Is China Playing By the Rules? Free Trade, Fair Trade, and WTO Compliance
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Statement of
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Thank you for giving me this opportunity to testify about an immensely important and complicated issue in the Sino-US relations as well as in the transition of China to a market-based economy.

The topic of the hearing is, "Is China playing by the rules? Free trade, fair trade, and WTO implementation." In my testimony, I will not address the question whether China is playing "fair" as I believe that fairness is an intrinsically subjective and political perspective. The first question in the fairness question is fairness to whom. If you hold the view that the cheap Chinese imports are "unfair" to those US firms producing the same products, one can equally argue that these imports are "fair" to those Americans who purchase these products. There are also American corporations which purchase imported intermediate products to manufacture their products. By this logic, those consumers who purchase America-made products that use imported intermediate products from China also benefit from cheap Chinese imports.

As much as I can, I will stay away from this so-called "fairness" question because I respectfully submit that this question itself is poorly defined. What I want to do here is to provide an analytical perspective based on facts and evidence rather than getting into a more complicated issue as to whether China's trade and investment practices are fair or not. I am also testifying here in my capacity as a business school professor who analyzes business and economic trends in China rather than as a lawyer who follows the detailed legal and regulatory issues involved in the WTO implementation. What I want to do here is to provide some general backgrounds relating to the role of foreign direct investment (FDI) and foreign trade in the Chinese economy. My argument is that assessing China's accession and implementation of WTO against this general economic background can yield a very different conclusion from assessing China's WTO implementation against the specific provisions in China's accession document. I believe that China's WTO implementation should not be judged on narrowly legal grounds but on the broader economic and social grounds.

There are three general points I want to make and emphasize in my testimony. First, China acceded to the WTO terms not as a closed economy but as a substantially open economy. In fact, by some measures, China is more open to FDI and foreign trade than the United States. This is a remarkable fact and we need to keep this in mind when we judge China's implementation record. Even if China were to have failed to implement each single provision of the WTO accession document, we cannot draw the conclusion that this is a closed economy designed to keep out foreigners. My second point is that while we can debate whether cheap Chinese imports are fair to Americans, we can legitimately make an argument that some of the Chinese regulations and practices are in fact unfair to the Chinese themselves, especially to the domestic private entrepreneurs, and the largest beneficiaries of unfair treatments are foreign firms; some are American firms.

The third point is that the fact that China appears to be quite open to foreign trade and FDI is in part a result of some fundamental inefficiencies of its economic system. These inefficiencies suppress the investment and market potentials of truly domestic private firms, which are the most efficient firms in the Chinese economy. The effect of this suppression is that foreign firms have found more business space in China because they do not compete with the most efficient domestic private firms to the extent possible. An implication of this way of looking at the roles of foreign trade and FDI is that as some of these inefficiencies are being alleviated in

the long run—five to ten years—the importance of foreign trade and FDI may very well decline in the Chinese economy.[1]

Let me organize my comments into three sections. The first section provides evidence to show that Chinese economy, *even before the WTO accession*, was already quite open and in fact, by some measures, more open to foreign trade and FDI than the United States. The second section explains this "foreign" bias in the Chinese economy—in favor of foreign firms and often to the detriment of domestic private firms. The third section provides some concluding remarks.

The unusual openness of the Chinese economy

By a number of conventional measures, China's economy in fact is quite open without the benefit of the WTO membership. On the trade side, a large portion of China's GDP is accounted for by foreign trade. Using official exchange rate conversion would yield a trade/GDP ratio of 40 percent, an extremely large share for a continental economy of China's size.[2] For the US, the foreign trade/GDP was around 20 percent in the 1990s. Japan had a similar ratio.

China is also quite open to foreign direct investment (FDI). Since the early 1990s China has been one of the largest FDI recipients in the world. In 1994, for example, China alone accounted for 49 percent of the total FDI flows to developing countries and 15 percent of the worldwide FDI flows. This ratio has declined in more recent years but China no doubt is the largest recipient of FDI among developing countries. For 2003, according to a number of estimates, China will surpass the United States in terms of the absolute level of FDI.

Not only is the absolute size of FDI large, its relative size—measured by FDI/capital formation ratio—surpassed that of many countries in the world (discussed below). I will also provide evidence to show that foreign-invested enterprises (FIEs)—i.e., joint ventures between Chinese and foreign firms or wholly owned foreign subsidiaries—have established a sizeable presence in the Chinese economy and, in a number of industries, have come to command a dominant position.

Foreign vis-à-vis internal trade

The outsized roles of foreign trade and FDI in Chinese economy are not only striking in comparing China with other countries but also in comparing China's dependency on external trade and on FDI with its patterns of internal, cross-provincial trade and investments. In a 1994 report, the World Bank—the best study to date—noted that inter-provincial trade normalized by provincial GDP was smaller than intra-European trade.[3] Transportation costs explain some of this but during the reform era inter-provincial trade has declined while there have been massive investments in roads, railways and airport facilities. This is a startling fact. Trade economists have long noticed a home bias in trade patterns, i.e., domestic residents tend to buy from each other much more than they do from foreigners. A study on the inter-provincial trade in Canada reveals that its internal trade about 20 times its trade with the 30 states in the United States—the states Canadian provinces traded with most intensively.[4] Canada and the United States are two very similar countries on economic, political, and linguistic dimensions that should facilitate trade between them and yet internal trade in Canada still exceeds external trade by a wide margin.

FDI/capital formation ratio

A good relevant measure of China's openness to FDI is not the absolute size of FDI but FDI normalized by the size of the host economy. Countries vary in their economic and market size and the size of FDI flows ought to be gauged relative to the size of the host economy. The absolute size of FDI flows for the United States in 1990 was much larger than the Chinese FDI but the US economy is roughly seven times as large

(on the basis of official foreign exchange conversion). In that sense, the United States is less "dependent" on FDI than China is even though the absolute size of FDI flows into the United States is much greater.

A common measure of the relative size of FDI is the "FDI/capital formation ratio," given by the amount of FDI inflows in one year divided by the total fixed asset investments made by foreign and domestic firms in the same year. (In the paragraphs below, I use the term, FDI dependency, to refer to this ratio.)

Table 1 Measures of capital inflows: Foreign loans, actual foreign direct investment (FDI), and contractual alliances, 1979-1999.

	Amount (US$100 million)				Percentage shares of total capital inflows (%)			Actual FDI inflows as a percentage share of fixed asset investments (%)b	
	Total	Foreign loans	Actual FDI inflows	Contractual alliancesa	Foreign loans	Actual FDI inflows	Contractual alliancesa	Of Fixed-asset investments by all firms	Of Fixed asset investments by non-state firms
1979-1982	124.57	106.90	11.66	6.01	85.82	9.36	4.82	--	--
1983	19.81	10.65	6.36	2.80	53.76	32.10	14.13	0.88	2.63
1984	27.05	12.86	12.58	1.61	47.54	46.51	5.95	1.60	4.52
1985	46.45	26.88	16.61	2.96	57.87	35.76	6.37	1.92	5.65
1986	72.57	50.14	18.74	3.69	69.09	25.82	5.08	2.07	6.21
1987	84.52	58.05	23.14	3.33	68.68	27.38	3.94	2.27	6.41
1988	102.27	64.87	31.94	5.46	63.43	31.23	5.34	2.50	6.86
1989	100.59	62.86	33.92	3.81	62.49	33.72	3.79	2.90	7.97
1990	102.89	65.34	34.87	2.68	63.50	33.89	2.60	3.69	10.90
1991	115.55	68.88	43.66	3.01	59.61	37.78	2.60	4.15	12.36
1992	192.03	79.11	110.07	2.85	41.20	57.32	1.48	7.51	23.52
1993	389.60	111.89	275.15	2.56	28.72	70.62	0.66	12.13	30.81
1994	432.13	92.67	337.67	1.79	21.44	78.14	0.41	17.08	39.18
1995	481.33	103.27	375.21	2.85	21.46	77.95	0.59	15.65	34.35
1996	548.04	126.69	417.26	4.09	23.12	76.14	0.75	15.10	31.81
1997	587.51	120.21	452.57	14.73	20.46	77.03	2.51	15.04	31.66
1998	579.36	110.00	454.63	14.72	18.99	78.47	2.54	13.25	28.27
1999	526.6	102.12	403.19	15.18	19.4	76.6	2.88	11.20	24.1
2000	594.5	100	407.1	17.71	16.8	68.5	2.98	10.3	20.6
2001	496.8	--	468.8	18.4	--	94.4	3.7	10.5	19.5
2002	550.1	--	527.4	21.3	--	95.9	3.87	10.1	--

Source: State Statistical Bureau, *China Foreign Economic Statistical Yearbook 2000* (Beijing, China Statistics ress, 2000). Statistics for 2000, 2001 and 2002 are from http://www.moftec.gov.cn/moftec_cn/tjsj/wztj/wztj_menu.html and EIU,

Notes:

a Contractual alliances refer to asset leasing, compensation trade, and product processing.

b Fixed asset investments refer to purchases of new plants, property, and equipment made by both domestic and foreign firms in a given year. All the figures include investments made by FIEs.

Column (3) of Table 1 presents three different measures of the relative FDI size during three periods in the 1980s, 1990s and the 2001-2002 period. The three periods represent different phases of continuous FDI liberalization, as briefly summarized in the table. Column (3a) uses the fixed asset investments undertaken by all firms, including foreign firms, as the denominator. Column (3b) includes only the fixed asset investments by nonstate firms, that is, collective firms, FIEs, and domestic private firms. Column (3c) includes the fixed asset investments made by private firms and FIEs. One noticeable trend is the sharp rise in the FDI/capital formation ratio beginning in 1992. When we use the fixed asset investments undertaken by all firms, including FIEs, the ratio rose from 4.2 percent in 1991 to 7.5 percent in 1992. In 1994, the ratio reached 17.1 percent. Column (3b) shows a more rapid increase in the FDI/capital formation ratio when FDI is normalized by investments made by nonstate firms.

State-owned enterprises (SOEs) account for a large portion of fixed asset investments. Since the investment activities of SOEs are heavily influenced by the government, it is more appropriate to compare the level of investment activities of foreign firms with that of nonstate domestic firms. Nonstate firms, including FIEs, are more market-driven and are subject to harder budget constraints compared with the SOEs. As the Hungarian economist Janos Kornai points out, SOEs are afflicted with an “investment hunger” and are prone to over-investing regardless of the market demand for their products (Kornai 1980). Thus, it is more meaningful analytically to compare the investment behavior of FIEs with other nonstate firms. Between 1993 and 1997, FDI accounted for over 30 percent of the fixed asset investments made by nonstate firms in each year and during the same period, on average, FDI accounted for about 53 percent of the fixed asset investments made by domestic private firms and FIEs. There is no question that FDI is a significant source of investment financing in China.

Table 2 presents data on FDI/capital formation ratios in China and a number of other countries to provide a comparative perspective. The data are broken down by three periods, 1986-91, 1992-98, and 1999-2000. China’s FDI dependency varied during these three periods. Compared with other countries in the table, it was initially low in the first period; it rose to a very high level in the second period; and it began to decline to a moderately high level in the third period.

Table 2 Relative FDI Size, Macroeconomic Developments, and Business Environment, Various Years

Countries	(1) Annual average FDI flows/gross fixed capital formation, all firms ratios (nonstate fixed asset investments only), %			(2) Gross domestic savings rate, 1994-97 (%)	(3) Current account balance/ GDP, 1994-97 (%)	(4) Business environment for foreign investors		
	(1a) 1986-91	(1b) 1992-98	(1c) 1999-2000			Rank in terms of ease of foreign acquisitions, 1996 (out of 46 countries)	Business environment rank, 1996-2000 (out of 60 countries)	Corruption perception rank, 1997 (out of 52 countries)
China	2.9 (8.6)	13.1 (27.9)	10.6 (21.5)	41.8	2.7	41	44	41
Philippines	6.6 (8.1)	8.3 (10.2)	7.6 (9.4)	15.5	-8.5	40	35	40
Indonesia	2.3 (3.4)	5.4 (8.9)	-13.7 (-22.7)	33.5	0.0	37	46	46

Thailand	5.5 (6.5)	5.6 (7.2)	11.9 (17.6)	38.0	-6.3	42	30	39
Malaysia	14.7 (22.8)	16.9 (24.3)	22.1 (30.3)	40.0	-0.8	43	24	32
Taiwan	3.6 (4.3)	2.2 (2.7)	11.8 (14.2)	25.6[a]	-2.7[a]	39	21	31
Korea	1.3 (1.6)	1.2 (2.0)	8.1 (10.7)	35.7	-1.8	46	29	34
Singapore	37.6 (49.7)	22.9 (30.3)	24.2 (32)	50.9	16.4	30	6	9
Brazil	1.6 (2.1)	7.7 (9.0)	27.6 (33.9)	20.1	-0.8	29	38	36
Mexico	8.3 (10.9)	13.5 (17.1)	10.7 (15.6)	21.4	0.5	28	34	47
India	0.3 (0.5)	2.2 (3.4)	2.1 (2.5)	21.2	-2.6	35	45	45
United States	6.5 (7.7)	6.9 (8.1)	15.8 (18.3)	15.6	-1.6	19	1	16
Canada	5.3 (6.1)	9.3 (10.6)	33.6 (38.6)	20.4	1.7	32	5	5
United Kingdom	13.6 (16.3)	13.5 (15.6)	41.9 (54.7)	14.7	-0.9	10	4	14
Russia	-- (--)	2.0 (2.2)	9.1 (10.5)	27.7	4.3	45	53	49
Poland	0.01 (0.6)	13.1 (16.0)	20.6 (23.7)	16.7	-1.7	31	31	29

Note: [a]: 1994 only.

Sources: FDI data are from United Nations Conference on Trade and Development (1998), United Nations Conference on Trade and Development (1999), United Nations Conference on Trade and Development (2000), and United Nations Conference on Trade and Development (2001). Private investment , savings and resource balance data are from the World Bank, World Development Report, various years and World Bank (1995a). For Taiwan, the source is Asian Development Bank (1995). The measure of ease of foreign acquisitions is based on a survey conducted by the International Institute for Management Development in Switzerland. Respondents were asked to rate countries according to a 11-point scale. A perfect score, 10, is given to countries that do not impose any restrictions on foreign acquisitions and 0 is given to countries where foreigners may not acquire control. The data are reported in International Institute for Management Development (1996). The business environment rank is a broader measure devised by the Economist Intelligence Unit. The country ranks for the 1996-2000 period are reported in "Business Environment Scores and Ranks" (2001). The corruption perception rank is devised by Transparency International; the 1997 data are reported on **http://www.gwdg.de/~uwvw**, accessed on October 23, 2001.

Between 1992 and 1998, on average, FDI flows into China accounted for about 13 percent of the gross capital formation of all firms annually. This ratio is one of the highest among the countries in the table, even compared with countries traditionally considered to be very FDI-dependent, such as countries in Southeast Asia. As pointed out earlier, even though the United States attracted a greater amount of FDI, the relative importance of FDI in the United States, at 6.9 percent during the 1992-98 period, was far smaller than it was in China. Compared with other Asian economies, China was less dependent on FDI in the 1980s, but its FDI dependency was among the highest in the region in the 1990s. China's FDI/capital formation ratio during the 1992-98 period was lower than that in Singapore and Malaysia, but much higher than that in Indonesia, Thailand, and the Philippines. The standard wisdom is that China is more similar to the Southeast Asian countries than it is to Korea, Taiwan, and Japan in terms of FDI dependency. That is true, but in fact China was among the most highly FDI-dependent economies in Asia during much of the 1990s. This is also the case if one uses gross domestic product (GDP), not fixed asset investment, to normalize FDI inflows.[5] (China's FDI/GDP ratio is high whether one uses the official exchange rate or the purchasing power parity rate. [6]) The claim that China is highly dependent on FDI does not at all hinge on benchmarking China against traditionally small recipients of FDI, such as Japan and Korea.[7]

China’s FDI dependency, in a comparative perspective, is all the more striking if one takes into account the substantial investment roles of SOEs in China. As already pointed out, SOEs?subject to softer budget constraints compared to nonstate firms?are prone to over-invest. It is reasonable to expect a country with substantial public sector investments to have a lower FDI/capital formation ratio. For this reason, China’s high FDI/capital formation ratio—inclusive of investments by SOEs—compared with other countries with a far smaller public sector is powerful evidence of the substantial role of FDI in the Chinese economy. Another way to illustrate the same point is to derive a FDI/capital formation ratio net of investments by public sector entities. This is indicated by the bracketed numbers in column (1b) of Table 2. By this measure, China’s FDI dependency was the second highest among all the countries represented in the table. During the 1992-98 period China’s FDI/capital formation ratio net of public sector investments was 27.9 percent, after Singapore (30.3 percent) but higher than Malaysia (24.3 percent).

In the 1999-2000 period, that is, column (1c) of Table 1.2, China’s FDI dependency declined compared with many countries in the table. A major factor was the rapid and sudden surge in FDI dependency among the advanced developed countries, such as the United States, the United Kingdom, and Canada, and developing countries, such as Brazil, Korea, and Thailand. It should be stressed that this sudden rise in FDI dependency constituted a substantial deviation from earlier dependency levels in these countries, suggesting that a number of country- and period-specific developments may have contributed to this outcome.[8]

What is also interesting is that since China’s WTO accession, in 2001 and 2002, FDI has continued to decline as a source of investment financing for the Chinese economy. FDI/capital formation ratio was 10.5 percent in 2001 and 10.1 percent in 2002. This echoes the argument that I laid out at the very beginning of this statement, i.e., a very important reason for China’s unusual openness to foreign trade and FDI is in fact a result of substantial inefficiencies of China’s economic system. WTO accord and other policy measures implemented by the Chinese government since the late 1990s have alleviated some of these inefficiencies and therefore have actually reduced China’s dependency on FDI. My own view is that in the long run the role of FDI is only going to decline in the Chinese economy as internal allocation of financial resources continues to improve.

FDI vis-à-vis cross-provincial investments

I pointed out before that the Chinese trade with each other less than they trade with foreigners. There is also a similar investment dynamic here. Some Chinese provinces depend on FDI to a far greater extent than they do on each other as a source of investment funds. Take Guangdong province as an example. In 1992, Guangdong invested about 2.5 percent of its total investments in other provinces while other provinces’ investments amounted to 1.7 percent of total investments in Guangdong. In the same year, FDI accounted for 31.7 percent of Guangdong’s investments, far surpassing both Guangdong’s export of capital to other regions and its import of capital from other regions.[9] In monetary terms, the 2.5 percent of outward investments in other provinces amounted to 399 million dollars. To put this number in perspective, in 1993, firms based in tiny Macao—known more for its casinos than its computers and for its gangs than for its garment making—invested 586.5 million dollars in China.[10] (Unfortunately, the more recent data on cross-provincial investments are not available. The consensus is that internal trade and investments increased somewhat in the late 1990s but still they are at a lower level compared with China’s foreign trade and FDI.)

This outsized investment position held by foreign firms is by no means limited to Guangdong, a province which has wooed foreign investments particularly aggressively. Sichuan, an interior province traditionally isolated from the outside world, also depended more heavily on FDI than on investments from other provinces. In 1993, investments from other provinces came to represent 0.22 percent of Sichuan’s total investments; foreign investments, however, represented 5.4 percent. The data compiled by the World Bank show that out of six provinces four on average relied more heavily on FDI than on investments from other

provinces between 1985 and 1993. This is remarkable and it shows the outsized foreign investor position in the Chinese economy.

The geographic dispersion of FDI is something that many people do not understand, including Chinese officials and Western economists. For example, in a presentation at a National Bureau of Economic Research conference, Zhang Shengman, a Chinese Ministry of Finance official and a managing director at the World Bank, argued that China "must strive for a more desirable distribution of capital flows, both geographically (more to the interior) and sectorally (more to some service sectors, retailing, banking, insurance, etc.)."[11] Two researchers, Edward Graham and Erika Wada, in a study on FDI in China make the following observation, "[V]ast areas of China, including ones where much state-owned industry is located, have not been touched by FDI" (Graham and Wada 2001, p. 5). In recent years, the Chinese government has made FDI promotion a prominent component of its development strategy for the central and western provinces.

The data that are often cited to support the geographic concentration hypothesis is that Eastern China accounted for 84.5 percent of cumulative FDI between 1985 and 1991 and 87.3 percent between 1992 and 1998 (Gipouloux 2000). The problem with this view is that it relies on statistics on the percentage shares of FDI distributed among Chinese provinces. Recall, however, that during the 1990s China attracted an enormous amount of FDI and thus a small portion of FDI going to the interior provinces is still a significant number. According to statistics provided in Gipouloux's study, the interior regions of China accounted for about 13 percent of cumulative FDI inflows between 1992 and 1998. During this period cumulative FDI flows into China as a whole amounted to $242.3 billion. This means that the interior regions of China received $31.5 billion in FDI. To put this number in perspective, India's entire FDI inward stock, as of 1997, was only $11.2 billion. In addition, the poor, hinterland provinces of China absorbed either more than or about the same level of FDI as some of the star economies in Latin America in the 1990s. As of 1997, the FDI inward stock for Argentina was $36 billion and it was $25.1 billion for Chile.[12]

In 1995, the average FDI/capital formation ratio for fourteen interior and western provinces was 4.9 percent; if investments by SOEs are excluded, the ratio was 14.9 percent.[13] The 4.9 percent figure puts these provinces above Taiwan (2.2 percent), Korea (1.2 percent), India (2.2 percent), and Russia (2.0 percent). (All the numbers refer to the 1992-98 period.) The 14.9 percent figure, that is, FDI normalized by investments of nonstate firms, would make China's interior and land-locked provinces number six out of the fifteen economies represented in Table 2 (excluding China). While she argues that the FDI distribution pattern in China is uneven, in her own paper, Lemoine (2000, p. 30) shows that FDI stock/GDP ratio for interior provinces was 10.9 percent in 1998. To put this number in perspective, in 1998, the FDI stock/GDP ratio for North America was 10.5 percent, for Central and Eastern Europe, 12.9 percent, and for South, East and South-East Asia, 10.5 percent.[14]

The ubiquitous presence of foreign firms across Chinese industries

FIEs, firms established through FDI, can be found in far more industries in than other countries. Empirical research on FDI has found that a general pattern of industry distribution of FDI is that FDI is concentrated in just a few industries. For example, in a survey article Newfarmer and March find that over 80 percent of foreign subsidiaries in Mexico and Brazil were in industries with four-firm concentration ratios exceeding 50 percent. Similar concentration patterns of foreign firms were found in Peru, Chile, Colombia, and Malaysia.[15] According to Bruce Kogut, FDI in Central European countries exhibited a similar pattern. Foreign firms were found in only a few industries, such as autos, consumer products, and telecommunications. And the investing firms were familiar ones, such as ABB, Coca-Cola, and Proctor & Gamble.[16]

FDI patterns in China are quite different in that FDI is present rather evenly across different industries. Data are available for FDI from Hong Kong broken down by industries for the 1990s for a number of countries on

a consistent basis. These data show substantially less concentration patterns in China. For example, in Malaysia, the top three industries with the most Hong Kong FDI accounted for 58.9 percent of the total materialized Hong Kong FDI in 1994. In the same year, on an approval basis, the top three industries in Indonesia with the most Hong Kong FDI accounted for 77.6 percent of the total Hong Kong FDI.[17] But in China, the top three industries, electronics, plastic products, and textiles, only accounted for 46.7 percent of total Hong Kong FDI as of 1993. The lower concentration ratio means that FDI is also present in many other industries in China. In fact among the twenty-eight manufacturing industries, none received more than 10 percent of total FDI as of the mid-1990s. The highest share was 9.6 percent in the electronics and telecommunications industry. The textile industry followed, at 8.9 percent.

Foreign controls of export marketing

It follows naturally that the large FDI inflows would have led to a substantial role of FIEs in the Chinese economy. This is demonstrated in Table 3. As of 1995, FIEs controlled over half of China's manufactured exports, or 51.2 percent. Because FIEs are restricted in the primary industries and FIEs are not allowed to be pure trading corporations, their export share of total exports is smaller; in 1995, it was 31.5 percent.[18] By 2002, FIEs accounted for over 50 percent of Chinese exports. Nationwide, FIEs dominate the export channels in a number of industries, such as electronics and telecommunications, garments and footwear, leather products, printing and record pressing, cultural products, and plastics, etc. In 1995, they accounted for over 60 percent of Chinese exports in these industries.[19] Nor are sales shares insignificant as well. In four industries, the sales shares of industrial FIEs exceeded 50 percent of industry sales and accounted for 21 percent of all manufactured sales in 1995. This share grew to 32.1 percent by 2000.[20]

Again, it is easier to illustrate the substantial role of FIEs in the Chinese economy by benchmarking China against other economies. FIEs in China have established a far more dominant position in export production than their counterparts in Taiwan, when Taiwan was in a comparable stage of development as China in the 1970s. As of the mid-1970s, FIEs in Taiwan accounted for only 20 percent of Taiwan's manufactured exports.[21] The share of FIEs in China's exports not only exceeds that of Taiwan but of other Asian countries as well during comparable stages of development. Two authors, Seiji Naya and Eric Ramstetter, provide some of the most complete statistics. Their paper shows that, except for Singapore, where multinational corporations (MNCs) have traditionally dominated domestic firms, no other Southeast Asian country came close to the 51 percent share of manufactured exports claimed by Chinese FIEs.[22] In Korea, between 1974 and 1978, foreign firms accounted for 24.9 percent of manufactured exports. In Thailand, in the 1970s, the share ranged from 11 to 18 percent, and in 1984 it was 5.8 percent.

Table 3 Export Shares of FIEs in Total Exports of Three Economies: China, Taiwan, and Indonesia (%)

	China (1995)	Taiwan (1980)	Indonesia (1995)
Labor-intensive industries	Garments and footwear: 60.5 Leather and fur products: 73.2 Furniture: 75.1	Garments and footwear: 5.7 Leather and fur products: 9.6 Lumber and bamboo products: 2.7	Garments and footwear: 33 Leather and related products: 19.7 Furniture: 14.0
Capital or technology-intensive industries	Electronics and electrical appliances: 83.4 Paper and paper	Electronics and electrical appliances: 50.5 Pulp paper and paper	Electric, measuring, and photographic apparatus: 78.8

	products: 53.4 Chemical materials and products: 31.6	products: 4.5 Chemicals: 34.9	Computers and parts: 91.8 Machinery and vehicle parts: 86.1 Paper and paper products: 29.8 Chemical materials: 42.3
Manufacturing industries	51.2	20.6	29.0

Sources: Chinese data are from Office of Third Industrial Census (1997) and Taiwanese data are from Ranis and Schive (1985, Table 2.12, p. 109). Indonesian data are unpublished and were provided to the author by the Indonesian government through the kind assistance of Timothy S. Buehrer and Lou Wells. Professor Lou Wells generously provided English translations of the Indonesian text.

Table 3 presents FIE shares of total exports in three economies, China (1995), Taiwan (1980), and Indonesia (1995). The table breaks down export data by labor-intensive and capital- (or technology-) intensive industries. Two patterns emerge. One is that the FIE shares of exports in labor-intensive industries are much higher in China than in Taiwan or Indonesia. For example, garment and footwear FIEs accounted for 60.5 percent of exports in China, but only 5.7 percent in Taiwan and 33 percent in Indonesia. FIEs similarly dominated exports in leather and furniture in China to a far greater extent than they did in Taiwan and Indonesia. The second pattern is that in capital- or technology-intensive industries, FIEs in China and Indonesia dominated exports to a far greater extent than they did in Taiwan. This is a more common pattern in developing countries, not only because the local capabilities in modern industries are low, but because the goods being produced are intermediate inputs, such as electronic components. Japanese firms, for example, have invested heavily in Southeast Asia to produce electronic components, which are re-exported to the parent firms.[23] Ownership arrangements are more common for this type of goods because often the only way for local producers to gain access to the supply chain of the MNCs is to be part of the MNC system. (In contrast, garments, footwear, and furniture are final goods or near final goods).

Foreign control of assets

The significant position of FIEs in the Chinese economy raises a natural question about control. Corporate control is a complicated concept but the simplest measure is the investor's share of the equity ownership. The higher the share, the more control the investor is said to have since equity ownership is usually an indicator of how decision-making power is apportioned among investors, through, for example, the number of board seats one can appoint. Since many FIEs in China are JVs, decision-making is shared among Chinese and foreign investors. The allocation of decision-making power is determined on the basis of their respective shares of equity ownership.

Foreign firms have established majority controls over FIEs in most industries. Only in 7 out of twenty-eight manufacturing industries are foreign firms found to have an average aggregate minority equity position, that is, the total equity value owned by the foreign firms is less than 50 percent of the industry sum of FIE equity.[24] State-owned monopolies or oligopolies are typically found in those industries where foreign firms have minority stakes. The tobacco industry is probably the most illustrative example. It is run by a single government agency, the China Monopoly Bureau of Tobacco Industry, which operates integrated production from tobacco procurement to cigarette making. But even in this heavily monopolistic industry, the combined equity stake of foreign firms already reached 46.9 percent by 1995. While foreign firms have

been able to make inroads into industries explicitly reserved for the most powerful government corporations, nonstate indigenous firms have been largely excluded.

Another characteristic is that foreign majority equity controls seem unrelated to some of the well-known features of these industries. Foreign majority controls span both labor-intensive industries, such as garments, footwear, and leather products, and capital-intensive industries, such as chemicals, machinery, and instrument manufacturing. This across-the-board foreign equity control contrasts with the Taiwanese pattern. In Taiwan foreign firms have dominant equity positions in certain industries, such as garments and footwear (71.8 percent), lumber and bamboo products (75.7 percent), and leather and fur products (79.6 percent). But in quite a number of industries, they are mere minority investors (such as nonmetallic minerals, chemicals, and the machinery industry).[25] Thus, in China not only do foreign firms have larger equity positions and thus putatively greater corporate control over FIEs, their controls are uniform across industries.

Why Chinese economy is "unusually" open?

Chinese economy should be considered "unusually" open in two ways. First, it appears to be more dependent on foreign trade and FDI even compared with many market-oriented, developed economies. Second, Chinese economy is unusually open in that some sectors of the Chinese economy are more open to foreign investors than to domestic private businesses. In fact, one can go further by arguing that precisely because Chinese economy is quite closed to the domestic private sector it has become more open to foreign investors as a result. I have elaborated on this point in greater detail in my recently published book, Selling China (New York: Cambridge University Press, 2003). Let me explain this point here.

Constitutional status: FIEs and domestic private firms

Western investors often view China's legal system as the single most important deterrent to FDI inflows. In 1997, a survey conducted by the European Commission of 200 European companies operating in China stated that "incomprehensible or unpredictable rules and legislation remain the principal obstacle to investment in China." Looking forward, foreign investors are not very optimistic about the prospects of rule of law in China. In a 1997 survey on twenty-two foreign firms active in China, only four of them expected the rule of law to become widely accepted in China while most of the respondents viewed rule of law to be a goal of the government but not reality of the Chinese economy and society. [26]

The usual question in the studies on government regulation is whether the regulatory environment is "business-friendly." The answer to this question in the Chinese context is easy: It is not. The Wall Street Journal and Heritage Foundation rated China in 2002 as a "mostly unfree" economy (given a bright yellow color to join the likes of India, Cambodia, Romania and Bulgaria) even after more than twenty years of remarkable economic reforms. According to the aft-cited study, "China's legal and regulatory structure remains so riddled with contradictory internal (*neibu*) unpublished guidelines and exceptions that foreign businesses say progress in the rule of law has actually slowed in recent years." (The Heritage Foundation and The Wall Street Journal 2002)

Many of these analyses, while not factually wrong, miss one of the most fundamental features of the Chinese economy. While it is widely recognized that Chinese legal system functions poorly, the relevant question is whether the Chinese legal system functions more poorly for some firms than for other firms. In particular, we want to know whether the legal system consistently favors one type of firms over others in accordance with the nationality of the firm. Here China is quite unique among many countries in that the government has created a legal framework that is on balance more favorable to foreign firms than to domestic private firms.

On balance, the legal treatment of FIEs has been far superior than that accorded to domestic private firms (although inferior to that of state owned enterprises or SOEs). The most remarkable example concerns the

constitutional treatment of FIEs and domestic private firms. China's Constitution, adopted in 1982, only six years after the Cultural Revolution, clarified and offered protection to the legal status of foreign enterprises operating in China (Article 18). Foreign enterprises were permitted "to invest in China and to enter into various forms of economic cooperation with Chinese enterprises and other Chinese economic organizations…."[27] Article 18 also swore to protect their "lawful rights and interests."

While Article 12 of the Constitution prohibited "appropriation or damaging of state or collective property," no such a commitment was made about the property rights of private enterprises. Remarkably, more than 25 years after reforms began, the Constitutional treatment of domestic private firms remains inferior to that of foreign firms investing in China. The Chinese state has yet to make a Constitutional commitment not to nationalize or expropriate the assets of domestic private investors without "due cause and compensation," the right foreign investors got in 1982.

One example is the low political and legal status of private businesses. Article 11 of the 1982 Constitution acknowledged the property rights of self-employed private businesses—termed the individual economy—but it did not acknowledge the property rights of other types of private firms. In 1988, Article 11 was amended to add a clause that the state permitted private firms and that the state was to protect their "lawful rights and interests, " but the amendment also subordinated the private sector to "a complement to the socialist public economy."[28] This meant that private firms were allowed entry only in industries where they did not pose a competitive threat to the SOEs, but the strength of property rights protection provided to private businesses lagged far behind that for SOEs and even for FIEs.

In more recent years, the treatment of domestic private businesses began to improve. In March 1999, Article 11 was amended again and the private economy was to be a "component" of the Chinese economy. This meant, at least nominally, that private firms, FIEs, and SOEs were to have an equal status. In 2001, the former president of China, Jiang Zemin, welcomed private entrepreneurs to join the communist party. In 2003, the Chinese officials were discussing a Constitutional amendment –to be adopted in 2004—that would specifically pledge protection of property rights to private businesses. (For texts of relevant clauses of China's Constitution, see Table 5.) [29]

Table 5 Evolving Constitutional provisions regarding private and foreign property rights in China, 1982-1999

Constitutional provisions	Adopted at the Fifth Session of the Fifth National People's Congress, December 4, 1982	The amendment adopted at the Seventh National People's Congress at its First Session, April 12, 1988.	The amendment adopted at the third session of the Ninth National People's Congress, March 1999
Article 11	"The individual economy of urban and rural working people, operating within the limits prescribed by law, is a complement to the socialist public economy. The state protects the lawful rights and interests of the individual economy. The state guides, assists and supervises the individual economy by administrative control."	Article 11 of the Constitution shall include a new paragraph, which reads: "The state permits the private sector of the economy to exist and develop within the limits prescribed by law. The private sector of the economy is a complement to the socialist public economy. The state protects the lawful rights and interests of the private sector of the	Article 11 of the Constitution is amended to: "The non-public sector of the economy comprising self-employed and private businesses within the domain stipulated by law is an important component of the country's socialist market economy. The state protects the legitimate rights and

		economy, and exercises guidance, supervision and control over the private sector of the economy."	interests of the self-employed and private businesses. The state exercises guidance, supervision and management over the self-employed and private businesses."
Article 18	"The People's Republic of China permits foreign enterprises, other foreign economic organizations and individual foreigners to invest in China and to enter into various forms of economic cooperation with Chinese enterprises and other Chinese economic organizations in accordance with the law of the People's Republic of China. All foreign enterprises, other foreign economic organizations as well as Chinese-foreign joint ventures within Chinese territory shall abide by the law of the People's Republic of China. Their lawful rights and interests are protected by the law of the People's Republic of China."		

Source: *Constitution of the People's Republic of China*, Beijing, Foreign Languages Press, 1994 and "Amendments to the Constitution of the People's Republic of China," (1999) *Beijing Review*, May 3-9.

Financial biases

As China's pace of integration into the world economy accelerated, some influential economists in China argued that domestic private firms were often regarded as inferior compared to other firms in the Chinese economy. A 2000 report by the Chinese Academy of Social Sciences concluded the following:[30]

Because of long-standing prejudices and mistaken beliefs, private and individual enterprises have a lower political status and there are numerous policy and regulatory discrimination and limitations. The legal, policy, and market environment is unfair and inconsistent.

For a long time, there was a severe lending bias against private firms in favor of the SOEs.[31] Until 1998, the four big state-owned commercial banks, which controlled most of the banking assets, were specifically instructed to lend to SOEs only. (The Bank of China could lend to FIEs.) Lending to nonstate firms by the four commercial banks remained a miniscule portion of their loan portfolios. Among the nonstate firms, FIEs were able to access the Chinese banking system more readily than the domestic private firms. It should be

pointed out, however, that the primary function of China's banking system is to serve the financial needs of the SOEs.

China's licensing policy also discriminated against private firms. In 2002, a top legislator, Tian Jiyun wrote in People's Daily that over 60 industrial sectors were open to FDI but only 40 industrial sectors were open to investments by domestic private firms. Foreign trade licensing was also biased against domestic private firms. While the FIEs could directly export and import products within their business lines and many SOEs could export directly, until 1999, most private firms were required to export through the official state-owned trading corporations.

Effects of discrimination against domestic private sector

One of the effects of discriminating against domestic private firms while maintaining a relatively open stance toward FDI is that foreign firms have managed to establish substantial market and industry positions, as documented in the previous section of this statement. In comparison, truly private firms—defined as those controlled by private entrepreneurs completely independent of the government—were still quite small. Excluding self-employed business units, truly private industrial firms only accounted for 9.2% of the value of the gross industrial output as of 2001. Industrial FIEs, in contrast, accounted for 28.5%.[32]

A related effect is that the business environment, while admittedly difficult for many foreign firms in China, is in fact even more difficult for domestic private firms. We have a subjective measure—the perceptions of foreign and domestic firms of the constraints of China's business environment—to illustrate this point.

Our perception data come from the World Business Environment Survey (WBES). The survey was implemented in 2000 and it focused on perceptions of factors external to the firm. Many dimensions of business environment were surveyed, ranging from perceptions of the national business environment as shaped by local economic policy; governance to the perceptions of regulatory, infrastructural and financial impediments and public service quality. The survey was done on roughly 100 firms in each of some 80 countries. For the first time, China agreed to be a part of this type of surveys.

Very fortunately, the survey breaks down firms by their foreign and domestic ownership. Table 6 presents the average response scores given by foreign and domestic firms to a number of questions measuring regulatory burdens, rule of law, helpfulness of the government, and general business constraints. The minimum score is 1, indicating a good business environment perception; the maximum score ranges from 4 to 6, indicating a bad business environment perception. (The survey includes firms with ownership ties to the government. I have excluded them from Table 6 in order to demonstrate the contrast between FIEs and domestic private firms.)

Table 6 The average response scores given by foreign and domestic private firms on business environment in China, 2000

	Foreign firms	Domestic private firms
Business regulations: 1=no obstacle; 4=major obstacle	1.79	1.90
Labor regulations: 1=no obstacle; 4=major obstacle	1.62	1.70
General constraint-taxes and regulations: 1=no obstacle; 4=major obstacle	1.86	2.17
Confidence in judicial system today: 1=fully agree; 6=fully disagree	2.59	2.77
Quality of courts: 1=very good; 6=very bad	3.15	2.97
Changes in laws and regulations: 1=completely predictable;	3.37	3.15

6=completely unpredictable		
Helpfulness of central government today: 1=Very helpful; 5=Very unhelpful	3.0	3.02
Helpfulness of local government today: 1=Very helpful; 5=Very unhelpful	2.76	2.62
General constraint—financing: 1=no obstacle; 4=major obstacle	2.93	3.48
General constraint—corruption: 1=no obstacle; 4=major obstacle	1.93	2.13

Source:World Bank Business Environment Survey.

In some areas, domestic private firms feel more constrained than foreign firms; in other areas they feel less constrained. In general, domestic firms are constrained in the area of regulations. They gave a higher score for business and labor regulations and on general constraint on taxes and regulations. In general, foreign firms are less satisfied with China's legal system than domestic firms, although domestic firms appear to have less confidence than foreign firms in China's judicial system. Foreign and domestic private firms rate government similarly in terms of helpfulness of the government, although domestic private firms view local governments as more helpful. On the two critical measures of a business environment, financing and corruption, domestic private firms indicate more constraints than foreign firms and on the issue of financing constraint, substantially so.

Concluding remarks

Let me conclude by coming back to a point I made at the very beginning of this statement. China's WTO implementation is not a narrowly legal issue but should be judged against the general economic background of the country. Chinese economy is in fact "unusually" open to foreign firms not because it has very liberal FDI policies but because it has very illiberal policies toward the domestic private sector. A thorough WTO implementation may in fact help ease some of the constraints on domestic private sector and thus may contribute to a decline of the role of foreign trade and FDI in the Chinese economy. In fact, this is already happening since China's WTO accession as the government is trying to create a more equal playing field for foreign firms and for domestic private firms.

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[1] I have made this argument in greater detail elsewhere. See (Huang 2003).

[2] Using the purchasing power parity conversion would yield a lower ratio, but the purchasing power parity measures are plagued by the uncertainty of exactly what constitutes the right purchasing power parity rate. If the “true” trade/GDP

ratio is half of the ratio based on the official exchange rate, 20 percent of the GDP in foreign trade is still quite large. In comparison, the same ratio for Japan in 1998 was about 20 percent and for the United States, it was 23 percent for 1994.

[3] (World Bank 1994).

[4] The finding was reported in (McCallum 1995), as quoted in (Ghemawat 2000).

[5] (Urata 2001) presents the FDI inflow/GDP ratios for nine Asian economies (China, Hong Kong, Korea, Taiwan, Indonesia, Malaysia, Philippines, Singapore, and Thailand) between 1986 and 1997. From 1986 to 1991, China ranked between number four and number seven among these nine economies. From 1992 to 1997, China consistently ranked either as number two or number three most dependent on FDI, behind Singapore and, sometimes, Malaysia. Take 1995 as an example. In that year, China's FDI/GDP ratio was 5.1 percent, compared to 2.2 percent for Indonesia, 2.0 percent for Philippines, and 1.2 percent for Thailand. (It was 4.8 percent for Malaysia and 8.5 percent for Singapore.) The choice of 1995 was not arbitrary. Because FDI flows can fluctuate more than GDP, I chose a medium ratio for China rather than either the highest or the lowest ratio. In 1993 and 1994, China's FDI/GDP ratio was high, at 6.4 percent and 6.2 percent, respectively, compared to 4.9 percent in 1997. The year 1997 probably should not be used as well because the Asian financial crisis might have adversely affected FDI flows into the Southeast Asian countries. The FDI/GDP ratios are from (Urata 2001).

[6] As is well known, purchasing power parity (PPP) exchange rates can vary from official exchange rates by a wide margin and, depending on which exchange rates are adopted, the FDI dependency ratios will differ dramatically. An additional source of complications is that extremely different purchasing power parity exchange rates exist. Even when a purchasing power parity rate on the high end is used, as in World Development Report 1996, China is still more dependent on FDI than many other countries, albeit at a smaller magnitude of difference. The FDI/PPP-based GNP ratio in 1994 was 0.78 percent for Asia as a whole and 0.81 percent for the industrial countries. At the same time, it was 1.13 percent for China, thus making China about as dependent on FDI as Canada (1.25 percent), France (1.46 percent), Australia (1.46 percent), and Portugal (1.07 percent). It was more dependent on FDI than the United States (0.69 percent), Japan (0.03 percent), Italy (0.21 percent), and the United Kingdom (0.98 percent). These data are reported in (Li and Lian 1999).

[7] Other researchers have also noted China's high FDI dependency. Francoise Lemoine (2000), in a detailed descriptive analysis of China's FDI, makes the following remark, "FDI capital stock represented 25 percent of China's GDP in 1998, a ratio almost comparable to that existing in smaller economies which were opened to international capital flows long before China…." Lemoine points out that on a per capita basis, China's FDI inflows appear to be low, compared to other Asian countries. In 1998, FDI stock per capita in China was only $160. This measure is highly questionable. On a per capita basis, China is low on many other fronts. To illustrate this point, by this measure, the war-torn Angola would be considered more attractive than China as an FDI host. In 1999, FDI stock per capita in that country was $537.

[8] It is likely that the huge mergers and acquisitions in the "new economy" sector of the advanced countries contributed to this rise in FDI dependency and that the financial crises in Korea, Brazil, and Thailand induced an increase in the type of FDI seeking opportunities related to financial distress in those economies. In Korea, for example, much of the FDI since 1998 went into the troubled financial industry. See (Huang and O'Neil-Massaro 2002). Of course, the financial crisis did not induce FDI in those countries where the crisis impaired political stability and economic growth prospects, as witnessed by the net outflow in Indonesia.

[9] Guangdong's investment figure is calculated from Table 2.6, (World Bank 1994, p. 52).

[10] To clarify, China bans FDI in casinos and thus Macao's large investment position cannot be attributed to this source of its competitive advantage.

[11] See (Zhang Shengman 1999), p. 181.

[12] The data on India, Chile, and Argentina are provided in (United Nations Conference on Trade and Development 1998), Annex Table B.3.

[13] There are sixteen provinces that are classified as interior or western provinces. No FDI data are available for two of these provinces?Inner Mongolia and Tibet. The remaining fourteen provinces are: Shanxi, Anhui, Jiangxi, Henan, Hubei, Hunan, Sichuan, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia, and Xinjiang. The figures are calculated on the basis of data provided in (State Statistical Bureau 1996).

[14] These figures are from (United Nations Conference on Trade and Development 2000), Annex Table B. 5.

[15] This research is summarized in (Moran 1998, p. 23).

[16] Central Europe exhibits a familiar pattern of oligopolistic rivalry among foreign investors. FDI may disturb national oligopolies, although, as Kogut points out, multinational corporations prevail in industries characterized by oligopoly. See (Kogut 1996).

[17] These data are calculated on the basis of Table 4.2 and Table 4.3 in (Yeung 1998).) In the text, I use data from the 1970s because the industrial groupings are most similar to those in China, thus facilitating a direct comparison. The materialized amount may differ from the approval amount if an investor fails to invest the pledged amount of capital.

[18] Export data for 1995 are from (State Statistical Bureau 1996). For some unknown reason, the Chinese government no longer released disaggregated FIE export data, broken down by economic sector or industry, after 1995.

[19] The source of data is Third Industrial Census. The firms covered by the Third Industrial Census are firms with an "independent accounting system." This raises a number of data issues. See the appendix to this chapter for a detailed explanation of a number of data issues involved in using Third Industrial Census.

[20] Calculated from data provided in (State Statistical Bureau 2001).

[21] The export share data for Taiwan come from (Ranis and Schive 1985).

[22] All the data on Korea and the Southeast Asian countries are from (Naya and Ramstetter 1988). Data for later years are more difficult to find, except for the export production data by FIEs in Indonesia cited in the text.

[23] A good discussion on this topic is found in (United Nations Conference on Trade and Development 1998), especially pp. 209-221.

[24] Most of the industries, including the more capital-intensive industries, have a large number of enterprises. For example, there were 1,409 FIEs in the transport equipment sector in 1995. The high foreign equity share is not the result of large equity positions of a few foreign firms.

[25] The Taiwanese data are reported in (Ranis and Schive 1985).

[26] Quoted in (Lubman 1998).

[27] For an extensive analysis, see (Gelatt 1983).

[28] The text of the 1982 Constitution and the 1988 amendment is found in, *Constitution of the People's Republic of China*, (Beijing, Foreign Languages Press, 1994).

[29] See Anonymous, "Amendments to the Constitution of the People's Republic of China," *Beijing Review*, May 3-9, 1999.

[30] Institute of Industrial Economics of Chinese Academy of Social Sciences, *China's Industrial Development 2000*, (Beijing: Economic Management Press, 2000).

[31] The phenomenon of a lending bias on the part of the Chinese banking system in favor of SOEs was widely documented. See Ronald I. McKinnon, “Financial growth and macroeconomic stability in China, 1978-1992: Implications for Russia and other transitional economies,” *Journal of Comparative Economic*s, 18**,** 1994, pp. 438-469, and Nicholas R. Lardy, *China's unfinished economic revolution*, (Washington, DC, Brookings Institution, 1998).

[32] Data are from the State Statistical Bureau, *Zhongguo tongji nianjian 2002[China Statistical Yearbook 2002]*, (Beijing, Zhongguo tongji chubanshe, 2002).