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Foreign Direct Investment and the Chinese Economy: Theory and Impact

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FOREIGN DIRECT INVESTMENT AND THE CHINESE ECONOMY:

THEORY AND IMPACT

by

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Abstract

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The Chinese economy has sustained a high rate of growth during the last three decades. This economic growth has been the outcome of an innovative strategy which the Chinese leadership has been implementing within the model of the state directed economy. This strategy has been manifested in a variety of tactical moves one of which is the utilization of Foreign Direct Investment as a source of finance and industrial know-how. The argument in this study is that Foreign Direct Investment has positively contributed to the phenomenal growth of the Chinese economy. Moreover, the performance of Foreign Direct Investment in China has generally behaved as expected by the theory of it. As a result, future extrapolation about the behavior of Foreign Direct Investment in China based on the theoretical models is permissible.

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Introduction

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Preface

The Chinese economy has been growing at a very high rate during the last three decades. This economic growth has been the outcome of an innovative strategy which the Chinese leadership has been implementing within the model of the state directed economy to meet its target for economic development.[1] This strategy is based on three moves: First, independent knowledge creation and management; second, importation of advanced technology and know-how; third, use of FDI as a source of finance and knowledge for the industry.[2] The volume of FDI that has been attracted by China, which has gone up more than a hundredfold since 1980, indicates that the third move has been very successful.[3] In fact, China has been the largest recipient of FDI when compared to all the other developing countries. Indeed one may wonder if the move for FDI is linked to the second move stated above.

My argument in this study is that FDI has been a very important component in the phenomenal growth of the Chinese economy behaving as expected by theoretical models. This is in defense of the model of the developmental state as a policy for modernization where the state takes active measures to provide the necessary conditions for

[1] In this study I will use the terms market-socialist, state directed economy, state-capitalism, mixed economy, developmental state interchangeably to mean an economy where the private and public sectors coexist but the state has a very active role in overseeing and planning and directing in general terms all economic activities in contrast to the typical western liberal economy where the state has a rather passive role centered on taxation and law.
[2] See "Spillover Effect of FDI on China's Knowledge Creation." *Chinese Management Studies*. 2 (2): 86-96.
[3] In 1984 FDI inflows were $0.4billion; in 2010 the value was $240 billions. Data from World Bank.

development regulating and canalizing the private sector and the market forces. The impact of FDI thus should not be seen detached from this developmental framework; that is of "internalizing the external," a concept I will elaborate on below. Nevertheless, the great impact of FDI on the Chinese economy is not as commonsensical as it may sound; the existence or the effects of the dyad 'developing country-FDI' should not be taken for granted nor in unison.

As I will be showing in Part Two, the attitude of China's economic policy with respect to FDI has not necessarily been identical to the economic policy of other developmental states. It would be deceiving, thus, to assume that knowledge about these economies can extend to the Chinese economy ipso facto. The model of the developmental state is not identical, but varies; although private investment may be present in large numbers, FDI, which is a very specific type of investment, may not. Furthermore, the presence of FDI may be of an important but nevertheless secondary role in line with the economic policy of the country in question. In the case of China, as I will be arguing, FDI was of primary importance and of crucial impact on the Chinese economy.

There have been many studies and views expressed about the causes or origins of the high growth of the Chinese economy.[4] My argument about the role of FDI in China does not mean that other factors-cultural or social- cannot be credited for contributing to the growth of the Chinese economy. Such factors and conditions are by no means unimportant. In fact they may be all complementary, and even being ontologically on a

[4]. For a treatise on the subject see Vladimir Popov "The Russian and Chinese Transition in a Wider Perspective" in *20 years of Transformation: Achievements, Problems and Perspectives*. Grzegorz W. Kolodko and Jacek Tomkiewicz. (eds) Nova publishers, 2011.

deeper level, having acted as enabling forces of what to follow. Consequently, my aim here is to focus on FDI as a very efficient "tool" or, as a tactic within the doctrine, found in the toolkit of the Chinese economic policy planning without disputing or rejecting views about other broader aspects of the Chinese society and their relation to growth.

The Chinese leadership embarked on substantial reforms in the late 1970's, which substantially transformed the economy. Growth started taking place while the economy started restructuring. Whereas farming and heavy industry were the two main domains of economic activity, the reforms yield to a movement towards light industry and services. After about two decades of growth China joined the World Trade Organization (WTO) in 2001. It was expected by several theorists that such a move would institutionally push China to integrate further with the global economy; that is, to further liberalize trade.[5] In economic terms it meant the efficient reallocation of resources in the Chinese economy.[6] FDI, particularly from other East Asian countries, was expected to increase and be allocated to high-value industries, such as electronics.[7]

It was also expected that competition would force China's economy to concentrate investing in its comparable advantage, which is the labor intensive industry of merchandise. In addition, China's entry into the WTO was considered by the

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[5] An exposition of the Neoliberal stand on economic liberalization and its virtues can be found in Milton Friedman, Economic Freedom, Human Freedom, Political Freedom,California State University 1992. For an economic development and balanced approach to free trade and economic liberalization see Peter Bauer, From Subsistence to Exchange, Princeton University Press, 2000. Nicholas Lardy also expected a positive impact on the efficiency of the Chinese economy by the WTO membership; see *Integrating China into the Global Economy*, The Brookings Institution, 2002 pp.119-120.

[6] Salvatore and Hatcher showed only a partial correlation between international trade (especially exports) and a more efficient allocation of resources. Their study did not include China. Dominick Salvatore and Thomas Hatcher, "Inward Oriented and outward oriented trade strategies." *Journal of Development Studies* 27(3) 1991.

[7] Hans Christiansen, H. and Mehmet Ogutcu, "Foreign Direct Investment for Development: Maximizing benefits, minimizing costs." *Global Forum on International Investment. Attracting Foreign Direct Investment for development. OECD*, Shanghai, 2002.

international community as the first step for a mutual tariff lift between China and other countries. Tariff elimination would make it easier for Chinese firms to penetrate other markets by engaging in FDI deals. Furthermore, there were projections that FDI would decrease in some sectors but at the same time was expected to flow into the State- Owned Enterprises (SOEs) since it was assumed that China's entry into WTO would bring about a political-regulatory liberalization.[8] In this study I will not deal with all of these issues, but I will focus on the nature and role of FDI in relation to Chinese growth.

Theoretical Framework and Implications

Before I turn to the specifics of the scope of this study I would like to lay out the theoretical perspective this study is conducted from. I will argue below that China is following a specific developmental attitude which can be theoretically located. As early as 1982, Johan Galtung was inquisitive of what the Chinese developmental strategy was. He tentatively positioned the Chinese strategy as indeed a strategy; that is, as conscious way for development and not as a trial and error haphazard method.[9] Galtung opined that the Chinese were following a middle path between the western liberal model and the Marxist model. The western model favored growth first and then distribution, whereas the Marxist, distribution first and then growth. Although the Chinese, Galtung observed, initially did embark on the Marxist model, they opted for a middle path- a path appearing erratic- wishing to take advantage of both. Galtung pointed to cultural reasons in order to

[8] Francoise Lemoine, *FDI and the Opening Up of China's Economy. CEPII.* Paper no 11. 2000.
[9] Johan Galtung. "Is There a Chinese Strategy of Development? A Contribution to an Everlasting Debate." *Review* (Braudel Center) 5-3, 1982.

explain the origins of the Chinese strategy and this attracted criticism.[10] My intent here is not to go into the debates about what are the causes of Chinese development policy at various times; this is beyond the scope of this paper. Rather, I will use Galtung's view of the middle path as a starting point of laying the larger theoretical framework for understanding the Chinese developmental policy.

China indeed has been following a middle path. Since the reforms were initiated in 1979, China has gradually ceased to be a communist planned economy by transitioning to one of market socialism. The option for an all out liberalization as the only way for development was rejected- as was to be implemented later in Eastern Europe with dubious success.[11] The gradual middle path bore fruit and this had a lot to do with the determination of the political leadership to push forward while the state all along has been exercising a watchful and active role in fostering the momentum gained.[12] International trade was an important component of this middle path doctrine since the Chinese economy needed know-how and finance. FDI was a vehicle for this since information and finance is internationally held not only by states but by private firms.[13] It has been a strategy of "internalizing the external."

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[10] Mark Selden rejecting Galtung's view, argued that the Chinese development policy is primarily based on the political economy of the class relations. "The Inner Logic of Chinese Development." *Review* (Braudel Center) 5-3, 1982. p.487.

[11] Whether such an all out option existed in 1979 is debatable but theorists such as Janos Kornai in his classic The Socialist System prescribed such a policy as opposed to a gradual approach being altogether apprehensive about the feasibility of market-socialism since prices would still be distorted leading to irrational decisions. See *The Socialist System: The Political Economy of Communism*. Oxford, 1992.

[12] Martin King Whyte underscores the role of the state in fostering development in allowing business activities without undermining the role of the state creating thus structural disturbances. "Paradoxes of China's Economic Boom." *Annual Review of Sociology*, Issue 35, 2009. p.377.

[13] For an analysis of the Information from a comparative advantage see Brandt C. Pasco, "Technology Transfer in a Ricardian Mode: Chinese Technological "Osmosis" in Theory and Practice." *Studies in Comparative International Development*, 32-4, 1998.

The concept of ‘internalization of the external’ is the prism through which the present study of FDI should be seen not only in its narrow economic, but also in its broad political economy of development sense. The opening up of the Chinese economy and its preference for FDI is a case of agency working within the constraints in a satisfactory pragmatic manner. It is within the global capitalist structure that the Chinese leadership undertook the reforms showing that success can happen without calling for the complete overthrow of the global capitalist structure.

The theoretical basis for a pragmatic course to development was outlined by Cardoso and Faletto, in their book *Dependency and Development*. Even though their examination was on the Latin American region, their historical-structural analysis can extend to other parts since the structure is one and global. Their approach takes into consideration both the agent’s capabilities and the imposing constraints of the structure, but refuses to align with either. Therefore, the extreme “orthodox’ views of both dependency and modernization approaches were deemed by Cardoso and Faletto as inadequate to provide with realistic tangible alternatives towards development.[14] This called for recognition of a middle path where gradually what is allowed -and there are things that are allowed- within the constraints of the global capitalist system can materialize instead of calling (and waiting) for an overthrow of the system itself.[15] The materialization of certain potentials, the authors argue, can happen if the agency or the political leadership of the state decides to act and seize the opportunities.

[14] Fernando H. Cardoso and Enzo Faletto. *Dependency and Development in Latin America*. University of California Berkeley, 1979; pp.173-176.
[15] Cardoso and Faletto in fact saw long term limits in the capitalist system which would call for its replacement. pp. xxiii-v.

Cardoso and Faletto tried to bridge the gap between the so-thought negating relationship of agency and structure using as a bond the concept of 'interests.' It is "the networks of interests" that bind groups and classes and by extension economies.[16] This binding takes place when the groups in question recognize that these interests can be served by 'internalizing' the knowledge the other group has for serving some similar interest of theirs. Although structure will impose constrains, Cardoso and Faletto note it is the local societies and the political leadership's task to utilize all means and not let any opportunity pass by. The authors, therefore, position agency within the state being suspicious to internationalist globalist ideas of agency. What is at the global level is the capitalist structure and this should be taken as rather constant.

The theoretical stance of Cardoso and Faletto became an important platform for a new thinking about development. Although, as noted, their focus was on Latin America, their insights can extend to other regions, as this study argues for China. The key factor has been the role of the state. Frederic Deyo wrote in 1987 that when it comes to the East Asian NICs the crucial factor has been the strong developmental state with a "commitment and a capacity for implementing well-chosen development strategies…[17] Peter Evans, building on *Dependency and Development,* went on to theorize about a more precise area of development, which is industrialist development. His concept of 'embedded autonomy' provides instructive insights on the area of industrial development of great importance to the Chinese development policy and situation.

[16] Ibid. p 173.
[17] "Coalitions, institutions, and linkage sequencing-toward a strategic capacity model of East Asian development," in *The Political Economy of the New Asian Industrialism*. Frederic C. Deyo (ed), Cornel University, 1987, p.201-3.

Cardoso and Faletto positioned agency at the state level refusing placing it at the level of the global. Peter Evans follows this approach and focuses at the level of the state in relation to development. As we may recall, Cardoso and Faletto call for the agency to take responsibility and not let opportunities go unexploited. Evans, in his book *Embedded Autonomy,* sees things in a similar manner. He observes that there is an important 'transformative role' the state has to take seriously. In more specific terms, the state has to take action to promote innovation and encourage 'productive forces' and 'entrepreneurship.'[18] Wealth for Evans is not to be created only by the private market, but the state has to actively be part of this creation. There has to be thus a triple alliance between foreign, local, and state capital. Stephan Haggard had observed in 1990 that although dependency theorists recognized the role of the state no public policy theory developed to connect the state with local and foreign actors.[19] Evans's 'embedded autonomy' concept focuses on rectifying this.

The process of wealth creation as a major part of the 'transformative role' of the state inadvertently will force the state to get involved with the structure of the global economy. This nexus, Evans argues, "between the internal accomplishment and external context become intimate and direct." [20] The linkage of interests therefore, is manifested in a manner of the 'internalization of the external' approach where the state has to have a 'robust' presence in the process of development. The 'internalization of the external' involves the interaction of networks of interests which 'without a robust internal structure

[18] Peter Evans. *Embedded Autonomy: States and Industrial Transformation*. Princeton University Press, 1995, p.6.
[19] *Pathways from the Periphery*. Cornel University, 1990, p.192.
[20] Ibid.

would leave the state incapable of resolving ‘collective action’…”[21] What is crucial, furthermore, for a developmental state are the relations of the agency with the society of the state.

Evans sees that a successful developmental state possesses a political leadership and an efficient bureaucracy, both of which are *autonomous* from the social basis, but also *embedded* in it. Hence his concept of ‘embedded autonomy’ comes about as the phenomenon which foretells developmental success and industrial transformation.[22] Evans has South Korea as the prototypical example where embedded autonomy has been taking place, while Brazil and India are considered. I hope that this study will provide credence to my argument about the possibility that China is also a candidate, especially if its role as a demiurge (to be discussed below) will become certainly more obvious than that of the embedded autonomy of the leadership and bureaucracy within society.

As stated above, Evans sees the state as an agent which has to take part in the creation of wealth and not assigned itself to the role of a passive observer or ‘correctional officer’ in society. The state thus has to become actively enmeshed in the creation of wealth since the private capital investment comes with inherent limitations. For example, investors are apprehensive about investing on infrastructure where input is high and returns uncertain. But this is not enough for Evans. The role of the demiurge surpasses the role of undertaking development endeavors where the private sector refuses to. The assumption in Evans’s thought is that private capital will also be,

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[21] Ibid. p.12.
[22] ibid., pp.12-13.

> incapable of successfully sustaining the developmentally necessary gamut of commodity production. Consequently, the state becomes a "demiurge" establishing enterprises that compete in markets for normal "private" goods.[23]

The above concept of demiurge as laid down by Evans can be detected in China. The agent in the form of the Chinese leadership on the state level is assigning to the state a strong role where the object is to create wealth and sustain development. The demiurge in essence and as Evans notes has a 'midwife' role to play. That is,

> instead of substituting itself for private producers, the state tries to assist in the emergence of new entrepreneurial groups or to induce existing groups to venture into more challenging kinds of production. A variety of techniques and policies may be utilized. Erecting a "greenhouse" of tariffs to protect infant sectors from external competition is one.[24]

Again, the properties of the "midwife" are hard to miss in the case of China. As I will show in this study the Chinese leadership has been taking extensive measures covering a broad range of 'midwife' characteristics. The tariff and tax "greenhouses," or setting up Special Economic Zones in order to act as "greenhouses' as well, fostering development and innovation are some examples. At the core of all these is FDI.

The whole idea of FDI is precisely that; that is, to connect the external with the internal recognizing the existence of common interests connecting groups and social classes.[25] When the Chinese started focusing on the inflow and potentials of FDI they didn't know the specifics but they did have a general idea about some of its benefits of internalizing the external and therefore satisfying common interests. The outcome

[23] Ibid p.13.
[24] Ibid pp.13-14.
[25] Taking the concept of 'internalizing of the external' that is adopting the external, to a more narrow economic sense internalization would be keeping the benefits or profits of investment internal to the firm rather than losing them as would be the case in franchise. As Alan Rugman has showed, the theoretical frameworks or models for codifying the behavior of FDI do take into consideration the internalization which is married to them. Alan M. Rugman. "New Theories of the Multinational Enterprise: An Assessment of Internalization Theory," *Bulletin of Economic Research* 38-2, 1986 p.103.

decades later shows that FDI did succeed in satisfying the above conditions as laid down by Cardoso and Falleto and Evans. That is, utilizing possible opportunities within the capitalist structure. FDI allowed the Chinese leadership and elite to generally embed itself into the broad interests of the Chinese society while keeping autonomy and a firm attitude.

Furthermore, it allowed the state to act as a demiurge involving itself with the creation of wealth by investing in commodities (State-Owned Enterprises) and participate in the market as a player. Finally, FDI was a promising means for the Chinese state to act as a "midwife" and aid in the birth of new knowledge and entrepreneurship. This study argues that the views and insights expressed in *Dependency and Development* and *Embedded Autonomy* are extendable to the developmental state of China.

Scope Innovation and Methodology

Foreign Direct Investment has been a very important type of long-term investment. The volume of FDI attracted to a particular country has the potential to determine to a very large degree the course of economic development. I will argue as a general thesis that the Chinese leadership's decision, acting within the framework of the model of developmental state where the state takes an active role within the global constraints, to accept FDI has had a crucial impact on the economy. The strategy was to use FDI as a development tool. On a narrower and specific level another argument I put forth is that the FDI behaved in China as described by the theory behind it. The purpose of this study is to substantiate the above.

In order to do that I will assess the FDI inflow in China during the last three decades and provide a concise picture of its impact on the Chinese economy. I plan, therefore, to trace the FDI inflows in China during the last three decades and appraise its impact on the economy. I will pay attention to China's entry into WTO and evaluate any impact it has had on the rate of growth of FDI in China and its effects. More specifically, WTO membership meant that Chinese exports will not face tariffs making investment in China more lucrative. But at the same time China would also have to lift its preferential treatment to FDI firms. There are thus two opposing forces here. My hypothesis is that the end of preferential treatment will not affect FDI inflows since this is not the determining factor. Besides, I hypothesize that the Chinese government would have to resolve to counterbalancing policies should a reduction of FDI occur and if FDI had shown to perform well.

In this study I am interested on the effects of FDI on the economy as depicted by aggregate economic values such as GDP and trade. However, since the idea of development is also socially related I will try to look into the interrelationship between FDI and private consumption in China since the latter is a good indicator of growth and development. Does economic development in a state-directed economy result in increase in consumption? My hypothesis is that it will since the economy is not closed; it is hard to see from the socio-economic point of view how a billion and more potential consumers will not be able to buy some of the products they produce. I will thus look into the above as a supplement to the main study providing some preliminary findings.

In order to substantiate the part of the argument about the theoretical behavior of FDI I will look into the theory of FDI itself. I will examine the theoretical basis and models of FDI and juxtapose the behavior of FDI in China with the theory. Theorizing FDI will allow me to learn about the conditions of possibility and evolution of FDI, an important condition of which is location.

There are numerous studies that have dealt with the issue of FDI in China and its effects on the Chinese economy. However, most of these works are overspecialized dealing with specific financial-economic or geographical sectors.[26] There are other studies that discuss the trends of FDI in China focusing on aggregate macroeconomic indicators such as GDP growth and the trade balance.[27] Many researchers have concentrated on the absolute value of FDI trying to uncover seasonal short-term fluctuations crediting various reasons for any change –such as the currency fluctuation or economic recessions in the FDI investors' home countries.[28] Furthermore, other studies tend to concentrate on the aggregate consumption.[29]

It is generally agreed by several theorists that the spillover effect of FDI will be beneficial for the developing countries. There have been skeptics who expressed theoretical doubts about the effects of FDI. Prebish, for example, had theoretically pointed to the possibility of the one-way benefits towards the country the FDI comes

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[26] See for example; Benassy-Quere et el. "Institutional Determinants of Foreign Direct Investment; The Chaotic attractor of foreign direct investment-why China? Frank ST Hsiao, MeiChu Hsiao, *Journal of Asian Economics*, 15 (2004); Ping Zheng, "The determinants of disparities in inward FDI flows to the three macro-regions of China," *Post-Communist Economies*, 23(2) 2011.
[27]Lai Pingyao, "Foreign Direct Investment In China: Recent Trends and Patterns," *China & World Economy*, Number 2, 2002; Linda Ng and Chyau Tuan, *FDI Promotion Policy in China: Governance and Effectiveness*, Blackwell UK, 2001; Francoise Lemoine *FDI and the Opening Up of China's Economy, CEPII* 2000; Steven Husted and Shuichiro Nishioka, *China's Fare Share? The Growth of Chinese Exports in World Trade*, University of Glascow, Adam Smith Research Foundation, 2012.
[28] See Lai Pingyao, "Foreign Direct Investment in China", *China & World Economy*, No 2, 2002; Frank ST Hsiao anf Mei-Chu W Hsiao,, "The Chaotic attractor of foreign direct investment-Why China?,"*Journal of Asian Economics* 15 (2004).
[29] Ewe-Ghee Lim, *Determinants of, and the Relation Between, Foreign Direct Investment and Growth, IMF Working Paper* WP/01/175, 2001;He Canfei & Zhu Shengjun, "Economic Transition and Industrial Restructuring in China," *Post-Communist Economies*, 19(3), 2007.

from. Even if there are some macroeconomic improvements, the host country, he argued, will not experience development as such since FDI will skew towards oligopolistic market transactions.[30]

De Mello points to the fact that FDI will attract human and material capital boosting productivity raising the wages and workforce training. Positive effects are to be reflected on the employment, production, exports and technology transfer.[31] Romer believes that there are substantial "idea gaps" between developed and developing countries. [32] FDI can aid into narrowing the gap by defusing the technology that comes with it boosting the productivity of firms –even those firms that might not be involved in FDI. [33]

Mody notes that FDI has not been successful in spreading convergence because "first, FDI flows remained highly concentrated and second, the benefits from FDI appear to have accrued principally where conditions were already conducive to investment and growth."[34] Nevertheless, despite the issue of convergence, Mody, measuring the elasticity of growth, finds FDI having a "strong impact on growth." [35] As stated earlier, location is such a condition –a precondition in the OLI model- and as I will show below, indeed there were some basic developmental preconditions. Even so, the success of the Chinese

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[30] Prebisch, R. "Development Problems of the Peripheral Countries and the Term of Trade," in Theberge, J. ed *Economics of Trade and Development*. John Wiley and Sons 1968.
[31] De Mello, LR. "FDI in developing countries and growth: a selective survey." *Journal of Development Studies*. 34 (1) 1997; Lim, E.G. see also *Determinants of, and the relation between, foreign direct investment and growth; a summary of the recent literature. IMF Working Paper*, no WP 01/175. ; Slywester, K. "Foreign Direct Investment, growth and income equality in less developed countries." *International Review of Applied Economics*. 19(3) 2005.
[32] For a study on technology and FDI see
[33] Sun, X. *Foreign Direct Investment and Economic Development: What Need to Do? Foreign Investment Advisory Service*, 2002. Johnson, A. *The Effects of FDI inflows on host country economic growth. CESIS.* Electronic Working Paper Series. No. 58. 2006.
[34] Ashoka Mody, *Foreign Direct Investment and the World Economy*, Routledge 2007, p.2
[35] Mody p.150 the elasticity of short term growth is .10 meaning 10% increase of FDI results to 1% growth.

leadership is of realizing the existence of these conditions of possibility for growth and for recognizing that FDI would yield high returns which in turn made the conditions even more conducive.

Edward Steinfeld, focusing on the institutional framework and the policy environment, is skeptical about the actual capitalization of FDI and its benefits.[36] Steinfeld does not deny that FDI brings capital and knowledge. In fact, China did well in actively seeking out FDI as a vector to bring in necessary knowledge. The issue for Steinfeld is that the governmental policy does not protect corporate organizations so that they can spur innovation in the long term. The leadership wants to protect national firms (private or public), the author argues, but also wants to take advantage of the 'comparative advantage' and that is for Steinfeld incompatible leading to 'shallow integration'; emphasis should be put, the author says, not on the national firm but on corporate organizations where innovation can develop in the long term. Steinfeld focuses on policy and not on the impact or behavior of FDI. His analysis is about the institutional regime not the FDI regime. Nevertheless, several of his claims may be true, but as he admits, more research is needed to determine the issue of integration.

A very important examination about the presence of FDI in China has been carried out by Yasheng Huang.[37] Huang tries to explain why the level of FDI in China has been at such high levels. His argument is based on a 'demand perspective' in relation to the Chinese firms as to complement the 'supply perspective', which is about the

[36] Edward S. Steinfeld. "China's Shallow Integration: Networked Production and the New Challenges for Late Industrialization." *World Development*. 32-11, 2004.
[37] Yasheng Huang. *Selling China: Foreign Investment during the Reform Era*. Cambridge University, 2003.

foreign investors' rationale for FDI in China.[38] The high demand for FDI, Huang argues, is the result of an institutional "political pecking" whereby Chinese SOEs are favored while private firms are discriminated against (loan restriction). Another reason is the economic fragmentation (regional regulations) which makes it harder for the private firms to gain access to capital. As a result, FDI has been the only way out for the private sector.

Huang's "institutional foundation" argument thus identifies institutional imperfections as pulling forces that explain a portion of the value of FDI in China. It is the state's preference for SOEs at the expense of the non-state firms, even though the latter are the most efficient and productive in the Chinese economy, which results in a demand for FDI. The author looks at the private firms in relation to the state to expose their search for FDI.[39] The institutional imperfections, however, have been found by other scholars to work in reverse; that is, limiting the inflow of FDI making China an "underachiever." Shang-Jin Wei has argued that more FDI would have been present in China had the regulatory burden and corruption been absent.[40]

Huang does not deny in general many positive effects of FDI on the Chinese economy. As he puts it "…China's huge FDI inflows are beneficial both to promote growth and to facilitate economic restructuring…"[41] Especially in 'global industries' of hi-tech, heavy industry or raw materials and banking, FDI, Huang states, is necessary.[42]

[38] Huang sees that there is an uneven increase in the ratio between domestic and foreign FDI when it should rise up proportionally as it happened in the US at the same time (1990s). *Selling China*, pp.2-3.
[39] Yasheng Huang, *Selling China*, p.65.
[40] Shang-Jin Wei. "Why Does China Attract So Little Foreign Direct Investment?" in Takatoshi Ito and Anne O. Krueger (eds). *The Role of Foreign Direct Investment in East Asia Economic Development*. University of Chicago, 2000.
[41] Yasheng Huang, *Selling China*, p. 65-67.
[42] Ibid., p.77.

His argument, as noted, is focused on the distorted 'FDI dependency' despite the adequacy of domestic capital to finance certain domestic firms. Some manufacturing industries in the private sector could have a positive impact on the economy without participating in FDI only if they were not legally restricted to the full areas of business activities found in an open economy.[43] Furthermore, Huang does not dispute the conventional reasons that attract FDI in China such as cheap labor and profitability but, adds one more of an institutional nature.[44]

What also is important in Huang's study is the clear identification of the explanatory variable; it is the political and economic institutional regime that distorts the potential for growth, and not the FDI regime.[45] The FDI regime has not negatively affected the competitiveness of SOEs and is not to blame for, he states. After all, the FDI regime is a liberal regime, as it should be. In addition, Huang states, even at the time of the research (1990's) there are noticeable changes to rectifying these distortions and newer research by other scholars points to a more rectified situation where the leadership opens up to the private sector.[46] Barry Naughton has observed that "private firms are now viewed as 'national' enterprises [and can] represent China in the global market place." [47] That can be seen in the growth of the private firms during the late 1990s even though the FDI regime became more liberal. This shows that FDI is not inhibiting the activities of the private sector.

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43 Yasheng Huang, *Selling China* p.3
44 ibid., pp.66-67
45 ibid p.87
46 ibid., p. 82; Bruce J. Dickson argues that the private sector is now supported by the regime in exchange for political support. See "Integrating Wealth and Power in China: The Communist Party's Embrace of the Private Sector." *The China Quarterly*, 192, 2007.
47 *The Chinese Economy*, p.361.

As Huang himself notes, a restriction on the FDI inflows would not have a beneficial effect on the private sector since, as said, the FDI regime is not the problem, but the institutional setting.[48] The entry of foreign firms did not cause private firms to be uncompetitive, he continues, since the uncompetitive firms have long existed before the appearance of FDI; there is no crowd out effect, but rather, there is the potential of beneficial effects. Buyer and supplier linkages, Huang notes, will take place between foreign companies and domestic ones provided the latter have access to capital to undertake expansion. Therefore, FDI companies are of potential benefit and not of competitive status to the domestic ones.[49] This is consistent with the fact that as FDI increased, so did the domestic business.

> The tenor of the "institutional foundation argument" is that a significant portion of FDI in China is induced by inefficiencies in Chinese financial and economic institutions. The statement in and of itself does not imply that the *effects* of FDI are inefficient. To argue that FDI inflows are caused by the myriad inefficiencies in the system is not anti-FDI, as sometimes construe by those who disagree with this view. An anti-FDI stance depends not on what one views as the causes of FDI but on what one views as its effects. FDI can be caused by inefficiencies, but its main effect can nevertheless be an efficiency improvement.[50] (his emphasis)

and

> My analysis portrays China's high FDI demand as a function of a number of institutional distortions. However, one should not infer from this analysis that the effects of FDI are inefficient. In fact, the opposite is true. As the FDI inflows were driven by opportunities created by the inefficiencies in the Chinese economy, the FDI effect was an increase in the overall efficiency of the Chinese economy…These examples powerfully illustrate both the inefficiencies in the Chinese economy and the ameliorating effects of china's FDI inflows. [51]

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[48] *Selling China* p.92
[49] ibid. p.93
[50] ibid., p.95
[51] ibid., p.318

Huang sees that FDI acted as a substitute for the loan constraints imposed by the government. Without the possibility of FDI many private firms would not have been able to function. "China is extremely fortunate to have received FDI from the ECEs; otherwise, its private firms would have atrophied under the weight of China's inefficient financial and economic institutions."[52] For Huang, the positive effects of FDI on the economy are mainly through loans and secondarily on know-how and technology. I tend to share Barry Naughton's opinion that both are at work.[53] In any case, the reasons why China decided to discriminate against the private sector are political. After the Tiananmen Square incident, the government reforms focused on recentralization as to mitigate centrifugal effects. Huang agrees that the cause was political in nature and in fact understands that this was not unreasonable to happen.

> One may argue that the political pecking order of firms described in this book is consistent with the political objective of preserving stability in a rapidly changing economy and society. Relying heavily on FDI, as a financing and restructuring instrument, is thus the second-best strategy…I do not question the logic that political stability should be a paramount concern and that if a heavier reliance on FDI is the outcome, so be it.[54]

As Huang consents, China's gradualist policy is "superior strategy" to transform a command economy to an open and the overall assessment is "strongly positive."[55] I agree with Huang's opinion that the situation has to change, and in fact it has to a good degree. As he had noticed more than a decade ago, there are changes (on which he devotes a chapter) rectifying the discrimination against private sector. As I will argue when

[52] *Selling China* p.97 & p.202.
[53] *The Chinese Economy,* p.360.
[54] *Selling China*, p.97
[55] ibid. p.336

discussing the theory of FDI in this study, such policy moves are necessary because without domestic production diminishing returns on the effect of FDI and growth will appear. FDI is a long term investment to acquire certain factors of production (finance, know-how) in order to later use for domestic production.

I cannot, therefore, but agree with Huang that “FDI is a means to economic growth, not an end in and of itself…a well-developed internal product and capital market is more important to [China’s] long-term trajectory than foreign capital supplies and foreign markets.” [56] In fact, as I will show, there was a decline in the value of FDI around 2000 and this is partially related to the high productivity of domestic firms making FDI less profitable for foreign companies.[57] Subsequent rising of FDI was directed at technological sectors (global industry) where the domestic competitiveness is lower. The need for foreign production and consumption is also necessary and as I will expose below, recent increases in the domestic consumption capability are promising indicators. In all, Hung’s study is not about the impact of FDI on the economy, but undoubtedly his research provides insights about the institutional workings of the Chinese economic policy.

In a later work, *Capitalism with Chinese Characteristics,* Huang makes the general argument that the engine of growth of the Chinese economy is the rural private firm but the state has neglected this sector.[58] I will only briefly consider few of his claims since this book is about the reforms of 1980s and 1990s. Huang sees that the 1990s were

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[56] *Selling China*, p.331

[57] Huang has taken note of that seeing that FDI into domestic low-tech light industry (textiles) has declined as of late 1990’s; p.204.

[58] *Capitalism with Chinese Characteristics: Entrepreneurship and the State*. Cambridge University, 2008.

a reversal of the 1980's pro-rural-domestic firm policies. I pointed out above the reasons for this, but I do not wish to deny his argument that most of the 1980's domestic entrepreneurship took place in the rural areas.[59] He is critical of the Chinese leadership concentration on urban centers as a place for investments and sees Shanghai, for example, as "inventive but not innovative", friendly to foreign entrepreneurs, but not to indigenous ones. He sees that Shanghai will suffer in the event of an external shock.[60]

All of the above may have been taking place (his data are a decade or more old). The external shock did happen however, in the financial crisis of 2007, and we need to see what the effects were on Shanghai and China. If we tentatively agree that China was affected less than other economies (as it was also in the East Asian crisis) then perhaps the economy was at least well insulated. Huang notes that credit was limited to private business in the 1990s because this sector was thought as posing higher credit risks (besides the ideological/political reasons).[61] This decision may have turned to have some merit if proven to have prevented the exposure of the economy to the international financial crisis. In any case, as I noted with respect to his other work above, such inefficiencies should be addressed during this and the next decade since the indigenous sector (production and consumption) is the key for China's long term prosperity.

Furthermore, here too Huang does see FDI as ameliorating the distortions of the Chinese policies and perhaps the supplier-buyer relationship we noted above probably has attributed to the rapid increase of the indigenous rural firms.[62] In addition I will totally endorse his claim that indigenous development is more efficient than FDI in some

[59] *Capitalism with Chinese Characteristics* ,p.51.
[60] ibid., p.209.
[61] ibid., p.154
[62] ibid., p.223 & p.265.

non-global industries.[63] FDI is meant to flow to industries that cannot do without it. Again there were political reasons behind this and FDI. As he admitted in his *Selling China,* this was the second-best option.

Comparisons with India are useful, but again, the political and historical conditions are different. India was a colony "protected" by the British. Many companies there have a century old history behind them. The geopolitical situation also plays a role. As Haggard and Cheng observed, no account of development is accurate if "high politics" (geopolitics and security alliances) are not taken into consideration and often they are not.[64] I would agree with this adding the history and internal politics and geography as well. In all, Huang sees the effects of policy on the development patterns and not the effects of FDI on the economy. His approach is on the institutional setting as the major explanatory variable not on FDI.

There are still other studies that discuss the trends of FDI in China focusing on aggregate indicators such us GDP, growth, and trade.[65] Researchers have concentrated on the absolute value of FDI and credit various reasons for any change –such as the currency fluctuation or economic recessions in the FDI investors' home countries.[66] The analyses in those studies are technical in order to focus on isolated factors that influence FDI

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[63] *Capitalism with Chinese Characteristics*, p.265.

[64] Stephan Haggard and Tun-jen Cheng. "State and foreign capital in the East Asian NICs." In Frederic Deyo, *The political Economy of the New Asian Industrialism*. Cornell University, 1987, p.86.

[65]Lai Pingyao, "Foreign Direct Investment In China: Recent Trends and Patterns," *China & World Economy*, Number 2, 2002; Linda Ng and Chyau Tuan, *FDI Promotion Policy in China: Governance and Effectiveness,* Blackwell UK, 2001; Francoise Lemoine *FDI and the Opening Up of China's Economy CEPII* 2000; Steven Husted and Shuichiro Nishioka, *China's Fare Share? The Growth of Chinese Exports in World Trade*, University of Glascow, Adam Smith Research Foundation, 2012.

[66] See Lai Pingyao, "Foreign Direct Investment in China, "*China & World Economy*, No 2, 2002; Frank ST Hsiao and Mei-Chu W Hsiao, "The Chaotic attractor of foreign direct investment-Why China?," *Journal of Asian Economics,* 15 (2004).

inflows in China, while the results are not universally accepted since data are changing and often readjusted. [67]

Most of the studies mentioned above are overspecialized, dealing with specific economic or geographical sectors at specific time-periods. The lack of very specific data is often resolved by estimations or revisions of the official data. Most of the researchers have focused on measuring particular effects, checking or correlating FDI to impact. This is important of course and I will also do similar comparisons, but on the aggregate since I am not interested here on industry specific level per se. I am interested on the concise aggregate to get a clear view on the effects.

Moreover, researchers have overlooked checking FDI against the theory of FDI. That is, how has the FDI behaved in China relative to what the theory FDI stated it would behave. In other words, instead of only looking at the relation of event and impact, I will look at the relationship between event and theory. This is something that I will try to do in this study and partially explain my need of looking at the aggregate impact of FDI. Being informed of the concise impact I will be able to check it against the theoretical basis to see if the behavior of FDI in China has been following the expected path. If it has then we can use the models to extrapolate about the future.

Furthermore, the role of location will be considered. Geography has only superficially been mentioned by the majority of the existing studies. As stated, some studies do concentrate on the impact of FDI in some geographical areas. However, the issue of geography is theoretically not problematized with emphasis mostly being

[67] Ewe-Ghee Lim, *Determinants of, and the Relation Between, Foreign Direct Investment and Growth*, IMF Working Paper WP/01/175, 2001; He Canfei & Zhu Shengjun, "Economic Transition and Industrial Restructuring in China," *Post-Communist Economies*, 19(3), 2007.

stressed on the political and economic spheres. In this study, I will bring in the variable of geography since location is an important variable-component of the modus operandi of FDI that interposes itself between the event and its impact in a dialectic relationship with it. That is, location has aided in attracting FDI and in boosting its impact. The purpose of this study in sum is to look at the relationship between FDI and Chinese economy from both an impact perspective and a theoretical one.

This paper consists of several parts. After having stated the purpose of the study in Part One, in Part Two I will deal with the theory behind FDI. We need to know what FDI is. Why foreigners venture into foreign lands undertaking FDI. What are its potential effects relative to growth? I will present Dunning's OLI schema to show under what conditions FDI can take place. I will also present two other theoretical models that can provide predictive insights, especially when integrated, about China's developing course and the mechanics of FDI. The predictions of these models will be compared later to actual evidence presented in this study. In addition, in the last section of this part I will attempt a comparative overview of the political economy of development. I will provide some comparative analysis of the development trends in various developing countries with emphasis on East Asia. In this way we can get a good picture of the similarities, but also the differences when comparing the Chinese economy to the economies of other developmental countries. In Part Three, I will present information on the impact of FDI on the Chinese economy and society. I will also be comparing the evidence to the behavior outlined by the theoretical models. In this part, the role of location in the form of Export Processing Zones in relation to FDI will also be discussed since the zones provided the institutional and physical base where FDI could start flowing to. Finally, in

Part Four I will provide a conclusion centered around the evidence and implications of the study.

Having stated the above one may have wondered about the methodology of this study. The methodology of this study should be considered analytical-qualitative and not quantitative. Although data and graphs will be used to pictorially show the situation discussed, I will not use any sophisticated quantitative analyses. I will only make use of simple data to establish the relationship between the variables and concepts analyzed.[68] These data should not be viewed as year-by-year accounting style changes, but rather as three, five or even decade long trends. Finally, what I will try to do to the extent possible is to enrich my epistemological/methodological approach of this study by taking into consideration a variable that is often neglected or cursory mentioned in political-economic analyses. This is, as stated previously, the variable of location. Therefore, part of this study points towards an effort to theoretically problematize the relation between geography and development policy.

[68] Data have been taken from databases such as the World Bank, Asia Development Bank and the China Statistical Manual 2011.

TWO

Foreign Direct Investment: Concept Theory and application

Introduction

FDI has been a very important investment form economic planners have been using as an instrument of growth for both developing and developed countries. It is, therefore, important to look more closely at FDI as an instrument of preference for economic growth in general in order to understand its usefulness and its demand and impact in the Chinese economy. As I noted previously, studies linking FDI with economic performance, whether aggregate or sectorial, often overlook the theoretical assumptions and framework around FDI preferring instead a technical and narrow approach of association between FDI and some specific area of the economy. It is pertinent, however, to look at the theory behind FDI in order to understand how it appears and how it (is expected to) behaves in the short, medium, and long term. Being theoretically informed about FDI and its subsequent behavior in the host country will allow us to better understand its impact on the Chinese economy, but most of all to check if this impact fits with theory.

During the last several decades the global value of FDI has increased considerably. The strengthening of the linkage amongst the economies of the developed and developing nations and the development of new emergent markets has had a reflection on the volume of the FDI. Furthermore, the weakening of trade barriers allowed various multinational companies to expand to other states and markets.[69] As a

[69] Dunning, J.H. "The global economy and regimes of national and supranational governance". *Business and the Contemporary World* 7 (1) 1995 pp.124-136; Dunning, J.H. et al. "Restructuring the regional distribution of FDI: the case of Japanese and US FDI." *Japan and the World Economy*. 19 (1) pp. 26-47.

result, East Asian developing states, with China as a prime example, have attracted the bulk of FDI during the last three decades.[70] In this part I will expose the theoretical basis of FDI and subsequently I will provide a comparative review of the development trends in some East Asian states where FDI inflows have been attracted during the last decades.

Foreign Direct Investment-the Concept

Foreign Direct Investment is the investment funds allocated by an investment entity based in a country to a particular investment endeavor in another country. This is a long-term investment where the investor holds at least 10% of the entity's stock or by participating in a joint venture with other foreign investors to a particular country.[71] It is important to note that FDI is not only the transfer of financial capital or funds, but includes the transfer of know-how and technology, production management, quality control and other related knowledge necessary for the successful operation of the business in question. FDI is the main method for funding international investment in production and is usually undertaken by Multinationals (MCs).

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[70] Moosa, Imad A., *Foreign Direct Investment: Theory, Evidence and Practice*. Palgrave Ma

[71] Liu X. Scott. *Foreign Direct Investment and the Multinational Enterprise*. Praeger 1997. In the case of China and according to the Law of China and Foreign Jointly-Owned Enterprises a foreign investor's share of total investment in an enterprise should be more than 25% in order for the FDI to also enjoy a preferential status (tax deductions).

Figure 1. World Inward foreign direct investment flows, annual, 1970-2012;In 2011 $million
Source: UNCTADSTAT

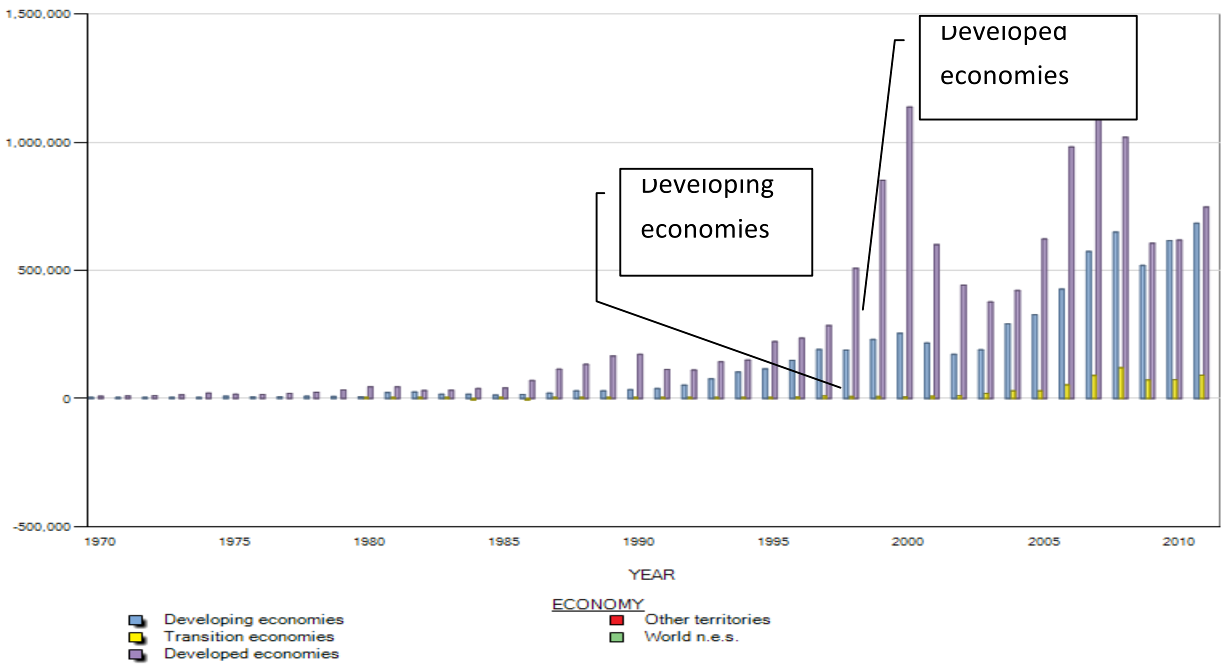
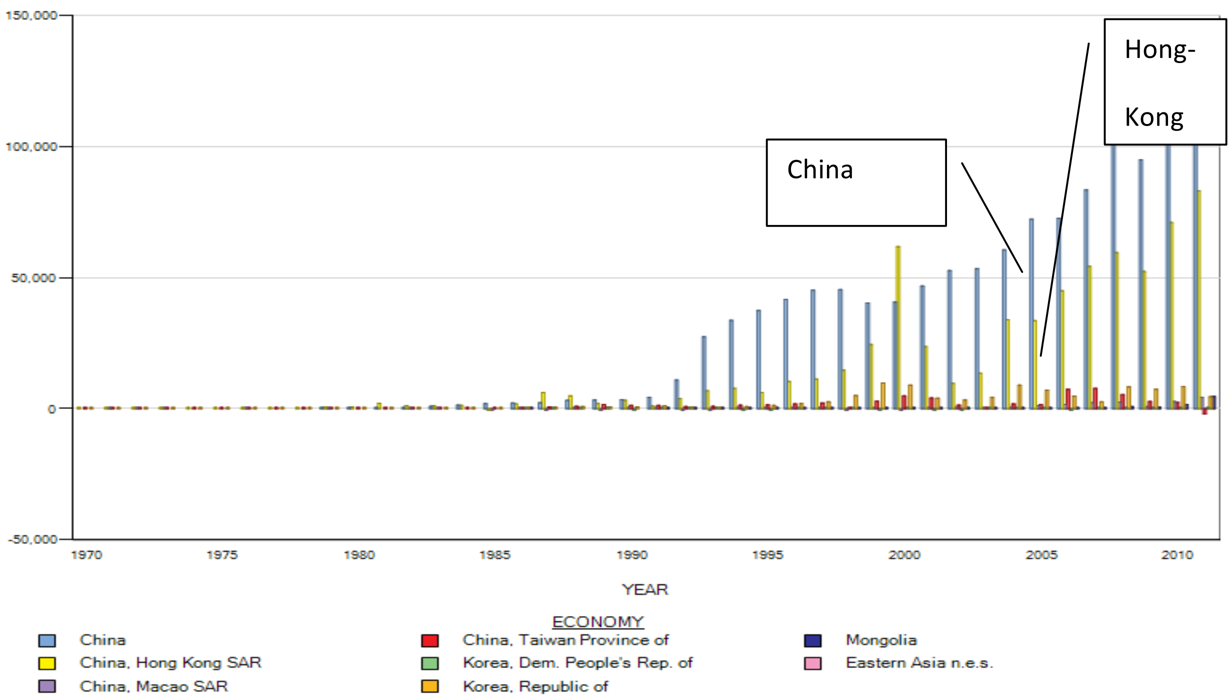


Figure 2. Eastern Asia Inward foreign direct investment flows, annual, 1970-2011;In 2011 $million Source: UNCTADST



The criteria that international investors and MCs use to decide where to go ahead with FDI are several. One criterion is the natural resources. Countries that are rich in raw materials attract FDI. Another criterion is the size of the market of the receiving country as measured by the GDP or GDP per capita. Furthermore, tariffs and other regulations are some factors that investor slook into before investing in FDI. Another important factor is productivity. Labor intensive states attract a high value of FDI because of the low cost of labor in those states especially combined with political stability.[72] The above factors have been the basis for several theories on FDI and its relation with economic development.

Foreign Direct Investment- the Theory

I will expose three theoretical schemes, which I will later check against the situation in China: Vernon's Theory of Product Cycle; Dunning's OLI model; and Dunning's Investment Development Path Theory (IDIP);

Theory of Product Cycle

Vernon proposed the theory of Product Cycle. The reasons why MCs are venturing into FDI in other countries have to do with the competition, innovation and market knowledge, as Vernon has shown.[73] A product is first launched in the domestic market, but after some time, that product is "matured." Then demand appears in foreign

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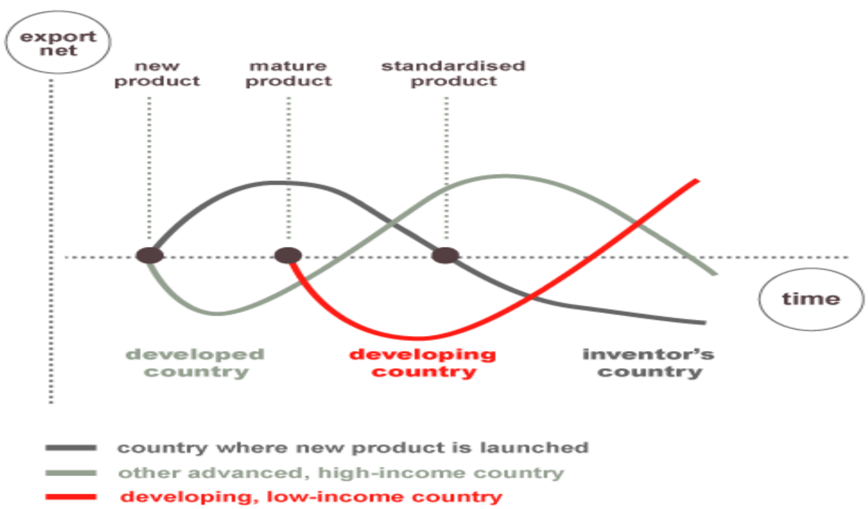
[73] Vernon, R. "International Investment and International Trade in the Product Cycle." *Quarterly Journal* of Economics ,80(2) 1966. Vernon, in his theory of product cycle, showed how companies make decisions about the location of production. The domestic producers know better which new products are needed in the domestic market than which good are suitable for export in foreign markets. Therefore, through FDI, foreign companies combine this knowledge in order to spread to new markets. Vernon did point to limitations of this model especially when applied to large MCs. See also Vernon, R. "The location of Economic Activity" in J.H. Dunning ed. *Economic analysis and the multinational enterprise*. Allen and Unwin, 1974.

markets. As a result, the producers seek ways to produce the product in those foreign markets and FDI is a tool for that. As the product matures the production line can move to less developed states. The Production Cycle model has been subject to critique since the technological gap between Japan, Europe and the United States has been closed.[74] However, China I would argue has been developing and therefore there is still a gap, although closing.

Figure 3. Theory of Product Cycle



OLI Model

More recently, John Dunning proposed a model based on his earlier work named the Eclectic Paradigm, which is based on three notions: Ownership, Location, and Internationalization (OLI Model).[75]

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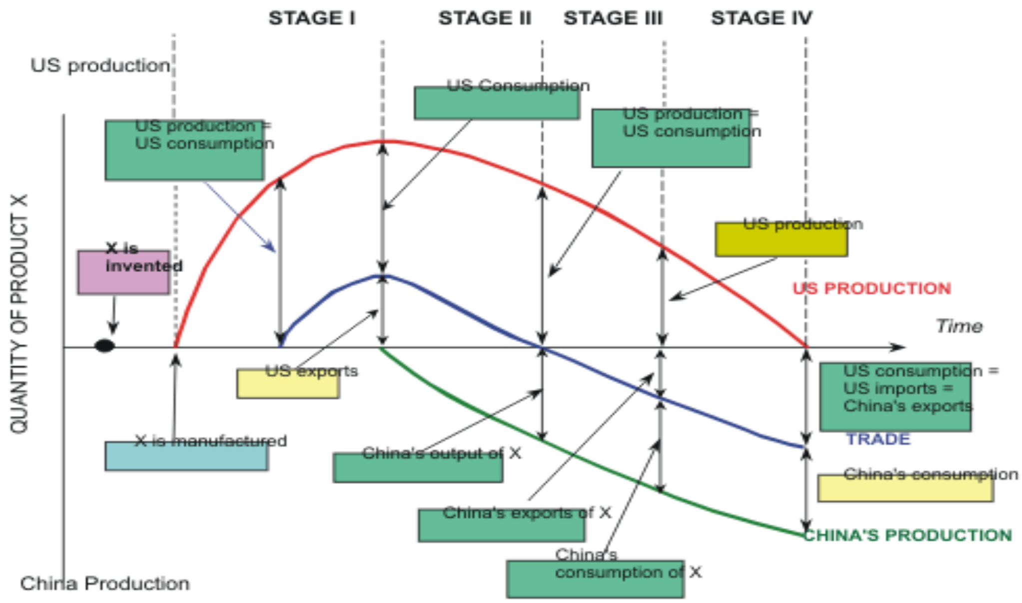
[74] For a critique of Vernon's model see the article by Lorraine Eden; "Bringing the Firm Back In: Multinationals in International Political Economy. " *Millennium-Journal of International Studies*. 20(2) 1991.
[75] Dunning, J.H. "The eclectic paradigm as an envelope for economic and business theories of MNE activity." *International Business Review*. 9(2) 2000. For more on MNCs see John H. Dunning. *Multinational Enterprises and the Global Economy*. Edward Elgar. 2008; John H. Dunning. "The eclectic

Figure 4. OLI Model.



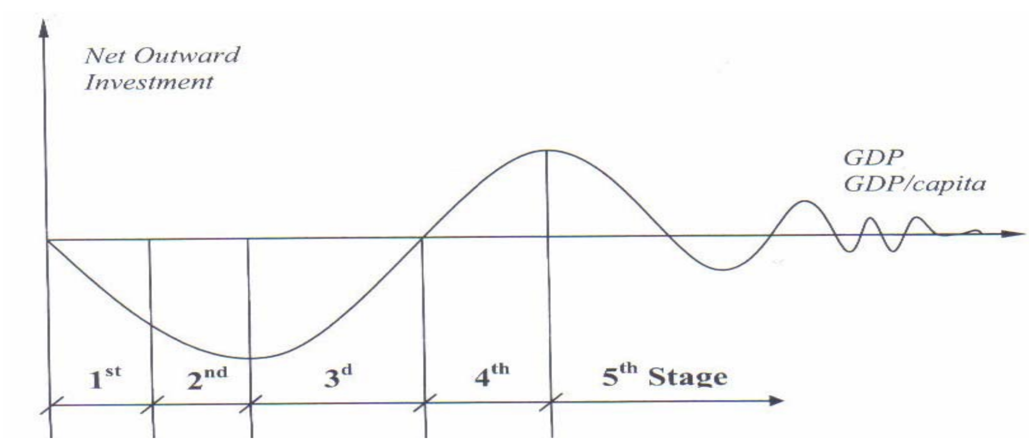
Ownership refers to specific advantages, meaning that the company in question will enjoy exclusive *rights* in the form of property rights or by monopolizing a particular market. MNCs have the ability to take advantage of the oligopolistic market structure to impose their terms in order to perpetuate this structure. That can often be at the expense of the domestic companies in a particular state. *Internalization* means that MNCs prefer to participate in FDI whereby it can keep the benefits (profits, know-how, etc.) internal, as opposed to franchise, and thus lose *control* of those advantages. The *Location* where FDI will take place has to be such that the products will be profitable to be exported to other foreign markets. The FDI should be compatible with the long term *strategy* of the firm in question (therefore an alignment of strategies should exist between the country and the firm).

(OLI) paradigm of international production: Past, present and future." *International Journal of the Economics of Business* 8(2) 2001; John H. Dunning, "Governments and Multinational Enterprises: From confrontation to cooperation." *Millennium-Journal of International Relations*, 20 (2), 1991.

Investment Development Path Theory

Dunning proposed that states go through five stages of development that are directly related to the net investment value.[76] At the first stage of the IDP the advantages of OLI are not fully met. During the second stage inbound FDI appears at an *increasing rate* (even higher rate than the rise of GDP), but limited outbound. The reason here is the sufficient size and purchasing power of the domestic market is strong enough to attract FDI. At the third stage the value of the inbound FDI decreases, but outbound FDI gains momentum. The cause is the *technological development* of the domestic industry which can now seek foreign markets to expand. During the fourth stage outbound FDI exceeds inbound, which is a sign that the domestic firms have spread internationally. Finally, during the fifth stage there is a balance between outbound and inbound FDI reflecting the maturity of the domestic market and the global expansion of the domestic firms.

Figure 5. Investment Development Path Theory



[76] Dunning, J.H. *Alliance capitalism and global business*. Routledge, 1997 p.236; Dunnign, J.H. and Narula R. "The investment development path revisited: some emerging issues." in Dunning and Narula (eds.) *Foreign Direct Investment and governments*, Routledge, 1996.

Global Development Paths

In this section I aim to accomplish two tasks. First, I will try to look into some other East Asian states, which also have been experiencing an impressive economic growth. By looking at some important players it will give us a broad understanding of the political and economic dynamics in this region. As I mentioned earlier, although there are similarities, especially within the East Asian region, there are also important differences, especially when comparing the Chinese economy with other developmental East Asian economies. I will proceed to this comparative evaluation by looking at two other East Asian economies, in addition to China. [77] South Korea and Taiwan have sustained a dynamic economic performance in the post-World War Two period.

The second task I intend to do in this section is to devote some space to theoretical approaches with respect to development to acquire an understanding on a global level. I will extend the comparison, although in a less technical presentation, to other parts of the world –i.e Latin America- since theoretical perspectives on development are relying on empirical data or historical-political processes in several areas of the globe. [78] In this section I will also make reference to the concept of FDI as to see it as component of development.

[77] The work of Roselyn Hsueh, provided me with very useful insights about the workings of the development in China. *China Regulatory State: A new strategy for globalization* (Ithaca and London: Cornell University Press, 2011). I am not going to include Japan in this comparison set since Japan was an early industrializer and never colonized.
[78] I will use as a 'guide' the excellent piece by Atul Kohli, "Nationalist Versus Dependent Capitalist Development: Alternate Pathways of Asia and Latin America in a Globalized World" *Studies in Comparative International Development* no 44 (2009).

East Asian Developmental Path

East Asian economies have managed to achieve an impressive growth utilizing "resources and economic and organizational creativity."[79] If we look at some data about the growth of three representative East Asian economies, we can see what the degree of that growth is.

Table 1. Annual GDP Growth % 1980-2013[80]

China	South Korea	Taiwan[81]
9.0	3.4	3.5

The Neoliberal explanation for the performance of the East Asian economies was that they were export oriented and, with respect to South Korea and Taiwan, the adoption of free market policies.[82] However, this approach is not accepted as such.[83] Rather, theorists have pointed to other factors. Sharing their suspicion I would prefer to search for some of these other factors. One such a factor that I believe helps to explain the high growth of the East Asian economies is not the free market approach per se. As Kohli states,

> Asian countries have created economies with high domestic saving rates, careful management of foreign investment, significant capacity to export manufactured goods and limited foreign debt. These economic trends emerged from planned activities of effective national states and helped stimulate economic growth.[84]

What is important in the above statement is the concepts of *planned activities* and *national states*. The world *planned* does not necessarily point to a closed or state dominated economy but one that the state oversees private activity and canalizes it

[79] Cardoso and Faletto, quoted in Kohli (2009) ft 1.
[80] From World Bank-World Development Indicators.
[81] Data for Taiwan are from Index Mundi for the time range 1999-2011.
[82] See for example Daron Acemoglu, *Political Economy of Growth: Towards a Framework*. IMF Training Seminar, 2007.
[83] Kohli rejects this free market explanation pointing to its ideological roots as reflected in the "Washington Consensus." (2009) p387
[84] Kohli, (2009) 390.

towards certain long term goals, while the public sector is also a player-competitor. The East Asian state, that is, is not one of the arbitrator or just the minimal tax collector neoliberalism would argue for, but one with an active control in the economy. We see that the growth of the Chinese economy is almost three times more that of the non-Socialist Taiwan and Korea, something which supports the model of the strong state. Let us compare in more detail some other factors.

Table 2. Gross Domestic Savings (% GDP)[85]

	1980	**1990**	**2000**	**2010**
China	34.8	39.1	37.5	52.1
South Korea	23.9	36.4	33.4	32.1
Taiwan	31.9	31	28.4	32.4

It seems that the main reason why residents of the above three states –and by extension several East Asian countries- save more is a state policy. The Chinese model of economic growth, as well as, the model of the developmental state of Taiwan and South Korea is based on nationalism. That means that the reliance on foreign capital must be minimized and a way to do that is to promote domestic savings as a means of investment. The Chinese state, despite the opening of its economy to foreign investment and trade, still values domestic savings even more that Taiwan and Korea giving the impression that is more 'hostile' to foreign investors-something not necessarily true as we will see.

Exports are also a major component attributing to the growth of the East Asian economies. The ratio of debt to the value of export is extremely low, whereas the ratio of the value of exports to GDP is high. But, whereas Taiwan and Korea see their export as a

[85] Data from World Bank-World Development Indicators.

fraction of GDP increase they also see their debt service as a fraction of export increase. In China, to contrast, export is booming, but debt in relation to export in decreasing, showing much less exposure to loans and reliance on non external finance. This shows a very extrovert economy with a huge exports sector, which further points to investment in the country, but not necessarily only by the state, hence the absence of need for the Chinese state to borrow money to carry out investment. Taiwan and Korea, in contrast, both of which have an increasing (manufacturing) export sector similar to China, prefer to carry out more government-sponsored investment which explains the larger fraction of debt to exports.[86]

Table 3. Debt Service (% export)

	1990	**2000**	**2010**
China[87]	10.6	4.9	0.6
South Korea[88]	12.8	16.7	32
Taiwan[89]	10.8	11.3	23.6

China has followed a less strict stance on FDI.[90] We see, for example, that whereas the other two East Asian states put barriers on FDI promoting domestic resources and technology instead, China is more open. As a result FDI inflow as a percentage of Chinese GDP in the period 1990-2006 was 3.6, whereas the figure for South Korea was just 0.6 for the same period.[91]

[86] For 2005 90% of Chinese exports were manufactured goods and 91% for South Korea.
[87] Data for China are from World Bank-World Development Indicators and denotes the Debt Service PPG and IMF only
[88] Data for South Korea are from IMF World Economic Outlook.
[89] Data for Taiwan are from Asia Development Bank and the value is the total external debt as a % of GDP
[90] Hsueh, Roselyn*; China's Regulatory State* (2011) pp. 10-15
[91] See Hsueh , *China's Regulatory State*, p.11

Table 4. Exports (% GDP)[92]

	1980	1990	2000	2010
China	11	16	23	31
South Korea	32	28	39	52
Taiwan[93]	-	40.9	46.6	63.7

China, South Korea and Taiwan have been pursuing an integration to the global economy on "their own terms" while refusing to conform to the guidelines of the free market economy as promoted by the Washington Consensus. [94] The end of colonization and the rupture of ties with the western powers allowed for more introvert economic policies. For South Korea and Taiwan, the ties that were created with the western powers were rather preferential and related to the security architecture (foreign aid). China, lacking allies, had to seek for FDI.

Development Evidence and Theory

The success of the East Asian economies can be theoretically interpreted using various theories of development. I would like to stress the importance of geography since the problematization of *location* is often overlooked from political economic studies. I will also present a theoretical model based on Path Dependency Theory. This, I believe, is of crucial importance in order to understand how FDI leads to development.

In a book titled *Geography and Trade,* Paul Krugman proposed, or rather, reintroduced the factor of space trying to explain the emergence of uneven development within states.[95] The model can be extended to theorize about the uneven development within regions (US manufacturing belt or European northern plateau). Krugman, quoting

[92] Data from World Bank-World Development Indicators
[93] Data for Taiwan are from Asian Development Bank.
[94] Kohli (2009) 396
[95] Paul Krugman, *Geography and Trade* (MIT press;1991)

Alfred Marshall, states three reasons: First, a localized industry can easily find skilled labor; Second, a localized industry creates demand; Third, spillover effects.[96]

The above, reminiscent of the theory of FDI, can be applied to East Asian development. Development in East Asia is concentrated mostly in Yellow and South China Sea littoral states. South Korea, Japan, Taiwan, Singapore, and Thailand are the most advanced countries. China is no exception. It is the eastern part of the country close to the seashore that has experienced the most economic development. Erik Wibbels, in fact, accepts Krugman's arguments it in order to supplement other theories of development such as Dependency Theory.[97]

Dependency theory is negative to "dependent development" a term that refers to the dependency on foreign capital and external markets in countries of the semi-periphery. However, "dependent development" does not necessarily exclude economic development. In his interesting analysis comparing the development process of the two regions, (Latin America and East Asia) Gereffi notes that dependency in East Asian was in the form of substantial foreign aid and foreign trade, which the recipients took advantage of.[98]

Finally, two variables that the above model takes into consideration is first, the influence of foreign aid, and second, the dependency management. Dependency theory pays attention to domestic institutions, as Gereffi notes, and is easier to predict the development of an economy by focusing on how domestic actors take advantage of

[96] Paul Krugman, (1991) 36-37.
[97] Erik Wibbels Cores, "Peripheries, and Contemporary Political Economy" *Studies in Comparative International Development* (2009) 44:441-449.
[98] Gary Gereffi "Rethinking Development Theory: Insights from East Asia and Latin America"in J. Timmons Roberts and Amy Bellone Hite, eds. *The Globalization and Development Reader*, Blackwell (2007) p.117

foreign aid. In the case of East Asia success "is explained in large part by the ability of domestic firms to manage effectively their dependency relationships in the areas of international trade and investment.[99]" The "export-platform role" refers to export zones where foreign firms are localized, and as shown by the model of economic geography, it can attract more investment.[100] . Rather technology skills and innovation are the factors that point to development.

As noted earlier, FDI is relatively low as part of the total investment and this is a reason why this study focuses on this small fraction of investment. It is small in volume, but with tremendous potential consequences, as I will show in more detail in the following parts. States such as South Korea and Taiwan have been rather hesitant to accept FDI compared to China and have been using domestic financial resources to promote domestic investment by domestic companies with foreign aid. In contrast, China has deviated from that approach accepting more FDI (without neglecting domestic investment as its high savings to GDP ratio show) and foreign technology as a way to develop its own capabilities.[101] Again, the volume of FDI may be relatively low as a fraction of total investment, but as Kohli observes, is not the value of the FDI investment as such, but rather, what comes along with it.[102] In China, South Korea and Taiwan FDI is channeled to heavy and high tech industries. However, there is another important observation made by Kohli and by Barry Naughton that has to do with the origin of FDI. For example, more than half of the FDI going to China comes from East Asia especially

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[99] Gereffi (1994) 126.
[100] Export zones are established by the less developed countries of East Asia where labor costs are still low. Gereffi (1994) p.129
[101] Hsueh (2011) p.3
[102] Ibid p.398

Hong Kong and Taiwan.[103] The local origin of the FDI shows how the factor of location is important in understanding the issue.

In this part I presented a concise comparative picture of the development situation in selected developmental East Asian states and also in Latin America. The comparison unveiled similarities and differences. Theoretical approaches were presented in order to comprehend the developments. The common denominator in the case of the East Asian states in the strong agency of the state which acted to utilize any opportunities presented within a capitalist or dependency structure. Although the doctrine was the same strategies are not identical. The analysis also brought in the role of location in its relation and how that creates path dependencies. FDI and location should not be treated as being indifferent of one another, just as FDI and development policy are not. I will now turn to FDI itself in more detail.

[103] Kohli sites evidence that as much as 66% of China bound FDI is originated from Kong Kong and Taiwan (2009) p399; *The China Circle*. Brookings 1997; Naughton also sees culture and cheap labor are factors for the Taiwan-China-Hong Kong trade.

THREE

FDI and the Chinese Economy

Introduction

One of the main aims of the reforms in China was to import technology and acquire know-how through learning and emulation of the progress achieved by other more developed states.[104] Deng believed that there is no contradiction between socialism and free market, especially when a combination of both would result to modernization and development. One can see Deng's approach as one in alignment with the arguments found in *Dependency and Development* and *Embedded Autonomy*. That is, there are opportunities within the structural constraints and an alignment of interests between the internal and the external (the state-agency and the global-structure) is possible.

As a result of the above attitude, FDI inflows became the means to import technology and know-how with long-term benefits as well as source of capital marketing access to domestic firms.[105] After keeping FDI under close scrutiny in the 1980's for ideological and political reasons the Chinese leadership moved forward to a more liberal FDI regime. [106] China has become the second most attractive economy for FDI behind the United States during the last two decades. FDI brings scarce capital where it is needed; it stimulates the domestic market and enhances productivity and knowledge.[107]

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[104] For China's modernization policies see Nir Kshetri. "The development of market orientation: a consideration of institutional influence in China." *Asia Pacific Journal of Marketing and Logistics*. 21 (1) 2009 pp. 29-35 and Harry Waters, *China's economic development strategies for the 21st century*. Quorum Books, 1998 pp. 1-14.

[105] Stephan Haggard, Pathways from the Periphery p.198.

[106] About this period see Barry Naughton "Deng Xiaoping: The Economist," *The China Quarterly*, No 135, 1993; David Shambaugh "Deng Xiaoping: The Politician," *The China Quarterly*, No 135, 1993.

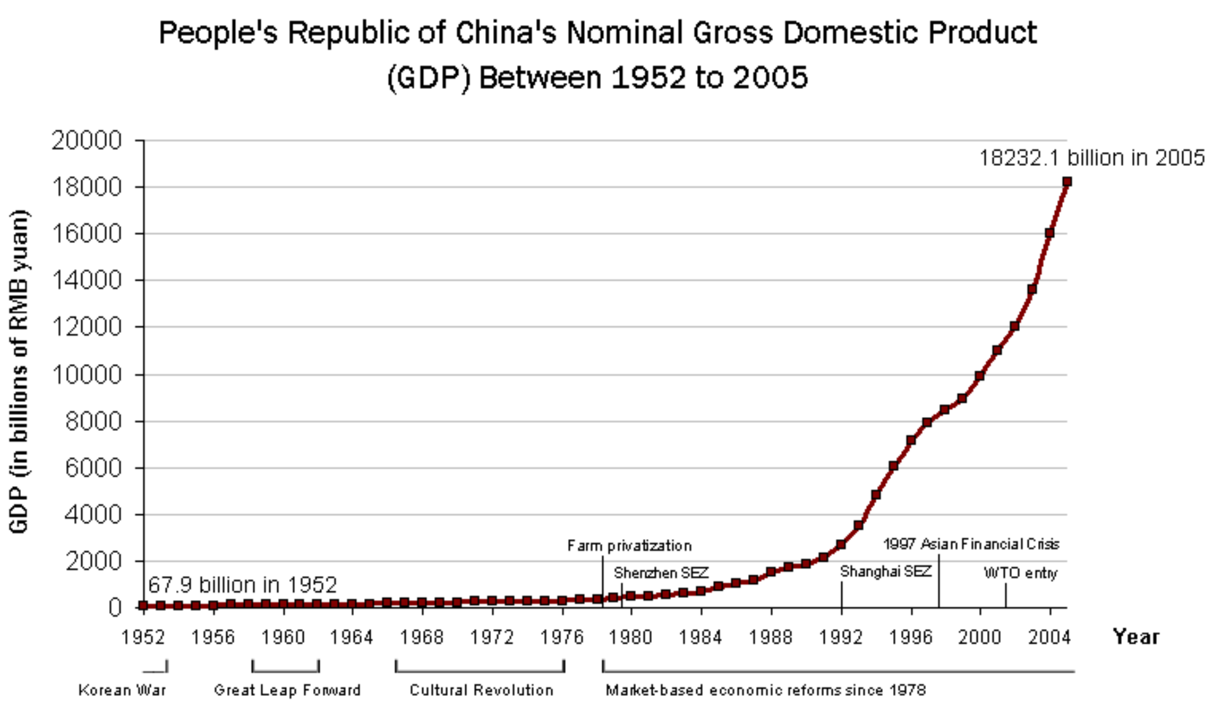
[107] Ashoka Mody, *Foreign Direct Investment and the World Economy*, Routledge 2007, p.1

FDI served as a factor for growth recognized as such towards that goal and lead to further developments of the initial conditions, substantiating my argument about the potentials of this kind of investment. I will now go into the behavior of FDI in China and compare its development not only in relation to aggregate outcomes, but also with geographic variables, while checking it against the theory of FDI itself.

FDI and the Chinese Economy: Event -Impact –Theory

There is a strong correlation between GDP and FDI in China.[108]

Figure 6.



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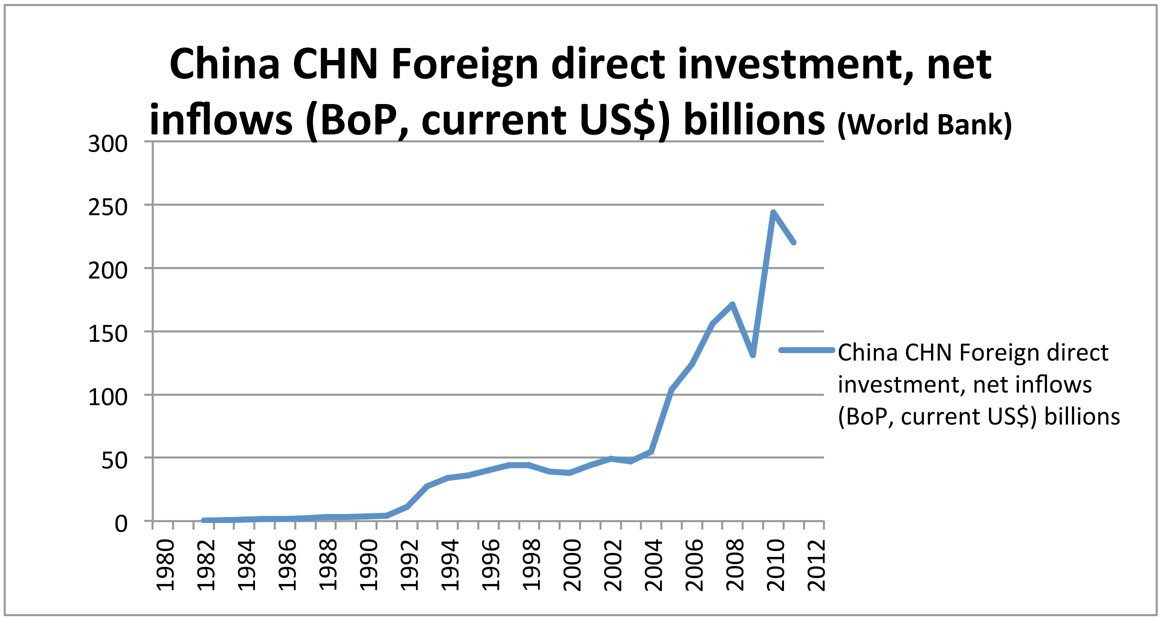
[108] Leonrard Cheng. & Yum Kwan. What are the determinants of the location of Foreign Direct Investment? The Chinese experience. *Journal of International Economics*, 51(2) 2000 pp379-400.

Figure 7.



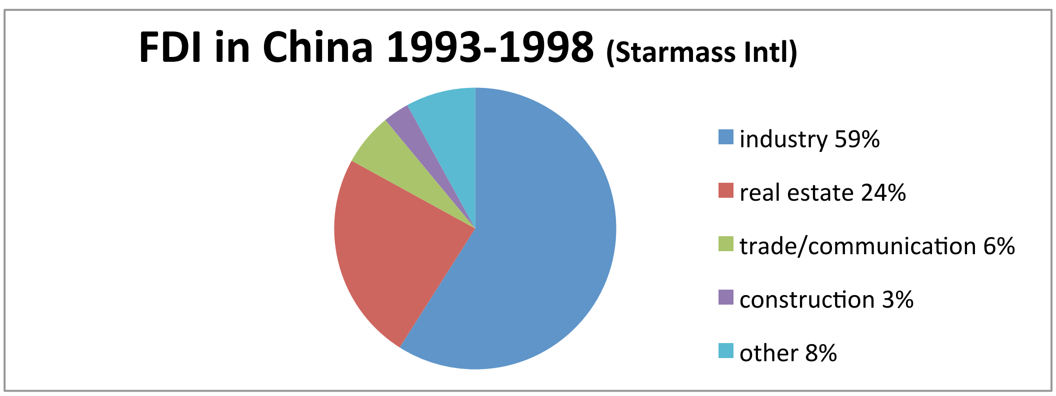
There are studies that show that most of FDI is attracted by the regions of China that are most developed in terms of infrastructure.[109] These regions are the eastern ones that are close to maritime transportation points. The local governments in these regions took advantage of their power on financial and investment policy as a result of the reforms and managed to attract FDI specifically to improve the infrastructure.[110] The location to which FDI is attracted to is of particular interest to development experts since it paves the path where future FDI will be attracted to, pointing to a recognition of the relation between event and location.[111] The Economic Zones (the role of which will be discussed below) in China are allowed by the government a substantial degree of

[109] Cheng & Kwan p385
[110] Wanda Tseng & Harm Zebregs, *Foreign Direct Investment in China: Some Lessons for Other Countries*, IMF Policy Discussion Paper PDP/02/03 2000.
[111] Cheng & Kwan p387

economic self-governance in exchange, as long as they are capable of accumulating funds primarily through taxation of firms and banks operating within their jurisdiction.[112]

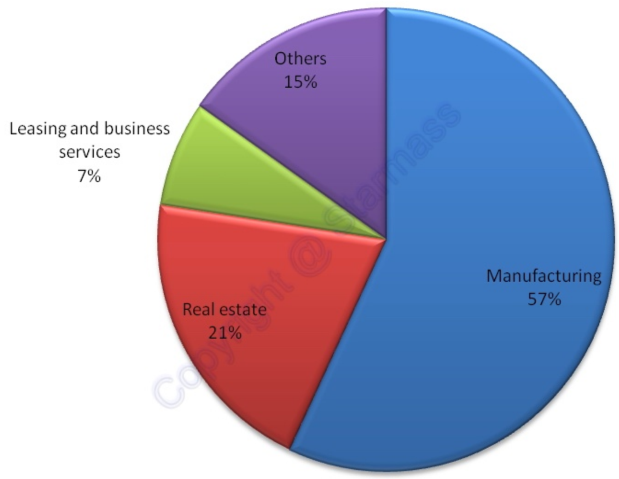
The Chinese investment policy has focused on attracting FDI while putting limits on other forms of financing. Compared to foreign loans and portfolio investments FDI has been of more magnitude than it was. For example, during the period of 1983 to1991, 60% of total external financing ($67billion) was in the form of loans.[113] During the period of 1992 to 1998, foreign financing reached $327billion, 70% of which came from FDI.[114] During the 1980's most of FDI had been directed in labor intensive industries and real estate and in oil industry. By 2000, 60% of FDI was directed to industry and 37% to services since the condition of Internalization could be better met in those industries due to higher returns.[115] Services in particular attract a good deal of investment value due to the short-term returns.

Figure 8.



[112] Zhang, Kevin, "Why Does China Receive So Much Foreign Direct Investment?" *China and World Economy*, 10(3) 2002, p55. During the 1980's FDI from Hong Kong accounted for 62% of total FDI in China, Japan for 14% and the US for 10%. Lemoine, "FDI and the Opening Up of China's Economy", 2000, p.28. See also Barry Naughton ed. *The China Circle*, Brookings Institute Press 1997.
[113] Lemoine, *FDI and the Opening Up of China's Economy*, 2000, p.21.
[114] Ibid.
[115] Lai Pingyao, "Foreign Direct Investment in China: Recent Trends and Patterns." *China and World Economy*, 3(1) 2003 p. 29.

Figure 9. **FDI in China 2009 (Starmass Intl)**



The Chinese government prefers market oriented FDI in order to use it as leverage for technology transfer from foreign investors.[116] Technology brought into China by the foreign investors is to be used by the China-based foreign plants. Once again, and as Barry Naughton noted, the aim of the Chinese government was to have this technology spread and imitated by the Chinese firms.[117] The know-how and technology has been thus the focus of economic policy which could be served best though FDI.

The benefits of FDI can be static and dynamic. Static benefits accrue when firms relocate their plants to take advantage of lower labor costs. As Naughton notes, static benefits had not been the lure for most of the foreign investors in China.[118] Dynamic benefits are based on the know-how and learning process. Imitation as a benefit of dynamic benefits is what Hong Kong and Taiwan have been practicing. There has been the opinion that China was not successful in accruing dynamic benefits in the 1980's and

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116 See Barry Naughton, *The Chinese Economy: Transitions and Growth*, The MIT Press, 2007, p420.
117 Barry Naughton, ed. *The China Circle*, Brooking Institution Press 1997 p.295.
118 Barry Naughton, 1997 p. 296.

early1990's.[119] Chinese producers were not in a position to acquire any knowledge since the final stages –packaging, shipping, marketing- were done on the foreign investor's home country. Naughton also noted that there were other reasons why the Chinese failed to accrue dynamic benefits in the 1980s. The financial system, for example, loans capital to certain investors on political grounds; land use was not guaranteed for use and foreign investors had to have the required funds beforehand. In addition, the Chinese investors themselves had had difficulty maneuvering the perplexed property rights system in China and thus have difficulty expanding.[120] However, these issues were to be expected short to medium term. As several researchers have found, the situation towards dynamic benefits started changing towards the end of the 1990s where firms even resulted to cooperation towards realization of such benefits.[121]

After China joined WTO in 2001, the FDI inflows increased, reaching a 60% increase in five years.[122] Two thirds of that increase went into the manufacturing sector. It is interesting to note here that the FDI inflows into the primary sector (agriculture) declined in the 2002-2006 period compared to the period of 1997-2001.[123] The reasons have to do with the small scale family-based production and the land tenure system both of which deter investment since there can be no guarantee for Ownership and

[119] Barry Naughton, 1997 p.297.
[120] Barry Naughton, ed. *The China Circle*, Brooking Institution Press 1997 p.298. Shang-Jin Wei in a study found that FDI in China was below its economic potential corruption being a reason since it deters foreign investors see "Why Does China Attract So Little Foreign Direct Investment?" in *The Role of Foreign Direct Investment in East Asian Economic Development*, Takatoshi Ito and Anne O. Krueger eds. The University Of Chicago Press 2000.
[121] See Leong H. Liew, "China's Economic Reform Experience: The End of a Pareto-Improving Strategy." *China Information* 14-129, 2000; Yukihito Sato, "Competition and Cooperation among Asian Enterprises in China." *China Information* 23-5, 2009.
[122] In 2007 the value of FDI was of $75billion, 60% up from 2001.
[123] See Chen, "Characteristics of FDI firms in China after the WTO accession" p.105.

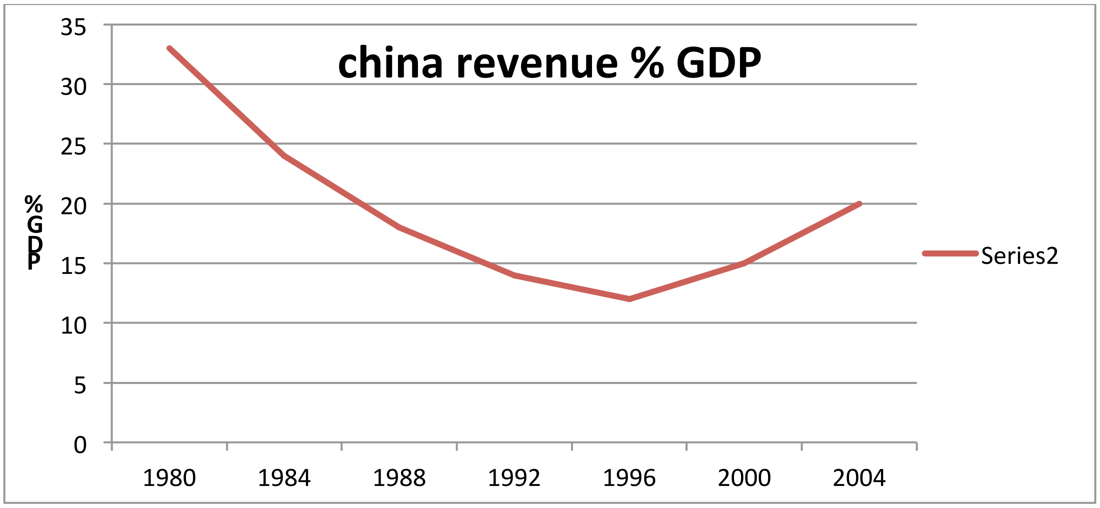
Internalization according to the OLI model.[124] In contrast, FDI inflows into the services sector have been increasing, but slower than the manufacturing sector at an annual rate of 6% for 2001-2006.[125]

As noted, FDI has been directed mainly at the manufacturing sector. As of 2006, FDI firms were comprised 21% of all manufacturing firms and employed 33% of manufacturing labor.[126] Chen notes that capital-intensive FDI firm assets were almost doubled in 2001-2006 period followed closely by the technology-intensive FDI firms.[127] These data show that even though China is still enjoying a comparative advantage in labor-intensive activities that is related to its very large population there is a trend appearing of a shift towards capital-intensive and technology-intensive industries. This is again in accordance with Vernon's Product Cycle Theory since a shift into capital insensitive industry will lead into more exports. FDI firms concentrate less on labor-intensive activities to avoid competition with the domestic labor-intensive firms, which have become more labor-productive in the recent years[128]

As expected, the reforms were to cause a reduction of the percentage of government revenue as a percentage of GDP depicting the expansion of the private sector in the economy.

[124] Chen, "Characteristic of FDI firms in China after the WTO accession" p.106
[125] Chen, "Characteristics of FDI firms in China after WTO accession," p.106.
[126] Chen, "Characteristics of FDI firms in China after WTO accession," p.108.
[127] Between 2001 and 2006 the total assets of capital-intensive FDI firms went up by 188%; the assets of technology-intensive increased by 173% and the assets of labor-intensive FDI firms by 110%; values taken from Chen, "Characteristics of FDI firms in China after WTO accession,"p.112.
[128] According to Chunlai Chen's data domestic firms' labor productivity was about 10% higher than FDI firms labor productivity. "Characteristics of FDI firms in China after WTO accession," p.118.

Figure 10. Source: World Bank



The Chinese economy not only transformed from one of central planning to an economy where *both* the state and the market played a major role, but the rate of growth has been sustained at a very high level.

Table 5. Average Annual GDP Growth % 1980-2013[129]

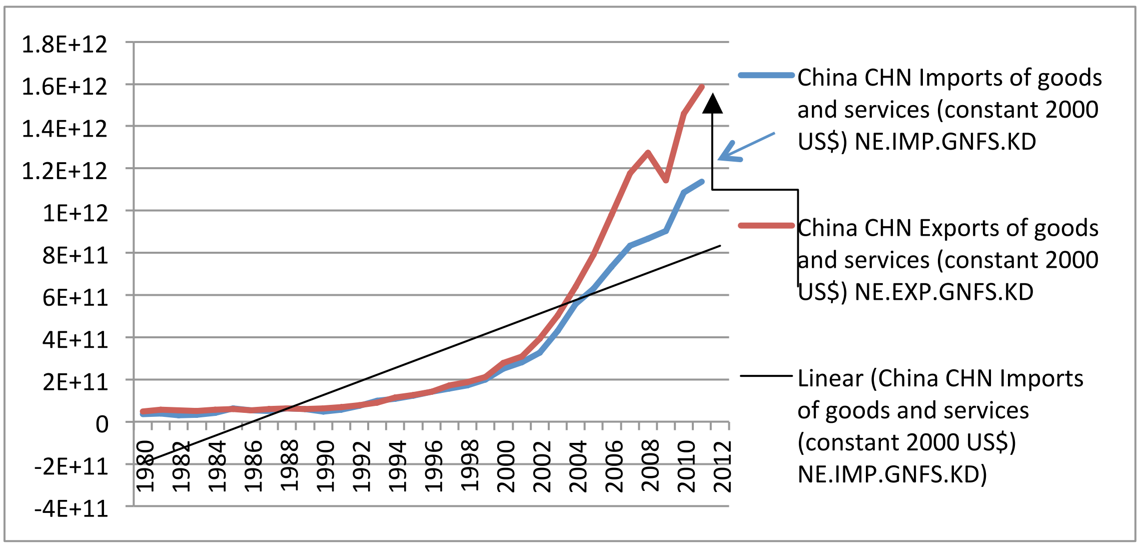
China	South Korea	Taiwan[130]
9.1	3.4	3.5

Moreover, international trade has been constantly expanding during the same period. China exports, as a percent of GDP, have increased three times between 1980 and 2010 and this is, as may be remembered, is in accordance with Vernon's Theory of Product Cycle.

[129] From World Bank-World Development Indicators.
[130] Data for Taiwan are from Index Mundi for the time range 1999-2012.

Imports rose from $35 billion in 1980 to $1.14 trillion in 2011, while exports increased from $48 billion to $1.6 trillion for the same period of time.[131] The rate of increase of imports and exports has been about 15% annually. That is *more than the annual growth of GDP* (9%) which indicates that the Chinese economy is becoming more open to international trade. The Chinese economy performance thus, has behaved well and in accordance with Vernon's Theory.

Figure 11. **China's Exports and Imports of Goods and Services**



Source: World Bank

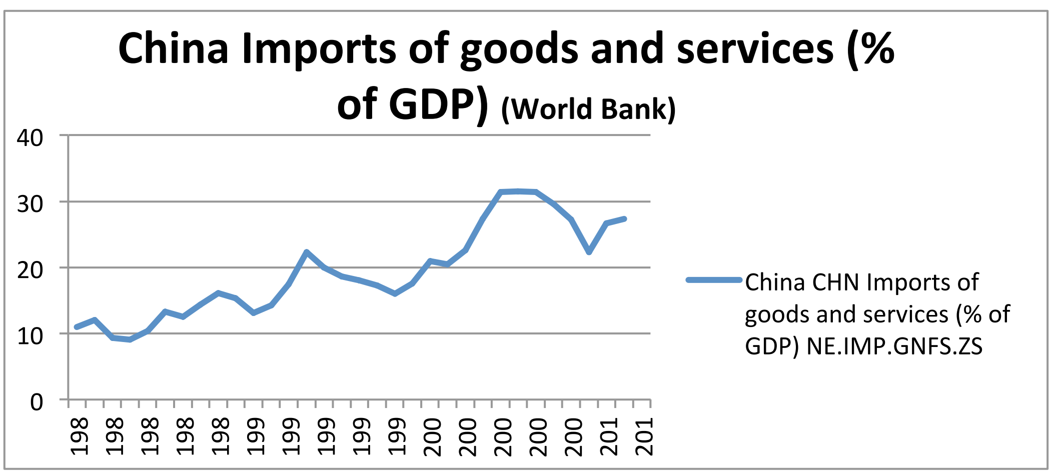
The idea of development has to have some positive social repercussions. The economic growth, as we will see, generally improved the living standards of the Chinese people. Not only was there an increase in income (from $186 in 1980 to $2,600 in 2010), but the household final consumption per capita went up considerably (from $137 in 1980 to $950 in 2010).[132] In 2000, 10% of urban households owned a computer set while in

[131] Data from World Bank.
[132] Data from World Bank; figures in $ 2000) and from *China Statistical Yearbook 2013* section 11-2. A drawback is the increase of inequality index from 55% in 1980 to 33% in 2012.

2012, 87% did.[133] The improvement of health care services can be shown in the reduction of the newborn mortality rate from 3.3% in 1991 down to 0.7 in 2012.[134]

The trade surplus presented above is in accordance with Vernon's Theory (stage III) which predicts an increase in domestic production. The earlier hypothesis stating this would indeed be the case since China is not a closed economy, is well supported. Therefore, using the model for future extrapolation we can say that with respect to domestic consumption the trend will continue until stage IV is reached. In other words, although production will in aggregate value increase, a greater proportion will be allocated for domestic consumption at this stage. As experts on economic development note, and I concur, technological innovation is the most important factor of growth.[135] Without innovation, even if there is capital accumulation, growth will not take place since diminishing returns will offset the use of capital (Lewis Turning Point). Therefore, innovation sets the boundaries for the rate of industrial expansion.

Figure 12.



[133] *China Statistical Yearbook 2013* section 11-9.
[134] Ibid. section 21-18.
[135] Justin Yifu Lin, Fang Cai, and Zhou Li, *The China Miracle: Development Strategy and Economic Reform*, The Chinese University Press, Hong Kong, 2003, p.12.

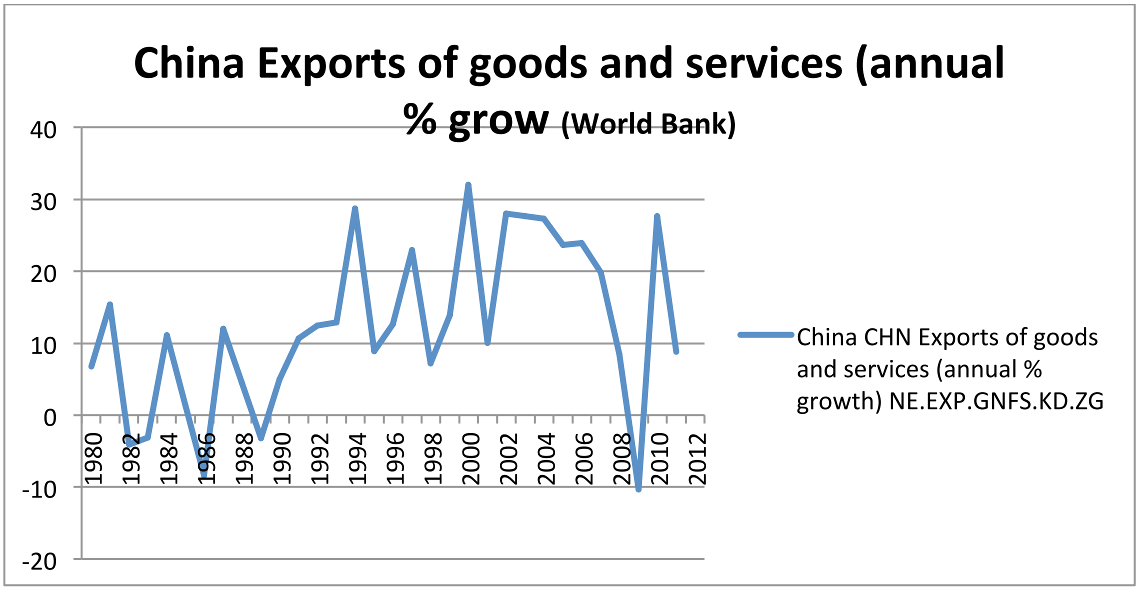


Figure 13.

China has managed to maintain a high rate of capital accumulation (40% of GDP) and that explains the high rate of growth, which takes place because of the technological advancement, as a result of the importation of know-how.[136] That is, regarding technological innovation, China has opted for the option to primarily purchase technology from abroad since it is much cheaper that undertaking research on its own. This is the point where has FDI played the most crucial role in the development policy of China. As noted earlier, FDI is not just finance invested but, technology and know-how. In any case, to avoid diminishing returns domestic technology after some point is necessary for a sustained growth.

The restructuring of the Chinese economy as a preparation for entry into the WTO but also as a result of the membership to this organization (2001) can be seen by the value of trade. Between 1998 and 2006, China imported goods and services at an

[136] Justin Yifu Lin, et al., 2003, p.15.

annually increasing rate.[137] The value of the imported goods and services as a percent to GDP went from 16% in 1998 to 32% in 2006. Similarly, exports have been increasing at a very high pace. As can be seen in the graph, the annual growth of exports has been at the rate of 20% before the economic crisis of 2008. China has been exploiting its comparative advantage in skilled labor surplus and its close location to sources of FDI to produce goods in competitive prices while rapidly absorbing foreign technology in accordance with Vernon's Product Cycle Theory. It is within this greater reform regime that the FDI were to function and unleash its full potential. This is where I will now turn to.

The rapid increase of FDI inflows in the early and mid- 1990'was followed by a slow down at the end of the decade. This, at first glance, looks to have fooled the theoreticians' expectations since this seems to lie at the margins or outside the boundaries of the Investment Development Path Theory (IDPT). Chunlai Chain explains by the decrease in transfers from labor-intensive activities which in combination with the East Asian financial crisis weakened the ability of East Asian firms to invest in China.[138] Furthermore, Chain notes that the rate of return was not of such a satisfactory level to the investors while key sectors of the Chinese economy were still monopolized by the state-owned enterprises leaving potential foreign investors out.[139] However, looking carefully we see that the slow-down was a temporary deviation and does not contradict the IDPT

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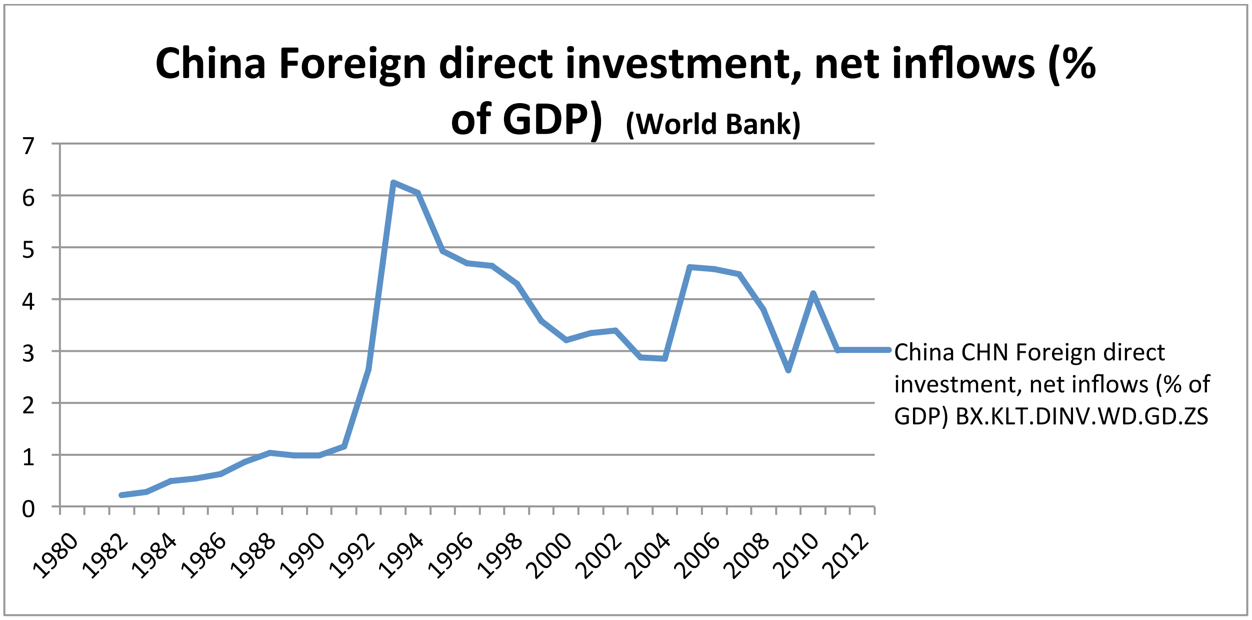
[137] Tariffs were lowered from 43% in 1992 to 17% in 1999 and down to 9% in 2005 (Values from IndexMundi). There were occasions where the Chinese government would revert to preferential treatment of FDI sources in order to attract them and canalize the investment to a particular industry or geographical area of the country;see Rosalyn Hsueh. *China Regulatory State* pp 22-26; Daniel Rosen, *Behind the Open Door, Foreign Enterprises in the Chinese Marketplace. Institute of International Economics*, Washington DC, 1999.

[138] Chunlai Chen, "Characteristics of FDI firms in China after WTO accession" in *China's Integration with the Global Economy*, Edward Elgar Publishing, 2009, p.53.

[139] Ibid.

because FDI picked-up again. Moreover, the IDPT takes into account the actual value of FDI and, as can be seen in the graphs, the value of FDI in $US kept increasing (but for two years); it was the share of FDI to GDP that decreased.

Figure 14.



During the third phase of FDI in China- the WTO phase- inflows, as noted, increased at about 8% annually. As the IDPT shows, the rate of FDI would be expected to decrease as China was transitioning between the second and towards the third stage of development. What marks the second stage of IPDT is that the rate of FDI growth will fall to the level of GDP growth or below. This is exactly what the data show. The rate of growth of FDI and GDP are about equal during the WTO (2001) phase. Moreover, as Vernon's model predicted, (stage IV) there is an increase in domestic-owned production, which means a lower rate of return for FDI, and thus, a decrease in the supply of it. This is encouraging since, as mentioned earlier, domestic production is a key factor for diminishing returns to be avoided. Domestic production should and must take over after a generation of FDI inflows since the latter were to act as long term spread of know-how to the domestic level.

It seems that the Chinese government has started to slowly back-up the domestic firms at the expense of the foreign MNEs, in accordance with the vision that FDI is a long term know-how acquiring strategy and not an end in itself. As a result, the fact that the new unified tax policy in effect since 2008 where equal tax rates were applied to both foreign and domestic companies would in effect be preferential to domestic ones since the new rate is an increase for the foreign investors only. [140] In 2007, the Chinese government announced that both foreign and domestic firms would be liable to a tax rate of 25% starting in 2008. This new tax policy aimed at reducing the incentives of round-tripping since it eliminated preferential clauses for foreign firms. However, the new tax regime was expected to be rather preferential to the domestic firms since the new tax is an increase for the foreign firms but not for the domestic firms.[141]

The unified code will not apply to firms in several important sectors such as high-tech, agricultural development; energy and others would be liable to only 15% tax rate. Firms investing in underdeveloped regions and Special Economic Zones would also have similar tax liability. The above affirm the hypothesis that FDI would not as a whole be affected by new regulations if deemed necessary for know-how. Thus only the sectors that know-how is needed, in combination with the geographical location in need of development, will enjoy a preferential status, but areas where there is a sufficient know-

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[140] According to some studies Round-tripping has inflated the value of FDI by as much as 33% as reported in the UNCTAD *Investment* Brief No2 2007.

[141] Although the income tax rate for domestic firms is nominally 33% in real terms is 25% so the new law wasnot expected to have any negative impacts on these firms; however, the foreign firms investing in China and were liable to a 15% tax and under the new law the tax were to increase to 25% expecting some short term negative impacts on small firms but not on Multinational enterprises. Chunlai Chen, *Characteristics of FDI Firms in China after WTO* accession, p. 103.

how acquired FDI will cease being sought as before for the benefit of the domestic industry.

The impact of FDI on growth is meant to happen in the long run and in a sustainable way. That is FDI is not so much a source of financial capital but as a source of know-how. The latter takes decades to spill over the economy and this should not escape any analysis of the role of FDI. Although the side effects and monetary impact of FDI would appear first, the know-how will appear in the long run. The mechanism of spill-over is perhaps of the most difficult phenomena to accurately describe. Spill-over takes decades to result into a finished form after going through several difficult to detect channels, forcing the researchers into making several assumptions. As Blomstrom and Kokko note, “there is strong evidence for significant spillover benefits from FDI but…do not occur automatically.[142]

FDI in the Chinese economy: Event- Location (Special Economic Zones)-Theory

Special Economic Zones (SEZ) is a geographically defined area, or an enclave, under a single management. The location is an advantageous one in terms of proximity to major trade routes. Within SEZ the management operates under a more liberal regime, compared to the rest of the country. That is, lower tariffs and faster processing of goods and services[143]. SEZ are important in that they aim to attract FDI, to employ skilled labor,

[142] Magnus Blomstrom and Ari Kokko “The Economics of Foreign Direct Investment Incentives,” in Heinz Herrmann and Robert Lipsey (eds) *Foreign Direct Investment in the Real and Financial Sector of Industrial Countries*, p. 48.
[143] Foreign firms in the zones were exempted from import/export duties and from profit remittances; tax rates were 15%, wages were 80% lower than Hong Kong and foreign personnel paid no taxes. Data found in Ota T. 2003 p. 23.

and export promotion. We should recall the important role of location, which was analyzed earlier in this study. The location of SEZ is far from being chosen randomly.

In the theory of International Trade, which is embedded in the larger theoretical framework of comparative advantage, the Heckscher-Ohlin (H-O) model has been a major example. The H-O model is generally speaking an expression of the Ricardian view that countries (should) produce and export those products that require cheap input and import the rest. This view as expressed by the H-O model runs contrary with the concept of SEZs since the model assumes that the factors of production are immobile.[144] For example, because the capital is very mobile the H-O model is considered inadequate to evaluate the effectiveness of SEZs. Koichi Hamada tried to analyze the impact of SPZs using a Ricardian 2-factor 2-commodity theoretical model.[145] His model points to rather limited benefits from SEZs. Furthermore, Chee Leong points out, there are several issues concerning the role of SEZs: for example, there is luck of data related to the SEZs; there is also the fact that the level of openness is not necessarily the effect of a policy.[146]Therefore, export to GDP ratio is not the best measurement. Leong tried to quantify policy shifts and found that the reform policies contributed to greater growth while increasing the number of SEZs less so. Furthermore, according the Leong' study, export growth probably leads to economic growth but on a diminished

[144] Skeptics state that there is not a theoretical agreement on the advantages and disadvantages of SEZs. The neo-classical school of economics is skeptical about the efficiency of SEZs. The skeptics' argument is that while FDI (foreign capital) is flowing into SEZs labor will be withdrawn from other labor intensive industries where the country enjoys a comparative advantage, to work on capital intensive goods in SEZs reducing thus the value of labor intensive goods; However, recent studies have reevaluated this argument and they rather invalidate it see Deveraux, J. and L.L. Chien.1995 "Export Zones and Welfare: Another Look" *Oxford Economic Papers 47*, 1995; Kankesu Jayanthakumaran. "Benefit-Cost Appraisals of Export Processing Zones: A Survey of the Literature." *Development Policy Review*, 21(1), 2003.
[145] Koichi Hamada. "An Economic Analysis of the Duty-Free Zone," *Journal of International Economics,* 4, 1974 p.236.
[146] Leong, Chee. *A Tale of Two Countries: Openess and Growth in China and India*, Nanyang Technical University 2006 p. 4.

(inelastic) proportion depending on the level- regional or national.[147] In this section I will argue that SEZ have played a very crucial role.

SEZs, although strictly speaking is a particular type of zone in China, it is used generically to include other Zones such as Export Processing Zones. SEZs operate in capital intensive environments and enjoy governmental support. SEZs were formed in the early years of China's economic reforms. The Chinese decided to follow the path opened by Taiwan and Korea to open limited areas of the national economy in an experimental way in order to wisely test new policies before applying them to the entire economy.[148] However, as has been stated earlier the policies of the developmental states were not identical, but reflected political-economic conditions. Thus, the Chinese, in contrast to the other East Asian developmental states, went directly to Export Oriented Industrialization skipping the stage of Import Substitution Industrialization.[149] As a result, four SEZs were formed in coastal areas with the task to promote trade reforms and currency exchange. Tatsuyuki Ota notes that the Chinese SEZs were unique because they linked foreign investment with trade.[150]These SEZs were strategically located close in Hong Kong and Taiwan so that they could expand the trade with these areas. This is what Dunning calls the location factor in his OLI model.

Another reason for the location of these zones was that in anticipation of the return of Hong Kong and Macao and possibly Taiwan to China, the Chinese wanted to close the development gap in the areas of China close to these territories in order to have

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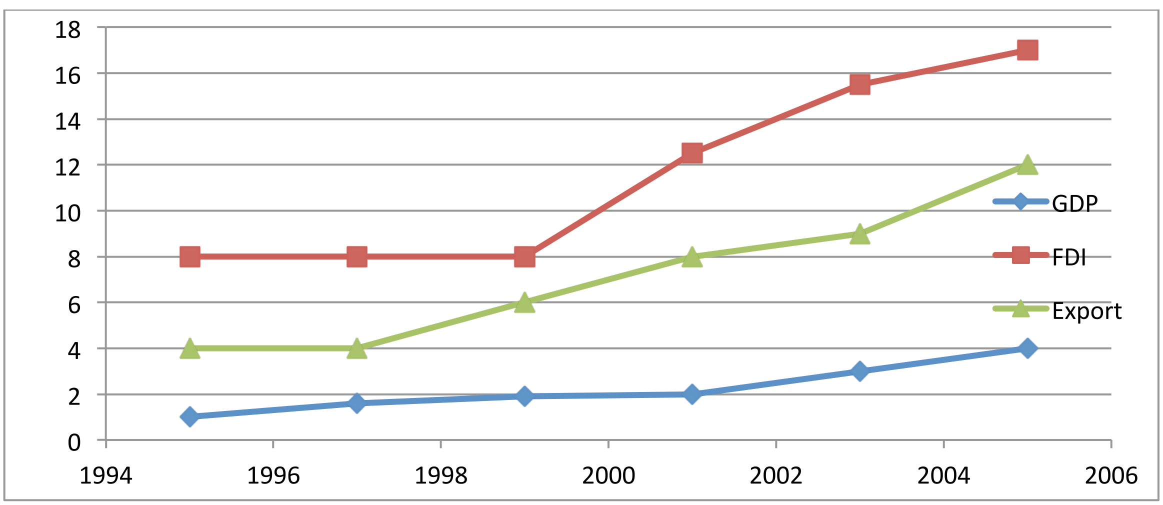
[147] Leong, Chee. 2006 pp.22-25.
[148] Jingdong Yuan and Lorraine Eden. "Export Processing Zones in Asia: A Comparative Study," *Asian Survey*, 32(11) 1992. pp.1036-1037.
[149] The role of Import Substitution (reducing imported goods by manufacturing them domestically) was undertaken by the foreign firms located in the SEZs.
[150] Ota, T. "The Role of Special Economic Zones in China's Economic Development as Compared with Asian Export Processing Zones: 1979-1995." *Asia in Extenso*, 2003. p.4. online

a smoother integration in the economy.[151]In any case, within few years, the four SEZs attracted 60% of total FDI; in 1985 they had attracted $1.2 billion, 20% of the national total.[152] The rate of growth in the SEZ was tremendous. In the SEZ of Shenzen, for example, the annual growth was 60% between the years 1980-1984, while the national average was 10%.[153] The total utilized FDI was about $37billion for 2007, about half of that national value.

Table 6. Special Economic Zones Data 2007 as % National[154]

FDI	Merchandise exports	GDP
33	35	25

Figure 15. **% Of National EPZs in China's Economy**[155]



[151] Ota, T. 2003 p.4.
[152] Douglas Zeng, "How Do Special Economic Zones and Industrial Clusters Drive China's Rapid Development?" in Douglas Seng ed. *Building Engines for Growth and Competitiveness in China: Experience with Special Economic Zones and Industrial Clusters*. World Bank Publications, 2010 p.9.
[153] Douglas Zeng, 2010, p.10. see also George Crane, *The Political Economy of China's Special Economic Zones*, Sharpe inc., 1990 pp. 146-154.
[154] Douglas Zeng, 2010, p.13. from National Statistical Bureau.
[155] From X. Fu and Y. Gao taken from China Ministry Of Commerce.

Many SEZs serve several purposes promoting, for example, both trade and technology. Export-Processing Zones (EPZs), in particular, were established with the purpose to promote exports. EPZs are located in the coastal areas close to ports where manufactured goods arrive for exporting. There are 57 EPZs, 44 of which are in the coastal area. EPZs were formed in 1984 and within ten years had a substantial effect of the FDI inflows in China.[156] After China joined the WTO, EPZs expanded quickly. From 2002 to 2006, 58 new EPZs were set up utilizing China's surplus labor.[157]Firms located in EPZs export processed goods to other countries where the returns are high. That allowed for the realization of the Internalization factor according to the OLI model. Within the zones, manufacturing activity takes place where goods are developed further and are exported in their final forms, but are often exported as semi-final goods as well.[158]

The impact of the EPZs on the Chinese economy, in general, has been substantial, as can been seen by the share of the zones on the country's GDP and exports in *relation to the FDI inflows*. The overall performance is satisfactory since they provided a 'nursery' for FDI which in turn impacted the economy.

The zones have absorbed excess labor while promoting exports, aiding into leading the way towards a market economy. Their role also was to promote Export Substitution Industrialization at the same time as promoting Import-Substitution

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[156] EPZs in combination with Industrial Free Zones and Enterprise Zones caused FDI to triple between 1990 and 1993. See Fu X. and Yuning, G. *Export Processing Zones in China: A Survey*, University of Cambridge, 2007. p.10.
[157] Fu, X. and Yuning, G. p15.
[158] Jayanthakumaran, 2003, p.53.

Industrialization. As stated, their effect on FDI has been noticeable as well.[159] The economic policy autonomy enjoyed in the zones, where they operated under a rather market-oriented regime rather than been controlled by the central government, allowed for a more sufficient allocation of resources. That meant that the firms kept ownership of their product, a crucial factor in the OLI schema. The positive impact had, as shown, an effect on the national economy at large, although it varies greatly from sector to sector.

The existing literature and data about the Chinese economy on the subnational level do not permit a comprehensive sectorial analysis about the SPZs. I do not think that it is necessary for the purposes of this study to delve into the specifics since I am interested on the general, but more accurate representation. Based on such concise picture it can be said, as a policy implication based on the Chinese case, that EPZs should be established at a specific locale where investors find attractive; and second, EPZs can create a "greenhouse" free-market economy meaning that not only within the zones there is limited government intervention, but that the same zones compete with one another creating the momentum for efficiency.

[159] Edward Graham is taking a neutral position of the issue of the relationship between FDI and EPZs. It can be true, he notes, that SPZs fostered FDI, which without the zones, would be not able to be attracted. It can also be argued that FDI would have arrived anyway since it was the location its self, not the SPZs, that attracted FDI. In any case even the "location itself" approach is a supporting evidence for my argument of problematizing location;. Edward M.Graham. *Do export processing zones attract FDI and its benefits. IEEP*, WDC,,10.1007, 2004 p.98.

FOUR

Conclusion

Lessons and Implications

My intent in this study was to argue on two levels; on the broad theoretical level in favor for the model of developmental state as a viable alternative towards development, and on the narrower policy level, which is where my main focus was, in favor of FDI as a tool in the development and growth of the Chinese economy behaving as theoretically expected.

On the theoretical level my argument was that China has been following a development doctrine which calls for the exploitation of the several opportunities lurking in the global structure. The concepts of 'internalization of the external' and 'embedded autonomy' call for the agent in the form of the state to act. That is, to foster the conditions for an alignment of interests between it and the structure as to internalize dynamics found in the structure. The state has to be both an autonomous and embedded agent within its border and society as to socioeconomically foster and nurse the internalized development seeds. I showed that China should be treated as a rather successful example of such a state since the policy on attracting FDI is consistent with this doctrine.

Aside from the doctrinal theoretical level, my primary examination was on the narrower tactical domain, but nevertheless organically related to the doctrine level. I presented FDI arguing for its consideration as perhaps the most successful and appropriate tool for internalizing benefits, while acknowledging that there are many variables that may contribute in fostering developments and may have influenced the political leadership on decisions of development. Given, however, that the conditions of possibility existed enabling the leadership to launch reforms, the focus on FDI in combination with SEZ proved to fulfill expectations for development. This is the case since FDI allows a developing country not only to acquire loanable funds but also, along with that, the ability to 'internalize the external' through *technological and managerial* know-how while the risks associated with FDI are spread to both the foreign investor and the host country. As I showed, the Chinese have done a good job exploiting these potential properties FDI possesses.

I tried to substantiate my argument about FDI by presenting the theoretical basis that supports the rationale for FDI. What is often missing from the literature is the discussion of what FDI is and its properties, which point to its potential behavior. In light of these properties and theoretical expectations I then reviewed the reforms the Chinese leadership undertook. Subsequently, I examined the impact of FDI on the Chinese economy by primarily showing aggregate values concurrently checking the impact against the theory; the latter mostly overlooked from similar studies. If impact and theory did not match then the theoretical models will not be good predictors for the route of the Chinese economy while in the opposite case would be reliable. The findings were consistent with the Dunning's IDPT and OLI models and Vernon's Theory of Product Cycle. These models predict in due course that China will be gradually transforming itself into a source of FDI. It seems that this is starting to take place with the beginning of FDI outflows from China to other parts of the world especially in Africa.

Furthermore, in addition to checking impact of event to theory as opposed to only checking event to impact, I examined the nexus of event and location. FDI has been a platform where a developing country with limited financial capital can utilize to maintain a high rate of growth, but the location of this platform needs to be at least cursory investigated, something usually missing since studies tend to focus on the political, social or economic areas, neglecting to problematize about geography. FDI started flowing into China during the 1980's. Even though only a section of the paper was devoted to the SEZ's, this should not underestimate their impact on the Chinese economy. The SEZs have played an important role in attracting foreign investors since they demonstrated a commitment by the Chinese for liberalization of the economy (by securing ownership and profits (the O and I factors) while presenting advantages physically as locales (the L factor).

During the 1990's and 2000's the value of FDI rose to very high levels, while shifting from labor intensive industries to capital and technology intensive ones. China's entry into the WTO initiated another boost phase for FDI- at an annual growth rate of 8%- validating the hypothesis that WTO membership would attract more FDI even if preferential status to foreign firms would be lifted. I suspect that the industries of the FDI is directed too are only those that are of global nature and not on the domestic level where the indigenous firm should possess an advantage. It also marked the entrance of the Chinese economy into the second phase, as the IDPT had predicted. FDI was concentrated in the manufacturing sector due to its large rate of return relative to the labor intensive industries. In particular, the high technology industries, which constitute about half of the industrial sector, were very competitive in attracting FDI.

The changing patterns of FDI allocation reflect the changes in China's comparative advantage. China's tradition in enjoying a comparative advantage in labor intensive industry is shifting to a capital and high technology comparative advantage. Therefore, I expect more FDI to flow into those industries since China is to maintain a satisfactory degree of economic growth and less on the rest. As a result, labor productivity and overall industry competitiveness is going to increase. Even though FDI and foreign firms may deprive domestic firms from developing, I will disagree that that is the case on average. Competition has caused productivity to be rather higher within domestic firms, both labor and capital intensive. The benefits of FDI were not kept secluded as in a command economy rather as predicted they are slowly spread to the consumers as showed by the improvement of certain social indicators. I expect that an increase in GDP per capita (although in an unequal distribution) will lead to a larger domestic consumer market which will spur demand for more capital intensive goods further expanding China's international trade.

As China is becoming more and more integrated into the global capitalist structure the market forces will begin affecting the Chinese society. In this paper I paid only some attention to some social indicators related to development. It was not my purpose to thoroughly examine the social transformations that are taking place in China. Development is not only aggregate macroeconomic indicators, but also social conditions as well. The first of course have to exist as well and that where I focused on limiting myself to this. Social indicator trends have to be examined as well since there has to be an organic balance between the two for a realistic notion of development to occur. As a potential challenge and key for China to continuing its role of the demiurge is to ensure and strengthen the continuation of the 'embedded autonomy' of the bureaucracy. Further research should be carried out in this domain since it will be perhaps the key for the realization of the benefits of development at the social level. In all, the purpose of FDI was to enable several Chinese industries to acquire financial capital and know-how. This is a long-term investment, but after three decades of FDI production must slowly shift to the domestic level. No sustainable development can exists, as I argued, if the domestic firm is not allowed and able to spur development and innovation. It seems that things are going this way. This decade and the next should be devoted to the domestic area of production innovation and consumption.

Finally, I am of the opinion that between the all-out neoliberalism which is here demanding more and the overthrow of the global capitalist structure, when that happens, there is a middle path that considers the role of the state as organic and dynamic as opposed to one of a passive coordinator. I see that as a manifestation of the expected “double movement” to bring back the equilibrium lost during the last 25 years.

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