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# China's Foreign-Investment Schizophrenia

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HONG KONG — China's economic revolution has many achievements: high growth rates, high agricultural production, an increase in rural living standards, an explosion in the output of consumer goods. Some of these, especially the agricultural reforms, have been so successful that they are politically irreversible. Nonetheless, the economy has now encountered major problems: excessive and often nonproductive investment, a profusion of Ponzi 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 old 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 welcomed foreign investment, establishing special economic zones and improving its legal codes. On the other hand are bureaucratic controls that eliminate most of China's risk but also scare off many potential investors. For Deng Xiaoping's reforms to succeed, China will have to make its 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 $4 billion. ($10 billion was "pledged," but only $4 billion was actually used.) Of that, $1.38 billion went to offshore oil and $2.4 billion came from overseas Chinese. Western non-oil investment in China during those five years was a fraction of Western investment in Brazil during one good year.

Why do foreigners invest in China? The potential attractions are lower 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 surcharges on wages, underdeveloped transportation and communications networks, and extremely high bureaucratic costs. Outside Shanghai and Canton, 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 science parks. Incentives, productivity, regulation and infrastructure are inferior to those of competitors.

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For most potential investors, then, the decisive attraction of China is access to the domestic market, which is big, new and rapidly growing—rare qualities in today's sluggish global economy.

But here the politics of fear intervene. China's pre-communist debt and high rate of inflation were among the great traumas of modern economic history. In reaction to this, China has insisted that most foreign investors cover the entire capital cost of their project with foreign exchange and then demonstrate that the project will generate enough foreign exchange to cover profits and the import of capital goods and raw materials. (Officially, the investor can convert back the principle invested without interest, but in practice the government seldom allows this.) The investor takes the entire foreign-exchange risk, although exchange rates are set by government fiat.

Under these rules, an export-oriented company must export enough to cover its foreign-exchange requirements. If it does so by producing a traditional Chinese 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 cover its foreign-exchange 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 unpalatable outcome. If it sells the goods for local currency, there will be many more buyers; but trying to attain agreement on how much foreign exchange was saved will become an accounting nightmare. Hence this option rarely occurs.

Third, a foreign manufacturer can sell a new product to the Chinese market, earn local currency, and buy other Chinese products for export. If the foreign manufacturer buys and exports traditional products with established markets, however, it will likely replace the exports of local firms and incur official disfavor. Also, it runs into the vagaries of controlled official pricing. In China, some products are priced low domestically to help consumers and high internationally to offset the domestic subsidy. Others are set low internationally to earn foreign exchange and high domestically to offset the international subsidy. Chinese companies usually export both and balance the gains and losses. But if foreign firms are allowed to choose their exports, they will gain unfair advantages by choosing only products that are subsidized; if not, they must create a trading company with no particular comparative advantage. If it is to export a non-traditional product, it will often face the mountainous expense of creating a new market. Thus such a consolidated balancing system seldom works.

China will attract enough foreign investors to satisfy its capital, training and technology needs only if it accepts greater risks and a longer horizon. Instead of insisting that every investment balance its foreign-exchange requirements during the joint-venture period, it needs to accept that some investments will contribute to a general upgrading of Chinese technology, skills, and efficiency at the cost of some debt and some risk. Some will balance their foreign-exchange costs eventually, but only after the joint-venture period.

### Taiwan 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. Then they used their skills and capital to set up competing firms, hiring away the multinationals' newly skilled workers. Soon the Taiwan electronics industry took off and became a global force. China could emulate this without compromising its principles and without endangering its admirable credit rating.

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 cover 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.

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