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The evolving role of foreign direct investment in China from 1978 onward

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THESIS

THE EVOLVING ROLE OF FOREIGN DIRECT INVESTMENT IN CHINA FROM 1978 ONWARD

by

Margarita A. Balish

December 2017

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From 1978 to the present day, China has developed its economy through the strategic use of foreign direct investment (FDI). This thesis demonstrates how Chinese economic reforms since 1978 have led to an increase in FDI inflows and illustrates how the government channeled those FDI flows to prioritize a process of economic development evolving from low-skilled to high-skilled sectors of the economy, evidenced by the country's evolving export profile over time. Through the examination of three different time periods, this thesis shows how shifts in government policy affected the inflows of FDI and how the government channeled this FDI. Between 1978 and 1989, the Chinese government funneled resources into non-strategic sectors, such as the textile industry. From 1989 to 2001, China reoriented its resources toward strategic sectors, including telecommunications. Finally, from 2001 to the present, China shifted its focus toward high–value added sectors of the economy, including automobiles, information and communications technology (ICT), and semiconductors. Overall, between 1978 and the present day, FDI has increased dramatically, reflecting China's economic priorities. The Chinese government's decision to use FDI to promote high–value added sectors showcases its ambitious and strategic policymaking in the service of rapid and sustained economic success.

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THE EVOLVING ROLE OF FOREIGN DIRECT INVESTMENT IN CHINA FROM 1978 ONWARD

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Submitted in partial fulfillment of the
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ABSTRACT

From 1978 to the present day, China has developed its economy through the strategic use of foreign direct investment (FDI). This thesis demonstrates how Chinese economic reforms since 1978 have led to an increase in FDI inflows and illustrates how the government channeled those FDI flows to prioritize a process of economic development evolving from low-skilled to high-skilled sectors of the economy, evidenced by the country's evolving export profile over time. Through the examination of three different time periods, this thesis shows how shifts in government policy affected the inflows of FDI and how the government channeled this FDI. Between 1978 and 1989, the Chinese government funneled resources into non-strategic sectors, such as the textile industry. From 1989 to 2001, China reoriented its resources toward strategic sectors, including telecommunications. Finally, from 2001 to the present, China shifted its focus toward high–value added sectors of the economy, including automobiles, information and communications technology (ICT), and semiconductors. Overall, between 1978 and the present day, FDI has increased dramatically, reflecting China's economic priorities. The Chinese government's decision to use FDI to promote high–value added sectors showcases its ambitious and strategic policymaking in the service of rapid and sustained economic success.

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LIST OF ACRONYMS AND ABBREVIATIONS

AR	Augmented Reality
BoP	Balance of Payments
CAD	Computer-Assisted Design or Computer-Aided Design
CCF	China-China-Foreign [structure]
CCP	Chinese Communist Party
China Unicom	China United Telecommunications Corporation
CJV	Contractual Joint venture
CNC	China Netcom Corps
CNC	Computer Numerically Controlled [lathes]
CTHK	China Telecom (Hong Kong)
EJV	Equity Joint venture
EOI	Export-Oriented Industrialization
ETDZ	Economic and Technological Development Zones
FEZ	Free Economic Zone
FIC	Foreign Investment Catalogue
FIE	Foreign Investment Enterprise
FTA	Free Trade Agreement
FTZ	Free Trade Zone
GDP	Gross Domestic Product
GM	General Motors
IC	Integrated Circuit
ICT	Information and Communications Technology
IDC	Integrated Device Manufacturer
IIA	International Investment Agreement
IoT	Internet of Things
IoV	Internet of Vehicles
ISI	Import-Substitution Industrialization
ITA	International Trade Administration
JV	Joint Venture
MDSD	Most Different Systems Design

MEI	Ministry of Electronic Industry
MFA	Multifiber Arrangement
MII	Ministry of Information Industry
MOS	Manufacturing-on-Silicon [lines]
MPT	Ministry of Post and Telecommunications
NEV	New Energy Vehicle
OBOR	One Belt One Road [initiative]
PBOC	People’s Bank of China
PLA	People’s Liberation Army
R&D	Research and Development
SASAC	State Assets Supervision Administration Commission
SEMA	Specialty Equipment Market Association
SEZ	Special Economic Zone
SOE	State-Owned Enterprise
SWF	Sovereign Wealth Fund
TVE	Township-Village Enterprise
VAS	Value-Added Service
VR	Virtual Reality
WFOE	Wholly Foreign-Owned Enterprise
WTO	World Trade Organization
ZTE	Zhongxing New Telecommunications Equipment Co., Ltd

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I. INTRODUCTION

Foreign direct investment (FDI) has been very important in China's economic growth and development patterns. In turn, the country's economic reforms have directly impacted the role of FDI. China has overall pursued economic liberalization reforms that have allowed the economy to become market oriented as it maintains fluctuating levels of state regulation. These reforms have attracted FDI, which has in turn affected China's economic performance.

China's economy has been able to grow and develop with the help of FDI, which has allowed it to develop domestic industry.[1] According to the World Bank, since 1982, FDI has been on an overall upward trajectory.[2] As Figure 1 demonstrates, FDI steadily increased in the 1980s, started growing faster in the 1990s, took off even faster in 2004, and reached its peak in 2013. Since 2001, China has been funneling FDI into the high value-added sectors of the economy, along with the military-industrial complex to build up its defense posture.[3] China is supporting strategic industrial sectors that help develop its technological infrastructure in order to promote national security objectives.[4]

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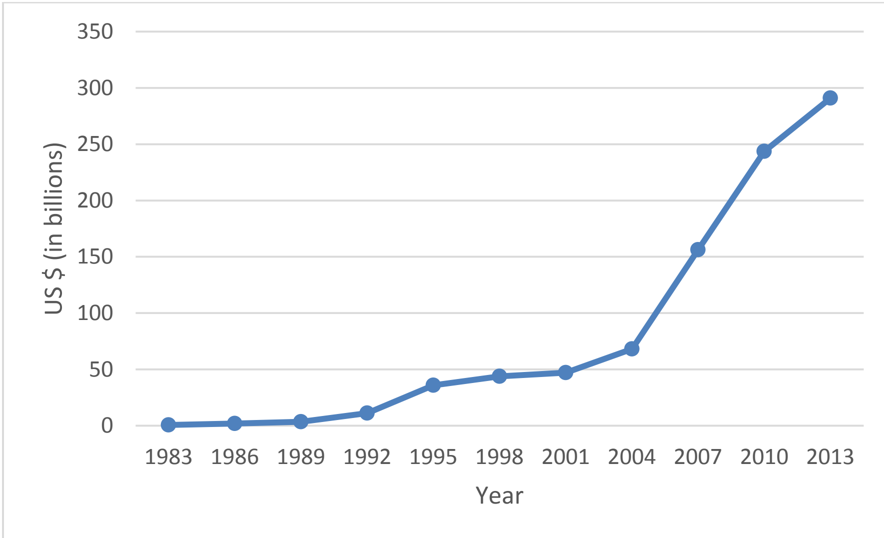
[1] Roselyn Hsueh, *China's Regulatory State: A New Strategy for Globalization* (Ithaca, NY: Cornell University Press, 2011).

[2] "Foreign Direct Investment, Net Inflows (BoP, Current US$)," The World Bank, accessed May 2017, http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD.

[3] "China Overtakes U.S. for Foreign Direct Investment," BBC, January 30, 2015, http://www.bbc.com/news/business-31052566.

[4] Roselyn Hsueh, "State Capitalism, Chinese-Style: Strategic Value of Sectors, Sectoral Characteristics, and Globalization," *Governance: An International Journal of Policy, Administration, and Institutions* 29, no. 1 (January 2016): 91–2, doi: 10.1111/gove.12139.

Figure 1. Net FDI Inflows into China from 1983 to 2013[5]



This thesis investigates the following question: "How has the pattern of reform and reversal over China's contemporary economic trajectory affected the volume of FDI flows and, in turn, their broader economic outcomes?" It demonstrates how the economic reforms and their degree of liberalization affected the nature of FDI by examining volume inflows and the allocation of funds to different sectors of the economy over the course of three different time periods: 1978-1989, 1989-2001, and 2001-present day. The main finding of the thesis is that the pattern of reform and reversal over China's contemporary economic trajectory has affected the volume and sectoral allocation of FDI flows and, in turn, their effects on broader economic outcomes. Through the examination of export trends and FDI volume, there is more evidence to suggest that from 1978 onward, government reforms have both increased the level of FDI and, through specific policy measures, increased the effectiveness by which FDI is allocated throughout the economy.

Between 1978 and 1989, the Chinese government, through decentralization, introduced the development of experimental locations, such as the special economic zones (SEZs), in the coastal provinces of China. These SEZs allowed for reduced tariffs;

[5] Adapted from "Foreign Direct Investment, Net Inflows (BoP, Current US$)," The World Bank, accessed August 28, 2017, http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD.

coupled with numerous incentive structures, foreign companies began investing in mainland China. The influx of FDI allowed China to develop its industrial sector, promoting low-cost manufacturing industries, such as textiles. In 1989, the Tiananmen Square massacre led to a reversal of reforms, wherein the government recentralized the economy due to depleted financial resources and fear over losing influence over the local authorities. With increased regulation, the government prioritized strategic economic sectors, such as the telecommunications sector, over the non-strategic. The Chinese government reassured its support of foreign investment after Deng Xiaoping embarked on his Southern Tour in 1992, after which FDI became crucial for the Chinese growth strategy. By 2001, the Chinese government realized it would have to abide by international economic standards if it were to become and remain a valued member in the World Trade Organization (WTO). Into the 2000s, the government faced the reality that if China were to continue its economic progress, it would have to develop high technology sectors. Through added incentives to foreign companies, government policy encouraged the channeling of foreign investment into the semiconductor, automobile, and information and communications technology (ICT) industries. Through economic reform, the government attracted FDI and channeled it into different sectors of the economy. As state economic prioritization changed, the government effectively developed policies to steer FDI into certain industries, allowing for the shift from the production of low-cost manufactured goods to high-technology production.

A. SIGNIFICANCE OF THE RESEARCH QUESTION

Since 1978, China has undergone tremendous reform in its economic system. This is largely due to the reforms that were implemented by Deng Xiaoping with the intent of making China more growth-oriented. As a result, since 1978, China has moved away from being a command economy to becoming more market-oriented.[6] Consequently, China has grown at an average 9.7 percent per year since 1989, developed its domestic industry, opened its borders to joint ventures, and become an integral member of the

[6] Sebastian Heilmann and Oliver Melton, “The Reinvention of Development Planning in China, 1993–2012,” *Modern China* 39, no. 6 (August 2013), doi: 10.1177/0097700413497551.

world economy.[7] China's economy has experienced significant development because of the implementation of market-oriented reforms and the removal of inefficiencies from the economy, which allowed for the growth of FDI.[8] Money funneled into the Chinese economy comes from all over the world, especially from the West and Japan, and also from the "bamboo network" of Chinese diaspora residing in Southeast Asian countries.

Since the reforms of 1978, leaders in China have seen material benefit in these changes, providing incentive to encourage them. Additionally, as it has begun to join the international community, China been drawn to embrace more liberal economic values. China has had to balance what it is doing internally with the expectations of foreign political investors. After Tiananmen Square, China needed to restore its reputation in the international community, attesting to the fact that China's reforms are constantly overshadowed by domestic, political strife, which does not always correspond well to Western standards and can put potential foreign investors in an ethical dilemma. Under the WTO, China has to adhere to strict international standards that ensure the promotion of transparent economic norms and an environment that does not violate the rights of foreign partners. China joining the WTO was a monumental step because it positioned itself at the hands of the international system, endorsing greater accountability and openness.

It may be the case that FDI has peaked in China, which has produced additional consequences. In 2015, for example, China "lost the top position as an investment destination to India."[9] This loss, according to Dasguptal, caused China to implement less restrictive measures on foreign investors, offering access to new areas of the economy, such as transportation. In this way, China is continuing to takes steps to make its markets more attractive to foreign investors.

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[7] "China GDP Annual Growth Rate, 1989–2017," Trading Economics, accessed May 2017. https://www.tradingeconomics.com/china/gdp-growth-annual.

[8] Yingyi Qian, "How Reform Worked in China," in *In Search of Prosperity: Analytic Narratives on Economic Growth*, ed. Dani Rodrik (Princeton, NJ: Princeton University Press, 2003).

[9] Saibal Dasguptal, "After losing to India in FDI, China opens up economy more," Times of India, December 31, 2016, http://timesofindia.indiatimes.com/business/india-business/after-losing-to-india-in-fdi-china-opens-up-eco-more/articleshow/56263891.cms.

China continues to maintain a focus on promoting FDI. One of the ways China has increased FDI is by drafting policies intended for the "opening up of manufacturing, service and financial industries to FDI."[10] To encourage these changes, the government has taken steps to decentralize by allowing "provincial governments to approve proposals for foreign investment up to $300 million."[11] China, Dasguptal contends, sees the necessity of promoting consumerism within its nation and wants to create a more advanced economy in high-end and innovative sectors, and it can accomplish this by attracting foreign money toward the following industries: automation, digitalization, financial services, railway equipment, environmental technology, and renewable energy. All of China's efforts to modernize show how China has created less restrictive economic policies, so that foreign investors will have more opportunity to contribute to China's domestic development. Therefore, China's economic policies and reforms have affected the status of FDI and which sectors are deemed as crucial to China's survival. China, the author continues, is also pursuing further liberalization in its economic policies, which allows it to attract FDI in fields such as research and development, manufacturing, and national defense sectors, all with the intent of promoting domestic growth.

Liberalization reforms intended to open up China to FDI, continue to remain a priority for the government. As of 2017, China has made additional steps in continuing to lessen restrictions for foreign investors.[12] China, Blumental et al. explain, implemented policies that were more lenient for foreign investors as part of a move toward deregulation to make China more attractive to foreign investment enterprises. The previous year, a decision was made where the government no longer had to follow through with an "approval requirement to establish FIEs in industry sectors that are not subject to foreign investment access restrictions, and are accompanied by the contemporaneous formation of an intra-government credit information platform for

[10] Ibid.

[11] Ibid.

[12] David Blumental et al., "China: New Measures for Deregulating and Promoting Foreign Direct Investment," Lexology, January 23, 2017, http://www.lexology.com/library/detail.aspx?g=b087304f-ac10-4d00-b2bb-bcea8492ec00.

foreign investors and a public credit information platform for FIEs."[13] The most recent policies aim to make foreign investment more attractive in sectors such as the manufacturing and mining industries, along with high-value added sectors such as services.[14] By lowering restrictions, the authors argue, China aims to get foreign investors more involved in the development of China's infrastructure to help realize its goal of becoming a manufacturer of high-end goods. China wants to accomplish this by giving foreign investors more equal footing in China's investment environment and promoting "greater transparency, improved administrative efficiency, expanded national treatment and new investment incentives."[15]

B. LITERATURE REVIEW

This literature review presents different viewpoints and perspectives in the academic community in regards to government policy and foreign direct investment and, in turn, between foreign direct investment and how it contributes to economic growth. The first section will explore arguments about FDI in general, and the second section will focus on existing arguments about FDI policy specific to China. In order to better understand the effects of government policy on FDI and, in turn, how FDI is funneled into different sectors of the Chinese economy, the nature of government policies and the level of state intervention must be addressed.

1. FDI Policy

Different schools of thought exist when it comes to analyzing the role of FDI in an economy. The first group of theorists argues that a lack of state intervention results in the growth and effectiveness of FDI. The second group believes that state intervention, specifically in the form of regulation, results in improved FDI and therefore economic growth. The final group argues that limited state intervention is a necessary tool to promote FDI and economic growth.

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[13] Ibid.

[14] Ibid.

[15] Ibid.

a. State Intervention Hinders FDI and Economic Growth

Some scholars focus on the negative consequences associated with a greater degree of state interventionist policies, arguing that using FDI to promote certain industries over others results in economic inefficiency and potential monopolies.[16] Marchick and Slaughter observe that while some countries are embracing liberalization policies to attract foreign direct investment, others are beginning to implement restrictive measures and are increasing state involvement.[17] Governments are collecting money through "sovereign wealth funds (SWFs), massive pools of capital controlled by governments that have taken stakes in a growing number of companies around the world."[18] As indicated by Marchick and Slaughter, SWFs are so engrained in industries, influencing the politics of the country where the company that is receiving FDI inflows is based, they allow for FDI to be used as economic and political leverage. Additional scholars, such as Dunning and Zhang Bin, believe that FDI results in market distortions and government intervention in some economies, ultimately creating monopolies and a framework that enables rent-seeking. Referenced by Wan, Dunning speculates that monopolies could occur from the build-up of strong corporations because they could receive subsidies from the government, at the expense of domestic industries.[19] Furthermore, Wan notes that Braunstein, Epstein, and Huang also support the idea that FDI can negatively impact economic growth because domestic industries do not receive the same attention and support from governments as foreign-invested enterprises and multinational corporations.

With less state regulation, FDI is able to flourish. Many scholars argue that FDI affects economic development in a positive way because it encourages technological

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[16] David Marchick and Matthew Slaughter, *Global FDI Policy: Correcting a Protectionist Drift*, Council on Foreign Relations, CSR Report No. 34 (New York, NY: 2008); Xueli Wan, "A Literature Review on the Relationship between Foreign Direct Investment and Economic Growth," *International Business Research* 3, no. 1 (January 2010): 52-6, http://www.ccsenet.org/journal/index.php/ibr/article/view/4718/3955. Wan identifies Dunning (1981); Braunstein and Epstein (2002); and Huang (1998, 2003); as proponents of this viewpoint.

[17] Marchick and Slaughter, "Global FDI Policy: Correcting a Protectionist Drift," 1–2.

[18] Ibid., 2.

[19] Xueli Wan, "A Literature Review on the Relationship between Foreign Direct Investment and Economic Growth," 54.

transfers, development of education, training opportunities; etc.[20] These scholars can be grouped in a category that is more liberally oriented and promotes neoliberal institutionalism and reforms. They demonstrate FDI to be an amalgamation of human capital and strong financial institutions, minimizing the role of state intervention. Caves argues that there is a positive relationship between FDI and economic growth, with technological gains coming through spill-overs and modernization efforts, along with the improvement of professional and management skillsets.[21]

According to Alfaro et al., the impact of FDI on the economy is the result of "absorptive capacities," or internal factors that shape the effectiveness with which FDI can be absorbed and utilized.[22] They state that countries are most likely to benefit from FDI if they are financially developed and also if they have human capital. Alfaro et al. argue this is because private businesses can develop even if they lack proper credit and make intermediate products that can then support the creation of more final goods through partnership with businesses overseas that specialize in final goods production.

Furthermore, FDI can have a positive impact on the economy as long as the FDI does not flow into an industry that competes with local markets, unless there is a distinction "between final and intermediate industry sectors."[23] FDI benefits the economy with the amassment of technology from overseas and other things as well.[24] Borensztein et al. claim that FDI can have a positive effect on an economy if there is sufficient human capital and that FDI ultimately helps with technological buildup; they also mention that states can distort the market by intervening in the economy to promote

[20] Laura Alfaro et al., "How Does Foreign Direct Investment Promote Economic Growth? Exploring the Effects of Financial Markets on Linkages" (working paper, National Bureau of Economic Research, 2006), 1-54, doi: 10.3386/w12522; Eduardo Borensztein, Jose De Gregorio, and Jong-Wha Lee, "How Does Foreign Direct Investment Affect Economic Growth?" (working paper, National Bureau of Economic Research, 1995), 1-22, doi: 10.3386/w5057; Xueli Wan, "A Literature Review on the Relationship between Foreign Direct Investment and Economic Growth," 53. Wan identifies Caves (1971) as a proponent of this theory.

[21] Xueli Wan, "A Literature Review on the Relationship between Foreign Direct Investment and Economic Growth," 53.

[22] Alfaro et al., "How Does Foreign Direct Investment Promote Economic Growth? Exploring the Effects of Financial Markets on Linkages," 1.

[23] Ibid., 35.

[24] Ibid., 1.

certain industries, thereby negatively affecting FDI even when subsidies are provided to foreigners.[25]

b. State Intervention Promotes FDI and Economic Growth

The pro-interventionist school of thought promotes the idea that states should retain the sovereign authority to impose their own rules on the market that they deem fit for their particular situation, otherwise an unregulated market can spin out of control.[26] This school places a strong emphasis on regulation to control the inflow of FDI. Mann assesses the merits of state-directed international investments agreements (IIAs), claiming that they can serve a purpose in allowing states to regulate in the public interest and thereby attempt to promote the best results in FDI inflow.[27] Multilateral organizations such as the World Bank and World Trade Organization side with allowing states to take care of their own affairs and implement domestic regulatory measures to the backdrop of liberal reforms in investments.[28] Mann therefore argues that tailored regulatory measures can help a state develop economically and use FDI effectively.[29] In a similar vein, Sun views FDI as crucial for economic growth and argues that a sound, unbiased regulatory and institutional framework are necessary to ensure that FDI is as effective as possible.[30]

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[25] Borensztein, De Gregario, and Lee, "How Does Foreign Direct Investment Affect Economic Growth?" abstract, 18.

[26] Howard Mann, "The Right of States to Regulate and International Investment Law: A Comment" (paper presented at the United Nations Conference on Trade and Development, Geneva, CH, November 2002); Ibrahim F.I. Shihata, "Regulation of Foreign Investment," *International Sustainable Development Law* 2 (accessed May 2017), https://www.eolss.net/Sample-Chapters/C13/E6-67-03-04.pdf; Xiaolun Sun, "How to Promote FDI? The Regulatory and Institutional Environment for Attracting FDI" (paper presented at the Capacity Development Workshops and Global Forum on Reinventing Government on Globalization, Role of the State and Enabling Environment, Marrakech, MA, December 2002).

[27] Mann, "The Right of States to Regulate and International Investment Law: A Comment."

[28] Ibid., 5.

[29] Ibid., 9.

[30] Xiaolun Sun, "How to Promote FDI? The Regulatory and Institutional Environment for Attracting FDI," 2-4, 14.

c. Limited State Intervention Promotes FDI and Economic Growth

To a greater extent that Mann, Shihata argues that FDI has become effective due to liberalization efforts, along with regulatory measures.[31] He talks about how when inward-looking economies impose regulatory measures, they are actually hindering economic growth, through the distortion of foreign investment by providing incentives for the development of specific sectors, which places foreign investors in a bind. Shihata also advocates for deregulation or regulation in outward-looking economies, which emphasize a strong legal framework that protects the rights of the investors through dispute settlement mechanisms. In other words, the government can implement regulatory measures, but only for the purpose of minimizing corruption in the form of, what Shihata calls "market abuses and safeguarding perceived national interests."[32] Overall, proponents of limited state intervention claim that the government needs to strategically determine where to implement oversight in the economy to appease domestic firms and foreign partners, and where to alleviate restrictive policies.

2. FDI Policy as Related to China

Similar to the theories describing FDI policy in general, different schools of thought exist concerning the role of FDI and state involvement in China. The first school argues that the lesser the degree of state intervention, the more China's economy will be able to attract FDI. The second group claims that limited state intervention can attract FDI. A third argument is that greater state regulation results in attracting more FDI.

a. State Intervention Hinders FDI and Economic Growth

One group of scholars emphasizes that China's embrace of economic reforms in 1978 enabled it to develop economically as it moved away from state interventionist

[31] Shihata, "Regulation of Foreign Investment."

[32] Ibid.

policies and pursued a liberalization strategy.[33] They advocate that China must continue to pursue liberal reforms if it wants to continue being a major competitor and welcome member in the international community. Broadman, Janda and Men Jing, and Pearson agree that state intervention stands in the way of economic development of liberal reform efforts.[34]

Some scholars take a position against government intervention on the basis that it may hinder the positive economic effects of FDI. Zhang Bin, for example, argues that China has been supporting its industrial sector at the expense of the service sector and, as the industrial sector struggles more and more, China is increasingly intervening in the market in attempts to correct this downward trend.[35] Furthermore, according to Zhang Bin, state-owned enterprises continue to receive incentives from the state, leading to bureaucratic barriers, undermining of private entrepreneurs, and overall, causing a limitation in investment opportunities.[36] This is especially true because SOEs have a monopoly over upstream sectors, or as Alfaro et al. describe, "forward linkages," subjecting the downstream sectors to be at the mercy of the "upstream SOEs."[37] Per Zhang Bin, the concern is that China is not developed enough financially and lacks

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[33] Barry Naughton, *The Chinese Economy: Transitions and Growth* (Cambridge, MA: The MIT Press, 2007); John C. Hsu, *China's Foreign Trade Reforms: Impact on Growth and Stability* (Cambridge, UK: Cambridge University Press, 1989); Thomas G. Moore, *China in the World Market: Chinese Industry and International Sources of Reform in the Post-Mao Era* (Cambridge, UK: Cambridge University Press, 2002).

[34] Harry G. Broadman, "A Litmus Test for China's Accession to the WTO: Reform of its State-Owned Enterprises," in *China and the Long March to Global Trade: The Accession of China to the World Trade Organization*, ed. Alan S. Alexandroff, Rafael Gomez, and Sylvia Ostry (New York, NY: Routledge, 2002); Richard Janda and Men Jing, "China's Great Leap of Faith: Telecommunications and Financial Services Commitments," in *China and the Long March to Global Trade: The Accession of China to the World Trade Organization*, ed. Alan S. Alexandroff, Rafael Gomez, and Sylvia Ostry (New York, NY: Routledge, 2002); Margaret M. Pearson, *Joint ventures in the People's Republic of China: The Control of Foreign Direct Investment under Socialism* (Princeton, NJ: Princeton University Press, 1991).

[35] Zhang Bin, *Easing China's Transition to a Services Economy* (Chicago, IL: Paulson Institute, 2016), 2, http://www.paulsoninstitute.org/wp-content/uploads/2017/01/PPM_Services_Zhang-Bin_English_R.pdf.

[36] Ibid., 6-7.

[37] Alfaro et al., "How Does Foreign Direct Investment Promote Economic Growth? Exploring the Effects of Financial Markets on Linkages," 2; Zhang Bin, *Easing China's Transition to a Services Economy*, 8.

adequate human capital to support a transition into the service sector.[38] Therefore, similar to Alfaro et al, Borensztein, and Caves, Zhang Bin believes that human capital and strong financial infrastructure are necessary to garner positive effects from FDI.

b. Limited State Intervention Promotes FDI and Economic Growth

Some scholars advocate that China was and remains a unique situation; due to its historical and cultural background, it can only develop economically by coupling new ideologies with old ones. Hsueh and Shambaugh are proponents of the idea that China grew economically through the implementation of market reforms and limited state regulation.[39] According to Hsueh, China tailored its policies based on what the economy required by implementing regulations when they were necessary to steer the market in a certain direction, and also by following through with liberalization practices.[40] Hsueh argues that China is pursuing a strategy of "bifurcated capitalism," meaning that China is combining free market practices with state involvement.[41] In her book, Hsueh describes China as a "regulatory" state, but this term has a very different meaning from the one ascribed to it by Chalmers Johnson, which is the more widely accepted definition for "regulatory"[42] Johnson refers to a regulatory state as one similar to U.S. capitalism; it is the opposite of a developmental, or interventionist, state which promotes state intervention in private market activity. Hsueh, on the other hand, regards the regulatory state as a phenomenon in between the two extremes of interventionism and liberalism.[43] In this way, Hsueh makes the argument for a bifurcated strategy in China where the nation is allowing for capitalism to thrive, while putting in place regulatory measures that steer the market by adding incentives for producers, protecting property gains. To

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38 Zhang Bin, *Easing China's Transition to a Services Economy*, 8-9.

39 Hsueh, *China's Regulatory State: A New Strategy for Globalization*; David Shambaugh, *China Goes Global: The Partial Power* (Oxford, UK: Oxford University Press, 2013).

40 Hsueh, *China's Regulatory State: A New Strategy for Globalization.*

41 Hsueh, "State Capitalism, Chinese-Style: Strategic Value of Sectors, Sectoral Characteristics, and Globalization," 98.

42 Chalmers Johnson, "Political Institutions and Economic Performance: The Government-Business Relationship in Japan, South Korea, and Taiwan," in *The Political Economy of the New Asian Industrialism*, ed. Frederic C. Deyo (Ithaca, NY: Cornell University Press, 1987).

43 Hsueh, *China's Regulatory State: A New Strategy for Globalization.*

demonstrate this bifurcation strategy, in her book she discusses how liberalization reforms, coupled with state intervention in allocating FDI, fueled economic progress, and she uses the automobile, textile, and telecommunications industries to justify this claim.

As the bifurcated strategy was implemented, a decentralization of control took place whereby centralized state control decreased and local authorities were granted with more power to make decisions, while still promoting state policy and objectives, only in a decentralized form.[44] Hsueh points out that the government strategically regulated industries to produce the most economically efficient result by being more involved in industries that were strategic, while having a hands off approach to nonstrategic industries.[45] Hsueh goes on to state that China did not head down a single path toward market reform, but instead implemented market governance measures, such as entry and exit rules and development standards, that were unique to specific industries. The government centralized bureaucratic elements in the strategic sectors with increased regulation to meet national objectives, while decentralizing state functions in the less valuable non-strategic sectors.[46] Through reforms such as decentralization, Hsueh claims that the Chinese government was still able to intervene in businesses seeing as the central government just delegated more authority to the local governments to prevent further ideological disconnect that colored the past; this effort limited corruption and predatory behavior by the state.[47] Even in 1992, when Deng Xiaoping opened up the economy further to FDI during his Southern Tour speech, he continued to emphasize regulatory measures to promote order and help allocate FDI to strategic sectors.[48] In this way, the state could still impart control on select industries such as textiles and telecommunications.[49]

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[44] Ibid., 23.

[45] Hsueh, "State Capitalism, Chinese-Style: Strategic Value of Sectors, Sectoral Characteristics, and Globalization," 85.

[46] Ibid., 89.

[47] Ibid., 87. Hsueh identifies Montinola, Qian, and Weingast (1995) as proponents of this theory.

[48] Ibid., 91.

[49] Hsueh, *China's Regulatory State: A New Strategy for Globalization*, 23.

In a similar vein, Qian explores how China developed economically at the same time as it implemented reforms in the form of transitional institutions that maintained a particular balance between the satisfaction of elite interest and economic efficiency.[50] Qian argues that China provided a unique economic situation because it pursued partial economic reforms and a market-oriented strategy, amidst the backdrop of state planning. After China embraced market reforms, China experienced a great deal of growth and moved away from being a centrally planned economy.[51] As China goes against the grain of "stabilization, liberalization, and privatization, following political democratization," Qian finds its economic reform policies "puzzling."[52] China, however, was able to grow by retaining a planned economy with features of liberalization, becoming "open to trade and foreign investment and sensitive to macroeconomic stability."[53] Hence, through limited state intervention, China was able to open its coffers to foreign support and continue regulating the allocation of foreign capital.

While China grew because it was able to introduce institutional reforms that reduced the distortions of a centrally planned economy, Qian states there is no standardized formula for which transitional institutions should be implemented.[54] Thus the balance for these reforms is precarious as China attempts to ensure "efficiency while remaining compatible with the interests of those in power."[55] Qian continues that the township-village enterprises (TVEs), dual-track system which maintains fixed prices while liberalizing marginal prices, government constraints to ensure respect for private gains, and fiscal federalism which produces incentivized local governments were all reforms that allowed for China to experience economic growth.[56] On the other hand, China did not succeed when it came to state-owned enterprises (SOEs), as they could not

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[50] Yingyi Qian, "How Reform Worked in China," 330.

[51] Ibid., 297.

[52] Ibid., 298.

[53] Ibid., 298–9.

[54] Ibid., 304-5.

[55] Ibid., 305.

[56] Ibid., 306-7, 318.

maintain the delicate balance between interests of elites and overall Chinese economic efficiency. Though he acknowledges that China's economy has improved, Qian does not speculate on what the future will hold for China.[57]

c. State Intervention Promotes FDI and Economic Growth

Another approach places more emphasis on state interventionism. Nolan demonstrates that China still needs to maintain a strong state to continue its development, but that it must work to improve its capabilities by reducing corruption, and that complete liberalization would actually be counterproductive.[58] Nolan depicts China as a unique case because it must balance its cultural and political framework with growing demands to adhere to global standards of free market economics. Chow argues that economic reforms in China are formed by taking China's history and culture into heavy consideration, and in this way, he demonstrates how state regulation of the economy is inescapable for China's economic development.[59] According to Chow, one of their societal values stems from Confucianism, which emphasizes working toward common goals for the better good.[60] Thus, he claims, historical patterns can shape a country's decision to embrace a necessary level of state involvement at the expense of personal benefit. Chow states that China has been prone to foreign trade for quite some time, bringing in examples such as trade along the Silk Road. Even though China welcomes a market economy, its historical background prevents it from entirely embracing western norms, hence, "nationalism in an important force behind China's economic and political practices."[61] Fewsmith's argument is structured differently from that of Nolan and Chow to the extent that the intents and circumstances vary. While Nolan and Chow regard state intervention as necessary and inescapable for state development, Fewsmith shows how

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[57] Ibid., 331.

[58] Peter Nolan, *China at the Crossroads* (Cambridge, UK: Polity Press, 2004), 177.

[59] Gregory C. Chow, *China's Economic Transformation*, 2nd ed. (Malden, MA: Blackwell Publishing, 2007), 10.

[60] Ibid., 21.

[61] Ibid., 22.

the intent was to increase regulation and the result was unintentional but positive.[62] For example, from 1978 to 1984, grain output rose because the government instituted a new tax system and a household responsibility system. Due to widespread corruption, in 1980, the government pursued retrenchment and sought to reinstitute planned economic policies, but as a result, businesses "decided to sell more of their product on the market" because of "excess production capacity."[63] According to Fewsmith, this is an example of how regulatory policies actually led China to become more market-oriented even though the outcomes of regulatory policies may have been perceived in a different light.

C. POTENTIAL EXPLANATIONS AND HYPOTHESES

Based on the literature review above, the thesis adjudicates among four hypotheses regarding the relationship between government reforms and FDI flow in China:

Hypothesis A: The first hypothesis is that greater state regulation and checks on economic reforms in China have distorted Chinese markets and hence have limited the effective use of FDI. Essentially, greater state intervention and constraints on liberalization reform have led to stifling of FDI, which has then led to ineffective allocation of FDI.

Hypothesis B: The second hypothesis is that government reforms have both increased the level of FDI and, through specific policy measures, increased the effectiveness by which FDI is allocated throughout the economy.

Hypothesis C: The third hypothesis is that government reforms have resulted in increased FDI for China, but the allocation of FDI has not changed, only volume.

Hypothesis D: The fourth hypothesis is that government policies have not affected FDI. This hypothesis is unlikely because FDI has changed considerably over the

[62] Joseph Fewsmith, "Plan Versus Market: China's Socialist Market Economy," in *The China Handbook: Prospects onto the 21st Century*, ed. Christopher Hudson (Chicago, IL: Fitzroy Dearborn Publishers, 1997), 100.

[63] Ibid., 101.

years, but is still under consideration in case other present factors are discovered that could have contributed to fluctuations in FDI.

Based on the literature review, the most accepted answer is that the Chinese government's economic reforms increased the level of FDI. This thesis studies the degree to which these reforms were implemented, how much state regulation remains, and to what extent government action affects FDI patterns. The analysis examines trends in different sectors of the economy to illustrate changes in FDI volume and shifts in sectoral allocation.

D. RESEARCH DESIGN

This thesis outlines how reforms in China have changed the role of FDI over the course of its reform trajectory by looking at the nature of economic reforms in three distinct time periods along with the evolving nature of China's approach to FDI over those time periods. The first time period is from 1978 to 1992 encompassing Deng Xiaoping's implementation of significant economic reforms throughout the country, the Tiananmen Square events in 1989, and the Southern Tour of 1992. The second time period is from 1992 to when China joins the World Trade Organization in 2001. The final time period focuses on events from 2001 to the present day.

This study relies upon a most different systems design (MDSD) approach within a single case study. The nature of the economic reforms implemented by the Chinese Communist Party (CCP) are the independent variable (the most different systems in question), whereas the nature of FDI is the dependent variable. The nature of FDI is analyzed in terms of the volume of inflow, the source of funds, type of investment partners, and preferred sectors and types of investment. In turn, I also briefly assess how these factors affected the economic landscape, focusing especially on patterns of sectoral growth.

I tested the hypotheses presented above through a process tracing approach applied to each time period in order to demonstrate how economic reforms reshaped FDI patterns and in turn led to varied economic outcomes.[64] This method was used to determine the state of FDI in China and overall trajectory of development of China's economy. I looked at government intervention since 1978 and linked it with the growth of FDI and the industries that were affected. In this way, I demonstrate that government policy was used to promote FDI in certain sectors, reflecting state prioritization. I also looked at experimental trials for reforms that China implemented in limited sectors of its economy, such as the SEZs, which created an influx of FDI; later, after they were deemed effective, these reform policies were implemented outside the SEZs. Additionally, I examined the introduction of international agencies and institutions and analyzed how they directly impacted China to reform before and after accession. China responded to pressure from the international community to liberalize and the reforms pushed it toward more effective allocation of FDI. As China's economy opened up, it grew more competitive with the international community, and began steering its FDI into high technology and innovative sectors.

E. THESIS OVERVIEW

Following this introduction, Chapter II examines how the reforms of 1978 came about under Deng Xiaoping and the Open Door Policy. The focus was on reforms that opened the door for market-oriented practices and moved the nation away from a command economy. These reforms included liberalization and the encouragement of foreign direct investment, allowing China to develop an industrial complex. Special economic zones were developed to test out the new liberal economic policies, which proved to be successful for economic development. The Chinese government predominantly funneled FDI into the textile industry, becoming a major exporter of low-cost manufactured goods.

Chapter III looks at the time period just after the 1989 crackdown following the Tiananmen Square protests and how this brought about liberal reforms such as decentralization in an effort to appease the international community. This chapter

[64] Andrew Bennett and Alexander L. George, *Case Studies and Theory Development in the Social Sciences* (Cambridge, MA: MIT Press, 2005), 177.

demonstrates how China lessened restrictions on foreign businesses to encourage foreign investment. The government privatized more businesses, while keeping most of the strategic sectors under control. Additionally, the government focused on supporting its dominant industries, while refusing to bail out failing ones. Through the government allocation of funds, most FDI was channeled into strategic sectors such as telecommunications. Meanwhile, private businesses had more access to foreign capital because of less restrictions by the government, allowing them to tap into FDI resources.

Chapter IV looks at events after China's accession into the WTO. The WTO set certain standards that the Chinese had to uphold to continue being an integral partner in the international community. During the 2000s, the economy shifted from focusing on low-cost manufactured goods and toward the development of high-technology and services sectors. Through the Made in 2025 Initiative, the Chinese government set the course for a strategy to one day become self-sustainable producers of high-technology goods. In the meantime, China realized it had to continue encouraging foreign capital and technology to build up their resources and expand capabilities.

The conclusion pulls together the overall findings on the direction of FDI and the role of the Chinese government in regulating the. Through the evolution of government priorities, policy changes were used to steer FDI into certain sectors of the economy, starting from low-cost manufacturing goods in 1978 and transitioning into high technology sectors by the 2000s.

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II. FIRST TIME PERIOD: 1978 TO 1989

Chinese government policies from 1978 to 1989 attracted FDI from overseas investors, allowing the government to develop non-strategic sectors of the economy, such as the textile industry. This increase in the volume and the effectiveness of FDI allocation supported government objectives of turning China into a competitive market economy on the world stage. Through government policies, China was able to restructure its economy, becoming a major producer and exporter of low-cost manufactured goods. Through Deng Xiaoping's reforms in 1978, China implemented liberal economic policies that allowed the country to welcome in FDI and channel it toward industrialization, moving away from a command economy into a market-oriented one. These government policies included decollectivization, decentralization, the development of special economic zones (SEZs), the dual-track system, and introduction of the township and village enterprises (TVEs). Through the privatization of non-strategic sectors, such as the textile industry, government policies provided businesses with newfound opportunities and access to foreign capital to develop their industries.

This chapter discusses the onset of China's economic reform period under Deng Xiaoping in 1978 and will end at 1989, just before the Tiananmen Square protests. Through the liberalization of economic policy and introduction of a market economy, non-strategic sectors that had the ability to move away from planned economic policy—such as the textile industry—were able to bring in FDI and expand their industries. The chapter begins by providing a macroeconomic picture to illustrate the reforms, followed by an explanation of how government policy attracted FDI. Then, the chapter shows how FDI translated into economic performance; this economic expansion and rise in the production of low-cost manufactured goods is demonstrated by analyzing the growth of the textile industry. Finally, the chapter illustrates how these economic developments were indicative of the Chinese government's approach to FDI in the 1980s.

A. MACROECONOMIC PICTURE

In 1978, Deng Xiaoping introduced China to market economic reforms, in an attempt to make China more competitive on the global economic scale.[65] This economic initiative was referred to as "*gaige kaifang*, or 'reform and opening.'"[66] Major elements of the reform included moving to market prices through the dual track system and distributing property rights through township village enterprises. In addition, China opened its borders to foreigners with the development of Open Cities, special economic zones (SEZs), and Development Zones to promote the free market reforms.[67]

Early reform in the 1980s consisted of decollectivation and decentralization through a process that Naughton calls the "shifting power and resources from the hands of central planners to local actors."[68] Naughton continues that China embraced rural reforms by reverting to a traditional system of household farms and moving away from a planned economic system and command economy. This initiative created incentive for individual households to produce higher yields because they were able to keep the excesses for their own personal use and profit. Following this initiative, the dual-track system was introduced in industry and agriculture, wherein the government set the price on goods that were sent to the state, but the workers were in charge of setting prices on the excess production. With shortened work hours, farmers increased their performance, which allowed them to funnel their energy into promoting township and village enterprises (TVEs). Beginning in 1984, in order to supplement the dual-track system, the role of the central government was minimized over time as enterprises sold more and more of their output, and the government allocated less materials.[69] Thus, the Chinese economy began to move toward a more market-oriented system.

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[65] Arthur Kroeber, *China's Economy: What Everyone Needs to Know* (New York, NY: Oxford University Press, 2016), 45.

[66] Ibid., 45.

[67] Harry Harding, *China's Second Revolution: Reform after Mao* (Washington, D.C.: Brookings Institution Press, 1987), 132.

[68] Naughton, *The Chinese Economy: Transitions and Growth*, 90–1.

[69] Ibid., 92-3.

As China embraced the dual-track system and slowly phased out their planned economic system, new opportunities for foreign partnership emerged. Beginning in 1979, the government relaxed entry barriers for companies in the industrial sector, allowing for private ownership and foreign competition.[70] According to Naughton, special economic zones—discussed further in the next section—were established to serve as test beds for new liberalization practices. While the government introduced the Law on Chinese-foreign equity joint ventures, promoting partnership with foreigners, joint venture opportunities arose between private enterprises and state-owned industries.[71] The Chinese government also pursued a policy of disarticulation by reforming areas that "were least tightly integrated into the planning mechanism."[72] As part of these reforms, from 1981 to 1984, the government set an internal rate in the market, during which period of time local businesses could profit by "convert[ing] their foreign exchange earnings into Chinese currency at a highly favorable internal exchange rate."[73] As a result, Harding notes that from 1978 to 1986, foreign trade increased, as seen when it more than tripled from \$20 billion to more than \$70 billion. Economic reforms thus provided incentive for the conduct of trade with foreign partners, and opened up China to favorable market opportunities.

China took a gradualist approach to economic reform as it continued to inject aspects of the market into the planned economy by promoting labor-intensive sectors to increase jobs in the cities and support the household economies.[74] According to Naughton, banks began to play an important role in transferring funds from the household sectors and into industry to alleviate the decrease in government savings as China moved away from a planned economy. Eventually, China's industries were able to embrace new development methods and universal business practices.

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[70] Ibid., 94.

[71] Naughton, *The Chinese Economy: Transitions and Growth*, 94-5; Yasheng Huang, "How did China Take Off?" *Journal of Economic Perspectives* 26, no. 4 (2012): 147, doi: 10.1257/jep.26.4.147.

[72] Naughton, *The Chinese Economy: Transitions and Growth*, 95.

[73] Harding, *China's Second Revolution: Reform after Mao*, 138.

[74] Naughton, *The Chinese Economy: Transitions and Growth*, 96.

B. HOW GOVERNMENT POLICY ATTRACTED FDI

FDI into China did not start out at a rapid rate, as the inflows were gradual.[75] Over time as the economic policies were implemented more effectively and took their full form and as legal institutions improved, Harding indicates that FDI began rising dramatically. From 1979 to 1983, FDI inflows averaged at $1.8 billion, while the period from 1983 to 1985 brought significantly more investment; in 1985 alone, the FDI inflows amounted to almost $2 billion.[76]

With the establishment of the SEZs, FDI gradually increased as investors from Taiwan, Hong Kong, and other developed countries contributed to China's development, and areas such as Fujian and Guangdong largely benefited from this investment growth.[77] The SEZs allowed for foreign partners to operate easily in China, drawing investment into these zones from overseas Chinese, and allowing for the formation of "wholly owned foreign subsidiaries;" these investments spread beyond the SEZs and brought new technology into China.[78] The SEZs allowed for contract bidding, promoted incentive pay, and developed land and equity markets.[79] Naughton states that China went even further in 1984 to develop economic and technological development zones (ETDZs) In fourteen coastal Open Cities. These ETDZs provided tax breaks to foreign investors and channeled the FDI toward technological and infrastructural development in areas such as "energy, transportation and ports construction."[80] Once the government determined that the coastal cities were able to flourish with the introduction of free market principles, it later used the SEZs and the ETDZs as blueprints for the development of rural areas.

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75 Harding, *China's Second Revolution: Reform after Mao*, 159-60.

76 Ibid., 159-160.

77 Naughton, *The Chinese Economy: Transitions and Growth*, 402.

78 Ibid., 406-9.

79 Ibid., 408.

80 Chen Chunlai, "The Evolution and Main Features of China's Foreign Direct Investment Policies" (working paper, Chinese Economies Research Centre, 1997), 10, https://economics.adelaide.edu.au/research/papers/cerc/cercwp1997-15.pdf.

China started out with joint ventures, but eventually realized the need to authorize wholly-owned foreign enterprises. In the 1980s, China predominantly promoted joint ventures (JVs), which lacked a legal entity.[81] By the mid-1980s (1987-1996), widespread equity joint ventures (EJVs) emphasized more integrated partnership between the foreign and local partners.[82] With this initiative came problems, however, as the goals of foreign investors and local entrepreneurs did not line up, resulting in a push toward wholly-owned foreign subsidiaries.[83] The ability of foreign investors to operate with even more autonomy further incentivized the establishment of foreign industries in China.

Foreign direct investment comes into China from many different locations, including the United States and Asian countries. The bamboo network has been a predominant vehicle for foreign investment, the intricacies of which are found in its history. The bamboo network consists of a group of interdependent businesses, mainly Southeast Asian, run by ethnically Chinese proprietors. In 1899, the United States enacted an Open Door Policy, which caused a spike in Chinese migration to U.S. territories in Southeast Asia.[84] In 1949, the Communist party took over rule in China, resulting in further migration of millions of Chinese citizens, mainly to Taiwan, Hong Kong, Singapore, Malaysia, Thailand, Indonesia, Philippines, and Vietnam.[85] The Chinese refugees faced discrimination and isolation in their new countries, causing them to band together to offer each other support. These communities preserved their Confucian ideals by promoting *Guanxi*, or connections, forming personal relationships that are mutually beneficial for both parties, regardless of rank or status.[86] Personal ties among the ethnic Chinese populace translated into business partnerships and economic

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[81] Naughton, *The Chinese Economy: Transitions and Growth*, 411.

[82] Ibid., 412.

[83] Ibid., 412-3.

[84] Allan FB Mendoza, “The Bamboo Network and its Impact on the Political Economy of Southeast Asia: A Comparative Exploration of Indonesia and the Philippines,” (October 2007): 9, http://dx.doi.org/10.2139/ssrn.1487020.

[85] Samuel Hughes and Murray L. Weidenbaum, *The Bamboo Network: how Expatriate Chinese Entrepreneurs are Creating a New Economic Superpower in Asia* (New York, NY: The Free Press, 1996), 3-8.

[86] Mendoza, “The Bamboo Network and its Impact on the Political Economy of Southeast Asia: A Comparative Exploration of Indonesia and the Philippines,” 5.

advantages. Upon establishing businesses overseas and due to their unwavering national commitment, Chinese immigrants and their descendants—the overseas Chinese—continued to send money back to the mainland which in turn contributed immensely to China's rising economy.[87]

Overseas Chinese sustain the economy of the bamboo network, and thereby contribute to China's economy in the form of foreign direct investment (FDI). In 1979, the SEZs—centered on technology, knowledge, and capital—created investment opportunities for foreigners; the Chinese government encouraged the overseas Chinese to invest in China by providing them with incentives and attracting them through liberal economic reforms.[88] Along with the government waiving or reducing their taxes, foreign investors were able to utilize the remainder of their tax income, and could compete with the locals to secure land rights.[89] In order to garner more foreign investment activity from overseas Chinese, the Chinese government undertook projects to form overseas Chinese cities—one located in Shenzhen in the Guangdong Province of China, known as the overseas Chinese town east.[90]

China has channeled its gains from foreign investment into technological projects. Through the Torch Program, which was launched in 1988, China began promoting the use of technology in business enterprises, particularly in high tech development zones.[91] As a result of this, China established approximately 30 high-technology development areas. Greer notes that research and development has been conducted in the cyber realms,

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[87] Ibid., 4-5, 9.

[88] Hughes and Weidenbaum, *The Bamboo Network: how Expatriate Chinese Entrepreneurs are Creating a New Economic Superpower in Asia*, 84.

[89] Charles E. Greer, *China Facts and Figures Annual Vol. 14, 1991* (Gulf Breeze, FL: Academic International Press, 1992), 266.

[90] Charles E. Greer, *China Facts and Figures Annual Vol. 14, 1991*, 267; "Overseas Chinese Town East (OCT East)," Travel China Guide, accessed November 16, 2016, https://www.travelchinaguide.com/attraction/guangdong/shenzhen/overseas-chinese-town.htm. "Overseas Chinese Town East (OCT East) is a large ecological resort brimming with a natural landscape, small towns of western and oriental styles, and entertainment facilities. It has three themed parks: Knight Valley, Tea Stream Valley, and Wind Valley. You can also pay homage to Buddhist statues at Huaxing Temple. There are also wonderful performances played in the resort every day. The most famous ones are Heavenly Zen, a dancing performance revealing the Chinese tea culture, and Roaring Flood, a live-action stunt show."

[91] Greer, *China Facts and Figures Annual Vol. 14, 1991*, 282-6.

development of new materials and bio-chemicals, and other technologies. More recent activity in China's prioritization of high technology sectors and research and development will be discussed in Chapter IV.

C. HOW FDI TRANSLATED INTO ECONOMIC PERFORMANCE

In the mid-1980s, China focused on manufactured goods as foreign investors moved in to incorporate China into their production chain.[92] Per Naughton, Hong Kong and Taiwan invested heavily in China by setting up labor-intensive production facilities, which would be part of a production chain and lead to the export of manufactured goods. By the early 1990s, the author continues, China had shoe and clothing industries established, and electronics industries were also established. China also funneled resources into the "chemicals, machinery, metals and minerals, and handicrafts" manufacturing sectors, but this section will concentrate on the textile industry.[93]

The textile industry is characteristic of how China used its economic reforms to steer improvement in a particular sector. The textile industry was a nonstrategic sector; therefore, it became more open to the trial of new economic strategies.[94] During the 1980s, government policies allowed for the growth of manufacturing sectors that required low-skill-biased labor.[95] China concentrated on producing "low-end textiles and cheap consumer goods."[96] A decentralization policy allowed for the expansion of the textile industry as local authorities had more leeway to encourage foreign investment in their markets through international advertising, while also receiving state support in the form of labor laws and other incentives.[97] Throughout the 1980s, Hsueh notes that other countries in Asia poured capital into China to start up apparel and textile factories. Over time, China was able to invest more resources to manufacture more complex forms of

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92 Naughton, *The Chinese Economy: Transitions and Growth*, 416-7.

93 Harding, *China's Second Revolution: Reform after Mao*, 143-4.

94 Hsueh, *China's Regulatory State: A New Strategy for Globalization*, 130.

95 Naughton, *The Chinese Economy: Transitions and Growth*, 330-1.

96 Kroeber, *China's Economy: What Everyone Needs to Know*, 56.

97 Hsueh, *China's Regulatory State: A New Strategy for Globalization*, 133.

textile products, such as garments.[98] From 1978 to 1985, Harding reports that China's exports of garments increased from 25 percent to 40 percent of the total foreign sales, largely a result of Chinese industries working with foreign companies and using their branding labels. Between 1980 and 1985, the textile industry grew at a yearly rate of 10.2 percent, and garments grew at nearly 20 percent a year.[99] In 1987, China exported approximately 39.44 billion dollars' worth of merchandise; out of this sum, 5.79 billion dollars were yarn and fabric manufactured goods, 3.75 billion dollars were clothing and garments, and 1.51 billion dollars were textile fibers.[100] These statistics demonstrates how much the textile industry accounted for China's merchandise exports. Figure 2 demonstrates the growth in value of textile exports between 1980 and 2015; between 1980 and 1989, the value of exports increased from \$2.54 billion to approximately \$7.22 billion, nearly tripling. Even though the steepest growth occurred after 2001, the 1980s laid the foundation for the development of the textile industry through the effective use of FDI.[101] The growth of importance of the textile manufacturing industry in the 1980s can be attributed to the economic policies that opened up China to foreign investment.

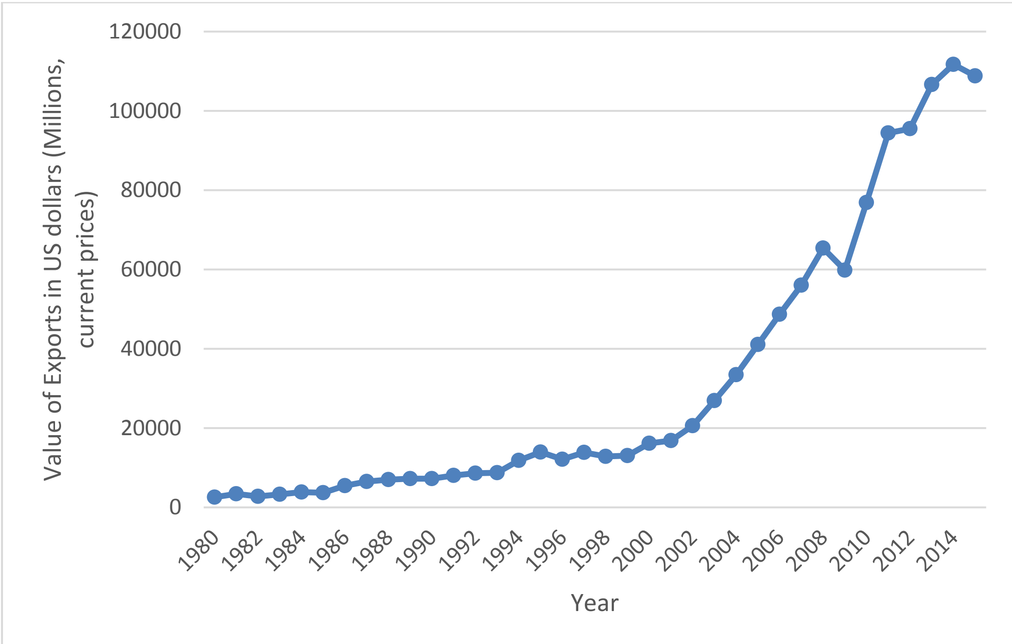
98 Harding, *China's Second Revolution: Reform after Mao*, 143.

99 Naughton, *The Chinese Economy: Transitions and Growth*, 331.

100 *China: Weathering the Storm and Learning the Lessons*, Report No. 19602 (Washington, D.C.: A World Bank Country Study, 1999), 79.

101 There is limited data on how much FDI is directly channeled into specific industries. Hence, the value of exports is a good measure of the success of development in certain sectors. By analyzing the growth in export values of certain commodities, we can demonstrate how the government creates policies that make FDI more accessible, channeling the FDI into certain sectors.

Figure 2. Textile Exports from China (Millions of Dollars)[102]



In the 1980s, the opening up of textile manufacturing to FDI set the stage for the industry to flourish through the 1990s with the help of foreign-invested enterprises.[103] During the 1980s, "[L]ocal governments, empowered by the abolishment of the MTI [Ministry of Textile Industry] and fiscal decentralization and motivated by revenue generation and other interests, used their licensing authority to aggressively court FDI."[104] Over this time period, the garment manufacturing industry had adapted extensively to liberal market practices, allowing for privatization.[105] Bosideng Corporation and Chenfeng Apparel are two examples, noted by Hsueh, of garment industries which became lucrative in a free market environment. Even though the state supported the textile industry by allowing for foreign textile enterprises to enter the market, officials did not follow up with "concrete industrial programs or financial

102 Adapted from "Merchandise Trade by Commodity," World Trade Organization Time Series in International Trade, accessed August 21, 2017, http://stat.wto.org/StatisticalProgram/WSDBStatProgramHome.aspx?Language=E.

103 Hsueh, *China's Regulatory State: A New Strategy for Globalization*, 135.

104 Ibid., 133.

105 Ibid., 138-9.

resources.”[106] Nevertheless, because the industry was able to embrace free market liberalization and privatize rapidly with less state regulation, China was able to bring in a significant amount of FDI by working directly with foreign partners.

While some critics claimed that international agreements prevented China from reaching its potential in this industry, other scholars purported that certain restrictions actually benefited China’s ability to acquire and effectively use FDI to develop its textile industry.[107] The Multifiber Arrangement (MFA) is an example of such an agreement that implemented restrictive measures on textile exports, but initially helped China with economic development in the 1980s. Regardless of the MFA restrictions, between 1981 and 1997, textile and apparel industries exports from China into the United States increased from less than 1 billion dollars to approximately six billion dollars.[108] With the restrictions in place, China’s textile market became more exclusive, giving it bargaining power when dealing with foreign investors.[109] China made quota available to foreign partners in exchange for foreign technology, which, according to Moore, it then used to develop its textile machinery and improve operations. Foreign textile companies competed to include China in their supply chain networks because if most of the assembly and manufacturing of products occurred on the mainland of China, the foreign countries could reap more of the profit through branding and marketing. Thus, through international arrangements and internal economic reform, China was able to develop its textile manufacturing industry.

The MFA catalyzed the Chinese transition from bureaucratic coordination to market coordination in the textile industry.[110] Undergoing pressures to compete on the international market, Moore explains that government officials did not want the textile industry to produce mass amounts of cheap goods to reach quotas, so they encouraged the

[106] Ibid., 138.

[107] Moore, *China in the World Market: Chinese Industry and International Sources of Reform in the Post-Mao Era*, 78.

[108] Ibid., 83.

[109] Ibid., 77-8.

[110] Ibid., 154-7.

production of quality goods, eventually deciding that the market could regulate supply and demand more effectively than government intervention in the textile industry. Hence, FDI was encouraged in the textile sector because these industries could acquire new technology and methods that would feed into the production of quality goods. By the 1990s, Moore continues, bureaucrats no longer wanted to be accountable for the financial burdens of the industry, which also influenced deregulation and the transfer of the industry toward market forces. As part of the SOE reform, the government allowed certain non-strategic sectors of the economy, such as textiles, to privatize because they were not concerned if those industries would fail. Hence, the rapid growth of the textile manufacturing industry in the 1980s can be partially attributed to the MFA, which facilitated the opening up of China's non-strategic sectors to FDI.

D. CHINESE GOVERNMENT FDI APPROACH IN THE 1980s

In the 1980s, the Chinese government understood that if it wanted to be a critical player on the international stage, it needed to embrace modernization and economic development.[111] According to Harding, the government also promoted economic liberalization as a means of acquiring new technology and adopting efficient economic methods. China's decision to open itself up to foreign markets can be interpreted as a survival and self-preservation strategy. The textile industry represents the effects of the market reform policies because since that industry was a non-strategic sector, it was able to move away more quickly from planned economic policies and have greater autonomy in development. The sector utilized the new economic policies to its advantage to bring in foreign investment and pursue development. The government realized that it was in its best interest to encourage production of quality goods; therefore, non-strategic sectors of the economy, such as textiles, were handed over to market forces, which ensured better production quality. China also used the MFA to its advantage to make deals with foreigners that would provide the Chinese with foreign technology in exchange for quota allowance.

[111] Harding, *China's Second Revolution: Reform after Mao*, 132.

As Naughton points out, this first period of reform can be characterized as "reform without losers."[112] Averse to risking the failure of strategic state industries, the government implemented reform gradually by first privatizing the non-strategic sectors of the economy. Additionally, the state established the SEZs to serve as experimental zones in which liberal economic policies would be tested in a closed environment; based on their success, these policies would be extended to other areas of China. Through the dual-track system, the government gradually weaned off of state controlled pricing, which also demonstrates the state's careful approach to market reform, as opposed to shock therapy reforms implemented by the former Soviet Union. Furthermore, the state established TVEs, which created greater competition to urban industries, further driving privatization and the need for financial investment. State and newly privatized industries turned toward foreign companies and, with their support, accumulated revenue in the form of FDI and established joint venture enterprises. China then embraced market-oriented reforms at its own pace, driving the increased production of cheap manufactured goods, turning China into an export-oriented economy.

Through economic reforms, China decreased state regulation over non-strategic sectors of the economy and opened up its access to foreign markets. Market-oriented policies allowed private businesses, such as textile companies, to acquire unprecedented amounts of foreign capital and use it toward development. The reforms that began in 1978 did not bring in huge volumes of FDI in comparison with international standards, but they set the stage for greater inflows of FDI in the 1990s. Nonetheless, the foreign capital that began entering the Chinese economy was funneled into the newly privatized, non-strategic sectors, allowing China's economy to grow.

[112] Naughton, *The Chinese Economy: Transition and Growth*, 91.

III. SECOND TIME PERIOD: 1989 TO 2001

From 1989 to 2001, Chinese government policies resulted in a dramatic increase in the volume of FDI, especially after 1992. Relying on these increasing FDI inflows, the government began to funnel foreign investment into the strategic sectors of the economy, such as telecommunications, with the goal of supporting the development of dual-purpose technology and meeting standards for World Trade Organization (WTO) acceptance. This chapter explores the continuation of economic reforms in China from 1989, the year the Tiananmen Square massacre occurred, to 2001 when China joined the WTO. In 1992 during his Southern Tour, Deng Xiaoping encouraged FDI inflows by reassuring the international community that China would continue to embrace market reform. Through regulatory measures and tailored state intervention, combined with further economic reform, the government channeled FDI into strategic sectors of its economy—that also served a dual-purpose in the economy in terms of promoting national security objectives—such as telecommunications, enabling these industries to grow substantially. Meanwhile, non-strategic sectors, such as the textile industry, also continued to benefit from increased market access to FDI, even though they had not been prioritized by the government. Specific economic policies included recentralization, state-owned enterprise (SOE) reform, fiscal reform, and legal reform.

The chapter begins by providing a macroeconomic picture to illustrate the reforms, followed by an explanation of how government policy attracted FDI. Then, this chapter shows how FDI translated into economic performance by observing trends in the telecommunications industry. Finally, this chapter demonstrates how these economic developments were indicative of the Chinese government's approach to FDI in the 1990s.

A. MACROECONOMIC PICTURE

In the late 1980s, discontent was prevalent among the Chinese people due to widespread corruption, inflation, and decreasing incomes.[113] This frustration, Naughton asserts, culminated in the student-led Tiananmen Square protests and, in response, the

[113] Naughton, *The Chinese Economy: Transitions and Growth*, 98.

government ordered the execution of hundreds of people in what became known as the Tiananmen Square massacre. For a period of time, between 1989 to 1991, officials discussed reversing the economic reforms from the 1980s through retrenchment, but this proved unnecessary as the economy managed to recover with the help of the market.[114] Consequently, in 1992, Deng Xiaoping embarked on the pivotal Southern Tour to again promote economic reform, emphasizing experimentation in the SEZs, which set the stage for a socialist market economy. Following these events, in 1993, deputy premier Zhu Rongji became a prevalent figure in shaping economic reform, phasing out the dual-track system as the economy moved away from planned industries.[115] The government also embraced, Naughton continues, fiscal reforms in 1994 through the recentralization of the economy. According to both Kroeber and Naughton, the Chinese government needed to regain its financial strength because it was no longer collecting tax revenues from local governments as it had in the 1980s; therefore, the government implemented new tax requirements. China also developed a foreign trade system and promoted regulation of the economy to support actors and ensure legal rights, ensuring further privatization.[116] In order to expand foreign trade, the government "devalued the currency, and established current-account convertibility."[117] By working toward a more efficient legal and fiscal system, the government was thus able to improve its management and consolidation of resources at the center, while still providing businesses with the autonomy to pursue market interests.

In 1995, China implemented SOE reforms, coining the phrase "grasp the big, release the small."[118] These reforms, Kroeber relates, would allow companies in the non-strategic sectors, such as manufacturing of consumer goods, to privatize, while retaining state control over the strategic sectors. SOEs, the author explains, had been operating under soft budget constraints, bailed out by the government if their performance was

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114 Ibid., 99, 403.

115 Ibid., 100-1.

116 Ibid., 102-3, 106.

117 Ibid., 104.

118 Kroeber, *China's Economy: What Everyone Needs to Know*, 93.

suffering. The 1990s introduced a period of "reform with losers," in which the non-strategic sectors could face bankruptcy.[119] Through hard budget constraints, the government no longer attempted to bail out every failing industry, allowing the center to retain larger cash reserves for use toward strategic sectors. These strategic sectors were known as the "commanding heights," which included heavy industries, infrastructural development, defense industry, energy, and automobiles.[120] The state, Kroeber relates, also implemented a reform that allowed SOEs to develop subsidiaries that incorporated the most lucrative aspects of the company; the idea was to list these subsidiaries on the overseas stock exchange in order to bring in revenue from global markets. Through all these reforms, the government aimed to consolidate certain parts of the economy and increase performance level—refraining from imposing a monopoly by encouraging competition within sectors.[121] As a result of these initiatives, more sectors of the economy were privatized and opened up to foreign influence.

B. HOW GOVERNMENT POLICY ATTRACTED FDI

Through a series of reforms in the 1990s, FDI inflows into China increased substantially as investors became more attracted to China's reformed economic environment. In particular, investors were influenced by China's improvement of its legal and tax codes and saw an opportunity to have a meaningful stake in the joint enterprises. After 1992, East Asian and other countries funneled money into China to support the manufacturing sector.[122] Because of the groundwork laid out in the 1980s, the Southern Tour speeches proved to be very effective; positive relationships had been established between the Chinese and foreign investors, and the Chinese were developing their institutions to extract more trust from the international community.[123] Deng reassured foreigners that China was still in pursuit of liberal economic reform. He then passed on

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[119] Kroeber, *China's Economy: What Everyone Needs to Know*, 94; Naughton, *The Chinese Economy: Transitions and Growth*. 91.

[120] Kroeber, *China's Economy: What Everyone Needs to Know*, 94.

[121] Ibid., 98, 101-2.

[122] Naughton, *The Chinese Economy: Transitions and Growth*, 401.

[123] Ibid., 403.

the torch to Jiang Zemin and Zhu Rongji to continue implementing the reforms he initiated.[124]

With Deng's reassurance, foreign investors became more confident that China was moving in the direction of a market economy and embracing universal values. After the Southern Tour, the state implemented price reforms which allowed for a re-stabilization of inflation and a transition toward strictly market-priced goods.[125] China opened its doors further to new sectors such as real estate, retail, and services, exciting potential investors.[126] With China funneling money into the services sector, namely commercial retailing, joint ventures expanded.[127] Chow emphasizes the impressive number of joint ventures in the following sectors: "finance, insurance, transportation, international freight forwarding, legal services, tourism, advertising, medical care and public health, accounting, assets appraisal, education, leasing, engineering design, consulting, and real estate."[128] Alongside the services, manufacturing, and real estate sectors, China also channeled billions of dollars of FDI into support of infrastructural development.[129] China also developed its high technology sector; from 1992 to 1993, the state created 18 additional ETDZs and a "high-technology development zone."[130] In 1997, FDI reached its maximum level, approximately $45 billion, and from 1990-2001, China's exports increased dramatically from $62 billion to $266 billion; foreign companies produced the majority of these products."[131] In conclusion, FDI into China took off in the 1990s as the government lessened restrictions on a plethora of sectors, which allowed for more diverse investment opportunities.

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[124] Kroeber, *China's Economy: What Everyone Needs to Know*, 48.

[125] Ibid.

[126] Naughton, *The Chinese Economy: Transitions and Growth*, 403-4, 410.

[127] Chow, *China's Economic Transformation*, 333-4.

[128] Ibid., 333-4.

[129] Kroeber, *China's Economy: What Everyone Needs to Know*, 54-5.

[130] Naughton, *The Chinese Economy: Transitions and Growth*, 409.

[131] Kroeber, *China's Economy: What Everyone Needs to Know*, 49.

Through economic reform policies, China has allowed foreign investment firms to conduct their business with less restrictions on the mainland, allowing for greater investment opportunities. In the early 1990s, China had many restrictions on foreigners in the financial sector, but by 2001, China made many changes to adhere to WTO standards.[132] By exploiting the standards that China needed to meet to ensure WTO acceptance, leaders of economic reform in China, such as Zhu Rongji, were able to convince the government to implement controversial economic reforms.[133] In 1994, the state instituted policies that permitted foreign financial institutions, such as joint venture banks, solely foreign-invested subsidiary banks, and overseas bank branches, to operate in China.[134] Despite legal limitations, Janda and Men Jing note how some foreign companies were able to operate in the strict environment; in the 1990s, foreign insurance companies that stemmed from Shanghai were offered tax deductions, market shares, and other incentives. While China instituted strict measures on the securities industry, it opened up its environment to foreign institutions in other areas.[135]

C. HOW FDI TRANSLATED INTO ECONOMIC PERFORMANCE

Between 1992 and 2000, the total amount of FDI, approximately $282.6 billion, accounted for over 90 percent of total FDI from 1979 to 2000.[136] During the 1990s, the government focused heavily on promoting the telecommunications sector by strategically funneling FDI into its development. When the state saw the growing threat to domestic development from the rising competition between the SOEs and Joint ventures, it began imposing restrictions on FDI. China may have attempted to steer resources away from the private companies, but businesses were able to find ways to continue amassing FDI

[132] Janda and Men Jing, “China’s Great Leap of Faith: Telecommunications and Financial Services Commitments,” 68.

[133] The economic reforms undertaken in China starting in 1978 were regarded as controversial because China was shifting from command economic principles to more liberal, market-oriented policies. There is controversy even in the definitions of what constitutes the current Chinese economic principles seeing as China views itself as a socialist market economy.

[134] Janda and Men Jing, “China’s Great Leap of Faith: Telecommunications and Financial Services Commitments,” 75.

[135] Ibid., 78.

[136] Yasheng Huang, *Selling China* (Cambridge UK: Cambridge University Press, 2003), 6.

through illicit means. Meanwhile, the textile industry continued its development without as much state emphasis because it was a non-strategic sector. Nevertheless, the textile industry was able to attract FDI and develop because it opened up to market-oriented practices and had the flexibility to solicit FDI. This section will briefly discuss the textile industry, but the case study will focus on the telecommunications sector because the latter was prioritized by the Chinese government.

1. Textile Sector

In the 1990s, the government began to decrease intervention in the textile industry, in contrast to its role in the telecommunications industry, thereby allowing for more liberalization.[137] After the state disbanded the MTI, per Hsueh, restrictions lessened in the textile manufacturing industry and certain rules became non-existent, especially in the fabric and garment manufacturing industries. Businesses began to heavily encourage FDI with these fewer restrictions. Through the economic reform policy of decentralization, the government granted the textile industry with more autonomy to pursue joint ventures and bring in FDI.

2. Telecommunications Sector

The telecommunications industry demonstrates the effective and intentional use of FDI for China's growth in the 1990s. The Chinese government values strategic sectors of the economy, especially telecommunications. China began to funnel FDI extensively into the telecommunications sector in the 1990s, and China currently continues to support its research and development through some level of state intervention. The state valued the development of telecommunications because it was dual-purpose, meaning it could help the economy and also protect national security interests.[138] Furthermore, telecommunications could be a road for China's economic move up the chain into services and the acquisition and production of high-value added sectors in the economy. Hsueh conveys that China wants to get to the point where they maintain and control the

[137] Hsueh, *China's Regulatory State: A New Strategy for Globalization*, 130.

[138] Ibid., 49.

carriers for the telecommunications. Through the reinforcement of government policies intended to increase financial flows into strategic sectors of the economy and imposition of stricter measures for other non-strategic sectors to gain government support, the telecommunications industry has been able to develop substantially in its production capacity.

In the 1990s, decentralization caused the state to relinquish some of its control over the telecommunications industry, resulting in increased competition for FDI between the state and private firms. China incentivized foreign companies to invest in Chinese telecommunications companies because they were considered value-added services (VAS) and had made tremendous advances in promoting efficient data transmission.[139] Private Chinese businesses, Hsueh notes, capitalized on this new market, and in 1994, China United Telecommunications Corporation (China Unicom) received its operating license. Alongside domestic businesses, foreign investors rushed into China to pursue joint venture opportunities in a previously untapped sector of the economy.

In the 1990s, companies were so eager to become involved in the telecommunications industry that, at times, they resorted to illegal measures, ignoring FDI restrictions: The Ministry of Post and Telecommunications (MPT) and the Ministry of Electronic Industry (MEI) both exploited the system and encouraged companies to obtain FDI through illicit means. The MEI influenced China Unicom to make deals with foreign banks and obtain foreign exchange loans without prior permission.[140] Consequently, China Unicom was able to bring in FDI by utilizing the "China-China-Foreign (CCF) structure, a technically illegal property rights and fund-raising arrangement," and between 1993 and 1997, a minimum of "forty-five foreign-invested companies invested US$1.4 billion through CCFs to develop and operate wireless and fixed-line networks; de facto foreign equity reached as high as 90 percent."[141] These examples of illegality demonstrate that Chinese businesses were resourceful and

[139] Ibid., 61.

[140] Ibid., 65.

[141] Ibid., 65-6.

continued to gain access to FDI and pursue economic growth by circumventing the law, even though the government did not always promote FDI and Joint ventures. Although government policies did not always directly benefit certain sectors of the economy, these non-strategic sectors found ways, albeit illegal, to gain access to FDI with the added advantage of less restricted foreign influence.

Similar to the government's development of telecommunications services, it also promoted its domestic telecommunications equipment industry. As with the development of the telecommunications sector through foreign financial support, the telecommunications equipment sector was also able to grow because of shared infrastructure. Additionally, the government implemented policies through incentives, that brought in greater amounts of FDI and promoted domestic telecommunications equipment corporations. Joint ventures were established with foreign companies such as Motorola, Nokia, Ericsson, Siemens, NEC, and Philips.[142] The state further encouraged FDI by lessening restrictions on ownership of companies on the mainland. No longer requiring companies to pursue joint ventures, Hsueh notes that businesses were able to go through the Posts and Telecommunications Industry Corporation to establish wholly foreign-owned ventures. To encourage the telecommunications equipment sector, the government also intervened in the economy. For example, Hsueh describes how the government partnered SOEs with joint ventures, pushed out investment guidelines that specified how much material input had to be derived from within the country, lessened restrictions on high-technology transfer, increased trade restrictions on low-technology goods in favor of domestic production, and provided sales tax discounts. Companies, well-known to this day, were able to develop because of these policies: Huawei became a prominent corporation in the telecommunications equipment sector as a result of these government interventionist methods.[143] These government implemented policies steered FDI into the telecommunications industry and helped promote domestic development.

[142] Ibid., 79.

[143] Ibid., 80.

In the late 1990s, leading up to the 2001 WTO accession, the government later began to discourage FDI in the telecommunications services sector and "eliminated joint venture efforts."[144] The government was beginning to formulate objectives of self-sufficiency, which included developing the capacity to produce domestic goods in strategic sectors such as telecommunications and wean off of reliance on foreign support. Nevertheless, as we shall see in the subsequent chapter, the state continued to bring in and learn from foreign capital and foreign technology, respectively, to assist with the development of its infrastructure, with the hope of become self-sustainable in the future and advancing its international prestige.

Shifting government focus away from the textile industry, China, through economic reform, facilitated the expansion of its telecommunications sector. By the late 1990s, Janda and Men Jing explain, satellite communications networks, telephone networks, mobile switching systems, and the paging market all increased their numbers.[145] The mobile market flourished as the state established China Telecom, followed by China Unicom, in the early 1990s. In 1997, the authors state, the government established China Telecom (Hong Kong) (CTHK), a cellular company which brought in foreign investment from Hong Kong, further allowing the telecommunications sector to grow. In 1998, state functions were consolidated by the creation of the Ministry of Information Industry (MII) to oversee the telecommunications industry; as a result of government-induced restructuring and the consolidation of industries in 1998, China Netcom Corp (CNC) was established. Furthermore, the PLA also began to take part in the telecommunications market and sought foreign investment.[146] The PLA's involvement demonstrates that the telecommunications industry was not only vital to economic growth, but to national security interests as well. Through government policy, such as the consolidation of industries and the promotion of dual-purpose strategic sectors, China was able to bring in large flows of FDI to promote the telecommunications industry.

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[144] Ibid., 61.

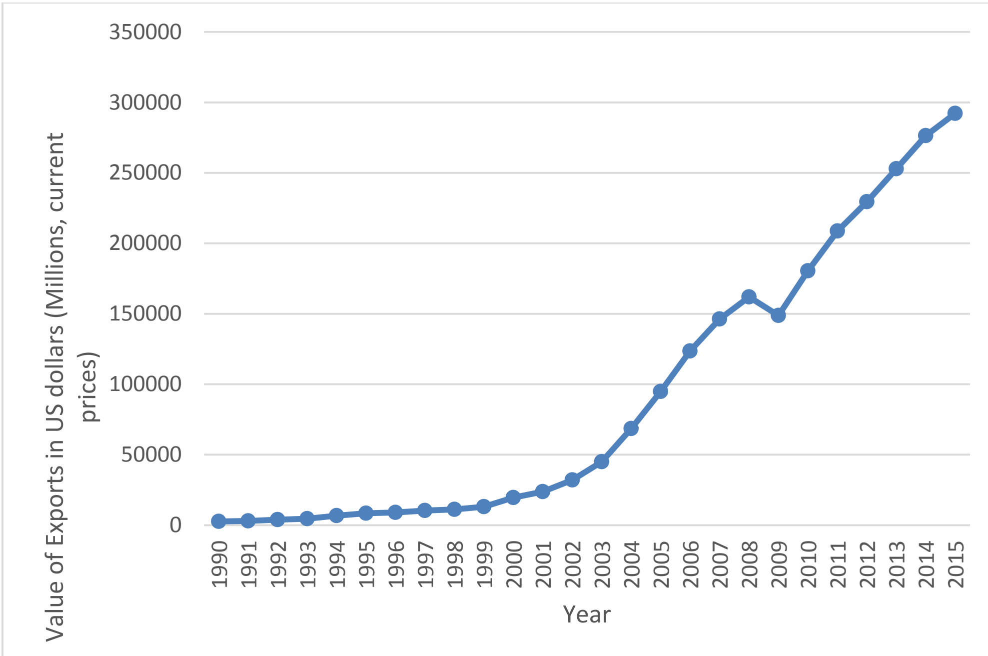
[145] Janda and Men Jing, "China's Great Leap of Faith: Telecommunications and Financial Services Commitments," 68.

[146] Ibid., 70.

Even though the Chinese government has tried to impose regulations on the telecommunications industry, FDI has remained a major factor in the development of this sector. In showing the cause and effect between government policy and FDI inflows, this narrative demonstrates the difficulty in determining whether China's government policies have impacted FDI. Alternatively, it could be argued that as a result of the government relinquishing its control over the market, private businesses were able to tap into foreign investment vehicles. Figure 3 demonstrates the growth of telecommunications equipment exports from 1990 to 2015. While the steepest growth occurred after 2001, the crucial buildup—with the help of FDI—leading up to the success of the telecommunications equipment industry occurred in the 1990s.[147] Thus, the level of exports is a good measure of how FDI is channeled into different sectors of the economy and is impacted by government policy. Throughout history, there have been examples of industrialization and economic growth taking place in different countries, allowing those nations to develop commodity-based economies. Although many nations have started out on the trajectory of import-based industrialization (ISI), only some have been able to pivot from fostering the growth of its infant industries to following an export-oriented industrialization (EOI) pathway to further economic success based on trade. Japan embraced EOI in the 1960s, allowing it becoming a major global trading actor. Meanwhile, Brazil followed an ISI trajectory in the 1900s, but did not transition into an EOI trajectory, which significantly hindered its prospects for economic growth. Hence, through other case studies, we can see how countries that embraced export-led growth were able to succeed economically.

[147] There is limited data on how much FDI is directly channeled into specific industries. Hence, the value of exports is a good measure of the success of development in certain sectors. By analyzing the growth in export values of certain commodities, we can demonstrate how the government creates policies that make FDI more accessible, channeling the FDI into certain sectors.

Figure 3. Telecommunications Equipment Exports from China (Millions of Dollars)[148]



The Chinese government constantly struggles to ensure that its domestic industries do not suffer with the introduction of foreign business, especially in the telecommunications sector. China mitigates this risk of having its domestic industries swallowed by foreign businesses by consolidating companies, such as the creation of a national paging company.[149] According to Janda and Men Jing, China also imposed tariffs on foreign companies so that they would be incentivized to involve themselves in joint ventures rather than simply inject information technology into the country. Nevertheless, the authors continue, prospects of accession into the WTO pressured China into rethinking its restrictions on foreign imports. In 1999, as part of its commitments to the WTO to open up the telecommunications sector, China vied to permit increased

148 Adapted from "Merchandise Trade by Commodity," World Trade Organization Time Series in International Trade, accessed August 21, 2017, http://stat.wto.org/StatisticalProgram/WSDBStatProgramHome.aspx?Language=E.

149 Janda and Men Jing, "China's Great Leap of Faith: Telecommunications and Financial Services Commitments," 71.

foreign ownership in value-added, mobile, and paging services.[150] By relinquishing some control of the telecommunications sector, the government is still able to retain oversight, while receiving the benefits of foreign technology and investments, demonstrating that China continues to prioritize this industry.

3. Automotive Sector

Throughout the 1990s, because strength in the automobile industry signified overall economic robustness, the Chinese government prioritized advancing this particular sector.[151] China's national industrial policy stressed increased economic partnership with foreign partners, mergers of strategic sectors such as transport and energy, and technological improvement. According to Fujino, China welcomed FDI into its automobile, telecommunications, construction, and electronics industries.[152]

The Chinese government attempted to advance the automobile sector in the 1990s through consolidation techniques, but soon realized that it needed to rely more heavily on foreign support. Through the implementation of "The Automobile Industry Policy" in 1994, the Chinese government promoted the development of the automobile industry.[153] To boost operational efficiency, corporations pursued a strategy of cooperation between different corporations to establish enterprise groups that would compete on the stock exchange, and sought to meet their goal by 2010.[154] With the lateral consolidation of numerous automobile industries, enterprise groups could divide their labor, allowing for more efficiency and specialization in production.[155] As FDI was introduced into the

[150] Ibid., 80.

[151] Chen Qiaosheng, "On the Adjustment of China's Industrial Structure: The Lateral Unification of Automobile Industries," in *China in the Twenty-First Century: Politics, Economy, and Society*, ed. Fumio Itoh (Tokyo, JP: United Nations University Press, 1997), 107; Fumiaki Fujino, "Comments," in *China in the Twenty-First Century: Politics, Economy, and Society*, ed. Fumio Itoh (Tokyo, JP: United Nations University Press, 1997), 131.

[152] Fujino, "Comments," 131.

[153] Chen Qiaosheng, "On the Adjustment of China's Industrial Structure: The Lateral Unification of Automobile Industries," 107.

[154] Ibid., 107–8, 121.

[155] Tetsuo Minato, "Comments," in *China in the Twenty-First Century: Politics, Economy, and Society*, ed. Fumio Itoh (Tokyo, JP: United Nations University Press, 1997), 133.

economy, the third wave of “automobile fever” promulgated throughout China.[156] With the exception of First Automobile Factory and DongFeng Motor Corporation, Chen Qiaoshing notes that most Chinese automobile industries did not have the resources to pursue innovation, resulting in $5 billion worth of imports by 1990. After 2001, the Chinese government realized the limitation of poor innovative capability, influencing them to absorb foreign technology and reverse engineer automobiles in order to strengthen their domestic industry, to be discussed in the subsequent chapter.

D. CHINESE GOVERNMENT FDI APPROACH IN THE 1990s

During the 1990s, the state was concerned with keeping its hold on the telecommunications sector. The government could not afford this sector to fail; therefore, it funneled large amounts of investment into the field. With the welcoming of joint ventures and enterprises with foreign partners, telecom companies were able to import new technology and management methods to further develop. The scenario resembled a catch-22 because China decided to restrict FDI to build up its domestic industry, but it could not accomplish this build-up without the use of FDI and working with foreign businesses to acquire new skills and assets. China has been trying to balance domestic business development and liberalization of industry, but overall, it has brought in FDI and used it toward the telecommunications industry. To reign in foreign businesses, China requires certain sectors to set up joint ventures.[157] In this way, China is able to guarantee that the technology transfers and new information goes to benefit the government directly, so that they can later use this information to advance their domestic industry. The textile industry, on the other hand, was of less concern to the government, therefore, it embraced greater liberalization and privatization. With greater autonomy, the textile businesses were able to bring in FDI freely. The state attempted to regulate the market so that its strategic sectors would benefit from growth, and almost seemed to provide them a cushion. Nevertheless, both the telecommunications and textile industries were able to bring in FDI to pursue development goals. This attests to the ambiguity

[156] Chen Qiaosheng, “On the Adjustment of China’s Industrial Structure: The Lateral Unification of Automobile Industries,” 108.

[157] Hsueh, *China’s Regulatory State: A New Strategy for Globalization*, 79.

between cause and effect of government policies and FDI inflows into particular sectors of the economy. The chapter, however, focused on the telecommunications industry because it better reflected how government policies intentionally increased FDI inflows into the sector. The 1990s brought increased opportunity for FDI with the lessening of entry and exit restrictions, improvement of the tax and legal codes and property rights protection, and the introduction of new sectors of the economy to foreign influence. Meanwhile, the government realized it needed to intervene at some level in order to promote strategic sectors as it worked to regulate the increased flow of FDI into the economy.

After Deng Xiaoping's Southern Tour of 1992, the volume of FDI inflows significantly increased as foreign companies were reassured that China would continue on the path of market reform. Through recentralization government economic reforms in the SOE structure, financial institutions, and legal institutions, foreign businesses were incentivized to increase their investments in China. The government funneled capital into strategic sectors of the economy, while allowing private businesses with non-strategic sectors to maneuver more freely and gain access to FDI. Overall, the volume of FDI increased because of government reforms and through specific policy measures, it was allocated more efficiently toward areas of focus. Because the government no longer had to concern itself with bailing out failing companies, it could turn its focus on developing strategic sectors, such as telecommunications, with the help of FDI. The government was further incentivized to develop sectors such as telecommunications because they had a dual-purpose in promoting national security. Meanwhile, market forces continued to support the development of privatized, non-strategic sectors. Hence, FDI evolved from the 1980s to the 1990s and was allocated more efficiently into strategic sectors of the economy.

IV. THIRD TIME PERIOD: 2001 TO PRESENT

From 2001 to the present day, Chinese government policies attracted increased volumes of FDI. The government understood that if it wanted to remain a strong economic competitor on the global stage, it needed to develop its domestic high value-added sectors. Thus, government policies resulted in the allocation of FDI toward the high technology sectors, including the automobile, information and communications technology (ICT), and semiconductor industries. This chapter looks at how China has continued to promote FDI from 2001—upon its accession into the World Trade Organization (WTO)—to 2017, through its economic policy. WTO standards influenced China to pursue fiscal reform, banking reform, further privatization of SOEs, a reduction of restrictions on foreign-owned ventures, and the development of free economic zones (FEZs).

The Chinese government has restructured its motivation for acquiring FDI from purely economic growth to self-sustainability, continuing to amass foreign support and technology. Additionally, as economic growth in China has slowed down, the government has begun to shift from supporting low-cost manufacturing sectors to high-value added sectors. Policies such as Indigenous Innovation and the Made in China 2025 Initiative, de facto began bringing in large amounts of FDI; China understands that it must amass as much foreign capital and technology as it can before the country can begin weaning off of it to pursue purely domestic innovation. The Chinese government has determined these development strategies to be important because a concerted movement toward self-sustainability and continued economic growth helps preserve regime legitimacy. Additionally, amassing foreign technology and methods is useful for both economic development and defense-buildup.

This chapter provides a macroeconomic outlook to describe China's economic reforms, followed by an explanation of how government policy has continued to attract FDI. Then, the chapter shows how FDI translated into economic performance by observing the automotive, semiconductor, and information and communications technology (ICT) sectors. Finally, this chapter demonstrates how these economic developments reflected the government's approach to FDI in the 2000s.

A. MACROECONOMIC PICTURE

As China entered the new millennium, it was not only dealing with its domestic politics, but was also needing to present an image of embodying liberal goals and values to the international community so that foreign partners would continue to invest. In 2001, China joined the World Trade Organization (WTO), which committed the nation even further to market reform and liberalization practices.[158] These practices included lessening of restrictions for foreign investors, the lowering of tariffs on foreign goods, and the further opening up of the service sector.[159] By 2002, to better adhere to international standards and expectations, the state had eliminated over 800 rules and updated over 2,000.[160]

As the Chinese continued to diversify their portfolio investment, upon joining the WTO, FDI into China increased notably. Figure 4 demonstrates that from 2001 to 2013, net FDI inflows into China increased from $47.053 billion to $290.928 billion. Unlike the majority of East Asia, the Chinese government is more decentralized when it comes to FDI approval, considering that local officials have more authority in promoting foreign investment projects.[161] The decentralized nature of the economy helps explain why East Asian countries find it advantageous to invest in China. By 2003, China was a prominent exporter of high-technology products, with the majority of foreign investment stemming from Taiwan and the United States.[162] North America, Europe, Latin America, and Africa also provided China with FDI inflows.[163]

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[158] Hsueh *China's Regulatory State: A New Strategy for Globalization*, 2.

[159] Chow, *China's Economic Transformation*, 334, 339.

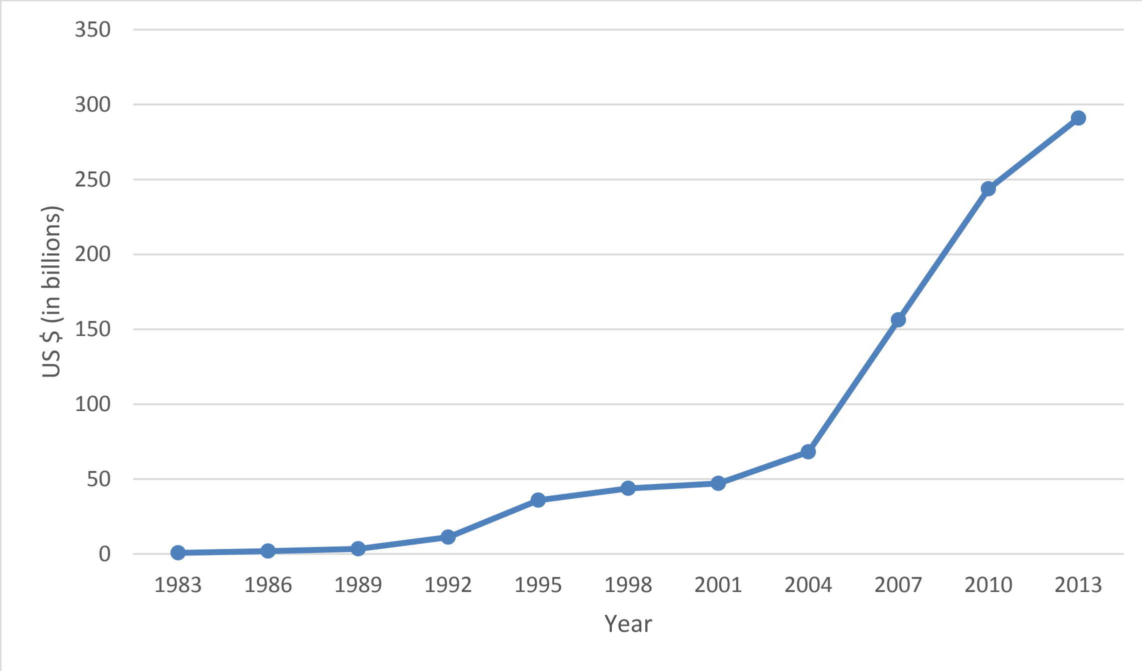
[160] Eric Thun, *Changing Lanes in China: Foreign Direct Investment, Local Governments, and Auto Sector Development* (Cambridge, UK: Cambridge University Press, 2006), 13.

[161] Naughton, *The Chinese Economy: Transitions and Growth*, 410.

[162] Ibid., 417.

[163] Chow, *China's Economic Transformation*, 330-1.

Figure 4. Net FDI Inflows into China from 1983 to 2013[164]



During the 2000s, as liberal reforms gave rise to flexible foreign trade and investment laws, FDI flows were reoriented toward different sectors. Between 2003 and 2004, the manufacturing sector made up the largest portion of FDI investment at 70 percent and, in 2003, almost 30 percent of the investments made up the services sector.[165] In 2003, over ten thousand “foreign-invested enterprises in service trades” had been established by the state.[166] Real estate had been the focus of the services sector, but shortly after the continued access of foreign investors, transport and telecommunications, along with wholesale trade and finance to international actors, climbed the prioritization

164 Adapted from “Foreign direct investment, net inflows (BoP, current US$),” The World Bank, accessed August 28, 2017. http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD.

165 Naughton, *The Chinese Economy: Transitions and Growth*, 419.

166 Chow, *China’s Economic Transformation*, 340.

ladder.[167] FDI has allowed China to reach new potential and become a part of supply chains, fostering further exchange of technological and managerial skills.[168]

Alongside these developments, by 2004, the Chinese government lowered tariffs on foreign imports and lifted restrictions on foreign-funded banks.[169] Chow explains that foreign retail companies moved in, legal rights improved, and laws were passed consistent with WTO obligations. One such law, the author continues, was the Foreign Trade Law, which further opened up market access by facilitating international trade. China implemented these reforms in a gradual manner in particular industries, such as automobiles, to prevent overwhelming domestic producers.[170] As of 2016, China had established bilateral investment agreements with more than a hundred foreign nations, along with fourteen free trade agreements (FTAs).[171] Overall, China followed through with many of its WTO promises as it worked to adhere to international standards of market policy. Currently, however, as previously mentioned in the discussion of telecommunications development in the 1990s, China has realized that it must work to favor its domestic sectors over international companies and lower foreign shares in industries; however, while committed to this promotion, China has lagged behind due to a lack of innovative technological capability.

Over the years, China has been implementing policies that stress domestic development of high-technology industry. Xi Jinping came to power in 2013 and has continued to emphasize market reforms and private entrepreneurship, along with moving China in a more self-sustainable direction.[172] In 2015, Kroeber asserts, the government introduced the “Made in China 2025” strategy, aimed to promote China’s ascent up the

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167 Naughton, *The Chinese Economy: Transitions and Growth*, 419-420.

168 Loren Brandt, Thomas G. Rawski, and Xiaodong Zhu, “International Dimensions of China’s Long Boom,” in *China’s Rise and the Balance of Influence in Asia*, ed. William W. Keller and Thomas G. Rawski (Pittsburgh, PA: University of Pittsburgh Press, 2007), 27.

169 Chow, *China’s Economic Transformation*, 340.

170 Ibid., 341.

171 U.S. Department of Commerce’s International Trade Administration, “China – 2 – Bilateral Investment Agreements & Taxation Treaties,” July 20, 2017. https://www.export.gov/article?id=China-2-Bilateral-Investment-Agreements-Taxation-Treaties.

172 Kroeber, *China’s Economy: What Everyone Needs to Know*, 51-2.

technology production chain and facilitate the creation of innovative goods by domestic companies. With a greater capacity and incentive to pursue innovation, China hopes to achieve greater self-sustainability and move away from its place on the lower end of the supply chain network.

1. Fiscal Reform

After the 1994 fiscal reforms, economic debt escalated because local officials borrowed heavily, prompting a revision of fiscal reforms.[173] The central government had attempted to rein in resources by taxing local governments and cutting funding, but officials did not foresee that local governments would resort to alternate means of financial acquisition which would send the economy into debt. Kroeber notes that localities utilized short-term loans to fund major infrastructure and heavy industry projects—projects that could take decades to produce results; in order to pay back their debts and provide for their people, local governments began to purchase land in the 2000s, using this land as collateral when borrowing bank loans.[174] While the local governments profited from increasing land prices, the rest of the country spiraled into economic misfortune. The central government realized that they had to incentivize local officials to initiate fiscal reforms through tax incentives, so they would channel their capital toward the development of the services sector and away from the heavy industry.[175] Hence, the government had to manipulate the local officials into embracing new fiscal reforms which would help counter the negative effects of the previous 1994 fiscal reforms

In 2014, the government introduced fiscal reform policies to help improve the economy and take it out of a downward spiral into debt.[176] The government, Kroeber notes, surmised that fiscal reform was vital to ensure the effective reform of other areas such as SOE reform. Local officials, the author continues, were subjected to stricter

[173] Kroeber, *China's Economy: What Everyone Needs to Know*, 122.

[174] Ibid., 118–9, 122.

[175] Ibid., 122, 124.

[176] Ibid., 121, 124.

regulations in that they were required to make their budgets transparent. Also, the central government was responsible for transferring capital to the local governments so they could balance their budgets, and it set out to translate debts into bonds.[177] The government devised incentives and measures to alleviate the pressure of growing debt from short-term loan borrowing. State officials reasoned that if they no longer promoted SOEs and prevented local officials from making immense profit from the taxes, then eventually the local officials would discover other sectors of the economy that would be more beneficial for investment. Through these initiatives, the state hoped to change the incentives of the local officials so they would invest more heavily in the services sector.

2. Banking Reform and State-Owned Enterprises

Around the time China joined the WTO, it began privatizing more sectors of its economy. Services such as retail became largely privatized by the late 2000s, and the wholesale sector also experienced some privatization as well.[178] This level of privatization and liberalization has allowed China to improve production of value-added export goods, and as China moves away from assembling items, developing the capability to produce final goods.[179] Through the privatization of SOEs, China aims to develop its high-value added sectors.

Despite continuing to make efforts in promoting privatization of industries in multiple sectors and providing investment support to private companies, the Chinese government continues to heavily sponsor the SOEs. Regardless of trends in greater production through private enterprises in the manufacturing sector, Lardy notes that the services sector—including telecommunications, finance, and transport—remains largely government-owned.[180] Additionally, the government maintains strict control over the tobacco and energy sectors.[181] The State Assets Supervision Administration Commission

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177 Kroeber, China's Economy: What Everyone Needs to Know, 122–3.

178 Nicholas R. Lardy, *Markets over Mao* (Washington, D.C.: Peterson Institute for International Economics, 2014), 80-1.

179 Ibid., 88.

180 Ibid., 79.

181 Ibid., 81.

(SASAC), established in 2003, regulates over a hundred SOEs; these industries enjoy lower tax rates and greater accessibility to credit and other resources.[182] As part of state reform, President Xi Jinping vouched in 2013 to level the playing field between SOEs and private enterprises by creating "mixed ownership" and promoting competition.[183] Notwithstanding these initiatives, the courts still favor SOEs in legal disputes, and the SOEs are largely influenced by CCP party members.[184]

B. HOW GOVERNMENT POLICY ATTRACTED FDI

Since joining the WTO in 2001, China has brought in a significant amount of foreign capital and technology. Foreign companies have become more involved in the Chinese market through equity joint ventures (EJVs) or contractual joint ventures (CJVs).[185] Furthermore, China eliminated many restrictive measures on FDI, listing more sectors of the economy as "encouraged" in China's Foreign Investment Catalogue

[182] U.S. Department of Commerce's International Trade Administration, "China – 7 – State Owned Enterprises," July 25, 2017, https://www.export.gov/article?id=China-State-Owned-Enterprises.

[183] Ibid.

[184] Ibid.

[185] U.S. Department of Commerce's International Trade Administration, "China—Joint ventures and Licensing," July 14, 2017. https://www.export.gov/article?id=China-joint-ventures. While EJVs require that the foreign partner has at least a quarter of the equity interest, CJVs do not demand that the foreign partner contributes a minimum investment.

(FIC).[186] According to the World Bank, from 2000 to 2009, FDI flows into the services sector tripled.[187] A large amount of these resources was channeled toward the production of high technology goods, and by 2012, foreign companies in China produced over 80 percent of high-technology export goods; with the driving force of WTO accession, China knew it had to embrace market liberalization reforms if it wanted to remain an attractive investment environment to the international community.[188] While the economy grew, however, China's inequality gap widened and internal conditions deteriorated. As the government feared that if economic grievances were expressed through social unrest, its legitimacy would be undermined, in 2006, the state set out to promote a "harmonious society;" it shifted its focus from solely promoting economic growth to developing the country's infrastructure to build up the countryside and help solve environmental problems.[189] To promote this type of society, the government instituted "Indigenous Innovation" to develop domestic infrastructure and high-tech sectors by providing

[186] U.S. Department of Commerce's International Trade Administration, "China – 1 – Openness to, & Restrictions Upon Foreign Investment," July 20, 2017, https://www.export.gov/article?id=China-1-Openness-to-Restrictions-Upon-Foreign-Investment; Alexander Chipman Koty and Zhou Qian, "China's 2017 Foreign Investment Catalogue Opens Access to New Industries," China Briefing, July 11, 2017, http://www.china-briefing.com/news/2017/07/11/china-releases-2017-foreign-investment-catalogue-opening-access-new-industries.html; U.S. Department of Commerce's International Trade Administration, "China – 4 – Industrial Policies," July 25, 2017, https://www.export.gov/article?id=China-Industrial-Policies. In accordance with the Foreign Investment Catalogue (FIC), China categorizes its industries as "encouraged," "restricted," or "prohibited" when it comes to allowing FDI. The state continues to liberalize industries and recently eliminated a requirement for foreign actors to seek pre-approval to invest in certain sectors. The newest version of the FIC was released in July of 2017; it eliminated thirty restrictive measures on FDI. Restrictions remain on certain sectors such as telecommunications and banking, but other industries have become more open to FDI. Regulations have become more relaxed in virtual reality (VR) and augmented reality (AR) fields, along with NEV batteries, information technology services, mining, transport, and energy. The Chinese government understands that it has limitations in certain high-technology sectors, and that, in order to grow, it must embrace FDI and foreign technology; therefore, China welcomes joint ventures in research and development in many of its sectors. China has a "Negative List," which contains sectors from the latter two FIC categories. State regulation exists in the restricted industries because foreign investors need approval from MOFCOM before pursuing their endeavors. Starting with the Shanghai Pilot FTZ (Free Trade Zone) in 2013, China's FTZs have been used as experimental testbeds for implementing the negative lists and pursuing economic liberalization.

[187] "Foreign Direct Investment: The China story," The World Bank. July, 16, 2010, http://www.worldbank.org/en/news/feature/2010/07/16/foreign-direct-investment-china-story.

[188] Kroeber, *China's Economy: What Everyone Needs to Know*, 53, 55.

[189] Maureen Fan, "China's Party Leadership Declares New Priority: 'Harmonious Society,'" The Washington Post, October 12, 2006, http://www.washingtonpost.com/wp dyn/content/article/2006/10/11/AR2006101101610.html.

companies rewards and incentives.[190] As a result of these new policies, China decided that it would eventually have to wean off of FDI to encourage its domestic business development. In the meantime, however, FDI flows into China continued because the government needed foreign capital and technology to lay the foundation for future goals of self-sustainability.

The movement of overseas companies into China inundated the country with new technology and better methods of conducting business, allowing them to move in the direction of self-sufficiency. China has used much of its FDI to improve the manufacturing of its precision machine tools, which require higher-end technology, and are important components for producing heavy equipment and transport.[191] According to Brandt, Rawski, and Xiaodong Zhu, the 2000s have brought about an immense improvement in the manufacturing of computer numerically controlled (CNC) lathes. They also point out that China is learning from their production methods to ensure the quality of a product with the help of foreign investment enterprises (FIEs). In addition, the authors assert that China is becoming more integrated in transnational supply chain networks by working with foreign partners. The FIEs support the build-up of domestic industry because they procure their equipment and tools from local businesses. Furthermore, some foreign companies sell their final product after having tasked China to process their goods as an intermediate step. China has also been working to improve its research and development (R&D) with the creation of items such as computer chips and hard disk drives.[192] From 1998 to 2003, China made up three percent more of the world's semiconductor demand at over ten percent suggesting that the more China works with international partners, the more international levels of standardization and universal market etiquette influence China.[193] In consumer electronics, China "shifted from a strategy of importing technology, to absorbing it through foreign-invested joint ventures

[190] Kroeber, *China's Economy: What Everyone Needs to Know*, 50-1.

[191] Brandt, Rawski, and Xiaodong Zhu, "International Dimensions of China's Long Boom," 28-9.

[192] Ibid., 30.

[193] Brandt, Rawski, and Xiaodong Zhu, "International Dimensions of China's Long Boom," 30; Hsueh, *China's Regulatory State: A New Strategy for Globalization*, 228.

and facilitating FDI in microelectronics."[194] Through continued partnership with foreign businesses, China is acquiring foreign business strategies and technology, allowing it to develop its technological infrastructure.

Since 1978, China has continued to develop economic zones that facilitate tariff-free trade and provide newfound opportunities for foreign investors to inject themselves into the Chinese economy. During the start of the reforms in 1978, China focused development in coastal regions by designing the SEZs.[195] By experimenting with economic reforms in the SEZs, China saw the immense benefits that its economy reaped and then began to extend similar reforms to other parts of the nation with the purpose of reenacting this same growth. Thus, in recent years, China has extended its efforts to promote economic development inland, establishing new free economic zones (FEZs) to bring FDI to the interior of the country.[196]

The WTO, upon China's entry, required concessions that would result in greater transparency to engender trust in foreign investors. China went through a transition and began restructuring its banks, allowing for financial joint ventures to funnel money into the domestic banks.[197] By 2002, over two hundred foreign financial institutions were established in China, with some able to conduct business in domestic currency, improving trade in services.[198]

As the government allowed for more privatization of SOEs, these newly-founded private companies became more efficient at utilizing foreign capital to achieve economic growth. In 2007, nearly sixty percent of value-added industrial output came from private firms, which included foreign-funded firms.[199] The government channeled the majority

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[194] Hsueh, *China's Regulatory State: A New Strategy for Globalization*, 228-9.

[195] U.S. Department of Commerce's International Trade Administration, "China – 4 – Industrial Policies."

[196] Ibid.

[197] Richard Janda and Men Jing, "China's Great Leap of Faith: Telecommunications and Financial Services Commitments," 87-8.

[198] Ibid., 75, 88.

[199] Lardy, *Markets over Mao*, 74.

of FDI through these companies, reaching $106 billion by 2010.[200] Meanwhile, from 1978 to 2011, state enterprise gross industrial output decreased from over 75 percent of total gross industrial output to approximately 26 percent.[201] As more SOEs were privatized, the government modified its policies to begin channeling more FDI into these private firms, steering FDI away from the remaining SOEs.

The Chinese government continues to promote FDI inflows and foreign technology amassment to help develop its indigenous industries. Meanwhile, the U.S. Department of Commerce’s International Trade Administration (ITA) offers a counterargument indicating that in an effort to develop domestically, China is imposing more rules and regulations that hinder foreign investment out of nationalistic concern.[202] According to the ITA, the government promotes SOEs and strategic sectors through incentives, and stymies foreign investment through cybersecurity policies, inability to protect intellectual property, and legal corruption. Furthermore, Chinese companies face greater restriction when it comes to acquiring foreign technology.[203]

Despite the government financially supporting SOEs, private firms have found new avenues for acquiring capital, mainly through FDI. The central government promotes the development of SOEs over private firms by providing them with more resources; financial institutions such as the People’s Bank of China (PBOC), extend preferential lending opportunities to SOEs demonstrating that private businesses sometimes have more difficulty accessing capital from the state banks.[204] Hence, the

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200 Ibid., 69. Due to limitations in gathering data, most academic literature contains ambiguities about how much money the government actually directly hands over to certain industries. Increased revenue and budgetary support to industries has been accomplished through the lifting of regulations. Additionally, some of the capital that the government provides to industries may have been state banking reserves it already had—capital that was not generated from FDI. For purposes of this discussion, trends and patterns are analyzed to establish which industries experienced growth in the form of production, exports, and accrued profits, as government policies changed.

201 Ibid., 75.

202 U.S. Department of Commerce’s International Trade Administration, “China – 1 – Openness to, & Restrictions Upon Foreign Investment.”

203 Ibid.

204 U.S. Department of Commerce’s International Trade Administration, “China – 6 – Financial Sector,” July 25, 2017, https://www.export.gov/article?id=China-Financial-Sector; Lardy, *Markets over Mao*, 109, 111.

private firms must rely more on foreign investment vehicles. This favoritism demonstrates that the government prioritizes strategic over non-strategic sectoral development. Industries such as telecommunications, petrochemicals, and energy sectors have preferential treatment when it comes to obtaining credit.[205] Entry and exit restrictions and difficulties in obtaining operating licenses poses additional obstacles for private industries, incentivizing these firms to vigorously seek out foreign investment, regardless if it is through legal means.[206] While counterintuitive, the lack of financial support from the government in the nonstrategic sectors actually incentivizes private firms to acquire FDI through FDI channels that are off the books.

Taking into consideration these incongruous viewpoints, I maintain that China is continuing to encourage FDI, but is working out how to balance protecting its national security interests. From 2015 to 2016, FDI inflows increased by over four percent.[207] Additionally, China is strategically accepting imports in some sectors such as automobile technology, while keeping a close watch over ICT imports. In recent years, the Chinese government has also allowed for greater foreign investment in indigenous stock markets and the interbank bond market.[208] Realizing the historical significance in economic development, the Chinese government continues to promote FDI into China.[209]

C. HOW FDI TRANSLATED INTO ECONOMIC PERFORMANCE

1. High-Technology and Automotive Sector

Through its automotive industry, the Chinese government demonstrated how it strategically channels FDI into a specific sector of the economy to promote the development of high-technology fields. China also uses FDI to learn appropriate business

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[205] Lardy, *Markets over Mao*, 109,111.

[206] Ibid., 111.

[207] U.S. Department of Commerce’s International Trade Administration, “China – 1 – Openness to, & Restrictions Upon Foreign Investment.”

[208] U.S. Department of Commerce’s International Trade Administration, “China – 6 – Financial Sector.”

[209] U.S. Department of Commerce’s International Trade Administration, “China – 1 – Openness to, & Restrictions Upon Foreign Investment.”

methods and absorb new technology, so that it can reverse engineer and use this knowledge to build up its own high-technology industry. As a result of these efforts, China has moved toward economic self-sustainability because of FDI; over the years, these investments have introduced China to foreign technology and business practices.[210] Kroeber explains that China continues to move away from heavy reliance on foreign support and is reducing foreign shares of exports, but it still faces challenges in the higher-technology fields. For example, the author explains, China has attempted to build up its automotive industry, but strictly Chinese-owned industries have not been able to break into the market of the developed world, and the most successful automotive industries in China remain joint ventures. Nevertheless, if China aims to become more domestically self-sustainable in industries such as automobiles, it must continue to utilize FDI to gain access to new technologies and standards for their development.

Similar to the textile industry, the automotive industry has been able to grow due to economic policies set in place, promoting liberalization.[211] The automotive industry, Hsueh states, was not considered a strategic sector; therefore, control of the market was decentralized. After building up the automotive industry through foreign partnership and assistance, China decided it was time to pursue a path of self-sustainability and gradually weaned off of foreign support. In the 1980s, joint ventures developed between SOEs and foreign companies; for example, "Shanghai Automotive and First and Second Auto Works partnered with Volkswagen and Peugeot."[212] By the 2000s, China began to further target and support domestic automotive industries, while still keeping a decentralized market.[213] The government accomplished its goals through subsidies, import tariffs, company merges, and "utilized FDI to deepen industrialization and promote domestic sector competitiveness at home and abroad."[214] In 1998, China sold 484,000 passenger vehicles, and by 2004, this amount increased to 2.3 million

[210] Kroeber, *China's Economy: What Everyone Needs to Know*, 55.

[211] Hsueh, *China's Regulatory State: A New Strategy for Globalization*, 216-7.

[212] Brandt, Rawski, and Xiaodong Zhu, "International Dimensions of China's Long Boom," 28.

[213] Hsueh, *China's Regulatory State: A New Strategy for Globalization*, 218-9.

[214] Ibid., 219.

vehicles.[215] In regards to the automotive parts industry, China dramatically improved production in this sector by using FDI resources, channeled through joint ventures.[216] From 2000 to 2004, trade in automotive components increased over five times, and trade, in both automotive equipment and products, increased four times in that same time period.[217] In 2005, China produced approximately $10 billion worth of automotive parts for export.[218] Figure 5 demonstrates the growth in China's automobile market from 1991 to 2003. Based on the data, the steepest growth in the automobile market within that timeframe occurred from 2001 to 2003, coinciding with China joining the WTO.[219] Passenger and commercial vehicle production, Thun reports, increased from 2.34 million units to 4.07 million units. Figure 6 shows how the value of automobile exports from China increased from $411 million in 1991 to $43.34 billion in 2015; the majority of the growth occurred after 2001.[220] With these advancements in its automotive industry, China has begun to reevaluate its role in the market and the next step is to funnel more resources into strictly domestic production.

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[215] Thun, *Changing Lanes in China: Foreign Direct Investment, Local Governments, and Auto Sector Development,* 7.

[216] Brandt, Rawski, and Xiaodong Zhu, "International Dimensions of China's Long Boom," 28.

[217] Ibid., 38.

[218] Ibid., 28.

[219] Thun, *Changing Lanes in China: Foreign Direct Investment, Local Governments, and Auto Sector Development*, 53.

[220] There is limited data on how much FDI is directly channeled into specific industries. Hence, the value of exports is a good measure of the success of development in certain sectors. By analyzing the growth in export values of certain commodities, we can demonstrate how the government creates policies that make FDI more accessible, channeling the FDI into certain sectors.

Figure 5. Automobile Market in China[221]

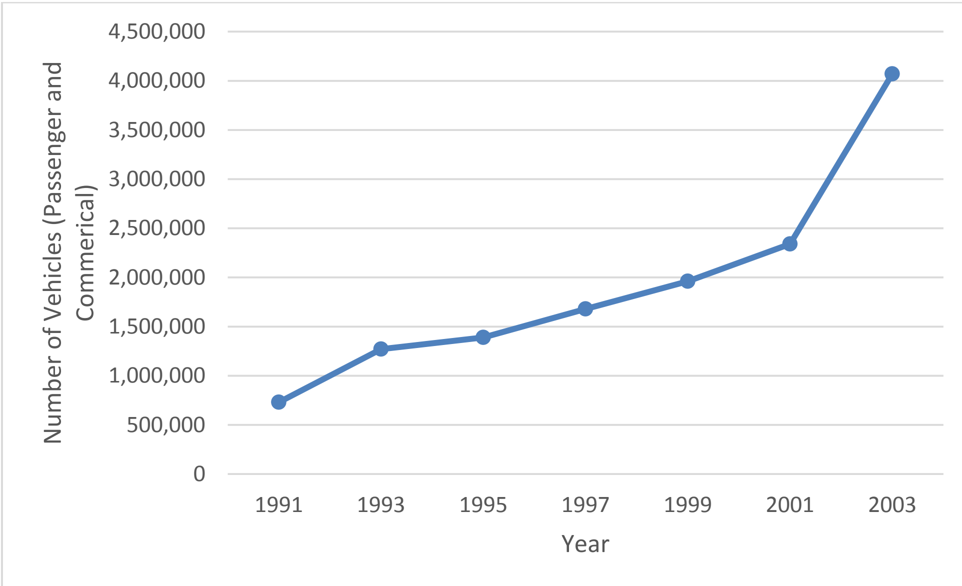
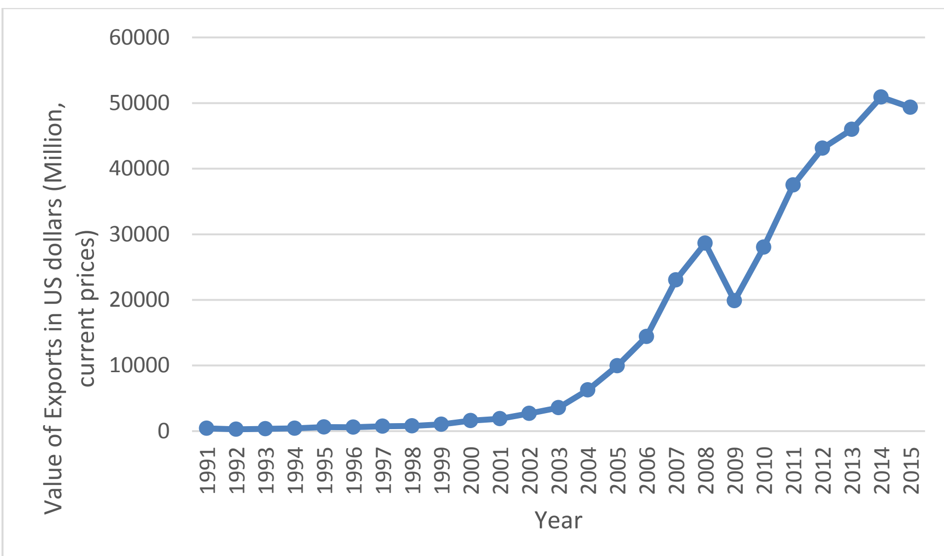


Figure 6. Automotive Products Exports from China (Millions of Dollars)[222]



221 Adapted from Thun, *Changing Lanes in China: Foreign Direct Investment, Local Governments, and Auto Sector Development*, 53.

222 Adapted from "Merchandise Trade by Commodity," World Trade Organization Time Series in International Trade, accessed August 21, 2017, http://stat.wto.org/StatisticalProgram/WSDBStatProgramHome.aspx?Language=E.

To balance protecting domestic industries and liberalizing the automotive industry, Hsueh notes that the government encouraged FDI, but put in place restrictions.[223] According to Hsueh, foreign investors were limited on how many joint ventures they could have ownership in, along with how many were allowed to receive FDI. The government aimed to promote domestic industry by, at times, limiting the scope of FDI into the automotive sector, while trying to still acquire FDI for foreign technology and information.[224] Even with these restrictions in place, foreigners entered the market and, in the 2000s, "[F]oreign-invested automobile joint ventures made up 75 percent of the domestic market in sales."[225] When Western automobile companies found it difficult to sell their products on the Chinese market because of high taxes and fees, they would establish joint ventures in China, which in turn allowed China to reap the financial and technological benefits.[226] These economic policies demonstrate how China sought to improve its domestic industries, while still promoting joint venture opportunities; China has been able to adapt new technology and methods, accomplishing this balance through the regulation of FDI. Arguably, China hopes to compete on the global front and advance its automotive industry to compete with top U.S. and European car companies.

Through the development of its automotive industry, China is gradually phasing out foreign automobile competitors, while absorbing their technology. The Chinese government launched a "Made in China 2025" initiative, aimed at promoting high-technology industries and switching over to domestic brand production.[227] In 2016, China sold more than 28 million automobile units and as part of the 2017 "Automobile Mid and Long Term Development Plan," China aims to further increase its production of new energy vehicles (NEVs) by setting quotas for foreign and domestic companies.[228]

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[223] Hsueh, *China's Regulatory State: A New Strategy for Globalization*, 219.

[224] Ibid., 217.

[225] Ibid.

[226] Craig Cole, "Chinese Automakers Could Seriously Shake up the Auto Industry," AutoGuide, February 4, 2017, http://www.autoguide.com/auto-news/2017/02/when-will-chinese-vehicles-make-it-to-the-u-s-.html.

[227] U.S. Department of Commerce's International Trade Administration, "China–Automotive Industry," July 14, 2017, https://www.export.gov/article?id=China-Automotive-Components-Market.

[228] Ibid.

Recently, China has started to produce high-quality vehicles such as electric buses that it now sends to the North American market; eventually, to advance its economic status in the international community, China needs to develop autonomous vehicles.[229] Apart from vehicles, China also aims to increase production quality of automotive components such as NEV engines and testing equipment.[230] As of 2015, foreign firms in the form of JVs and wholly foreign-owned enterprises (WFOEs) produced the majority of automotive parts.[231] Currently, however, more domestic Chinese firms are learning from their foreign partners and becoming self-sustainable and competitive in automotive parts production. To encourage internal development, the government provides subsidies to domestic NEV producers.[232] In 2017, the state released the "Plan of Promoting Vehicle Power Battery Industry Development," which involves bringing in foreign research and development facilities to assist with developing the domestic lithium-ion battery industry.[233] Furthermore, China is phasing out foreign competition by implementing the "Luxury Car Consumption Tax" in 2016.[234]

The government has utilized its regulatory mechanisms in order to promote certain automotive firms by incentivizing foreign firms to pair up with domestic companies in joint ventures.[235] According to Thun, China desires First Auto, Dongfeng, and Shanghai to become prominent automotive industries in the future; therefore, the state has strategically aligned these industries with foreign companies. By imposing strict regulations, the author explains, on licensing and forcing mergers, the government discourages smaller companies from gaining influence, thereby leaving their favored

[229] Cole, "Chinese Automakers Could Seriously Shake Up the Auto Industry."

[230] U.S. Department of Commerce's International Trade Administration, "China–Automotive Industry."

[231] EU SME Centre, "The Automotive Market in China," 2015, https://www.ccilc.pt/sites/default/files/eu_sme_centre_sector_report_-_the_automotive_market_in_china_update_-_may_2015.pdf. "The Automotive Market in China," 13.

[232] U.S. Department of Commerce's International Trade Administration, "China–Automotive Industry."

[233] Ibid.

[234] Ibid.

[235] Thun, *Changing Lanes in China: Foreign Direct Investment, Local Governments, and Auto Sector Development*, 68-9.

companies at an advantage. Through these regulatory measures, the government sets up the economy in such a way that funnels FDI into its preferred companies, even within the same sector, such as automotive.

In order to amass foreign equipment, China encourages countries to share their technology by granting market access in exchange.[236] For example, the Specialty Equipment Market Association (SEMA) encourages U.S. specialty auto parts companies to invest in China.[237] While China agreed to grant General Motors (GM) the joint venture contract, in return, it has demanded GM share general spec model drawings and its computer-assisted—also known as computer-aided—design (CAD) capability.[238] China's acquisition of foreign equipment with the help of foreign investors has allowed it to pursue a path of self-sustainability and the development of advanced technology.

2. Information and Communications Technology (ICT) Sector

After 2001, China lessened its restrictions to adhere to international quotas set by the WTO, which resulted in increased inflows of FDI toward the ICT sector. In 2005, China eliminated tariffs on over 250 ICT items.[239] As a result, Mu Zi reports, FDI began to pour into China to support the ICT industry: between 2001 and 2006, China received approximately $100 billion for the ICT-related manufacturing industry. In that same time period, Mu Zi notes, sales of ICT products in China increased six-fold to reach $3.84 trillion, and exports increased by five times to $520 billion. Between 1996 and 2014, China's ICT trade increased from $35 billion to $329 billion.[240] Figures 7 and 8 illustrate

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[236] Ibid., 63.

[237] U.S. Department of Commerce's International Trade Administration, "China–Automotive Industry."

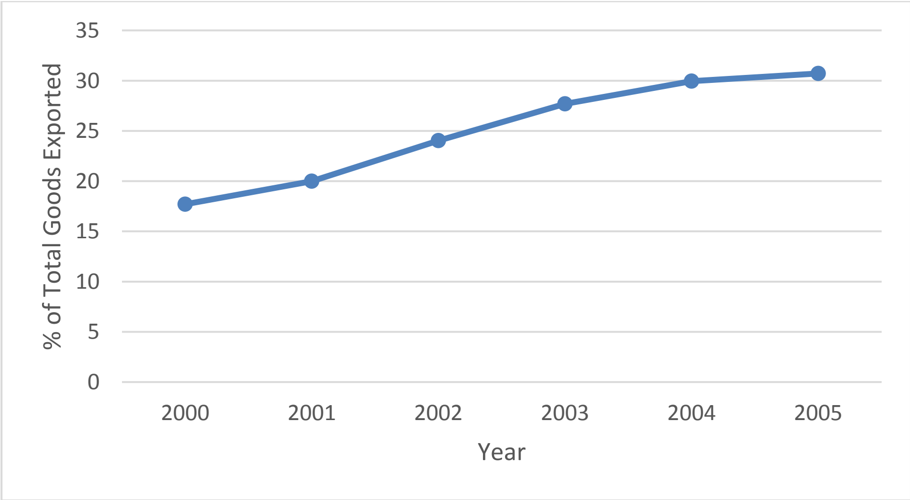
[238] Thun, *Changing Lanes in China: Foreign Direct Investment, Local Governments, and Auto Sector Development*, 68.

[239] Mu Zi, "Joining WTO boosts technology sector," China Daily, North American ed., December 12, 2006, https://search.proquest.com/asianeuropeanbusiness/docview/258053022/D065054DB6F8498EPQ/5?accountid=12702Mu Zi, "Joining WTO boosts technology sector."

[240] Dan Steinbock, "Climbing the ICT ladder," The China Business Review, March/April, 2007. https://search.proquest.com/asianeuropeanbusiness/docview/202689131/D065054DB6F8498EPQ/15?accountid=12702.

the growing prioritization of the ICT industry by the Chinese government.[241] According to Figure 7, in 2000, ICT exports accounted for 17.71 percent of the total goods export from China.[242] After China joined the WTO, the state acquired more money through FDI, which was channeled toward the ICT sector. By 2005, the World Bank reports that ICT exports made up 30.72 percent of total exports. Figure 8 shows that telecommunications, computer, and information services exports increased from $1.701 billion in 2000 to $25.425 billion in 2016.

Figure 7. Information and Communications Technology (ICT) Exports[243]

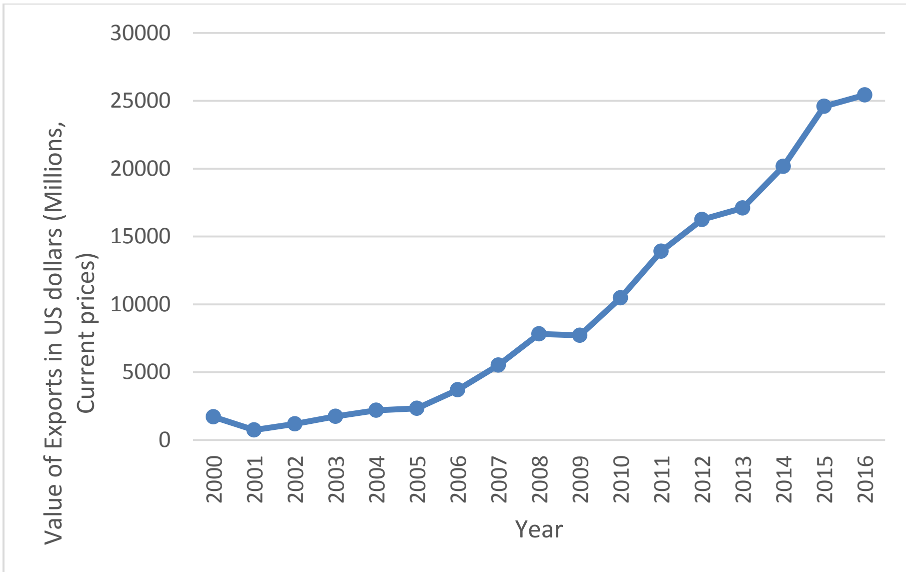


241 "ICT goods exports (% of total goods exports)," The World Bank, 2007, http://data.worldbank.org/indicator/TX.VAL.ICTG.ZS.UN?end=2015&locations=CN&start=2000&view=chart.

242 Ibid.

243 Adapted from "ICT goods exports (% of total goods exports)."

Figure 8. Telecommunications, Computer, and Information Services Exports from China (Millions of Dollars)[244]



Upon joining the WTO, China has had to balance opening up its strategic industrial sectors to FDI and preserving its national security and economic self-sufficiency. The Chinese government strongly promotes the indigenous development of the ICT sector, as it is a high-value added sector of the economy. To accomplish development of this strategic sector, the state is investing in ICT technology and also restricting foreign imports. Meanwhile, policies under the WTO ensure that China still pursues openness and welcomes FDI and foreign companies on the mainland.

While the presence of foreign companies poses a threat to Chinese domestic firms, the Chinese government continues to use the WTO guidelines to its advantage by absorbing foreign technology and capital. The government is thereby directing FDI toward strategic sectors of the economy such as ICT development. Simultaneously, China

244 Adapted from "Trade in Commercial Services, 1980-2013 (BPM5)," World Trade Organization Time Series in International Trade, http://stat.wto.org/StatisticalProgram/WSDBStatProgramHome.aspx?Language=E, accessed 21 August 2017; "Trade in Commercial Services, 2005-onwards (BPM6)," World Trade Organization Time Series in International Trade, accessed August 21, 2017, http://stat.wto.org/StatisticalProgram/WSDBStatProgramHome.aspx?Language=E.

has an interest in protecting its national security by limiting the exposure of certain aspects of its strategic industries to the outside world. China mitigates foreign involvement in the ICT sector by imposing barriers that protect the integrity of its systems and ensure cyber and intelligence security.[245] Meanwhile, foreign nations question China's intentions and whether it can uphold its end of the bargain in ensuring that cybersecurity regulations meet WTO standards.

As part of China's strategy to develop its domestic technology through the "Made in China 2025" initiative, China continues to improve its information and communications technology (ICT) industry, claiming status as "the world's second largest ICT market."[246] ICT technology includes the following sectors: mobile Internet, cloud computing, Big Data, Internet of Things (IoT), and telecommunications. While the state incentivizes domestic ICT development through different action plans, it continues to dissuade foreign companies from taking full part through restrictive measures such as the 2016 Cybersecurity Law; Huawei and Zhongxing New Telecommunications Equipment Co., Ltd (ZTE) are domestic Chinese telecommunications companies that have flourished in this new environment.[247] The development of ICT serves a dual-purpose in the political economic landscape of China, hence, the government insists on regulating this sector, while strategically disseminating FDI.

As China absorbs foreign technology, it will be more capable of becoming a self-sustainable ICT producer in certain sub-sectors. In order to achieve its goals, China accepts FDI as a necessary step leading to eventual autonomous production in the ICT sector. China has attempted to protect its national security in critical industries such as ICT by enforcing stricter rules on foreign firms in the form of limited market access and acquisition of intellectual property and source code.[248] Through this limited intervention, China seeks to both protect its national security interests and receive foreign support to

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[245] U.S. Department of Commerce's International Trade Administration, "China –Technology and ICT," July 25, 2017, https://www.export.gov/apex/article2?id=China-Technology-and-ICT.

[246] Ibid.

[247] Ibid.

[248] U.S. Department of Commerce's International Trade Administration, "China – 4 – Industrial Policies."

develop its domestic industries. In essence, China pressures foreign companies to reveal sensitive information about their business practices and technology, so they can later implement reverse engineering measures.[249]

Through the undertaking of high technology projects in its urban environment, China works to advance its economic prowess. China has prospects for creating the Internet of vehicles (IoV), demonstrating the connection between the high technology automotive and ICT sectors.[250] Additionally, China is encouraging FDI in its "Smart Cities," which regulate urban environment from cameras to electric grids through integrated technology.[251] The Chinese government is ambitious to expand its high-technology sector with the help of foreign investment, encouraging imports and capital support. With foreign investment, China desires to transform infrastructural activity and public services into technologically-dominated systems, fueling the vision of smart cities.

3. Semiconductor Manufacturing Sector

Throughout the 1980s and 1990s, China's semiconductor industry was still in its early development stages as Chinese businesses imported semiconductor lines and manufacturing-on-silicon (MOS) lines from overseas companies.[252] After China joined the WTO, the government was pressured by international parties to open up its semiconductor industry. Per the Information Technology Expansion Agreement, foreign companies were entitled to duty-free access in many of China's semiconductor industries.[253] Understanding the economic benefit of absorbing foreign technology and practices, China utilized FDI to encourage research and development in the semiconductor industry. China quickly developed its semiconductor sector, reaching

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[249] Ibid.

[250] U.S. Department of Commerce's International Trade Administration, "China –Technology and ICT."

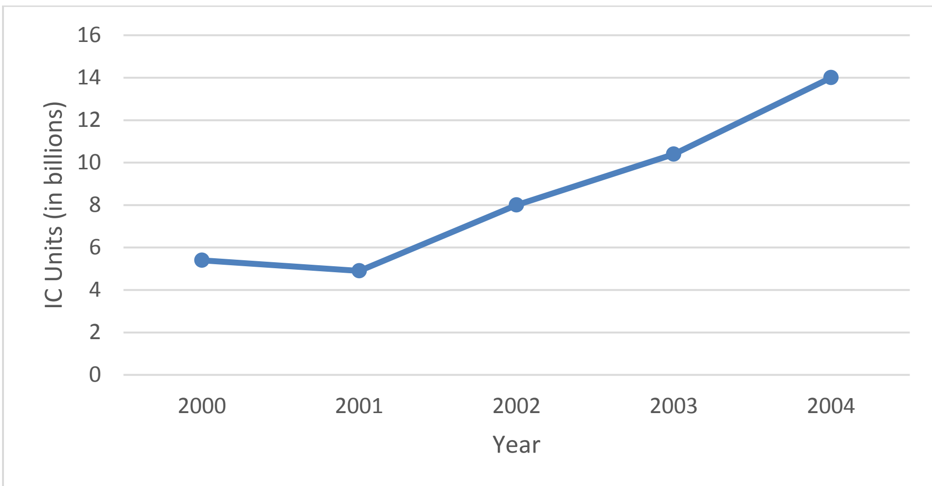
[251] Ibid.

[252] William W. Keller and Louis W. Pauly, "Building a Technocracy in China: Semiconductors and Security," in *China's Rise and the Balance of Influence in Asia*, ed. William W. Keller and Thomas G. Rawski (Pittsburgh, PA: University of Pittsburgh Press, 2007), 49.

[253] U.S. Department of Commerce's International Trade Administration, "China –Technology and ICT."

unprecedented success by 2005.[254] By 2007, Keller and Pauly note, China focused on developing the microelectronics sector and sought to further develop semiconductor integrated circuits (ICs). Figure 9 illustrates the rapid growth of the semiconductor industry after joining the WTO by detailing trends in IC production; between 2000 and 2004, IC output nearly tripled and has since maintained an upward growth trajectory. Figure 10 shows how the value of IC and electronic components exports from China increased from $128 million in 1990 to approximately $105.28 billion in 2015; the majority of the growth occurred after 2001.

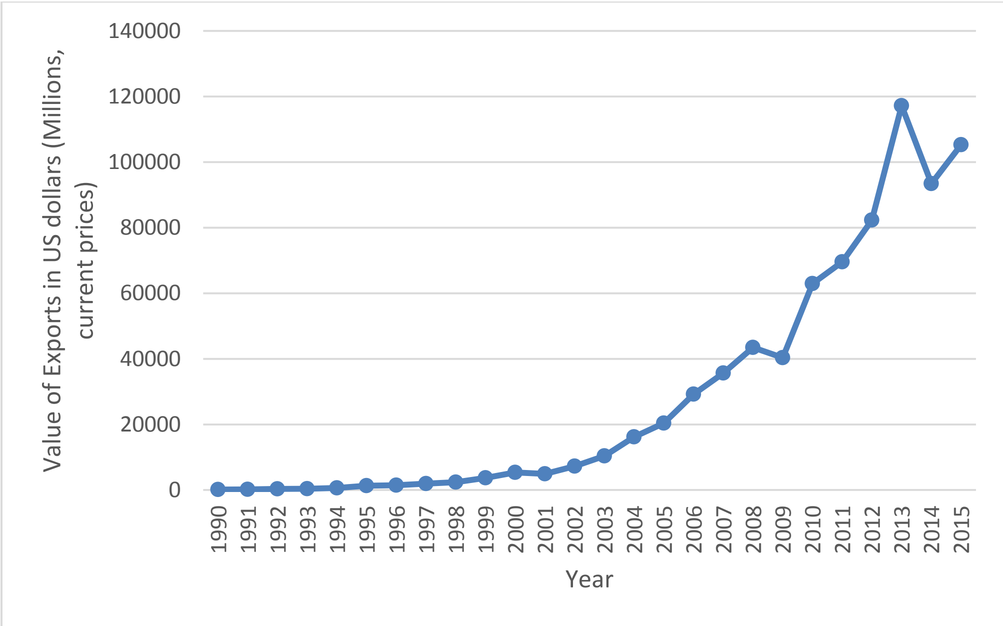
Figure 9. Integrated Circuit (IC) Production in China[255]



[254] Keller and Pauly, “Building a Technocracy in China: Semiconductors and Security,” 49-50.

[255] Adapted from Keller and Pauly, “Building a Technocracy in China: Semiconductors and Security,” 51.

Figure 10. Integrated Circuits and Electronic Components Exports from China (Millions of Dollars)[256]



The Chinese government made the semiconductor industry a priority for economic development and recognized the importance of effectively utilizing FDI to attain its success. To develop the semiconductor industry, the state provided incentives and channeled capital toward domestic companies producing semiconductors and semiconductor manufacturing equipment.[257] By 2004, the government established over 150 design houses for IC analysis tools.[258] China, according to Keller and Pauly, continues to use the resources gained from foreign technology transfers and foreign investment to develop its own domestic industry, accomplishing such progress through reverse engineering and absorption of new design techniques. With the help of the National Science Foundation, China is transitioning from injecting FDI into low-cost manufacturing and steering it toward research and development (R&D); many any

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[256] Adapted from "Merchandise Trade by Commodity," World Trade Organization, Statistics Database, Time Series in International Trade, accessed August 21, 2017, http://stat.wto.org/StatisticalProgram/WSDBStatProgramHome.aspx?Language=E.

[257] U.S. Department of Commerce's International Trade Administration, "China –Technology and ICT."

[258] Keller and Pauly, "Building a Technocracy in China: Semiconductors and Security," 55.

industries, including Huawei in the Shenzhen SEZ have improved their capabilities in IC tool production.[259] China's strategy to develop its domestic semiconductor industry is part of the Made in China 2025 Initiative. As China works to develop its high-technology sectors through the encouragement of FDI, the government focuses on educating its own populace in technological knowledge domestically and by sending them to study abroad, along with bringing in field experts from overseas.

China's development of its semiconductor industry serves a dual-purpose because it not only benefits the economy, but also the military. The People's Liberation Army (PLA) is benefiting from the import of microelectronics technology because it can restructure the purpose and use it toward electronic warfare capabilities such as command and control, advanced weapons systems, and radar and antisatellite technology.[260] Hence, the semiconductor industry plays a national strategic role in China.

While China prioritized the domestic development of chips for semiconductors, it has faced many challenges; China finds it more difficult to rise up in the high value-added chain than when it worked with other nations as part of a supply chain network. Keller and Pauly explain that the state set quotas for domestic Integrated Circuit production that it wanted to reach by 2010, resulting in increased regulation of strategic sectors of the economy.[261] China's goal, the authors continue, has been to become an integrated device manufacturer (IDM) and domestically produce the chips used to create the semiconductors; this would allow them to produce a final product, along with the parts used in its assembly. China, however, had to put its main objective on the back burner in exchange for faster production and export of semiconductors. In 2000, instead of pursing the IDM model, the authors explain that China contracted out microchip production to Taiwanese foundries that set up semiconductor fabrication facilitates on the mainland, further delaying their ultimate goal of self-sustainability. At the same time, China knew it had to keep bringing in foreign technology to make these domestic advancements, and the nation has been able to acquire new manufacturing technology

[259] Ibid., 48-9, 55, 58.

[260] Ibid., 53–4.

[261] Ibid., 50.

through the foundries. By 2002, Chinese foundries were growing in scope and were exporting microchips, even though they were low in quality. Companies in the United States, Japan, and Europe were also providing China with technologies to assist with its development.[262] Gradually moving toward its goal of self-sustainability, China faces obstacles as it has to consider the importance of long-term economic growth over short-term profits.

D. CHINESE GOVERNMENT FDI APPROACH IN THE 2000s

China aims to become a producer of high value-added sector goods and services, and not simply an intermediary in a multi-step process.[263] From 1989 to 2005, China's exports of high-technology goods increased from less than $2 billion to almost $220 billion.[264] In the mid-2000s, China realized its immense disadvantage in the high value-added sector.[265] Foreign companies, Bergsten et al. argue, were establishing wholly foreign-owned enterprises in China and importing equipment for assembly, which left Chinese businesses out of the supply chain in high technology sectors such as semiconductors, microprocessors, and computers. Amidst challenges such as intellectual property protection and weak legal institutions, China began to pursue a policy of becoming a developer of high-tech components.[266]

China has been proactively building up its innovation capabilities and has been achieving results in research and development.[267] It still, however, faces challenges in its production of high quality products without the financial help of foreigners; this challenge is evidenced in its automotive industry, along with consumer electronics and

262 Ibid., 54.

263 Kroeber, *China's Economy: What Everyone Needs to Know*, 56.

264 Fred C. Bergsten, Bates Gill, Nicholas R. Lardy, and Derek Mitchell, *China: The Balance Sheet: What the World Needs to Know Now About the Emerging Superpower* (New York, NY: PublicAffairs, 2006), 100.

265 Ibid., 106.

266 Ibid., 107.

267 Anil Gupta and Haiyan Wang, "How China's Government Helps—and Hinders—Innovation," Harvard Business Review, November 16, 2016, https://hbr.org/2016/11/how-chinas-government-helps-and-hinders-innovation.

aviation.[268] The Chinese, Kroeber notes, have had more success in producing simpler products such as telecommunication and automotive equipment. As of 2016, even though China has exported over 40 percent of consumer electronics, it has not reached the capability of designing software and integrated circuits. Hence, the domestic firms that supply electronics, are considered sub-par in quality and produce goods that people settle for when they cannot afford the latest technological brands.[269] China finds itself at the point in its economic trajectory where it needs to pursue creative adaptation, through which it can develop new innovative technologies using available foreign technology, without necessarily having to entirely reverse engineer and create a replica through creative imitation.[270]

China's government directly intervenes in business practices to promote certain industries over others, while still maintaining a free market framework. Arguably, China will continue to promote its domestic high-technology to become more competitive on a global scale, in sectors such as automotives; due to its reliance on foreign technology transfer, it will take time for China to phase out FDI and become completely autonomous. Even with the move toward the favoring of SOEs, China is still bringing in troughs of FDI.[271] With the help of FDI, China has already learned from foreign businesses how to impose quality control, utilize new technology, and adhere to practices that are more efficient in the long-run. These developments have allowed China to pursue growth of the automotive industry and expand domestic companies abroad.[272] China's efforts to consolidate automobile firms to form strong enterprise groups are in line with their state policy, referred to as *jituan gongsi* or *jituan qiye*.[273]

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[268] Kroeber, *China's Economy: What Everyone Needs to Know*, 57-8.

[269] Ibid, 58-9.

[270] Tai Ming Cheung. "The Chinese Defense Economy's Long March from Imitation to Innovation," Journal of Strategic Studies 34, no. 3 (June 2011): 328, doi: 10.1080/01402390.2011.574976.

[271] Kroeber, *China's Economy: What Everyone Needs to Know*, 49.

[272] Brandt, Rawski, and Xiaodong Zhu, "International Dimensions of China's Long Boom," 38.

[273] Thun, *Changing Lanes in China: Foreign Direct Investment, Local Governments, and Auto Sector Development*, 7.

China still faces a growing challenge in its continued pursuit of high-value added manufacturing because of its weak legal framework and restrictive environment, which negatively affect investor confidence. The nation's stated policy goals do not entirely align with its actions.[274] Gupta and Wang argue that while the state aims to improve the high technology sector, it also seeks to preserve its political legitimacy through restricted information and media access. China also focuses on quantity over quality in development, and lacks a mechanism to protect intellectual property, dissuading foreign companies from pursuing innovation. The state is on an upward trajectory, the authors relate, when it comes to amassing foreign technology, but it must also take into consideration that foreign partners in joint ventures will not be able to produce the latest technology if their efforts are stifled by fear over a weak legal system that favors SOEs and party interests. As China continues to regulate its high technology sectors, it must keep in mind that foreign firms need to have flexibility in their work environment if they are to pursue innovation and remain motivated to develop their projects in China.

By examining China's economic development patterns, trends demonstrate that the state is focusing on building up its automotive, ICT, and semiconductor industries in order to expand economically, while also improving defense capabilities. The government is prioritizing strategic electronic sectors of the economy such as telecommunications, semiconductors, and computers in order to become a strong economic player on the international arena, achieve self-sustainability, and build up its defense posture. Through FDI and the acquirement of foreign technology, China will learn new methods and practices from foreign countries, and continue to funnel investment toward the education of its people in science and engineering disciplines.

China still faces slower economic growth, putting into question its ability to sustain its upward trajectory.[275] Due to regulatory measures that promote SOEs to support the national security interests of the Chinese Communist Party (CCP), foreign investors feel as though they are at a disadvantage in China's current business

[274] Gupta and Wang, "How China's Government Helps –and Hinders—Innovation."

[275] U.S. Department of Commerce's International Trade Administration, "China—Market Overview," July 14, 2017. https://www.export.gov/article?id=China-Market-Overview.

environment.[276] As China's reforms from the past few decades become overshadowed by increased state-led regulation, many foreign nations believe China will not be able to sustain its economic growth. Besides the "Made in China 2025" initiative, China has also implemented the 13th Five Year Plan to promote domestic industry development; these measures further discourage foreign investors due to added restrictions and discriminatory practices.[277] Nevertheless, FDI continues to grow in China and policies such as the FIC and WTO oversight ensure that China is headed in the direction of transparency and economic liberalization. While some of these recent initiatives have been modest in opening up the economy to FDI, Chinese leadership has recently expressed the need for further reform and liberalization policies.[278] According to recently stated party goals, the CCP intends to continue promoting socialism with market-oriented economic policies.

At the 19th Party Congress that took place in October 2017 in Beijing, Xi Jinping announced the platform of the CCP and expanded on previously set economic goals. According to Xi Jinping, the government must focus on improving the standard of living of the Chinese people and leveling the playing field by developing additional areas of China.[279] As China started on its path toward economic development, the government focused mainly on coastal cities. With the rise of inequality that threatens the stability of the regime, Xi Jinping is making it a priority to develop rural areas of China and develop inland infrastructure through projects such as the One Belt, One Road Initiative (OBOR).

Through the Congress, Xi Jinping cemented his influence in China. The leader's name was added to the CCP charter, referring to his political thought: "Xi's Thought on

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276 Ibid.

277 U.S. Department of Commerce's International Trade Administration, "China – 0 - Executive Summary," July 25, 2017. https://www.export.gov/article?id=China-0-Executive-Summary.

278 Koty and Zhou Qian, "China's 2017 Foreign Investment Catalogue Opens Access to New Industries."

279 Zheping Huang, "All the buzzwords Xi Jinping added to the Chinese Communist Party's constitution," Quartz, October 25, 2017, https://qz.com/1111474/chinas-19th-party-congress-all-the-buzzwords-xi-jinping-added-to-the-chinese-communist-partys-constitution/.

Socialism with Chinese Characteristics for a New Era."[280] Through his ideology, Xi seeks to continue promoting socialism in China, while maintaining a market-oriented economy. According to Phillips, he looks to the achievements of the CCP, and desires to build on them. China's leader is determined to develop their economy and have the nation assert itself on the international stage, becoming a global leader. In order to achieve this "China Dream" of leadership, China aims to have achieved environmental improvements, reductions in inequality, and socialist modernization by 2035.[281] China's growing influence poses a threat to western concepts of democracy because China is promoting an alternative path toward development and nation-building.

In the 1980s, China began taking in FDI as government policies encouraged free market practices. Industries gained access to foreign investments and used them to develop mostly non-strategic sectors of the economy, such as textiles. In the 1990s, FDI inflows increased dramatically, and FDI allocation evolved to cover strategic sectors such as telecommunications. By the 2000s, FDI inflows increased even further because of China's accession into the WTO and the nation's stagnating economic growth. In an effort to preserve state legitimacy and develop dual-purpose industries advancing national security objectives, China encouraged FDI inflows and asserted its intent of eventually becoming self-sufficient. Hence, FDI inflows continued to increase, amidst the movement toward indigenous innovation, seeing as China had been implementing a long-term strategy to first acquire as much FDI as possible before it began decreasing its dependence on foreign support. With this new strategy in mind, the Chinese government began allocating more FDI toward high-technology and innovative sectors, moving away from manufacturing capabilities and into services functions.

280 Tom Phillips, "Xi Jinping becomes most powerful leader since Mao with China's change to constitution," The Guardian, October 24, 2017, https://www.theguardian.com/world/2017/oct/24/xi-jinping-mao-thought-on-socialism-china-constitution.

281 Zheping Huang, "Your five-minute summary of Xi Jinping's three-hour Communist Party congress speech," Quartz, October 18, 2017, https://qz.com/1105337/chinas-19th-party-congress-your-five-minute-summary-of-xi-jinpings-three-hour-speech/.

V. CONCLUSION

Through the examination of four potential explanations on the relationship between government policy and FDI attraction, this thesis answers the following question: "How has the pattern of reform and reversal over China's contemporary economic trajectory affected the volume of FDI flows and, in turn, their broader economic outcomes?" After thorough analysis of three distinct time periods in Chinese history—1978 to 1989, 1989 to 2001, and 2001 to present day—this thesis presents evidence indicating that government policies attracted FDI over these three time periods. In addition to the volume of FDI increasing, allocation of foreign investment shifted across different sectors of the economy in favor of evolving government priorities.

From 1978 to 1989, the Chinese government funneled FDI into non-strategic sectors, such as textiles, to improve its economic standing as an export-oriented nation of manufactured goods. Between 1989 and 2001, the government shifted its focus and began channeling FDI into strategic economic sectors, such as telecommunications, to advance dual-purpose technology and gain acceptance into the World Trade Organization (WTO). Finally, between 2001 to the present day, in the midst of slowing economic growth and the looming threat of the middle income trap, the Chinese government began redirecting FDI to support the advancement of high technology sectors and high value-added production to advance dual-purpose technology and domestic development. Thus, research evidence supports the second hypothesis, indicating that government reforms have both increased the level of FDI and, through specific policy measures, increased the effectiveness of FDI allocation throughout the economy, in fulfillment of state priorities.

The Mao era left China in an untenable economic position. In 1978, Deng Xiaoping introduced economic reforms that have allowed China to industrialize and join the global economic community. These reforms included decentralization, decollectivization, the establishment of special economic zones (SEZs), the dual-track system, the creation of township-village enterprises (TVEs), and the privatization of non-strategic sectors. China channeled FDI to develop manufacturing industries, such as textiles, allowing it to pursue export-oriented growth. Decentralization allowed for the establishment of the special economic zones, where Chinese businesses formed joint ventures with foreign firms. By the 1990s, the government instituted policies such as recentralization, state-owned enterprise (SOE) reform, legal reform, fiscal reform, privatization of more non-strategic sectors, and greater government support of strategic and dual-purpose sectors. These policies attracted FDI, which propped up additional sectors of the economy such as telecommunications. In the 2000s, the Chinese realized they needed to transition into innovation fields to boost economic growth, so they began to promote joint ventures in automobile and high-technology manufacturing. Government policies included the establishment of free economic zones (FEZs), fiscal reform, the Made in China 2025 Initiative, the Harmonious Society, Indigenous Innovation, and tailored government intervention in strategic sectors.

Due to economic reforms that started in 1978, FDI inflows into China rose significantly; from 1982 to 2013, FDI increased from $636 million to over $290 billion.[282] The government strategically channeled FDI to develop sectors that state officials believed would most significantly benefit China's economy. Their decision-making was based on the demands of the international community, and the nation's maturing status in the international order. Additionally, officials took into consideration the state of the domestic economy and the direction of market forces. Government reforms attracted FDI inflows, and government priorities were reflected in the evolving allocation of FDI into different sectors of the economy.

A. EVOLUTION OF GOVERNMENT POLICY AND FDI

The role of FDI has changed since the inception of economic reforms in 1978, designed to increase China's production of cheap manufactured goods. From 1978 to 1989, China focused on developing its low-skilled manufacturing sector as part of a plan to increase its economic growth. State policies, such as the creation of the special economic zones, allowed foreign investment vehicles to channel funds into its manufacturing sector. The government used its available resources, such as manpower, to

[282] "Foreign direct investment, net inflows (BoP, current US$)," The World Bank, accessed August 28, 2017, http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD.

promote assembly-line industries. Consequently, the success of manufacturing industries, such as textiles, encouraged China to export cheap material goods to other countries. People were eager to get involved with new business ventures and develop private enterprises to facilitate production of consumer items. Table 1 presents a concise summary of the research findings of this thesis.

Table 1. Summary of Findings

	Government Policies	**FDI Deployment in Economy**	**Government Priorities**
First Time Period **1978–1989**	Decentralization, decollectivization, SEZs, dual-track system, TVEs, privatization of non-strategic sectors	Mostly non-strategic sectors, i.e., textiles	Economic growth, export-oriented trajectory
Second Time Period **1989–2001**	Recentralization, SOE reform, legal reform, fiscal reform, privatization of more non-strategic sectors, more government support of strategic sectors, dual-purpose sectors	Mainly strategic sectors, i.e., telecommunications	Dual-purpose technology, acceptance by international community
Third Time Period **2001–Present**	FEZs, fiscal reform, Made in China 2025 Initiative, Harmonious Society, Indigenous Innovation, tailored government intervention in strategic sectors	Mostly high value-added sectors, i.e., ICT, automobiles, and semiconductors	Need for continued economic growth, avoidance of middle income trap, infrastructural development, bridging of inequality gap, dual-purpose technology, self-sustainability/domestic development, regime legitimacy

Between 1989 and 2001, the government reshaped its policies in light of the Tiananmen Square social protests and economic inefficiencies in the form of non-performing loans and struggling bank funds. As factories were built and SEZs introduced foreign investors, the government continued to embody remnants of the planned economy, such that it would bail out state owned enterprises if they were inefficient, resulting in what Naughton refers to as "reform without losers."[283] People and companies were compensated for their losses, resulting in inefficiencies. As a result of masking these inefficiencies, inflation increased and people's standard of living was threatened because the prices on imported goods rose, thereby affecting "the finished product on the Chinese market."[284] This increase in prices became a problem because if it takes a lot of money to produce goods because of expensive prices on imported raw materials, the marginal gain becomes minimal once the goods are exported. In addition to marginal gains from exports, many foreign companies were also being disincentivized from investing in China because of its weak legal institutions, the entry and exit restrictions, and rising costs.[285] Frustrations among the people of China led, in the late 1980s, to the Tiananmen Square protests, during which students congregated to express grievance over rising inflation and economic inefficiencies. The government responded by massacring the protesters and reversing reforms in the 1990s. Following this period of retrenchment, Deng Xiaoping set off on his Southern Tour and was able to reintroduce market reform strategy and a call for foreign investment. Consequently, FDI took off after 1992 and joint ventures flooded the Chinese market. With national security interests in mind, the state began to channel its investments into the development of the telecommunications sector.

By the time China joined the WTO in 2001, it was already on a path to expand its investment portfolio and invite FDI into the services economy. China's strategy for channeling investment evolved as the nation consciously developed its own domestic industry and phased out foreign capital shares. China wanted to improve the services

[283] Naughton, *The Chinese Economy: Transitions and Growth*, 91.

[284] Harding, *China's Second Revolution: Reform after Mao*, 161.

[285] Ibid.

industry with the help of foreign funds, technology, and education, so that it could eventually develop solely domestic industries in this sector. China has continued to gradually phase out FDI and promote domestic development. Meanwhile, China realizes that it can only accomplish this goal of self-sustainability if it continues to adapt methods of foreign technology and channel the FDI properly to develop its industries.

From 2001 to the present day, the government realized the need to develop its ICT and high technology sectors. China opened up its economy more to international influences such as the WTO. Over time, China grasped the reality that if it wanted to be a vital player in the international market scene and uphold its status as a strong power, it needed to expand its development into the services and high technology sectors. This realization was amplified as China's economic growth has begun to slow down in the last few years, prompting officials to reevaluate their production priorities and emphasize preserving regime legitimacy. Hence, the state began to funnel more money from foreign investment vehicles and expand joint enterprises to automotive, semiconductors, and other high technology industries. Through this strategy, China hopes to acquire enough knowledge from foreign companies to be able to fully adapt their practices and begin to innovate technological products through domestic firms.

B. FUTURE PROSPECTS

Since joining the WTO, China has continued to implement economic reforms to strengthen its institutions and make its environment more attractive to foreign investors. Nevertheless, China has been notorious for taking too long to follow through with reforms that have been instituted by international economic organizations, such as the WTO. Moreover, the lack of speed points to deeper fear of losing control of the nation's economic trajectory, which the government fears is a threat to political stability and the legitimacy of the Chinese Communist Party (CCP). In recent years, economic growth has slowed down in China, causing it to reevaluate its priorities and change the direction of its FDI. As noted, in the past, China invested in heavy industry and low-skill manufacturing; however, if China wants to sustain its high economic growth, then it must transition into high value-added production. Hence, the Chinese government is working to use the FDI in the form of capital and foreign technology to build up its own arsenal of high-technology sectors. Over time, China may phase out FDI in certain sectors of the economy until it is self-sustainable in top-tier production, but for now, China is funneling FDI into these high-technology fields.

As China's economic influence in the Asia-Pacific region and world increases, the international community is faced with new challenges. It is uncertain whether China will challenge the global order and pursue revisionist policies to assert itself as a hegemonic power, or if the nation will continue to maintain the status quo. Through the evaluation of government policy, we can better understand how government priorities are reflected in the economic landscape of a nation. In China's case, the government went from prioritizing economic growth in the 1980s to economic growth combined with the advancement of national security objectives in the 1990s. Finally, in the 2000s, the government shifted its focus toward innovation and technological capabilities, in an effort to preserve state legitimacy. Additionally, China wants to develop its internal infrastructure and industry to bridge the inequality gap, and further quell any potential for uprisings that could challenge the regime. Overall, China hopes to become self-sustainable in the future as part of an effort to assert its prestige on the international stage, demonstrate the strength of the CCP regime to the population, and amplify its economic growth before it stagnates. As China focuses on dual-purpose economic development, it also promotes the military-industrial complex, building up its security posture. Through the continued study of economic trends and patterns, we can better articulate China's government priorities and understand the greater implications of its decision-making strategy.

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