Kong and floating a DM 1500 million Eurobond in Frankfurt.\(^11\) In addition, it is actively seeking participation for joint ventures in China, thereby earning the fees which would otherwise go to foreign

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\(^6\)ibid.


\(^8\)Wilson, op. cit., p. 16.


banks.\textsuperscript{12}

In addition to the Bank of China, the China Industrial Trust and Investment Corporation (CITIC) competes with the People's Bank of China for international business. The CITIC is directed by the former Shanghai industrialist, Rong Yiren. His appointment to the CITIC was seen as an encouraging sign that Chinese leaders were impatient with slow growth and wanted a trade investment apparatus that could respond to market opportunities.\textsuperscript{13} The principal purpose of the CITIC is to facilitate foreign investment in China. Accordingly, CITIC’s concerns are broad based: merchant banking, investment matchmaking for foreign companies in China, overseas investment for Chinese companies, issuance of foreign currency bonds, real estate leasing and trade consulting. In fact, the company’s consulting group evolved into a subsidiary called China International Economic Consultants, which provides market research, and financial, legal and marketing consultation to foreign companies operating in China.\textsuperscript{14}

Like the Bank of China, CITIC has been active in joint ventures with foreign companies in coal mining, cement production, elevator manufacturing, food processing, and light industrial manufacturing. In about thirty of the projects it has put together, CITIC has also taken an equity position. One of its most innovative endeavors was its purchase of timberland in the State of Washington and its establishment of its first overseas investment project, CITIFOR, Inc., to obtain forestry experience and timber supplies.\textsuperscript{15} The CITIC also competes with the Bank of China in the area of foreign currency transactions.

An additional source of competition for the Bank of China is the new authority given in 1985 to the Industrial and Commercial Bank, another of the four specialized banks under the People’s Bank of China, to engage in foreign currency transactions in the Special Economic Zones. When the People’s Bank of China was designated as the central bank, the Industrial Bank assumed control over its urban branch network and is now the chief source of working capital.\textsuperscript{16} The bank now boasts 3,000 branches and offices and is responsible for almost three quarters of China’s domestic deposits and loans. By maintaining a surplus of deposits over loans, it is also a net provider of funds to the central bank. In addition to granting small loans, the Industrial Bank has also formed the first joint venture bank in China, in partnership with a Hong Kong group, Panin

\begin{itemize}
\item \textsuperscript{12}Wilson, op. cit.
\item \textsuperscript{14}ibid.
\item \textsuperscript{15}ibid., p. 59.
\item \textsuperscript{16}\textit{China Trade Report}, July 1986, p. 9.
\end{itemize}
Holdings.\textsuperscript{17}

The Agricultural Bank, the third of the four specialized banks, had been abolished before the Cultural Revolution, but was re-established in 1979 and assumed supervision over the rural offices of the People's Bank of China. With the return to family farming under the agricultural responsibility system in recent years, the Agricultural Bank now lends to individual households instead of agricultural cooperatives. It set up a division to promote borrowing from abroad for export oriented rural industries, but it recently announced that its priority is agriculture and not rural industries which should instead rely on their own profits.\textsuperscript{18}

The fourth specialized bank, the People's Construction Bank of China, was at one time an organ of the Ministry of Finance. In the pre-1979 era, the bank was responsible for allocating budgetary grants from the State to state owned enterprises for investment purposes. Today, those grants have been substituted for loans and the bank's work now primarily involves supervision of those loans, making it an important supervisor of investment projects and funding.\textsuperscript{19}

The final member of the Chinese banking system is the China Investment Bank, which was established in 1981. It is responsible to the State Council via the Ministry of Finance, and its main responsibility is to raise foreign investment funds for construction and renovation projects in China, particularly through the World Bank and other international financial institutions, in the form of long to medium term loans.\textsuperscript{20} It acts as agent for the international institutions by dispersing their funds to small and medium sized Chinese enterprises and Chinese-foreign joint ventures.\textsuperscript{21} By the end of 1984, the bank had approved about 100 projects involving $200 million in foreign currency.\textsuperscript{22} Consequently, its staff has had to become well versed in the detailed requirements stipulated by the World Bank. The expertise and sophistication obtained by those at the China Investment Bank through such international exposures may substantially effect China's future development. It is hoped that the China Investment Bank will bring to China the developed financial practices and methods of the international organizations with which it deals, and that such practices will subsequently spread to the various

\textsuperscript{17}Wilson, op. cit., p. 21.
\textsuperscript{18}China Trade Report, July 1986, p. 9.
\textsuperscript{19}ibid.
\textsuperscript{20}Zhao Hong, 'China Investment Bank Opens New Channels for Attracting Foreign Funds', China's Foreign Trade, September 1985, No. 103, p. 15.
\textsuperscript{21}China Trade Report, July 1986, p. 8.
\textsuperscript{22}Maurice Howard, 'China and the World Bank', China Now, Spring, 1985, p. 17.
Due to the relatively recent decentralization of the Chinese banking system, the biggest challenge to the new banking system is the control of credit which is the most important instrument of monetary policy. The People’s Bank of China relies on three principal means of controlling the total volume of credit that can be granted by the specialized banks. First, it establishes an overall credit plan each year, including the targets for the specialized banks. Within the overall credit limit set by the People’s Bank of China, the specialized banks assign credit ceilings to their regional branches. The People’s Bank then issues notices on the permitted level of borrowing by the specialized banks’ branches from the regional branches of the People’s Bank. The specialized banks can "borrow" outstanding credit that it was allocated in another loan category as long as it stays within its overall credit ceiling, although there is no real penalty for exceeding the ceilings.

The second way in which the People’s Bank controls credit is through a reserve requirement; the specialized banks must re-deposit a portion of their deposits with the People’s Bank. Previously, the amount was different for household deposits, enterprise deposits and rural deposits, but in 1985 the requirement was changed to a uniform 10% for all banks.

The third form of control of credit control is implemented through the terms of the loans from the People’s Bank to the specialized banks. They can borrow from the People’s Bank at 4.7% interest for amounts up to their credit limit and at 5.04% beyond that limit. However, the specialized banks only receive 4.3% on their deposits. The interest differential serves as a disincentive for borrowing by the specialized banks.

It is, however, the job of the local bank manager to actually discriminate between individuals or enterprises who will receive the limited credit available. The interest charged on working capital loans was 7.2% in 1985, but the local bank has the flexibility to adjust that rate marginally for enterprises showing great promise. It is said that managers of Chinese enterprises are less than satisfied with local bank managers’ performance regarding decisions on loan extensions. They claim that local bank officials are inadequately trained and are influenced by political considerations resulting in the

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23 Wilson, op. cit., p. 20.
24 ibid.
26 ibid.
27 ibid.
28 Wilson, op. cit., p. 22.
extension of numerous questionable loans. In the present tight-money era, these enterprise managers are finding it difficult to upgrade their facilities in an effort to modernize.\(^2^9\)

In spite of these changes, a successful active monetary policy is inhibited by the distorted price structure and partial reversals and unforeseen problems with indirect policy initiatives. Thus, authorities have, from time to time, reverted to direct controls when faced with unwanted resource allocation.\(^3^0\)

While the advent of decentralization of the banking system is revolutionary, the biggest advance in banking is the introduction of what are called "stock issues" for which the People's Bank of China has management responsibility.\(^3^1\) In Shanghai, the Heaven Bridge Department store issued "shares" two years ago and the response was overwhelming. The payment of a 15% dividend on those issues was the first to be paid in China since 1949, and is twice the amount of annual interest paid by banks to depositors. The issue was followed by issues in Guangdong province with some companies paying dividends of up to 24%.\(^3^2\)

The role of the People's Bank and the Industrial and Commercial Bank in these share transactions is to issue shares on behalf of enterprises, pay them the proceeds and pass on to shareholders the interest or dividends. This can be viewed as China's equivalent to a stock exchange.\(^3^3\) These new stock issues have become a financing tool for factory managers to replace the government funds that they once received to cover all their needs, and to supplement what is provided by the banks in the form of loans.\(^3^4\)

Usually the "stocks" are in small denominations with a fixed term, and a shorter term maturity period of perhaps one to five years. Redemption is usually guaranteed by local authorities, although the Shanghai branch of the People's Bank recently indicated that shareholders would bear some financial responsibility for potential company losses. However, regardless of potential liabilities, there are certain perks to stockholders such as priority classification for rental space in offices under construction.\(^3^5\)

The stockholders are usually paid in both interest and dividends, with the interest either being fixed at the time of subscription, or pegged to the People's Bank deposit rates. Interest is paid to shareholders first, and dividends are distributed according to the

\(^{29}\) *China Trade Report*, September 1986, p. 5.

\(^{30}\) Wulf and Goldsbrugh, op. cit., p. 226.

\(^{31}\) Wilson, op. cit., p. 23.

\(^{32}\) Ibid.

\(^{33}\) Ibid.

\(^{34}\) *Beijing Review*, January 7, 1987, p. 17.

\(^{35}\) Wilson, op. cit. p. 24.
net profits after payment of interest, tax and employee bonuses. Since the return from stock has been higher than that on deposits, and the issues are normally officially guaranteed, stocks are a more attractive investment than depositing money in the bank. However, there is no secondary market yet, and the cost of transferring shares is quite high, which seems to deter many depositors from transferring deposits into the purchase of stocks. There is certainly the potential for this type of hybrid stock market to fuel China's modernization programs. However, before this development plays a significant role in financing economic activity in China, most Western observers agree that a secondary market and less regulatory supervision is required.36

In order for the Chinese banking system to be successful at its new responsibility of ensuring adequate amounts and profitable uses of resources in the modernization efforts, it will want to be even more active in the foreign markets, and it follows that foreign competition will be looking to enter China's domestic financial market.37

The role of foreign banks in China has also changed in recent years, albeit not to the extent that many would have hoped. As of April 1984, foreign banks are permitted to open branches in any of China's Special Economic Zones, whereas previous rules had confined their operations to representative offices unable to engage in banking business, per se. Today, 93 foreign banks are represented in China. Most have a representative office in Beijing, since branches of foreign banks are not permitted in China's capital, and there are 22 branches currently operating or about to be opened in the Special Economic Zones.38

In spite of the influx of foreign banks, China does not seem interested in opening up its domestic market to real commercial banking competition from overseas.39 This is reflected in the limited functions allowed the foreign representative offices and branches. The main functions of the representative office are to gather market information, establish contacts, help their customers identify, negotiate and finance joint ventures and do correspondent banking.40 For a branch of a foreign bank, the functions are more extensive. They include trade finance, letters of credit, foreign currency loans, and foreign currency or renminbi deposits. The restrictions are, however, that deposits can only be accepted from foreigners and overseas Chinese. The renminbi deposits are only

36 ibid.
37 ibid.
39 Cited in an unclassified telegram from the American Embassy in Beijing to the Department of Commerce.
40 Wilson, 'Waiting Game for China's Foreign Bankers', op cit.
acceptable if the bank is acting as agent for the Industrial and Commercial Bank. In fact, for deposits, overdrafts, outward remittances and settlement of import transactions, foreign banks may deal only with foreigners. The local business is confined virtually to lending. In addition to these prohibitive regulations, China requires that a branch of a foreign bank be initially capitalized at or above $U.S. 12.5 million, a requirement which is reportedly dissuading many foreign banks from entering the limited market.\(^{41}\)

With these excessive rules governing foreign banks, it would seem that the costs would considerably outweigh the benefits in opening a branch or even a representative office in China. But those banks that have entered the market seem to have done so more for its potential than for any immediate return on their investment. It may be a gamble for these banks to anticipate that Chinese officials will eventually allow foreign banks to fully compete with China’s banks in China’s domestic financial services industry, especially given the tremendous advantage of expertise and assets and seemingly unlimited resources held by foreign banks. However, there is a role for foreign banks that is more certain. Rather than gaining access to the domestic market, it would involve the financing that will be the crucial factor in determining which foreign company will, in the future, win a particular Chinese contract. The Chinese are soon expected to partake of commercial credit offshore, especially as rates go down, so creative packaging of credit and guarantees will be in demand. Many foreign banks are hoping that having established a presence in China will enhance their chances in the financing competition.\(^{42}\)

It is clear after reviewing the many aspects of the changing trade system and changing banking system that the evolution of modernization is occurring at different paces and to different degrees for various sectors. The third topic reviewed in this paper, foreign investment in China and its legal framework, will demonstrate the variance in these changes even further.

\(^{41}\) ibid.

\(^{42}\) Telegram from American Embassy officials in Beijing, op. cit.
CHAPTER 4
Foreign Investment in China and its Legal Framework

One of the most important aspects of the open door policy in China is the strategy of attracting foreign investment. Once this policy was pursued, however, it was soon realized that the development of a written legal framework was necessary not only to gain the confidence of potential investors, but to protect China's interests as well. Thus, concurrent with the growth of foreign investment has been the adoption of hundreds of laws to regulate that investment. This chapter begins with a short description and explanation of the forms of investment available to foreign enterprises in China and discusses the current Chinese priorities, the attraction of high technology and the ability to maintain a balanced foreign exchange account, which any potential investor must understand and consider. The chapter then examines an aspect of foreign investment in China that has only recently emerged, but must be included in any discussion of the topic, namely the growing attitude that China is not the good investment prospect that many believed it to be when the open door policy was announced. The reasons provided for this change in attitude are numerous, but the one cited most often is China's incomplete legal framework. Since China first opened its door to foreign investment, this has been a recurring complaint by foreign businesspersons. But, many foreigners fail to understand that the role of law in China's history is very different from its historical role in most Western countries. Thus, a brief discussion of the evolution of China's legal system will be provided in an effort to understand the Chinese perception of law and the significance of the laws that have been promulgated.

There was one particular incident that occurred soon after the open door policy was announced which clearly demonstrated to both foreigners and the Chinese that a complete legal infrastructure to regulate foreign investment was absolutely necessary. In 1979 the Chinese began building the Baoshan steel plant near Shanghai with Japanese technology and equipment. But before construction was completed, the Chinese cancelled twenty two contracts pertaining to the plant. The embroiled controversy that followed, and the tireless effort to resolve the dispute to the satisfaction of all parties, was so extensive and seemingly insurmountable that it threatened the future of Sino-Japanese relations. Therefore, this chapter discusses the Baoshan incident in detail, because valuable insights
can be gained from its background and outcome, demonstrating the need for written laws in China to deal with foreign investment, and also revealing much about the internal constraints that the Chinese face in their efforts to modernize. Finally, the chapter concludes with an explanation of the legislation the Chinese have enacted in addressing their critics, with specific emphasis on legislation pertaining to legislation pertaining to equity joint ventures.

The simplest form of foreign investment in China is compensation trade. Originally, it was the most popular form of foreign investment attracting some 1,370 contracts by the end of 1984.\(^1\) It was especially popular with Hong Kong textile manufacturers who wanted to move a portion of their production to China. However, it declined significantly after the United States increased the severity with which it applied its country of origin rules: the rules prohibited Hong Kong manufacturers from using Hong Kong's quota allocation when too much of the value of the garment was produced in China.\(^2\)

Compensation trade is basically a loan transaction where both the initial advance and subsequent loan repayments are made in kind. The foreign compensation partner either sells the Chinese party new equipment or technology on credit or lends the equipment and technology to the Chinese enterprise. The purchase price is repaid in instalments of products, either produced by the equipment or technology or less frequently by the provision of other goods manufactured by the Chinese enterprise. Compensation trade contracts also stipulate an interest rate, which is added to the instalment repayments and is also paid in kind.\(^3\)

A second form of foreign investment in China is co-operative investments which refers to a wide variety of arrangements whereby Chinese and foreign entities agree to co-operate for a specified period of time for the purpose of jointly producing certain items or rendering certain services. Co-operative investment arrangements can be divided into two categories: joint development arrangements and contractual joint ventures.\(^4\)

Joint development contracts have been limited to Chinese-foreign activities with respect to offshore oil exploration, development and exploration contracts. Thirty one such contracts have been signed so far and the amount of investment pledged by the

\(^{1}\) *China Trade Report*, March 1986, p. 1.


\(^{4}\) Ibid., p. 110.
foreign oil companies is over $U.S. 2 billion.\(^5\) In projects for joint development, the exploration stage is funded at the sole risk of the foreign investor. If oil is found in sufficient quantities for commercial development, both the Chinese side and the foreign oil company invest in the joint development of resources. Once production has begun, the recovered oil is divided between the parties as stipulated in the joint development contract.\(^6\)

Contractual joint ventures are the most common form of co-operative investment arrangement. There are two distinct forms: in the first an entity with the status of a legal person is created, while in the second no legal entity is created and the business relationship takes the form prescribed by the venture contract. In China, contractual joint ventures have been established for the joint construction and management of hotels and have even been used as a vehicle for joint Chinese-foreign tenders in World Bank supported development projects.\(^7\) However, there is little published legislation specifically governing contractual joint ventures. There are not even any regulations which state the method by which a contractual joint venture is to be approved by the Chinese government. Nevertheless, a set of rules is said to be forthcoming.\(^8\)

The equity joint venture in China has the most complete set of published laws. The Joint Venture Law provides that joint ventures should take the form of a limited liability company to exist for a stated duration to be agreed upon in the contract, but not to exceed thirty years. The equity joint venture has three characteristics that distinguish it from other forms of business cooperation: (1) pooled assets; (2) shared profits and losses; (3) joint management.\(^9\)

The last major vehicle for foreign investment in China is the wholly foreign owned enterprise. While in the past this form of investment was not discouraged, it certainly was not encouraged in the same way that contractual and equity joint ventures were encouraged, because the Chinese government was less able to exert direct pressure on the wholly owned foreign enterprise. Nevertheless, that attitude is changing as evidenced by legislation that was enacted on April 12, 1986 regulating wholly foreign owned enterprises. As is true of almost all initial forms of legislation in China, the law is very


\(^6\)Dong Shizhong, 'Answers to Foreigner's Questions About Investing in China', *Intertrade*, February 27, 1985, No. 2 p. 44.

\(^7\)Moser, 'Foreign Investment', op. cit., p. 111.

\(^8\)ibid.

vague and attorneys are uncertain of the appeal it will have to foreign investors because it
does not allow a completely free hand in their operation.\textsuperscript{10} For example, the enterprise's
investment situation will be regularly inspected and monitored by the Administration of
Industry and Commerce and production programs shall be reported to the Chinese
authorities, a requirement that most businesses will find particularly objectionable.\textsuperscript{11}
Nevertheless, the change in attitude from the time when wholly foreign owned enterprises
were considered to compromise Chinese sovereignty is considerable. Furthermore, the
detailed regulations on the implementation of the law are likely to correct some of the
ambiguities and allay many of the concerns.\textsuperscript{12}

Regardless of the form of foreign investment, the Chinese clearly have two priorities
in mind for the type of investment they want to attract; those that will introduce high
technology to China so that it can be utilized in its modernization efforts, and those that
are able to maintain a balanced foreign exchange account. Both priorities are born of
necessity—the first because the Chinese are convinced that without advanced technology,
their modernization efforts will never reach their aspirations. The second is due to their
severe shortage of foreign exchange reserves. The following is an expanded discussion of
those priorities.

Throughout the process of formulating economic policy since 1979, the faith of the
Chinese leadership in science and technology as powerful instruments for economic
development has remained undiminished.\textsuperscript{13} Chinese leaders have repeatedly emphasized
the importance they place on gaining advanced technology from industrial market
economies, a priority that was again highlighted in the Seventh Five Year Plan
(1986-1990). In order to gain a full understanding of the Chinese perception of
technology imports and their role in the Chinese economy, a brief review of their
historical experience in relation to such imports is helpful.

Chinese imports of technology since 1949 have been characterized by four peaks.\textsuperscript{14}
During the first, lasting until the late 1950's, the Soviet Union was the most dependable
source of foreign equipment and technical assistance. Technology imports during this
period were almost exclusively in the form of large, complete sets of equipment. This
resulted in the Chinese associating all technical imports with large products. It also left

\textsuperscript{10}\textit{China Trade Report}, August 1986, p. 1.
\textsuperscript{11}ibid.
\textsuperscript{12}ibid.
\textsuperscript{13}Richard Conroy, 'Technological Change and Industrial Development', in Graham Young, ed.,
\textsuperscript{14}Stanley Lubman, 'Technology Transfer to China: Policies, Law and Practice', in Michael
J. Moser, ed., \textit{Foreign Trade, Investment, and the Law in the PRC} (Oxford: Oxford University
Press, 1984), p. 84.
the impression with many Chinese that accepting technological imports was equivalent to being dependent on said imports.\textsuperscript{15}

This first technology import phase ended when relations between China and the Soviet Union cooled. The second phase, from 1973 to 1977, included technology imports from the West and Japan for the first time since 1949.\textsuperscript{16} This phase, too, was characterized by imports of large plants, many of which encountered considerable difficulties, also influencing current Chinese thinking on technology imports. The difficulties included construction delays on some projects and a shortage of materials required on others. The consensus of many critics at the time was that imported technology simply could not be absorbed and applied to China’s needs; a view that is occasionally voiced today.\textsuperscript{17}

The third phase of technology imports occurred from 1978-79, which again saw the import of large plants, including the large Baoshan iron and steel plant located in Shanghai.\textsuperscript{18} Many of the plants were petrochemical plants which consumed a large amount of energy and caused other economic dislocations. Others required large amounts of materials that had to be imported at a high cost. The result of this period was the realization that a thorough assessment of China’s needs, and of the relationships between imported projects and the rest of the Chinese economy was lacking.\textsuperscript{19}

China is currently experiencing its fourth phase of increased technology imports, and its policies reflect lessons and experiences of the first three waves. First, China has diversified its technology sources. According to the Japan-China Economic Association, during 1978-1984 China selected Japan as the source of 52\% of its imports of whole plants and high technology, Western Europe for 38.2\% and the U.S. for a mere 7.1\%.\textsuperscript{20} Second, fewer large plants are being purchased and a much higher emphasis is being placed on the rejuvination of existing facilities. Finally, there has been a shift away from importing equipment, and a move toward importing knowledge and training.\textsuperscript{21} But, it should be noted that this last development is causing concern among some Western suppliers who

\textsuperscript{15}ibid.
\textsuperscript{17}Lubman, op. cit., See also the discussion in the beginning of chapter 1 regarding Chinese self-reliance and the absorption of imported technology into the Chinese economy.
\textsuperscript{18}This project will be discussed in detail later in this chapter, as it had a profound effect on a number of Chinese modernization policies.
\textsuperscript{19}Lubman, op. cit.
\textsuperscript{21}Lubman, op. cit., p. 86.
are uncomfortable handing over their technological information. "The Chinese wanted us to give them the technical documents for the most sophisticated parts, and they would take it from there.", explains Martin Postch, Deputy Managing Director of Volkswagen.²²

It is evident that foreign businesspersons are concerned about sharing trade secrets with the Chinese without proper safeguards. Although the Patent Law of the People's Republic of China was passed on March 12, 1984 after more than five years in the making, there are some vague items that concern foreign businesspersons. For example, while the law states that infringement will be handled by "patent control organs", very little is known about these "organs" and how they will make decisions regarding infringement and compensation. Also, while the law directs foreign applicants who have no residence or place of business in China to apply for patents in accordance with bilateral treaties, "regular residence" and "place of business" are never defined. Finally, the question of patent protection for computer programs is not even directly addressed.²³ Consequently, China's attempts to acquire business knowledge without accompanying product purchases may continue to meet with considerable resistance.

The lessons of the past have also shown Chinese leaders that better planning and feasibility studies are needed, especially with an emphasis on integration of domestically manufactured equipment with that purchased from abroad. Rather than stressing the most advanced technology available, most officials are increasingly aware that emphasis should be on the appropriateness of the technology and China's capacity to absorb it.²⁴

Although there has been a reassessment of Chinese policy toward technological imports, it should not be misunderstood as a reversal of the policy that places a priority on technology from the outside world as the key to China's modernization. That policy remains intact as is evidenced by new tax laws entitled Interim Regulations on Reduction and Exemption of Tax on Royalties of Proprietary Technology which became effective January 1, 1985. In order to encourage the importation of technology, this law provides that income tax on the royalties of patent technology would be cut in half to 10% and certain transactions would be wholly exempt. This reduced tax or exemption from tax is applicable to proprietary technology which is: 1) offered for developing production in agriculture, forestry, fishing and animal husbandry; 2) offered for Chinese scientific research institutions to carry out scientific research and experiments; 3) offered

²⁴ Lubman, op. cit.
to China’s key construction projects for exploiting energy resources and developing communications and transportation; 4) offered for energy-saving and for prevention and control of environmental pollution; and for proprietary technology imported for use in eight additionally named "important technical spheres". 25

Although technology transfer is certainly a priority in China’s foreign investment strategies, since the drastic depletion of its foreign exchange reserves in late 1985, China’s other priority for foreign investment is that it generate sufficient foreign exchange to meet its own needs. American companies investigating projects have been told that new joint ventures, in order to get approval, will have to export 51% or more of their output and that the state will not be able to subsidize joint ventures in the early years in the form of foreign exchange for the purpose of profit repatriation. 26

To generate hard currency on their own, some American firms in China have gone into unrelated export businesses. Pepsi-Cola International, which is a partner in a joint venture plant in Fuzhou, will expand its operations in China next year by investing in the Chinese marble export industry, for which Pepsi expects to earn $U.S. 2 million in foreign exchange. 27

Restraints on foreign investment due to shortages in foreign exchange are not expected to be short-lived. Although reserves were reported to have increased 16% to $U.S. 12.5 billion in the third quarter of 1985 as a result of the clampdown on imports, the increase was mainly attributed to growth in foreign exchange deposits at the Bank of China, i.e., borrowed reserves, which account for three quarters of China’s total reserves and offset a continuing drop in State-held reserves. Figures released in April 1986 indicated that total reserves were approximately $U.S. 10 billion suggesting that there has been little progress in replenishing coffers. 28

Foreign investment in the People’s Republic of China is a phenomenon that has emerged only recently, yet its early success is remarkable. By the end of 1984, more than 3,195 Chinese foreign equity and contractual joint ventures had been approved by the Chinese government. 29 However, the amount of contracted foreign investment dropped in the first half of 1986 compared with the same period in 1985, showing the first decline since China’s recent drive to attract foreign investment. Statistics released by the

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25 This explanation of the law was provided by Wang Zhengming, Secretary-General of the China Economic Law Research Association in a paper presented to the 13th International Trade Law Conference on November 1, 1986 in Canberra, Australia.

26 Cited in an unofficial telegram from the American Embassy in Beijing to the Department of Commerce.


28 Telegram from American Embassy officials in Beijing, op. cit.

29 Ibid.
Ministry of Foreign Economic Relations and Trade show that investments were nearly 50% lower during this period.\textsuperscript{30} The main reason cited for the decline is an extensive list of problems and bureaucratic red-tape facing investors, beginning with the approval process for investment projects.

Despite China's encouragement of foreign investment and its many decentralized policies, approval of foreign investment projects is still closely linked to China's State planning mechanism. In general, all proposed projects utilizing foreign capital or technology which are to be undertaken by the Ministries at the state or local level, as well as those projects undertaken indirectly through subordinate corporations or other business units of such entities, must first be submitted to the relevant state or provincial economic planning commission for review. Upon approval, the projects are then included in the annual plans of the commissions which are sent to the State Council for ratification.\textsuperscript{31} Thus, the approval process for foreign investment projects is primarily a means to ensure that projects are actually in the plan before they are initiated. As a further precaution, the Chinese are not allowed to even begin negotiation on a project until it has been approved and included in the plan. To ensure that authorized projects are carried out according to the specifications in the State plan, all projects must be approved by the relevant government authority before a contract is considered legally binding which is of utmost importance to foreign companies.\textsuperscript{32}

The most frustrating problem faced by foreign investors is that there are no statutes or guidelines to indicate what level of approval is required for a particular project. However, the basic approval criteria in the past generally depends on the total amount of Chinese and foreign investment involved. As a general rule, any project with a total investment of $U.S. 3 million or less need only be approved by the ministry under whose authority the project is undertaken. Whereas a total investment above that amount requires approval by the Ministry of Foreign Economic Relations and Trade (MOFERT). There are, however, exceptions to this rule, particularly for projects in the SEZs where local officials can often approve projects in excess of $U.S. 10 million.\textsuperscript{33}

The lack of clear guidelines on the approval process is only one of a growing number of complaints provided by foreign businesses as reason for reassessing their intentions to invest or re-invest in China. The Western press has cited numerous incidents of other problems that have been encountered.

\textsuperscript{31}Moser, 'Foreign Investment', op. cit., p. 106.
\textsuperscript{32}ibid., p. 107.
\textsuperscript{33}ibid., p. 108.
Under the title, 'Sweet is Turning to Sour', the June 2, 1986 edition of *Time* magazine highlighted the problems experienced by American Motors in its joint venture with a Chinese automaker to assemble Jeeps in Beijing. After turning out just 800 automobiles, production had to be indefinitely stopped for financing reasons. The Chinese government blocked the financing with which the plant was to buy Jeep kits from an AMC factory in Canada. The government's action was part of an across-the-board clampdown on import purchases which had caused the severe drop in foreign exchange reserves. As the article stated, prospective investors in China scrutinized the Jeep situation in an attempt to gauge the government's commitment to attracting foreign investment.\(^{34}\)

Additionally, as also reported in the foreign press, foreign businesses find their profits are eroded by what they describe as hundreds of unforeseen expenses. For example, the manager of a Western operated hotel noted that the tax on a shipment of food from Hong Kong varied from 20% one month to 60% the next.\(^{35}\) Also, Volkswagen's Santana assembly plant in Shanghai must import the majority of most production parts since those made in China do not meet their standards, while officials at Otis Elevator in Tianjin complain of low productivity and poor quality control, and managers at Gillette's razor blade venture in Shenyang complain of the lack of qualified technicians.\(^{36}\)

In matters involving labor, taxes, custom duties and living costs the press reports that there is a perception among foreigners that they receive discriminatory treatment and consequently many potential investors are deciding not to invest in China.\(^{37}\) However, a more fundamental reason for the recent decline in investment can be traced to the different approaches to business taken by the Chinese and their foreign partners. The Chinese are primarily concerned about macro-development aspects such as overall industrial development patterns, technology transfer, foreign earnings and employment effects, whereas foreign investors are business oriented and profit driven.\(^{38}\)

The foreign exchange imbalance prevalent among many foreign enterprises is a consequence of these contradictory approaches. As discussed in Chapter 1, many foreign investors came to China for its domestic market, an entirely rational strategy for a profit making enterprise.\(^{39}\) However, the Chinese, approaching the situation from a macro-economic perspective, want to protect their domestic industries, so the domestic markets

\(^{34}\) *Time*, June 2, 1986, p. 56.
\(^{36}\) ibid.
\(^{38}\) *China Trade Report*, December 1986, p. 4.
\(^{39}\) ibid.
are generally closed to foreigners. Thus, the foreign investors are unable to convert renminbi sales revenue from domestic sales into hard currency through the official source. So, while the investment is in foreign exchange, the returns are in unconvertible renminbi.\textsuperscript{40}

The reports of all the problems encountered have had such an impact that many firms are even starting to view China less as a market in itself. "Companies are asking how can they integrate China with their operations in other East Asian countries," says Professor Denis Simon, of the Sloan School of Management at MIT.\textsuperscript{41} So widespread is the disillusionment that U.S. Embassy officials in Beijing have bluntly described China as "an investment environment which no one, except for the Chinese has yet characterized as attractive."\textsuperscript{42}

The complaints and apparent change in attitudes about China as an investment site have not escaped the attention or concern of the Chinese officials and press. Referring to the complaints of hidden costs and high taxes, Chinese journalist Shu Hanfeng wrote in Shanghai's \textit{World Economic Herald} in December 1985 that China was driving away foreign business with a "form of over-cleverness that lacks intelligence." He concluded, "You can only make money if you let other people make money."\textsuperscript{43} Addressing an American business group in June 1986, Prime Minister Zhao Ziyang acknowledged that there were "inconveniences" because of shortcomings in China's legal system, its limited foreign exchange and low industrial efficiency. But he said, "the problems will surely be resolved."\textsuperscript{44}

In an effort to alleviate the problems and concerns, Peking released a 22 clause concession document on October 11, 1986 entitled, \textit{The Provisions of the State Council of the People's Republic of China for the Encouragement of Foreign Investment}. According to the provisions, preferential treatment will be granted to two kinds of enterprises; productive enterprises whose products are mainly for export and enterprises possessing advanced technology. Such projects will be given priority in the supply of water, electricity, transportation and communication facilities as well as fixed rents.\textsuperscript{45} Regardless of the obvious effort involved, the documents was reported to be a disappointment to those expecting drastic changes in the access rules, and the foreign

\textsuperscript{40}ibid.
\textsuperscript{41}\textit{Forbes}, December 15, 1986, p. 185.
\textsuperscript{42}Telegram from American Embassy officials in Beijing, op. cit.
\textsuperscript{43}\textit{Time}, June 2, 1986, p. 57.
\textsuperscript{45}\textit{Beijing Review}, October 20, 1986, p. 5. This is yet another clear indication of the Chinese priorities which were discussed previously in this chapter.
exchange earnings problem which was only addressed briefly in one clause. Critics claim that the provisions represent no real substantive change and merely codify what was supposed to be common practice.\textsuperscript{46}

However, one encouraging result of the provisions is the increased cooperation of officials at the local level. Officials in Peking, Shanghai, Zuhai, Qingdao, and Xiamen have adopted measures to supplement the provisions that are tailored to their own conditions.\textsuperscript{47} For example, in an effort to reduce the expenses of enterprises, Xiamen has abolished six charges that are now labelled as unreasonable. These include charges on gas development and for import and export approval.\textsuperscript{48} In Zhuhai, all foreign enterprises can enjoy a five-year income tax exemption starting from their first profit making year.\textsuperscript{49}

While these efforts are helpful and are an important reflection of the Chinese leadership's attitude that China has a role to play in the success of foreign enterprises, continued attention to one specific area would probably do the most to appease concerns and complaints: a more extensive legal system for the regulation of foreign economic activity. But, it must be remembered that the Chinese and Western perception of law are very different.

Written law, as the Western world knows it, has not been the source of authority in China's history. When the Chinese and foreigners first approached the prospect of doing business together, they did so from entirely different perspectives of what would make the deal work. The Westerners goal was a binding agreement secured by a stable and enduring legal system.\textsuperscript{50} The Chinese saw the stability not in the power of the law, but in the strength of human relationships. To them, a contract formalized what was essentially a personal relationship. Although the Chinese culture reflects a philosophy that governance is more by people than by laws, the Chinese are now developing a more institutionalized legal system.\textsuperscript{51} In an effort to gain some insight into Chinese thinking on the subject and to appreciate the progress that has been made, it is necessary to review the history of the law in China which is very different from its history in the West.

In his comparative analysis of law in modern society, Roberto Unger draws a fundamental distinction between customary law, bureaucratic law and pluralistic law. Customary law is not codified; it is simply the accepted standards and practices of a

\textsuperscript{46}China Trade Report, December 1986, p. 1.
\textsuperscript{47}ibid.
\textsuperscript{49}China Trade Report, December 1986, p. 5.
\textsuperscript{51}ibid.
community which give rise to reciprocal expectations of conduct. Bureaucratic law, however, consists of explicit rules that are enforced by a government. Bureaucratic law is formal, customary law is informal. Pluralistic law is a balance of social forces to protect the citizen from the state. Laws are broad and as binding on the rulers as the ruled.52

Unger's contrast between customary law and bureaucratic law closely parallels the distinction between Confucianism and legalism in Chinese philosophy. Confucianism stressed the virtues of individual morality and denigrated written laws, regulations and punishments as ineffective and counterproductive.53

Superimposed on these traditional Chinese legal values, since the Revolution of 1949, have been legal concepts based on Communist ideology, initially derived from the Soviet model.54 Between 1949 and 1957 China's legal system evolved from a skeletal judicial structure, with a few statutes utilizing the principles of mass-line justice, to a new stage of legal institutionalism which made use of legal statutes and was far more conciliatory. However, in 1957 China's progress with a written legal system came to a halt. Mao had never been comfortable with the complex, cumbersome statutory apparatus of Soviet-style legality. Suddenly, various proposed pieces of legislation, including the criminal code which had survived twenty drafts, were tabled indefinitely.55

During the Great Leap Forward (1958-1960) there was an even further erosion of the remaining legal apparatus, and the system of public trials in criminal cases all but came to an end with the exception of a few well-publicized cases. Then, with the advent of the Cultural Revolution in 1966, legal concerns were completely subordinated to political goals, and the Red Guards justified their actions with the Maoist injunction, "rely on people, not on law, for government".56

Mao's death and the subsequent arrest of the Gang of Four opened the way for a revival of China's shattered legal institutions. In accordance with the spirit of the Third Plenum, the Chinese legal system underwent a profound overhaul between 1979 and 1982. The most important reforms enacted were a comprehensive criminal code, a companion code of criminal procedure, and a revised State constitution.57

Under the heading, "Fundamental Rights and Duties of Citizens", the revised

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55 Baum, op. cit., p. 79.
56 ibid., p. 82.
57 ibid., p. 85.
constitution reinstated the principle that "all citizens of the People's Republic of China are equal before the law". In the new constitution, power and authority are at least formally divided, with citizens reasonably protected from the state, and the party ostensibly answerable to the law.58

Nevertheless, China's 1982 constitution does not describe a truly pluralistic legal order as Unger described. Although it is relatively legalistic, it represents rule by law and not rule of law. Rule by law reflects a situation in which the State utilizes the law to direct its policies in a predictable way. The rule of law, however, implies that citizens are protected by their guaranteed rights which even the State cannot disregard.59

The relevance of this discussion to foreign businesspersons' expectations of a structured legal system in China is clear. The Chinese are not accustomed to a written legal code as being the complete and final source of authority. Therefore, when they attempt to write legal provisions for investment, they do so from a perspective of intending to write guidelines that can be flexible if necessary. Although this is suspect to the foreigners, and understandably a source of concern since it is generally unwise for a business to invest in an atmosphere of uncertainty, the motive is not necessarily to gain the advantage over the foreign party. Rather, this author believes that such methods are, first, a customary approach in China, and second, a means of protection against their acknowledged inexperience in legal matters.

It seems that the Chinese are willing to meet the demands of the outside world by conforming to the standard of a written, comprehensive legal structure. But, just as foreign business representatives are apprehensive to enter into an inconclusive arrangement that might change and leave them disadvantaged, so, too, are the Chinese wary of being locked into conclusive arrangements that are ill suited to their needs. Therefore, it is necessary for foreigners to bear in mind this historical perspective of the role of law in China in their analysis of the Chinese legal system.

The following is a detailed account of an incident in China involving foreign investment which clearly demonstrated the need for written legislation regulating foreign investment, as well as an analysis of the difference that the laws in existence in China today would have made on its outcome.

On December 23, 1978, a groundbreaking ceremony took place at Baoshan, on the banks of the Yangtze River, for a multi-billion dollar steel plant which was to be built with Japanese equipment and technology. Unfortunately, within nine months, the plant

58ibid., p. 95.
became the center of controversy and legal dispute of such magnitude that it became the
catalyst for the development and implementation of laws regarding foreign investment in
the People's Republic of China. In addition, many foreign observers consider the details
of the Baoshan incident to be significant for providing insight into the process of settling
commercial disputes between foreign and Chinese enterprises -- an issue that had not
previously surfaced.

After establishing relations by signing a Joint Communiqué between the two
countries in 1972, Japan regarded China as a significant source of coal, oil, tungsten and
chromium, and as an important market for Japanese steel, machinery, plant equipment,
chemical products and synthetic textile fibres, and was eager to develop the trade
relationship.\(^{60}\)

In 1977 the Nippon Steel Company (NSC) and the China National Technical
Import Corporation signed a technical agreement and a protocol covering construction of
the Baoshan facility, which was to be built in two phases with phase one to be completed
by October 1981 and phase two to be completed in 1983. The NSC designed the complex,
but it was not the sole supplier. Phase one was divided into twenty one separate
packages, twelve of which were to be supplied by the Nippon Steel Company and the
other twelve by other manufacturers.\(^{61}\)

However, phase one of the project suffered a serious setback when, in early 1979,
China suspended the contracts because the State Council realized that the country had
ordered plants for which it lacked the necessary foreign exchange. By late 1978, China's
foreign exchange reserves were estimated at approximately $U.S. 2 billion less than the
total value of contracts signed in 1978.\(^{62}\) Consequently, the State Council ordered a
review of recently signed contracts and halted all pending negotiations. However, the
contracts were eventually reinstated in late 1979 after the Japanese agreed to a deferred
payment schedule. This first Baoshan dispute was very educational to both the Japanese
and the rest of the world, to the extent that the plans and objectives of the State Council
could influence foreign investment.\(^{63}\) This was, however, not to be the end of the
disputes over the Baoshan contracts.

The second dispute emerged in 1981, and was far more serious. Whereas in 1979

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\(^{61}\) David A. Sneider, "The Baoshan Debacle: A Study of Sino-Japanese Contract Dispute


\(^{63}\) Sneider, op. cit., p. 43.
the dispute did not involve a breach of contract, because the parties had not received the government approval which was a necessary condition for the contract's validity, nor did it involve a monetary loss by any of the Japanese companies, the 1981 dispute involved both.

Shortly after reinstatement of the contracts, negotiations for the remaining sections of phase one were started as well as negotiations for parts of phase two. In April of 1980, the Chinese signed agreements for two of the largest facilities. A seventeen company consortium, led by Schloemann-Siemag of West Germany and including several Japanese companies, won the DM 1.3 billion order for the cold rolling mill and the Mitsubishi Group won the $U.S. 382 million order for the hot strip mill, both including a ten percent down payment. But, in November of 1980, the Chinese announced that they intended to postpone the implementation of phase two.64

The reason for this postponement was twofold. Heavy spending for capital investment was resulting in unprecedented deficits in the national budget, and was also contributing to high rates of inflation. This led to calls from both politicians and the press for a cutback on capital construction.65 On August 25, 1980, Liu Lixin, a Vice President of the People's Construction Bank, writing in the Beijing Review, called for a decrease in the importation of complete plants and instead an emphasis on upgrading existing ones.66

Therefore, due to domestic constraints, the priorities of the State Council were changing. In addition, criticisms of the Baoshan plant itself were increasing. Opponents cited its high cost and claimed that it was too advanced for the country's needs. They also claimed it would be more expensive to operate than it would be to import steel. Moreover, problems such as its proximity to Shanghai and possible air pollution to the city were raised. It was essentially concluded by critics that the plant had been acted on in haste.67

In December, the State Planning Commission adopted a new strategy; a shift in emphasis from heavy industry to light industry, and a tightening of central control over economic development which resulted in the cancellation of several hundred large scale projects, including phase two of the Baoshan plant.68 The total value of the cancelled contracts involving Japanese companies came to $U.S. 1.4 billion, resulting in the largest

64 China Newsletter, December 1980, p. 3.
65 Sneider, op. cit., p. 565.
66 See also the discussion in the beginning of this chapter on this development in the context of China's historical experience with imported technology.
67 Sneider, op. cit., p. 566.
68 ibid., p. 568.
single cancellation of contracts in the history of Japanese trade. All five of the
Japanese companies that were affected by the cancellation had received a 10% down
payment, but Mitsubishi had proceeded so far on the project that its losses would exceed
the downpayment. The reaction by most Japanese businesspersons was utter disbelief
that the Chinese would unilaterally break the contracts, but it was an action that many
attributed to complete naivete of international business practice. An executive of the
C. Itoh Company said, "I get the feeling that China simply doesn't understand the
gravity of the situation." The furor in Japan over the cancellation of the contracts was
almost unprecedented and many viewed the situation as the most serious friction in Sino-
Japanese relations in recent years. The Japanese never viewed their options in this
dispute in terms of consultation and then arbitration, as the Chinese preferred, but as
negotiation and if necessary compensation.

Mitsubishi officials led the negotiations that followed on behalf of the business
community and their own position was that the company should be compensated $U.S. 79
million, an amount equivalent to approximately 20% of the contract price and more than
double the 10% down payment. This was to cover losses in machinery and equipment
already in production at the time of cancellation, losses related to technical assistance,
losses related to disruptions in factory operations, and lost profits. Mitsubishi then
threatened to file export insurance claims if its demands were not met. However, the
Chinese rejected the proposal objecting strongly to the last demand. Chinese officials
complained that compensation for indirect losses was unacceptable under socialist
economic principles, regardless of the dictates of international business practice.

Finally, after months of continued negotiation, Mitsubishi, acting on its own behalf,
and Chinese trade officials reached an agreement. Mitsubishi was awarded half of its
original request, $U.S. 40 million, and was assured priority consideration should the
project be resumed in the future. After Mitsubishi's settlement, the remaining Japanese
firms reached a similar agreement while Schloemann-Siemag accepted a postponement of
its contract in lieu of compensation.

Ultimately, the Baoshan debacle was settled by negotiation. However, partly as a
result of the Baoshan incident, China's legal system pertaining to foreign investment has

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71 Robert G. Sutter, The China Quandry: Domestic Determinants of U.S. China Policy, 1972-
72 Sneider, op. cit., p. 586.
74 Sneider, op. cit., p. 588.
been more fully developed since 1981. At that time, there were no legal guidelines to resolve the contract dispute. But, in 1984, regulations for foreign economic contracts in the Shenzhen Special Economic Zone were adopted by the Foreign Economic Contracts Law (FECL) which was enacted in March 1985. The FECL administers all contracts between Chinese and foreign firms, with the exception of international transport contracts.\(^{75}\)

Were the Baoshan controversy to occur today, the FECL would govern its resolution.\(^{76}\) The law provides that the parties of a contract shall stipulate the law that will govern their contract, on the condition that contracts signed in China relating to Chinese-foreign investment be in conformity with the laws of China.\(^{77}\) There is no indication that the Baoshan contracts contained a governing law provision, but the contracts did bear a greater resemblance to the law of China than Japan. Since China was the principal place of negotiation and execution of the contract, that aspect would remain unchanged under the FECL.\(^{78}\)

The FECL also stipulates that if a contract is disputed, the parties should attempt a resolution by negotiation and, if necessary, by arbitration which can be conducted in either country.\(^{79}\) Although arbitration was not an option being considered by the Japanese, their position may have changed if this provision were applicable to the Basoan dispute.\(^{80}\)

However, Article 28 provides that contracts may be modified only after consultation and agreement between the parties. Consequently, under the FECL, the Chinese would not have been allowed to cancel the contracts as they did in 1981.\(^{81}\) Although the law does allow unilateral cancellation for limited reasons, the only one that could possibly apply to the Baoshan incident is the occurrence of "an event that the parties could not foresee at the time of conclusion of the contract and the occurrence and effects of which cannot be overcome".\(^{82}\) It could possibly be argued that the State Council’s necessary change in its plan meets this description, but it is unlikely that the definition would cover

\(^{75}\)ibid., p. 594.  
\(^{76}\)ibid.  
\(^{78}\)Sneider, op. cit., p. 595.  
\(^{79}\)ibid.  
\(^{80}\)ibid.  
\(^{81}\)ibid.  
\(^{82}\)ibid., p. 596.
such an incident. Furthermore, in the past foreign commercial transactions, the Chinese have generally insisted that governmental acts do not meet such a definition.\textsuperscript{83}

One of the most interesting features of the FECL, when applied to the Baoshan dispute, involves the settlement of Mitsubishi’s claim for compensation of lost profits which the Chinese rejected as contrary to socialism. The FECL provides that when one party is in breach of a contract, the other may demand compensation for its losses, and losses are defined as those that should have been foreseen by the breaching party.\textsuperscript{84} Whether or not loss of profits, as claimed by Mitsubishi, meets this definition is debatable.\textsuperscript{85} However, U.S. law and international practice include loss of profits in the calculation of damages incurred when a contract is breached, and the FECL provides that if Chinese law is silent on an issue, international practice is applied.\textsuperscript{86} Furthermore, future disputes of this nature should be more easily resolved since Chinese policy no longer views profits as being incompatible with socialism.\textsuperscript{87}

As one Japanese official described the Baoshan controversy, “This incident was an extremely good lesson for both the Chinese side and the Japanese side. The tuition fee, however, was probably a bit too high”.\textsuperscript{88} Although China has expanded its legal system since the Baoshan incident, many believe that the Japanese are still wary of investment in China because of the inadequacy of the legal system and they are all too familiar with the problems that this can cause. However, the recent enactment of joint venture regulations is said to be particularly encouraging to the Japanese, as well as to other foreigners.

The effect that published law has had on foreign investment is particularly clear in regard to equity joint ventures. From 1979 to 1983 China completed less than 200 equity joint venture contracts. In 1984, foreign and Chinese partners completed 741 ventures following the promulgation of the Regulations for the Implementation of the Law of the People’s Republic of China on Joint Ventures Using Chinese and Foreign Investment (often referred to as the J V Implementing Regulations).\textsuperscript{89} In addition, the Ministry of Foreign Economic Relations and Trade issued a Model Contract for Joint Ventures which put the regulations into a usable form.

The J V Implementing Regulations expanded on the 15 articles in the 1979 Joint

\textsuperscript{83}ibid.
\textsuperscript{84}ibid.
\textsuperscript{85}ibid., p. 597.
\textsuperscript{87}Sneider, op. cit., p. 598.
\textsuperscript{88}ibid., p. 602.
\textsuperscript{89}Telegram from officials at the American Embassy in Beijing, op. cit.
Ventre Law which set forth the general principles governing the establishment and operation of joint venture enterprises. The J V Implementing Regulations made some changes to the 1979 law in an attempt to correct perceived errors in the previous legislation. In addition, the Chinese authorities attempted to further correct the 1979 legislation in a piecemeal fashion adopting a series of more detailed regulations to address specific issues. These included specific regulations on registration, labor relations, rules for extension of loans to joint ventures by the Bank of China and a special tax law for joint ventures. In all, there are approximately 150 pages of published statute law and regulations relating to equity joint ventures.90

This effort to improve the investment environment and to correct any loopholes in the written legislation continues. Toward the end of 1985, a new problem being encountered by joint ventures was identified; earning and retaining hard currency, especially since the massive spending on foreign imports has resulted in tight restrictions on foreign exchange reserves.91 In response, Chinese officials adopted in February 1986 The Regulations for Balancing Foreign Exchange Revenue and Expenditure of Joint Ventures. To some this is considered to be the most innovative concept attempted by the Chinese to date.92 However, to others the regulations are disdainfully ambiguous.93

Specifically, the new measures outline four new ways for foreign investors to earn hard currency. The first measure allows a foreign partner with shares in two or more joint ventures to pool the foreign exchange earnings of them all in order to set off deficits in one against surpluses in another, and thereby allow the legitimate income from all the joint ventures to be remitted abroad.94 However, since few foreign partners have shares in more than one enterprise, the Chinese tenacity to attract foreign investment is revealed, for this provision will act as an incentive to further invest in China.

The second measure encourages joint ventures to re-invest their domestic (renminbi) earnings in projects, including Chinese enterprises, that are earning foreign exchange.95 Because of the possibility that tightened domestic credit will make it more difficult for Chinese enterprises to get renminbi loans, and they will therefore consider accepting equity infusions in renminbi from foreign investors exchange for a share of foreign exchange earnings, this measure shows promise.96 However, it requires

91See chapter 1 for a full discussion.
92Telegram from officials at the American Embassy in Beijing, op. cit.
94Ibid.
95Ibid.
96Telegram from officials at the American Embassy in Beijing, op. cit.
reinvestment of earnings, so that remittable profits become more and more remote.97

The third measure allows joint ventures to sell their advanced technology products or import substitutions on the domestic market for payment in foreign exchange. However, exactly which products meet that definition remains vague.98

Finally, the measure allows the Chinese government departments in charge of several joint ventures to draw on the foreign exchange earnings of profit-makers to provide hard currency to those ventures with operating deficits. However, this provision has generated some debate concerning whether such a transfer of funds will adversely affect productivity by penalizing those ventures that are generating hard currency income by restricting their control over their foreign reserves.99

It is still too early to examine the impact of these recent regulations on the foreign exchange earnings problem faced by many joint ventures. But, at the very least, it is an encouragement to many that the Chinese officials recognized a problem and have made a sincere effort to deal with it. One official of the Tianjin Foreign Economic Relations and Trade Commission said, "We now have our rules and regulations to go by. No one must think a joint venture is a chunk of fat meat to be stung at will."100

The pursuit of foreign investment in China is probably the most widely publicized development in China's modernization efforts. This is probably true because the scenario of the Chinese population partaking of foreign goods is the antithesis of the isolationist China to which the outside world had become accustomed. Many observers are amazed at the transformation; a transformation which is so drastic that many others are doubtful it will last. Skeptics see far too many dichotomies in the path that is currently being pursued and predict that China will eventually forego its modernization drive, and may possibly even overcompensate into a complete reversal of the progress achieved during recent years. It is this topic of the possible obstacles to modernization that chapter 4 of this paper will address.

98Telegram from officials at the American Embassy in Beijing, op. cit.
99Ibid.
100Beijing Review, December 8, 1986, p. 5.
CHAPTER 5

Conclusion

Recently, foreign business representatives have voiced concern regarding the commercial and political risks to foreign investment in China, particularly in light of heightened uncertainty about foreign exchange availability and repatriation of profits, confusion over China's bureaucratic structure, rising costs of doing business in China, and the recent political upheavals. These and other disincentives, including what the representatives consider to be China's skeletal legal framework and limited information resources, have restricted foreign investment in China to a level far below initial Chinese expectations. For those foreign companies that have made the decision to invest, the initial costs have been very high and, for many, the pay-off is still years away.1

In discussing the level of foreign investment in China, it is important to note that while investment appears to be accelerating in dollar volume and number of projects, a lag factor obscured the slowdown in the rate of growth during 1986 -- the result of the foreign exchange squeeze.2 Many of the joint ventures that were signed in 1985 were the culmination of several years of negotiations. The number of joint ventures for which discussions were initiated in 1986 is still unavailable, but is expected to be somewhat lower than in 1985, a decrease which is primarily due to foreign uncertainties and foreign currency restraints.3

Nevertheless, it is the opinion of this author that for certain types of businesses which are interested in a long-term investment, China is and will remain a stable, attractive business site, and that the Chinese leadership is indeed very committed to attracting foreign investment. Evidence of their commitment is seen in each of the topics reviewed in this paper.

First, in the foreign trade sector, the Chinese have implemented revolutionary policies such as decentralization of the management of trade in order to provide Chinese

1Cited in an unclassified telegram from the American Embassy in Beijing to the Department of Commerce.
2China Trade Report, July 1986, p. 4.
3China Trade Report, October 1986, p. 16.
enterprises and local officials direct access to foreign traders. In addition, the State now allows various enterprises to retain a portion of their foreign exchange earnings, thus creating a direct incentive for local officials to become equally committed to promoting increased foreign trade. Also, the Special Economic Zones and open coastal cities, which were created to attract foreign investment for trade purposes, have received preferential treatment in the allocation of resources and liberalization of rules for foreign investors.

Second, China's officials have made a concerted effort toward decentralization of China's banking system. For example, new banks have been established for the purpose of facilitating the changes occurring within China, including the influx of foreign enterprises. In addition, China now allows competition between certain banks in the generation of international business, a situation which would hardly be allowed if attracting such business was not a top priority.

Third, the changing legal structure of the People's Republic of China best illustrates the commitment of China's officials to attracting foreign investment. China's legal framework continues to progress from a system which placed little emphasis on the written law, to a system which encompasses literally hundreds of written laws and regulations, many of which pertain specifically to foreign investment and were implemented in response to concerns voiced by potential foreign investors. As was demonstrated by the Baoshan incident and the subsequent promulgation of the Foreign Economic Contracts Law (FECL), the Chinese have been quick to implement the required regulations once the need is recognized, which is evidenced by the Regulations for Balancing Foreign Exchange Revenue and Expenditures of Joint Ventures. The foreign exchange deficiency among joint ventures is a fairly recent problem, but one which is already being addressed in these regulations.

Finally, in the opinion of this author, the commitment of the Chinese leadership to attracting foreign enterprise can be seen in the efforts by Deng Xiaoping to accommodate, rather than to ostracize, China's conservative political faction which is generally unsupportive of the reform efforts. This pragmatic accommodation has been a contributing factor to the adjustments and partial retrenchments in reform policies over the recent years.

Rather than interpreting these changes in policy as evidence that the commitment to reform is questionable and that China teeters on the brink of major reversals in policy, it is the opinion of this author that the reasons for such readjustments are twofold. First, they are due to China's inexperience in directing ambitious and often complex policies. This is evidenced in the recent announcement that China will probably be required to renegotiate current contracts due to a shortage of foreign exchange reserves, a predicament created by general inexperience and excessive spending on foreign
purchases. Second, the readjustments are an effort to appease critics of the reforms, to work with them rather than against them and, thus, reduce the possibility that their opposition will seriously threaten the success of the reforms.

For Deng Xiaoping, the reform policies are an important, long-term change and not merely a short-lived phase to which he is not committed. Deng advocated pragmatic changes throughout the 1960s and 1970s, and was consequently twice purged by Mao. Thus, his personal commitment to reform is well established; but will China’s commitment to the reforms survive Deng Xiaoping?

Foreign observers have speculated about China’s post-Deng economic policies for years, and generally conclude that any predictions carry a substantial margin for error, with the task being even more difficult since the resignation of Hu Yaobang. However, Deng seems already to be in the process of grooming a more suitable successor, Zhao Ziyang, the Premier, who, like Mr. Hu, has been in the forefront of the reforms. Recent statements indicate that Mr. Zhao has lost none of his enthusiasm for economic reform, but he is less keen on political reform. This political conservatism is seen as a reason for his appeal to the conservative party officials, who must be sufficiently appeased on the political front for economic reforms to constructively continue.

In addition, another factor which suggests a continued commitment to the reforms following Deng’s departure is that the key party Secretariat is dominated by reformers, and the Politburo, which is somewhat less dominated by reformers, rarely meets. Even the senior ranks of the army, which opposed the reforms in the early 1980s, had a change of leadership in 1984 due to retirements, which effectively strengthened support for and decreased opposition to economic reforms. Also, while many Communist Party members joined the party during the Cultural Revolution and may be expected to have sympathies for the old ways, the Chinese Communist Party is structured in such a way that change is not initiated from the lower ranks.

Finally, a theory which lends additional support to the scenario that reforms will continue after Deng’s departure holds that many of the reforms have taken on a life of their own and would be very difficult to reverse. This is particularly true in agriculture,

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4 The Sydney Morning Herald, February 26, 1987, p. 3.
6 The Sydney Morning Herald, January 19, 1987, p. 3.
8 ibid., p. 58.
9 ibid.
as was discussed in chapter 4, since many groups that were once disadvantaged in China are reaping some of the benefits of the reforms. In the industrial sector there is also built-in momentum, although probably to a lesser degree than in agriculture. For example, the expansion of foreign trade in manufactured goods has made many enterprises aware of the importance of understanding market forces and foreign business practices, an awareness which only leads to further interest in reform. In addition, it would be exceedingly difficult for China’s leaders to revert to an isolationist economic posture after various enterprises have experienced the freedom of foreign trade and foreign exchange accumulation, and after China’s citizens have enjoyed the benefits of foreign consumer goods which are increasingly more affordable and available.

Clearly, the commitment to reform in China is not dependent on the commitment of one or two leaders. At the time the reforms were implemented, they reflected a widespread dissatisfaction with the country’s dismal economic condition, a frustration which is unlikely to abate in the near future.

China will continue down the path of reform, as is indicated in their economic planning. Release of China’s 7th Five Year Plan (1986-1990) confirmed China’s commitment to foreign investment and outlined not only its role in future development, but the direction the reforms will follow in the next five years. In general, the plan called for a gradual cooling of the annual growth rate, a continuing commitment to the internal economic reforms, and no major shift away from the open door policy.

However, any complete discussion of China’s future economic policies must include an analysis of China’s recent and projected trade figures. Between 1978 and 1984 the country enjoyed an average annual export growth of 16.5%. However, China’s trade figures rapidly deteriorated from a $U.S. 3 billion surplus in 1982 to a $U.S. 1 billion deficit by 1984. Within the first seven months of 1985, the deficit ballooned to $U.S. 7.89 billion. Imports rose in 1985 by 60.8% over the previous year, while exports slipped 2.3%.

Regarding imports, there were many contributing factors to the 1985 increase. First, as previously stated, local officials were allowed to retain a portion of foreign currency earnings, which, when coupled with China’s relaxed import restrictions, enabled

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10 Ibid.
11 Ibid.
14 China Trade Report, October 1985, p. 4.
them to purchase foreign consumer goods, which they often re-sold domestically.\textsuperscript{15} In addition, the foreign investment projects that were being established in the Special Economic Zones and coastal cities seemed to exacerbate the problem of excessive consumption. As was discussed in Chapter 1 of this paper, only 20\% of the Shenzhen Special Economic Zone’s products were exported in 1985. The remaining products were sold domestically, which resulted in profit repatriation by the foreign business partners. Also, this further whetted the appetite of the Chinese people for foreign goods, which were now attainable due to increased incomes.

In addition to the increase in imports, the decline in exports aggravated China’s balance of payment problem. The reasons for the decline were numerous. First, oil exports suffered from low prices worldwide, as did exports of other commodities. Also, China continued to suffer from domestic restraints such as transportation bottlenecks and rising production costs.\textsuperscript{16} Additional reasons for China’s decreasing export figures included product price increases and alleged quality control problems. It has been said that the alleged decline in quality was a direct result of a lack of incentives, since the insatiable domestic market claimed any goods not sold abroad.\textsuperscript{17}

However, since the disastrous trade results of 1985, China’s trade figures have shown a moderate improvement, showing a decrease in the trade deficit from $U.S. 7.61 billion in 1985 to $U.S. 5.76 billion in 1986, according to the Ministry of Foreign Trade and Economic Relations figures, with the turnaround being attributed to Beijing’s efforts to address the imbalance. In early 1986, officials projected that China’s oil export revenues would decrease substantially. In an attempt to compensate for this loss of foreign income, several export boosting policies were initiated, including increased export targets for state enterprises and a 15\% devaluation of the renminbi to increase the overseas competitiveness of Chinese products.\textsuperscript{18} As a direct result, export of several items grew substantially during 1986 with coal exports up 60\% over the previous year, textile exports up 22\% and electrical machinery exports up 40\%.\textsuperscript{19} Also, to address the unmanageable increase in imports, Beijing imposed strict import bans on certain items, mostly consumer goods, and restricted the foreign purchasing autonomy previously enjoyed by local officials.

The initial results of these policy changes are somewhat encouraging, but can not be

\textsuperscript{15}China Trade Report, July 1986, p. 4.

\textsuperscript{16}China Trade Report, October 1985, p. 4.

\textsuperscript{17}ibid.

\textsuperscript{18}China Trade Report, February 1987, p. 1. See discussion on page 11, chapter 1 of this paper.

\textsuperscript{19}ibid.
taken as indication that China has mastered its balance of payments predicament. Obviously, China could easily remedy its trade problems in a perfunctory, if short-sighted manner, by forsaking its modernization and open door policies, and reverting to ascetic self-sufficiency. However, given the progressive temperament of China’s leadership, and for reasons previously stated in this paper, it is the opinion of this author that China must learn to manage its trade imbalances using the full range of options available in the international business community.

For China to achieve its modernization goals, short-term current account deficits may be necessary, and should be viewed as an investment in future development. However, China should not follow the path of those developing countries in which the original goal of development and modernization has been overshadowed by complications resulting from the magnitude of foreign debt financing. Of course, such flexibility in financing would result in a reversal of China’s long-standing policy against obtaining foreign loans, an issue that is apparently the subject of considerable disagreement among Chinese officials.

In late 1985, Chi Haibin, Vice Minister of Finance, said that China would expand its borrowing from the World Bank and other governments to commercial institutions. However, the 1986 budget set foreign borrowing at Rmb 5.5 billion, roughly doubling the figure for 1985, but still somewhat insignificant in comparison to China’s projected 1986 expenditures of Rmb 214 billion. The 1986 borrowing figure is roughly equivalent to 15%-20% of China’s export earnings, Beijing’s proclaimed maximum for foreign debt repayment, which indicates that there has not yet been a significant shift in China’s attitude toward foreign borrowing.

However, it is unlikely that China can continue to refrain from substantially increasing its foreign borrowings, since trade projections based on the Seventh Five Year plan and data from the Ministry of Foreign Economic Relations and Trade put China’s cumulative deficit in the year 1990 at approximately $U.S. 50 billion.

Currently, China’s exports supply 80% of China’s foreign exchange reserves, but with decreasing international prices for its major export products, such as crude oil, and with protectionism threatening textile imports, it is clear that to continue its modernization programs China will be required to increasingly seek funds from other sources. To date, China has maintained on paper, remarkably large foreign exchange reserves in spite of the large import bills, although its reserve balance has dropped from

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21 Ibid.
$U.S. 17.6 billion in mid 1984 to U.S.$ 11.4 billion in mid 1986.\textsuperscript{22}

Many observers question why China's foreign-exchange reserves have not been more rapidly depleted, since the trade deficit during much of this period was rising by $U.S. 1 billion a month.\textsuperscript{23} Apparently, Chinese officials "discovered" substantial foreign exchange reserves in various accounts. Also, according to statistics provided by the Bank for International Settlements in Basle, China withdrew considerable amounts from its deposits in foreign commercial banks.\textsuperscript{24} But, it is important to note that these methods for increasing foreign exchange reserves are primarily cosmetic measures, and do not fundamentally address China's underlying trade problems.

However, with the projected trade deficits, Chinese officials are engaging in increasingly favorable public discussion regarding the uses of foreign commercial borrowing. In 1986, Wang Deyan, President of the Bank of China, claimed that the amount raised from foreign loans was too small. Rong Yiren, Chairman of the CITIC, was quoted in \textit{China Daily}, as saying, "It is important to tackle the phobia that whatever came from capitalist countries was bad. It should no longer be considered a loss of face to borrow money from abroad."\textsuperscript{25}

Nevertheless, even if China embraces the capitalist notion of foreign borrowing with greater enthusiasm, it is almost certain to continue its traditionally conservative investment strategy; keeping costs low and diversifying the sources of its loans. It will also continue to first seek "soft" loans from sources such as the World Bank or foreign governments, which carry more favorable terms than those from private institutions, a priority which will be enhanced by its recent entry into the Asian Development Bank.\textsuperscript{26}

The implications of China's balance of payments situation and the 7th Five Year Plan paint a fairly specific picture for China's foreign trade and for foreign investment in China. Chinese officials expect foreign trade volume to increase 40% to 50% over the plan's five years, and a greater emphasis will be placed on balancing imports with exports, in part by restricting certain import items and the use of foreign exchange reserves. To boost exports, China will establish bases for producing export commodities mostly in the coastal areas. The Special Economic Zones and coastal cities will continue to play an active role in this export promotion.\textsuperscript{27} China may also attempt to balance

\textsuperscript{22} \textit{China Trade Report}, February 1987, p. 13.
\textsuperscript{24} ibid., p. 8.
\textsuperscript{25} ibid.
\textsuperscript{26} ibid., p.9.
\textsuperscript{27} Telegram from officials at the American Embassy in Beijing, op. cit.
foreign trade by increasing its involvement in cooperation treaties and licensing arrangements which require only a minimum of hard currency. China has already entered into several of these arrangements with West German companies.\(^{28}\)

In the opinion of this author, China's foreign exchange reserve dilemma is likely to continue well into the 1990's. However, Chinese officials are aware of, and responsive to, their policy shortcomings, which will eventually effect China's trade balance in a considerably positive way. Potential foreign investors will find a plethora of incentives to invest in sectors that are in dire need of an infusion of capital and technology such as energy, transportation and telecommunications. However, in the future China is likely to stringently require that specific percentages of a foreign enterprise's total production be exported.

In summary, it is the opinion of this author that while China certainly has its limitations for the types of investment it hopes to attract, it remains an attractive business site for those businesses which meet its required needs. With a population of over one billion people, China is a vast potential market. Although access to the domestic marketplace may be a slow, gradual process in most instances, those companies which have established their presence, and assisted China in achieving its goals, will be in the best position to take full advantage of that access as it occurs. Consequently, foreigners should view potential investment in China with an eye to the future, and with a reservoir of patience for the present.

\(^{28}\) *China Trade Report*, January 1987, p. 9.
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