China's Foreign-Investment Schizophrenia

By Peter Kwok and William Overholt

HONG KONG — China's economic revolution has many achievements: high growth rates, high agricultural production, an increase in rural living standards, and exports of consumer goods. Some of these, especially the agricultural reforms, have so far been so successful that they are politically irreversible. Nonetheless, the economy has now encountered major problems: excessive and often nonproductive investment, a profusion of Point schemes, an explosion in the money supply, shortages caused by abortive price reforms, a decline in foreign reserves, and corruption.

These difficulties have curtailed major reforms and created a titanic political struggle. On one side are the politics of hope, which seek gain by taking risks, becoming more open and market-oriented in the manner of Yugoslavia and Hungary and borrowing ideas from South Korea and Taiwan. On the other side are the politics of fear, which would avoid the risks of inflation, shortages, inequality and debt by retaining bureaucratic controls and moving China toward a form of industrial Stalinism.

Investment Climate

Nowhere is this dilemma clearer than in Chinese policies toward foreign investment. On one hand, China has opened its doors to foreign investment, establishing special economic zones and improving its legal codes. On the other hand, China has policies far more attractive to foreign investment.

Outside the oil sector, China hasn't attracted massive foreign investment. From 1979 through 1984, total foreign investment was $1 billion. ($1.2 billion was "pledged," but only $1 billion was actually used.) Of that, $1.3 billion went to offshore oil and $2.4 billion came from overseas Chinese. Western new-oil investment in China during those five years was a fraction of Western investment in Brazil during one good year.

Why do foreign investors invest in China? The potential attractions are low production and transportation costs thanks to China's cheap labor and proximity to Asian markets; secure raw materials; a favorable investment climate; and access to China's domestic market.

In truth, however, China-based industries face low labor productivity, numerous roadblocks to transportation and communications networks, and extremely high bureaucratic costs and delays. Low costs usually don't materialize. The attraction of China's large reserves of raw materials has been weakened in the 1980s by a world-wide commodity glut. Although China's new investment codes and special economic zones reflect impressive efforts, its investment environment cannot yet compete with South Korea's industrial parks and Taiwan's export more efficiently, however, it competes against local firms and draws official disfavor. If it manufactures and exports non-traditional products, which the Chinese generally don't produce very competitively, it almost certainly would have to accept abnormally low profit margins.

Second, a foreign manufacturer can create its own base and export costs by producing locally what it used to import. But if it sells its product in China for foreign exchange, then it will have problems competing with imports. If the government protects the manufacturer, then Chinese buyers will be subsidizing a foreign company—a politically unacceptable outcome. If it sells the goods for local currency, there will be many more mountainous expenses of creating a new market. This is such a consolidated balancing system seldom works.

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Tibetan Example

In earlier days, foreign electronics firms in Taiwan enjoyed cheap land, cheap wages and the right to import equipment and materials without crippling restrictions. To some observers, this situation seemed exploitative. But local people received training and acquired capital from these firms. Some eventually became subcontractors, enhancing their capital. Some became subcontractors, enhancing their capital. Some became subcontractors, enhancing their capital. Some became subcontractors, enhancing their capital. Some became subcontractors, enhancing their capital. Some became subcontractors, enhancing their capital. Some became subcontractors, enhancing their capital.

For instance, China could offer more attractive conditions for foreign investment near Shanghai, where high-quality labor and infrastructure are available. It could open the electronics industry to foreign companies, provide competitive incentives, and allow them to pay whatever wages would attract workers. It could allow them to stay only part of their capital costs with exports and allow them to remit profits at the official exchange rate.

The extent to which China does this will be a key indicator of the balance between its politics of hope and politics of fear.