IMPLICATIONS OF FOREIGN TRADE SECTOR REFORM IN CHINA
1978-1992
Beyond Neoclassical and Dependency Theory

by

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Submitted to the Department of Political Science
in Partial Fulfilment of the Requirements for the
Degree of

MASTER OF ARTS [□ □ □ □]
in Political Science

at the

Massachusetts Institute of Technology

May 1995

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Table of Contents

Abstract ........................................................................................................... 3

Introduction .................................................................................................... 4

Section 1
    China’s Foreign Direct Investment Strategy During the Reform Period .......... 5

Section 2
    Subcontracting in China’s Foreign Trade Sector ....................................... 37

Section 3
    Reforming China’s Foreign Trade Corporations ....................................... 51

Section 4
    Conclusion .................................................................................................. 79

Bibliography .................................................................................................... 82
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ABSTRACT

This paper considers the impact of economic reforms on China's foreign trade sector in three areas:

1. Foreign direct investment
2. China's subcontracting manufacturers

China's bargaining model of foreign direct investment with respect to local content requirements is analyzed in comparison with the experiences of four other Asian countries developing their automobile industries. As a means of linking foreign invested ventures with the nation's economic development goals, Chinese authorities, in general, play a stronger role in negotiating the terms of foreign investment than has been observed in the ASEAN Four.

In its manufacturing sector with export subcontractors, the Chinese government has been less involved in negotiating on behalf of national goals. In consequence, China's export manufacturing sector more closely resembles other developing countries, where factories have little bargaining power, with control invested largely with middlemen, whose loyalties are linked with their foreign clients. This phenomenon is giving rise to a new entrepreneurial elite of Chinese managers who are starting their own firms.

The discussion of China's foreign trade corporations places them within the larger context of the challenges faced by China's state enterprises. Using examples from her experience working with Chinese foreign trade corporations over the last fifteen years, the author discusses how decentralization has affected firms conducting international business.

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INTRODUCTION

Both dependency theory and neoclassical economic theory have a bargaining process between the host country and foreign investors as a central assumption in their models of foreign direct investment. Dependency theory views the bargaining process as one which often does not favor the host country’s goals of economic development and overall serves to weaken national interests.

In contrast, neoclassical economics assumes that foreign direct investment plays a positive role in developing countries’ industrialization efforts, and, in general, views multinationals as bringing positive benefits to host countries.

The purpose of this paper is to explore the middle ground between these two opposing views of foreign investment with respect to foreign trade sector reform in China. The first section explores how the Chinese government bargained with foreign investors to achieve higher local content requirements than is usually observed in developing countries. In looking as China’s exporting subcontractors in the second section, I argue that decentralization of foreign trade corporations has shifted former alliances and created new loyalties, which have resulted in an erosion of local firms’ and workers’ bargaining positions. China’s foreign trade enterprises are currently in a dynamic state of change in which interests and alliances are frequently shifting as China makes the transition toward a market economy. In the current environment loyalties depend upon the opportunities presented by a situation, with bargaining power shifting between foreign trade enterprises and an emerging new entrepreneurial elite of managers from China’s largest trading corporations. In documenting some of these recent changes, my view is that there is no final or predetermined result of the bargaining which is taking place in China today.
SECTION I
China's Foreign Direct Investment Strategy During the Reform Period

China's program of economic reforms was officially announced in December 1978 at the Third Plenum of the Eleventh Central Committee.

Movement toward liberalization of the foreign trade regime took the form of structural changes in the economy and the initiation of policies to encourage foreign direct investment.

China has pursued an economic development strategy which includes import substitution industrialization, with tariffs and quotas in place for both imports and exports as a means of promoting the development of domestic industries. It has devalued its exchange rate as a mechanism to promote exports. The government has sponsored export promotion through its subsidization of its national and provincial foreign trade corporations, and establishment of special economic zones. Recent liberalization efforts have included granting foreign investors 100% equity holdings along with increased remittance of profits.

Dual Pricing and Tax Reform are Key Areas of Government Intervention in Foreign Trade Sector

China followed the examples set by its Asian neighbors, Taiwan, South Korea, and Singapore, the newly industrializing economies (NiEs) and gave priority to industries and sectors where limited government investment would produce rapid economic growth. Foreign trade corporations were decentralized and given freedom to promote subcontracting production, using the income generated from foreign exchange earnings to fund industrialization efforts.

China's system of dual pricing during the reform period was promoted as an attempt to mirror the "responsibility system" that was successful in agriculture, generating huge productivity increases.¹

¹ Overholt, unpub paper, 1992, p. 4.
The responsibility system had developed in conjunction with the state's decision to abandon agricultural communes and return to household farming in the 1980's. A new system of cadre administration was introduced. While the state remains a claimant in the process, peasants could for the first time in decades keep what they wanted to sell in private markets and sell the rest to the state based upon the economic incentives it provided.²

A chief characteristic of the dual pricing system is the prices of raw materials and energy sources are kept artificially low by the Government. Price subsidies have given rise to many structural conditions, the key ones influencing the foreign trade sector being that goods' prices are either too low and do not reflect their true costs; or that, in some cases goods are priced too high reflecting initial development costs, but no downward re-adjustment as economies of scale are achieved. Issues such as these reverberate throughout the foreign trade sector as well as in China's heavy and light industrial goods sectors.

One of the key distortions in the socialist price system is that manufacturing profitability increases while agricultural and extractive industries' profits are kept low.³ Yet trade theory's law of one price— that domestic prices should tend toward international prices—rarely holds, particularly if foreign and domestic goods do not compete in the local economy, as has been the case in China.⁴

China's pricing strategy is germane to an import substitution regime, with its overvalued exchange rate and domestic currency losses from trade.⁵ Agricultural subsidies and artificially low food prices have been strategies to support industrialization, as surplus labor from rural areas migrates to urban areas in search of jobs in industry. Market oriented policies have not been introduced

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² Oi p. 6.
³ MacMillan and Naughton p. 138.
⁴ Taylor, p. 18.
⁵ Lardy, p. 21.
yet in this area as the government continues to favor planning and administrative controls over food prices.\textsuperscript{6}

Despite criticism of the two track approach\textsuperscript{7}, the nearest comparative alternative to China is the Soviet Union. The former Soviet Union's big-bang model of economic liberalization has had severe recessionary consequences for the economy and industrialization. Few would disagree that China's approach has been much more efficient in Pareto allocation of resources\textsuperscript{8} regardless of price rigidities. As fewer and fewer goods are covered by State planning and market prices are becoming increasingly dominant, dual track pricing recedes from the center of the debate concerning distortions caused by government policy.\textsuperscript{9}

Conventional development theory suggests that late industrializing nations get prices right by allowing supply and demand to determine prices, which is usually achieved by using low wages to gain a comparative advantage in labor intensive industries.\textsuperscript{10} However, successful late industrializing countries such as Korea, Japan, Taiwan have used subsidies to lower the cost of capital, promote exports, and to in essence get prices wrong by preventing market forces from being the sole determinant of prices, such as interest rates. This state support has helped the Asian miracle economies overcome their structural handicaps and lack of proprietary technologies as well as inadequacies of a low wage advantage, to industrialize. Their success rests upon systematic government intervention to promote manufacturing investment.\textsuperscript{11}


\textsuperscript{7} Cui, unpublished paper, p. 13.

\textsuperscript{8} Cui , ibid.

\textsuperscript{9} Cui, ibid, p. 12.

\textsuperscript{10} Amsden, p. 11.

\textsuperscript{11} Amsden, ibid.
In China the reform process has been gradual but effective with regard to prices, with some observers arguing that China's prices are closer to those of the market today, citing a national decline in industry profit rates.\textsuperscript{12}

China's system of dual pricing, however, has promoted the growth of China's export manufacturing sector. dual pricing has enabled mass production of goods at world competitive prices (and below); and within a decade has propelled China into a position as one of the world's leading exporters.

The incentives and rules governing foreign investment have required continual refinement and have been sufficiently generous to attract $20 billion in foreign investment in the first decade of reform.\textsuperscript{13}

\textbf{Licenses and Tax Reform}

As a step toward gradual marketization and reform the Chinese government instituted a system of import and export licensing to control the volume and composition of trade as well as changes in the tax structure.\textsuperscript{14}

China's exchange rate had been overvalued since the early 1970s which created commodity export losses losses from trade in domestic currency.\textsuperscript{15}

Licenses were introduced to control the rising demand for imports which could impact negatively on China's foreign exchange earnings which were at that time limited. Export licenses are to used to protect against excessive exports of products that are underpriced on the domestic market. China's currency remained overvalued until the late 1980's, which created a strong demand for imports. Licenses were required for 55\% of exports and 46\% of imports in 1989.

\textsuperscript{12} MacMillan and Naughton, p. 136.

\textsuperscript{13} Overholt, p. 4.

\textsuperscript{14} Lardy, p. 43.

\textsuperscript{15} Lardy, p. 66.
Trade theorists cite licensing as one of the key measures of an import substitution regime in the process of liberalization.\textsuperscript{16}

China also instituted broad changes in its domestic tax structure to conform more closely to international conventions. The key measure of the change implemented in 1984 was the State Council's decision to rebate to exporters a portion of the indirect taxes paid on export goods. Policies vary in different countries regarding taxes on producer goods, but China's system imposes a tax of each stage of the production process. These taxes are central to the question of trade losses from exporting.

When Chinese enterprises incurred losses from trade it was argued that the government had already collected taxes at each stage of the production process. Therefore, these losses were not in fact genuine, and because of these "false losses" the government could afford to subsidize the losses incurred by enterprises on exports as a part of its intergovernmental finance strategy.\textsuperscript{17}

With the rapidly rising volume of foreign trade during the 1980s foreign trade losses rose as well due to the continued overvaluation of the yuan. The profits on imports had been used to help subsidize the losses on China's exports until 1980, when an unanticipated 3.18 billion yuan appropriation was required from the state treasury. The losses from trade had reached proportions where it was no longer possible for the Ministry of Foreign Trade to cover them entirely.

\textbf{Incentives to Foreign Trade Corporations}

Trade losses were among the reason the government initiated a program of incentives given to foreign trade corporations to increase exports.

The rules were changed to allow foreign trade corporations to keep a larger portion of foreign exchange over the contracted amount with central government. The government also loosened requirements of amount required of foreign exchange to be held under contract. This allowed foreign trade

\textsuperscript{16} Krueger 1978, 24-26.

\textsuperscript{17} Lardy, 1992.
corporations to actually spend foreign exchange they retained from performing above contract. Numerous foreign trade corporations on visits to the United States of America began making stops in Bahamas to establish off-shore accounts for themselves, as extra insurance against any future change in government policy.\(^{18}\) Foreign trade corporations were empowered to represent any domestic seller of merchandise that was not restricted, allowing managers and employees to utilize their informal as well as formal suppliers' networks.

**Establishment of Special Economic Zones**

In early 1979 the Chinese government established four special economic zones (SEZs) with the purpose of creating areas in which rapid economic growth could begin and then spill over into other regions as a component of China’s economic development. The experimental nature of the zones was stressed to critics from inland regions as a way to gain the benefits of foreign investment while restricting foreign cultural influence to a few limited areas, much like the trading ports of the Ming, the treaty ports of the Qing, and the extraterritorial concessions of the late Qing and early Republican periods.\(^{19}\)

The Guangdong cities of Shenzhen, Zhuhai, Shantou, and Xiamen in Fujian province, were to be the export platforms from which China’s development process would spread. Because of their geographical proximity to Taiwan and Hong Kong, it was hoped that these SEZs would also form the basis for closer links with overseas Chinese business communities. China’s SEZs were modeled after the export processing zones found elsewhere in Asia. Export processing zones offer special concessions in the form of reduced duties and taxes, flexible investment forms, inexpensive unskilled labor, and streamlined administration.\(^{20}\) China’s SEZs offered similar incentives with the added goal to become the regions’ major centers of general economic reform. China’s SEZs were to

\(^{18}\) Interview with sung suen le - NYC 1989.

\(^{19}\) Shirk, p. 49.

\(^{20}\) Pearson, p. 83.
emphasize modernization in the areas of education industry agriculture tourism real estate science and education. China’s model of SEZs is a distinct departure from other developing countries’ experience with EPZs. Unlike in countries like the Philippines where the social benefits of EPZs have long been debated because of their isolation and lack of integration in the local economy, the Chinese government established their SEZs with the mandate that they bring economic development to the region.

The export processing zones received generous financial subsidies in the form of fiscal and foreign exchange revenue contracts. Guangdong and Fujian received five year contracts permitting them to retain almost all of the taxes and industrial profits generated by firms in their jurisdiction, with Fujian receiving a $150 million yuan subsidy annually. Foreign exchange retention allowances were also very liberal. SEZs were allowed to retain all the hard currency they earned from trade, unlike other localities who normally could keep on average only 25%.\textsuperscript{21}

**Decline in China’s Former Industrial Centers**

Guangdong, with its experimental special economic zones, greatly outperformed Shanghai and Liaoning, which were China’s traditional exporting centers as a result of foreign direct investment during 1980s in the form of exports from foreign invested firms. EPZs. SEZs exploited their proximity to Hong Kong and their distance from the Center; i.e., Beijing, and became a center for Foreign direct investment in toys, agriculture goods, and garments. Guangdong’s comparative advantage in low cost/labor intensive goods, made it possible for the province to specialize in these products more easily than the other two cities which were weighted heavily toward heavy industry. Guangdong also had more firms, and fewer that were state owned.

\textsuperscript{21} Shirk, p. 51.
At the same time Shanghai and Liaoning were experiencing decline in industrial productivity due to structural problems in the heavy industry sector.\textsuperscript{22} Between 1981 and 1989 industrial productivity in Shanghai was 5.3\% points lower than the national average and Liaoning was only .27 higher than the national average even though it had been the leading center in previous years. Technical progress was slow and plant equipment is obsolete; these are problems which face all of China's industrial cities.

In 1984 the government extended special economic status to northern cities as well in an effort to de-emphasize SEZs and to encourage capital to flow northward and inland. Several inland cities as well as 14 major coastal cities were given special open status. This is an example of the government's efforts to lure investment to spread around the country while still keeping relatively close reigns on the terms of that investment. Foreign invested joint ventures still had to comply with Chinese government regulations and bargain with officials over investment terms. China was able to negotiate and implement this broader mandate in part because of its attractiveness as a future export market for Western firms and multinational corporations. The vision of a billion customers has inspired many to enter China for the last 200 years, as far as back as 1789 with Lord MacCauley's ill fated voyage from England in which he was dismissed by the Quing Dynasty's Chien Long emperor, and his gifts rejected an event which helped set the stage for future Sino-British conflicts culminating in the Opium Wars.

\textbf{Chinese Government Policy Regarding Joint Ventures:}

Three major sets of laws were introduced between 1979 and 1986 defining the legal status for foreign equity joint ventures. The early joint venture law of 1970 offered asset protection ("of legitimate profits") to foreign investors as well as other rights and interests that the government recognized.\textsuperscript{23} The sticking point

\textsuperscript{22} Guo et al., p. ?

\textsuperscript{23} Pearson p. 106.
for many foreign would-be investors was the stipulation that Chinese laws would govern joint venture activity. In many other countries joint venture partners have the option to choose to have their contracts enforced according to laws other than those of the host government. This was a point negotiators continue to press with the Chinese authorities until 1986 when China agreed to allow most types of investments to designate the law of a third country as the governing law for the venture.\textsuperscript{24}

The Chinese government's policy on joint ventures had to serve 2 purposes in order to meet the approval of both reformers and conservatives: (1) attract and keep foreign capital, and (2) address concerns of both reformers and conservatives regarding negative impact of foreign direct investment. Those concerns were expressed in the following comments:

"While learning advanced (foreign) science and technology, China will on no account import the capitalist system, which is built on the exploitation of man by man, or its decadent ideology and way of life"

- Xinhua News Agency\textsuperscript{25}

The challenges to host governments in negotiating with multinationals regarding the terms of their investment are generalizable to the struggle between the multinational and domestic partners over the necessities of local accumulation.\textsuperscript{26} The role of government in successfully navigating its relationships with multinational corporations is to successfully balance coercion with a package of incentives attractive enough to ensure foreign investors' continued presence. China did not consistently succeed in this respect. Numerous problems in foreign invested joint ventures were reported in the foreign press, as Westerners sought to innovate around problems of local supply shortages or local content requirements when quality or quantity standards were not met. The Chinese authorities,

\textsuperscript{24} Pearson, ibid.

\textsuperscript{25} Pearson, p. 37.

\textsuperscript{26} Evans, p. 44.
however, generally insisted upon maintaining their position on local content and the contribution of local resources to enterprises' output as they are integral to China's national planning strategies.

The Chinese government's need for control was equal to its need to absorb foreign investment. The problem was complicated by the fact that while authorities wanted technology transfer and Western management methods, enterprises often could not successfully absorb them.

Reformers loosened foreign direct investment policies when it was clear that foreign companies had ambivalence about investing because of concerns about the economy, and negative stories began appearing in the media about the hazards of doing business in China which added to companies' concerns.

Foreign pressure induced conservatives to drop their opposition to joint ventures, allowing economic policy and reform to proceed. Liberalization occurred with a loosening of controls on some issues with no concurrent tightening of controls on others. This led to an overall relaxation of the regime's control over foreign direct investment. The government, in some cases, pulled the necessary levers to induce more foreign direct investment under foreign pressure, or as a by-product of reforms occurring elsewhere in the economy in some cases due to the government's growing confidence in foreign methods.

Foreigners contributed about 39% of the capital in equity joint ventures between 1979-1988. The average for all countries and for the individual countries was well above the 25% minimum required by the Chinese government. In the late 1980s Government was pushing for more foreign equity share but was not always getting it as Western firms wanted to limit their exposure in China—many firms were there to establish themselves in China for future selling opportunities. In many cases the joint venture itself wasn't firms' primary reason for being there. Further liberalization would be required in order to significantly boost foreign direct investment.

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27 Pearson, p. 100.

28 Pearson, Ibid.
Economic Development Through Joint Ventures

The Chinese government had a clear preference for joint venture projects in sectors it viewed as important to China's rapid modernization. Chinese foreign investment policies during the 1980s were designed to promote broader national economic development goals.

Beijing directed joint ventures to be established in industry sectors considered essential to China's achieving rapid economic growth. Enterprises established in the SEZs were to provide advanced technology, foreign exchange, or export capability. Initially Hong Kong and overseas Chinese provided the bulk of investment in the hotel and real estate development sectors (see chart, p. 86) and constituted a significant portion of foreign direct investment until 1986. But tourism and real estate development did not bring in significant high tech or export oriented manufacturing, and in 1986 government began discouraging this type of investment in favor of those priorities emphasizing high-tech.

Local Content Issues

Foreign firms historically have failed to create linkages in China due to poor infrastructure and transportation networks, in the context of its turbulent history this century. Nearly all U.S. corporations were starting from scratch when they entered China in the early 1980's. Despite the foreign investment partner having agreed to a given level of domestic content in joint venture agreements, goals were not always met by the venture due to lack of available inputs at the quality or volume standards required for goods being produced for export. In other cases the quality and specification of the local goods were not compatible with foreign production processes and technology (p. 132).

The domestic goods purchased by joint venture firms for production supplies required for inputs were often below what was needed in quantity, necessitating imports. But the terms of the joint venture agreements usually stipulated local content was to be increased with a targeted percentage, often between 70-80% to be reached within five years.
Chinese negotiators pushed for domestic content clauses in contracts as standard procedure. China faced increasing foreign exchange shortages during the mid-1980s, which contributed to the government declaring the local content clauses non-negotiable on local content issues.

Contracts for oil exploration (China's largest exporting sector during the period) frequently required use of local materials and contractors. In the cases in which domestic content clauses were omitted from the final joint venture agreements they were criticized by the government.

Article 9 of the Joint Venture law states that "in the purchase of raw and semiprocessed materials, fuels, auxiliary equipment, etc., a joint venture should give first priority to Chinese sources but also may acquire directly from the world market."  

Article 57 of the Implementing Regulations applies the less stringent condition that a Joint Venture has the right to decide whether it buys inputs in China or from abroad. However, where conditions are the same it should give first priority to purchase in China.

Although less strict than the Joint Venture law, China's negotiators maintained adherence to the local content requirements. The Regulations of the People's Republic of China on Special Economic Zones in Guangdong Province encouraged the use of Chinese machinery and raw materials in the Special Economic Zones by offering joint ventures lower prices on these goods.

Joint venture contract terms varied, but high local content goals were a consistent theme. One European joint venture contract specified preference for Chinese products with payment to be made at the prevailing domestic price. Some joint ventures did not have such requirements, and one consumer goods

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29 Lardy, 1992.

30 Pearson, p. 272.

31 Pearson, ibid.

32 Pearson, ibid.
joint venture\textsuperscript{33} imported 95\% of its raw materials to guarantee consistent quality. Local content terms regarding inputs varied depending upon the type of products being produced by the joint venture. Many components and accessories during the 1980s simply could not be found on the local markets in China. The Joint Venture Law and Implementing regulations did allow the ventures to import, although it strongly encouraged domestic sourcing.

Even in the lower tech sectors of textiles and consumer goods industries it was common for US firms to source parts and supplies not available in China from Hong Kong. Chinese foreign trade corporations and factories today often can supply domestic parts that previously were sourced through Hong Kong from domestic suppliers. Foreign trade corporations previously were not allowed to freely source products from anywhere in China in order to complete an order. Restrictions on the scope of foreign trade corporations business activities were more limiting during the early and mid-1980s, which inhibited the linkage of Chinese firms in the foreign trade sector with domestic sources of supply. Trade corporation staff were inexperienced in building outside sourcing networks, and referred Western customers to Hong Kong to solve a sourcing problem rather than try an untested local source.

Comparing China and the ASEAN Fours Local Content Bargaining Strategies

This section will discuss China's foreign direct investment bargaining strategy with respect to the bargaining strategies employed by the ASEAN Four ((Thailand, Malaysia, Indonesia and the Philippines) in developing their automobile sectors. The issue of local content requirements is the focus of this discussion. The evidence as reported by Doner and Pearson appears to suggest that a developing country with a high degree of political commitment and the willingness to follow through on that commitment can successfully achieve desired local content levels in foreign invested joint ventures.

\textsuperscript{33} Pearson, ibid.
The ASEAN Four's government agencies rarely negotiated domestic content levels as high as the Chinese required of their joint venture partners. When Chinese joint ventures encountered difficulties in reaching local content levels as stipulated in contracts in several instances the government gave financial help to ventures in the form of short term foreign exchange concessions. Beijing Jeep and Hitachi both received foreign exchange relief when the Japanese yen appreciated. The Chinese government financed domestic kit assemblers' purchases as a strategy to survive short term currency fluctuations. This assistance is credited with helping to raise local content to 85% from 40% at the Hitachi venture. 34

Additionally, the Chinese government financed the establishment of local companies to source local products and supplies for joint ventures. In contrast, the ASEAN Four's experience entirely different because governmental institutions did not intervene when foreign invested joint ventures encountered problems that were linked to the local economy's structural difficulties.

For example, foreign exchange crises in the Philippines did not provoke the government to intervene on behalf of local firms although it might have helped them avoid bankruptcy. Excessive competition among too many local auto firms did not prompt the government to call for industry rationalization with a program of support and incentives to encourage "downsizing" of the sector. Both of these conditions are cited as contributors to the overall weakening of the Philippine's auto industry.

The Chinese have adopted both of these strategies in sectors it deems crucial to national development goals.

The Chinese strategies also addressed the potential problem of dualism in the economy between joint ventures and rest of economy. Local content requirements inhibited joint ventures from sourcing all necessary supplies outside China when faced with quality and foreign exchange difficulties. The government subsidized local firms to supply inputs to joint ventures, creating inland linkages.

34 Pearson, p. 113.
with domestic firms. As a way to generate foreign exchange, joint ventures were encouraged to export products from the local Chinese economy but the government restricted how much joint ventures could export of those other products. The Chinese government this way kept joint ventures where they wanted them without giving them the opportunity to become increasingly competitive with Chinese foreign trade corporations.

Authorities' goals clearly were to lead and link Chinese firms with foreign joint ventures, but the structural problems, mentioned above, in the economy prevented strong links from developing spontaneously. Joint ventures were also subjected to the often changing reform environment during the 1980s with little bargaining power other than exit. The State Plan itself was actually reflecting tensions of central vs. decentralized control debates among conservatives and reformers going from strong central control and coordination (1979-1983) to partial loosening of control during the mid-1980s to strengthening of the center again 1987-1988 (p. 115). 1989 saw a remarkable loosening again prior to the pro-democracy crackdown, followed by greater retrenchment of central coordination through the subsequent two years.

The Chinese government also limited the joint ventures local access to the domestic market in a number of key ways. Central directives called for the setting of prices at which joint ventures could sell goods on the local market to be equivalent to those of domestic goods of equivalent quality. By linking the laws on joint ventures with the State Plan, joint venture firms' access and influence in the economy were tied to state directives. This linkage required joint ventures had to abide by changes in government policy targeting Chinese enterprises.

Hitachi's joint venture production plan had to cut in half the volume of its television production reflecting a new directive decreasing annual production of TV sets.35 The result of such a policy was that joint ventures had to produce in accordance with government economic development planning not only at the time the contract was negotiated but beyond, as new policies were enacted.

35 Pearson, p. 113.
China's foreign direct investment strategy linked joint ventures closely with the government's macro planning efforts as a mean to integrate foreign capital into the state's system of planning. (For example, the amount of and uses for foreign capital were specified clearly in the national Five Year Plan. A proposed project first had to be approved and included in the annual plan before negotiations could begin.\textsuperscript{36}

While linking joint ventures closely with the Plan, Chinese reformers at the same time were reducing size of the Plan. By 1986 the number of commodities under state commercial control had fallen to twenty from two hundred fifty-six. Liberalization brought perils of supply shortages to joint ventures who were locked into agreements requiring high local content but no guaranteed supply of raw materials and other inputs as had been previously guaranteed. This created problems for joint ventures as the State Plan decreased in scope. As a result joint ventures faced shortages the same as did domestic firms because domestic supplies were outside the Plan were difficult to obtain.

By inextricably linking joint ventures within the structure of the Chinese economy at large, the government was able to pressure foreign invested enterprises to become more integrated with the local economy.

But pressure from China's reformers did lead to greater autonomy for joint ventures. The foreign investment environment was increasingly liberalized in the late 1980's as joint ventures received increased freedom to form their own production and distribution plans.\textsuperscript{37}

State planning efforts were at no time observed to this degree in the ASEAN Four's countries negotiating local content in their auto industries. When government subsidies and protection were initiated however local content levels were positively affected.

The ASEAN Four's automobile markets were generally fragmented, with too many local firms competing against one another which drove down both

\textsuperscript{36} Pearson, p. 112.

\textsuperscript{37} Pearson, p. 114.
profits and prices. Capacity utilization averaged 70% in the sector. Local content levels were able to reach 30% levels only with the assistance of government programs.³⁸ Political stability also seemed to play a role in negotiating and implementing local content requirements, with less stable regimes (Philippines) performing less successfully than stable ones (Thailand).

**Autos and Appliances in the Mid-1980s**

The Peugeot joint venture auto contract (1985) specified a gradual increase in domestic components from 20% to 70% then 95% for the distant future. A shoe-producing joint venture was allowed to import 40% of required raw materials, which as a low-tech labor-intensive business seems generous.

Throughout the 1980s the Chinese government stated that shortfalls in achieving domestic content requirements was an unhealthy tendency. Joint ventures commonly required between 30% and 80% of inputs to come from domestic sources, with local content specifications at the higher end of the range more prevalent.

Increasing percentages of domestic components over the life of the joint venture were also specified in autos and electronics joint ventures, assuming the quality and quantities of domestic materials would increase.

These domestic requirements in turn created domestic incentives and opportunities for local Chinese firms to make the necessary investments in improvements to upgrade technical and quality levels to meet the joint venture requirements. Hitachi and Volkswagen both had local content requirements of 80% after the ventures' 5th years.

China's financial and administrative support of local enterprises was an effort to overcome problems of "disarticulation" that local firms in host countries often face due to their lack of connection and linkage with other domestic firms in their industry.³⁹ As a result, exports of those sectors which are disarticulated

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³⁸ Doner, p. 62.

³⁹ Evans, p, 28.
do not feed back into the host economy the way they do into the economies of industrialized nations. When a developing country sources equipment and inputs from abroad there is no "multiplier effect" of new investment that feeds into the local economy creating linkages between firms and stimulating local demand.

The ASEAN Four's experience was one in which a large number of local firms entering the automobile industry drove down profits and led to industry rationalization. Chinese automobile firms are traditionally state owned and have been numerous and eager to participate in joint venture agreements—rationalization was not officially a national policy issue until very recently with the July 1994 announcement of "China's Automobile Industrial Policy."

In fact, China's excessively numerous automotive suppliers brought their own challenges. Beijing Jeep's difficulties required the intervention of Vice Premier Zhao ZhiYang to resolve successfully. Their 1986 joint venture agreement involved thirty-five research institutions and parts manufacturers from eleven provinces, many of whom did not meet what AMC considered to be workable standards either in the production processes or products they offered. EK Chuo's joint venture producing motorcycles had one hundred local parts and components suppliers under contract.

In a careful analysis of the ASEAN Four's automobile industry successes and failures, Richard Doner concludes that market size, political risk and economic resources are poor predictors of a country's bargaining strength. Political strength is crucial, as well as a willingness and ability to mobilize resources and exploit opportunities favorable to the host country. China made the political conviction to advocate for very high local content requirements, and institutionally was able to implement its goals through a combination of financial support and an unwillingness to compromise downward on LC targets.

Richard Donor makes a number of key arguments that are relevant to developing a theory of Chinese foreign direct investment during the same period.

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40 Evans, ibid.

41 Pearson, p. 272.
In the experiences of the ASEAN Four, Japan plays a much more central role in the development of each countries' "comparative advantage" strategy due to being a major source of foreign direct investment.

As noted earlier Japan was a major trading partner of China's but did not play as central a role during the development of China's foreign direct investment bargaining model during the reform period. Each of the ASEAN Four countries attempted to follow some sort of import substitution model of industrialization with initial production of consumer goods, followed by subsequent moves toward export promotion. Each has met with varying degrees of success largely as a result of political and institutional successes and failures to promote this transition (see Tables 1 and 2).

The ASEAN Four's relationships with Japan have been characterized by exports of primary goods and raw materials, such as oil, to Japan to help fuel its economic growth. In turn they import Japanese capital goods to fund their ISI efforts.

This dependency on Japan for capital goods contrasts with the Chinese model, in which the government emphasized foreign direct investment requirements so as to avoid dependency upon capital goods imports for the achievement of economic development goals.

The larger macroeconomic issues faced by the ASEAN Four in the early 1980s reflected China's dilemmas as well—the urgency of preserving foreign exchange and expanding local content in exports. But the ASEAN Four's liberalization efforts were not as dirigiste as China's. Their local content goals were rarely met, little technology transfer occurred, and integration of firms in the automotive sector were largely vertical and not horizontal.\(^{42}\)

Fragmentation of the market was a common problem for all the ASEAN Four—too many firms competing against each other led to industry rationalization that did not favor local owners and in the Philippines' case led to de-nationalization of the industry. The Philippines central bank refused to provide

\(^{42}\) Doner, p. 43.
foreign exchange to Ford and GM during an exchange crisis, constituting one of the key reasons for the exit of both firms.\footnote{Doner, p. 44.}

Under similar conditions China gave short term support to help keep Hitachi's joint venture going. In contrast, local firms in the Philippines sold out to Japanese firms when they could no longer obtain foreign exchange to pay for their imported inputs. Firms went bankrupt in the absence of the continuous subsidies, as China opted to do until very recently\footnote{Car Industrial Policy, FBIS, July 15, 1994.} with its state owned suppliers.
### Comparison of ASEAN Four Auto Goals and Achievements

<table>
<thead>
<tr>
<th>Issue</th>
<th>Goal</th>
<th>Achievement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Local Content (physical)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Philippines</td>
<td>initially 62.5%, then 30% physical</td>
<td>30–35%</td>
</tr>
<tr>
<td>Thailand</td>
<td>25% for 1976; initially 50% for 1983, then frozen at 45%; raised to 60% in 1987 and 70% in 1988; frozen at 54% in 1988</td>
<td>never implemented</td>
</tr>
<tr>
<td></td>
<td>80% by five years for diesel engines</td>
<td>project just beginning, but TNC commitments obtained</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Saga &quot;national champion&quot; auto at least 36%, in 1986, then gradual increase</td>
<td>TNC commitment obtained (Mitsubishi), 47%, then down to 30% but up to 50% in 1989</td>
</tr>
<tr>
<td>Indonesia</td>
<td>no specific LC targets; stress on local prod. of more complex parts and components; assem. of CV from locally assem. or migprod. parts, by 1987—implications of over 70% LC</td>
<td>roughly 40%; higher for Astra</td>
</tr>
<tr>
<td></td>
<td>local engine mfgrs. orig. date 1986, subsequently unspecified; engine assem. by 1985</td>
<td>engine assembly begun 1985</td>
</tr>
<tr>
<td><strong>Rationalization</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Philippines</td>
<td>not over 4 assemblers; reduce models</td>
<td>8 throughout 1970s model prod.; c.u.r. 40%</td>
</tr>
<tr>
<td>Thailand</td>
<td>reduce models; no more than 3 diesel engine firms</td>
<td>model prod.; c.u.r. 55–70%; 4 firms, but same Thai firm in 3 of the 4</td>
</tr>
<tr>
<td>Malaysia</td>
<td>exclude all makes but Proton from 1,200–1,500 cc niche</td>
<td>47% of niche, but declining market—under 20% c.u.r. moderate success; c.u.r. roughly 60%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>reduce makes and models</td>
<td>moderate success, but strengthening Chinese; accepted 7 mfgrs.</td>
</tr>
<tr>
<td></td>
<td>reduce assem. groups to 8</td>
<td></td>
</tr>
<tr>
<td></td>
<td>limit engine mfgrs. to 3</td>
<td></td>
</tr>
<tr>
<td><strong>Nationalization</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Philippines | explicit emphasis; promote local parts firms | weak; as-

### ASEAN Automobile Policies

<table>
<thead>
<tr>
<th>Issue</th>
<th>Goal</th>
<th>Achievement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
<td>local parts firms and maintain Philippine assemblers</td>
<td>numerical and tech. growth of local firms; central role of large Thai producer in engine project</td>
</tr>
<tr>
<td></td>
<td>implicit effort to promote local firms generally; more explicit in engine production</td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>develop &quot;national champion&quot; (as well as ethnic champion) in assembly</td>
<td>initial success, with foreign support; subsequent Japanese takeover</td>
</tr>
<tr>
<td>Indonesia</td>
<td>promote &quot;pribumi&quot; parts firms</td>
<td>fairly weak parts firms; pribumi presence overall weak; but local Chinese presence in assm./parts prod. strong</td>
</tr>
<tr>
<td><strong>Exports</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Philippines</td>
<td>major emphasis: reduce foreign exchange use; become part of reg. and int'l div. of labor</td>
<td>growth of exports, but of import bill as well</td>
</tr>
<tr>
<td>Thailand</td>
<td>moderate and recent efforts; explicit only in engine project</td>
<td>recent export growth; potential for further expansion</td>
</tr>
<tr>
<td>Malaysia</td>
<td>recent but desperate efforts</td>
<td>very minor success</td>
</tr>
<tr>
<td>Indonesia</td>
<td>not targeted</td>
<td>minimal; but recent (1987) plans for engine export</td>
</tr>
</tbody>
</table>

*Table 1*

*c.u.r. = capacity utilization rates.*
### Table 3.1. Size and Economic Growth Rates of NICs and ASEAN Countries, 1985

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>165.2</td>
<td>86,445</td>
<td>523</td>
<td>3.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>15.7</td>
<td>33,360</td>
<td>2,128</td>
<td>4.2*</td>
</tr>
<tr>
<td>Philippines</td>
<td>54.7</td>
<td>32,789*</td>
<td>600*</td>
<td>1.6*</td>
</tr>
<tr>
<td>Thailand</td>
<td>51.3</td>
<td>38,572</td>
<td>752</td>
<td>4.2</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>5.4</td>
<td>34,081</td>
<td>6,288</td>
<td>6.3</td>
</tr>
<tr>
<td>South Korea</td>
<td>41.1</td>
<td>86,180</td>
<td>2,099</td>
<td>6.4</td>
</tr>
<tr>
<td>Singapore</td>
<td>2.6</td>
<td>15,970</td>
<td>6,238</td>
<td>6.7</td>
</tr>
<tr>
<td>Taiwan</td>
<td>19.1</td>
<td>59,141</td>
<td>3,095</td>
<td>6.4</td>
</tr>
</tbody>
</table>

**Source:** Adapted from James et al. 1989, tables 1.3 and 1.4.

*1970–85.
*GNP.
*The Philippines' low cumulative rate reflected the financial crisis and economic downturn of the early to mid 1980s (see table 3.5 below).

### Table 3.2. Changes in Economic Structure (Percentages)

<table>
<thead>
<tr>
<th>Country</th>
<th>Agriculture’s Share in GDP</th>
<th>Industry’s Share in GDP</th>
<th>Industry’s Growth Rate</th>
<th>Labor in Agriculture</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Korea</td>
<td>38</td>
<td>14</td>
<td>25</td>
<td>40</td>
</tr>
<tr>
<td>Taiwan</td>
<td>24</td>
<td>6</td>
<td>30</td>
<td>46</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>2</td>
<td>1</td>
<td>40</td>
<td>22</td>
</tr>
<tr>
<td>Singapore</td>
<td>3</td>
<td>1</td>
<td>24</td>
<td>39</td>
</tr>
<tr>
<td>Indonesia</td>
<td>59</td>
<td>26</td>
<td>12</td>
<td>40</td>
</tr>
<tr>
<td>Philippines</td>
<td>26</td>
<td>25</td>
<td>28</td>
<td>34</td>
</tr>
<tr>
<td>Malaysia</td>
<td>30</td>
<td>21</td>
<td>24</td>
<td>35</td>
</tr>
<tr>
<td>Thailand</td>
<td>35</td>
<td>20</td>
<td>23</td>
<td>28</td>
</tr>
</tbody>
</table>


*1971–85
of automobile kits and components. Because of frequent downgrading of local content goals and requirements which occurred in all of the ASEAN Four, political institutions couldn’t successfully implement projects like Philippine’s PMADE car initiative, which was a national project that neither reduced the import bill of the industry nor raised local content percentages significantly.

While the ASEAN Four’s trade relationships were two-way in that they did compel Japan to export as well as import, this requirement in and of itself was not enough to resolve difficulties with local content and foreign exchange issues facing local firms.

Of the ASEAN Four, Thailand has been the more successful in local content and exports, in part because it developed regional markets for its low-tech items which were within its local production capabilities, now moving into more mid-tech range. This strategy was promoted by Thai firms which supported import substitution policies. As elsewhere in the ASEAN Four, Japan’s largest automobile firms dominate the auto sector in Thailand, the sole local exception being Siam Cement who has ownership in local partnerships with Japanese firms. Thailand has succeeded better than its neighbors in achieving local content due to enacting policies which strengthened local firms. The strengthening of local automobile interests, along with persistent local content targets for autos, as well as parts, has increased Thai firms’ participation in projects that increased technological transfer and subcontracting opportunities. The Thai government also enforced tough rationalization efforts as well as pushed exports via central levels.

Japan’s strategy as the major foreign player in these markets has inhibited the development of local auto firms. The Japanese advertisements and strength in product differentiation raise technological entry barriers for local firms that do not have the state’s financial support. Local firms’ import bills increased as a result

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45 Doner, ibid.
46 Doner, p. 46.
47 Doner, p. 75.
of localization goals not being met, which strengthened Japanese firms as an unintended consequence.

Government institutions in the ASEAN Four did not intervene in the auto industry when international markets were slow or foreign partnered firms needed foreign exchange assistance. Slow sales hurt local ventures, making imported car parts more costly. China's departure from this model may have contributed to joint ventures' ability to endure during externally imposed crises.

The ASEAN Four all had relatively open economies tempered with import substitution policies similar to China regarding tariffs and extensive licenses for infant industries. Despite controls on vehicle imports, the lack of additional definitive policies led to a proliferation of numerous domestic suppliers in each of the ASEAN Four. Depressed profits and an excessively competitive local market prevented the development of efficient economies of scale. Unlike China, local content requirements did not stimulate the relatively rapid growth of domestic parts industries, which is an important part of a fully integrated auto industry.

But a key weakness among the ASEAN Four was their lack of strong central guidance on ensuring import substitution operations, which Doner argues does in fact lead to the development of viable export industries. Yet despite disappointments in reaching local content goals and the slow or arrested development of locally owned firms and national cars in Malaysia and the Philippines their industries grew in each case. They faced challenges of fragmented markets and insufficient capacity utilization, yet their industries did manage to progress. Those indigenous firms who survived rationalization grew (p. 88).

Policy implementation appears to be a strong point for China. Localization policies in ASEAN were a clear goal but difficulties in their implementation were due to political institutional financial support. China changed its policies on foreign exchange and subsidized local firms to keep them open. The ASEAN

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48 Doner, ibid.
Four's institutions did not sufficiently exercise the leverage they possessed in order to better strengthen local content efforts.

In negotiating foreign direct investment, China was willing to offer a combination of incentives and support—loans during exchange rate fluctuations, waiving local content requirements when required inputs not available on the domestic market, which resulted in joint venture agreements that achieved a greater share of local content than the ASEAN Four were able to achieve in the development of their auto industries. Chinese authorities during the 1980’s were willing to let negotiations take years, even a decade (as in the case of Mercury Marine) in order to attain contract terms that matched national development goals.

Lack of Japanese Presence in Chinese Joint Ventures

Japanese firms were not major investors in joint ventures during this period (Table 3). Issues of local content and the difficulty of foreign exchange repatriation were disincentives for Japan to enter China by means of foreign direct investment when there were other alternatives. The Baoshan steel mill in Shanghai which is China’s largest and most profitable steel mill was one of Japan’s earliest major investments in Chinese industry. The project stalled numerous times and was frequently cited as one of the most difficult foreign financed projects to bring to successful completion.

Table 3
Origin of Investors in EJVs in the SEZs, 1985–1988 (Sample)

<table>
<thead>
<tr>
<th>Location of Investment</th>
<th>Hong Kong/ Macao</th>
<th>United States</th>
<th>Japan</th>
<th>Other Asia</th>
<th>W. Europe and Canada</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shenzhen</td>
<td>164</td>
<td>14</td>
<td>3</td>
<td>11</td>
<td>4</td>
<td>196 (62.0%)</td>
</tr>
<tr>
<td>Shantou</td>
<td>16</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>0</td>
<td>18 (5.7%)</td>
</tr>
<tr>
<td>Zhuhai</td>
<td>30</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>1</td>
<td>37 (11.7%)</td>
</tr>
<tr>
<td>Xiamen</td>
<td>40</td>
<td>5</td>
<td>3</td>
<td>14</td>
<td>3</td>
<td>65 (20.6%)</td>
</tr>
<tr>
<td>Total All SEZs</td>
<td>250</td>
<td>20</td>
<td>8</td>
<td>30</td>
<td>8</td>
<td>316 (79.1%)</td>
</tr>
</tbody>
</table>

Table 3
Several Japanese joint venture negotiations faltered because of the Chinese insistence on local content clauses. Japanese firms instead focused on exports of affordable consumer products into China during this period to take advantage of a domestic consumer boom in the early and mid-1980s. The Japanese targeted this Chinese consumers needs as well as their growing disposable income and pursued a strategy of exporting goods for retail sale that Chinese consumers welcomed and could afford. These goods were chiefly in consumer electronics and appliance sectors which US producers, once dominant, had decades before exited and surrendered world market share to the Japanese. This is in sharp contract with US firms’ strategies during the 1980’s, which focused primarily on joint ventures.

And, unlike US firms, Japanese exporters were positioned to take advantage of the boom in consumer retail purchases during the mid-1980’s. Chinese consumers as well as businesses wanted electronics as well as the cars and trucks that Japan specializes in, particularly VCRs and watches, that were paid for in cash with foreign exchange. In contrast, at that time US producers made few products Chinese consumers could afford, given Chinese monthly salaries are about $40 US. In fact, one of the demands presented by the pro-democracy demonstrators in 1989 to the Chinese government was to reduce the number of inexpensive Japanese products flooding the Chinese market.

It was during this time of wait and see regarding foreign direct investment for many Japanese firms that many US firms pursued elaborate joint ventures that incurred tremendously high overhead; Japanese firms did not pursue complicated red tape fraught joint ventures with Chinese partners as it was viewed as too difficult to implement the regional development strategy Japan was employing throughout Asia in negotiating with the Chinese government. This strategy varies country by country, but essentially consists of targeting countries’ industries for development in specific sectors that will serve Japan’s regional division of labor as seen in its relationships with the ASEAN Four above.

Since the late 1980s however as the investment environment has been increasingly liberalized, Japanese joint ventures are increasing steadily as are training centers and R&D partnerships with Chinese firms which mesh with
China's priorities of learning and technology transfer. In contrast, US firms are predominantly pursuing direct sales of goods to Chinese consumers, with few implications for a growing partnership between US and Chinese industry. In fact, Craig Allen, a senior commercial officer at the US embassy in Beijing was recently quoted as saying that US companies..." are not going to be able to export forever on a large scale without making any commitment to the market. Companies that haven't started thinking about direct involvement are missing the boat."^{49}

China developed exporting capabilities in the low tech range of the automotive industry through exports by firms that were not necessarily in joint venture's (such as the Foxboro Corporation in Shanghai) but also through subcontracting arranged by foreign trade corporations. As local trading corporations and manufacturers work with Western auto importers they develop capabilities to supply their own emerging industry and to supply Japan's and other trading partners' industries.

Japan's regional economic strategy at first glance does not mesh with China's national development goals of self sufficiency as an exporter, and it is interesting to note Japan chose not to bargain with China under those terms. Chinese officials noting the absence of Japanese foreign direct investment in the automobile industry have in private discussions indicated they would like to leave the Japanese out of the development of China's national car.^{50}

Throughout Asia Japan has consistently led the NICs of Taiwan and South Korea, in particular, and the ASEAN Four through a "multiple catch-up process"^{51} which involves moving through stages of comparative advantage, from labor intensive exports (food, textiles, and low-tech appliances) into capital intensive and knowledge based industries.

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^{51} Doner p. 25.
If a host country's bargaining leverage is influenced by long term financial resources, China has significantly more leverage than most other developing countries. It has one of the world's most conservative foreign exchange management regimes. Its total net debt in 1992 was $5.4 billion, with relatively high foreign exchange reserves covering nine months. (Banker's standards of credit-worthiness require that a country have reserves to cover at least three months of average imports.)

Although China's reform process has been gradual with occasional policy reevaluations and reversals, economic liberalization continues with signs that it is not only robust but capable of producing favorable results with respect to rapid economic growth. China's GDP growth for 1991 to 1994 is averaged at 10%.

The approval process has become less of an obstacle given the current emphasis on promoting foreign investment, but government officials continue to evaluate each project to ensure that it fits within state guidelines toward: (1) promotion of exports to increase foreign currency income; (2) introducing advanced technology; and (3) providing technical or managerial training.

Host countries' bargaining opportunities have increased worldwide as foreign direct investment has risen during the last three decades. US direct investment in manufacturing in Latin America has grown from $400 million following WWII to over $10 billion in the 1990's German and Japanese foreign direct investment has risen even more rapidly in the last decade. US multinationals operating in developing countries can no longer unilaterally determine the terms of their relationships with local partners, or choose to forego a presence in a rapidly growing country due to concerns about risk. Today's international firms recognize that if they are not present in China others will be.

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52 Doner, p. 94.
54 Overholt, ibid.
there taking advantages of opportunities they have declined. Much of the pressure US corporations exerted upon the Bush and Clinton administrations following the June 4th 1989 crushing of the pro-democracy movement and subsequent debates over the renewal of most favored nation status for China rested upon their concerns that the US would lose billions of dollars in investment opportunities to other nations who chose to maintain an uninterrupted presence in China. In the months following the June 1989 crackdown while Most Favored Nation status was being debated in Congress as well as throughout the country Japan made $6 billion in loan credits available to China.\textsuperscript{56}

Chinese officials appear to recognize that foreign transnationals have market opportunities and access that Chinese local firms do not have, and they wish to level the playing field whenever possible. Given that multinational firms maximize their profits in terms of a global strategy and not a local one, Chinese authorities recognize that national goals and the goals of the foreign investor do not necessary meet, even in the context of their joint venture.

A Vice Minister of China’s Ministry of Posts and Telecommunications recently delivered the following message to the President and COO of General DataComm Industries." We are not going to open our markets without the trade-off of access to American technology and know-how. This is not the age of pillage and plunder."\textsuperscript{57}

Beijing’s priorities are technology, transfer, and the upgrading of China’s domestic industries. Foreign capital offers answers to some of China’s most compelling challenges regarding economic development issues.

**New Bargaining Model of Local Project Management?**

China’s leaders are in a difficult balancing act as they seek to introduce market policies without raising serious employment concerns in a country with a population of 1.2 billion. Industrial restructuring requires the development of new

\textsuperscript{56} H. White unpublished paper April 1992.

\textsuperscript{57} Intl Business, Dec 1994, p. 48.
institutions to handle the displacement of workers without posing threats to social and economic stability. China currently lacks instructions to manage localized redistribution of assets should enterprises go bankrupt, which compromises the reform process. Downsizing and lean production trends, which are western management tools, may not be appropriate models for the world’s most populous nation that is currently in a process of widespread structural shifts. Somewhere between 50-100 million workers from agriculture are presently migrating to cities searching for jobs in industry. The recent construction of Beijing’s Third Ring Road Signals that China’s planners being well aware of potential friction that foreign capital intensive projects pose for Chinese labor.

In just 10 months, 15,000 Chinese contractors earning between $20 and $40 a week built 13 miles of a six-lane highway that includes 11 overpasses for traffic and 24 overpasses for pedestrians, 6 river bridges, 2 railway bridges and 5 tunnels.

The low-tech production approach impressed Canadian experts working on the project. The head of mission to The World Bank, Peter Bottelier, remarked, "What I find so interesting is that it was all accomplished with relatively old technology—very small trucks, very small bulldozers, old Russian drills...Chinese contractors, don’t even feel they need the big equipment...It’s inefficient from their point of view, because labor is cheap relative to capital here."

A Canadian contractor stated he would have used lots of heavy machinery and, at most, 1,000 workers. "There’s no way we could have 15,000 people on a site."

Further, Bottelier reported that the bidding for the Ring Road was above-board and competitive even though it involved numerous public companies.

The winner promptly subcontracted most of the work "to very small, private operations. It’s as flexible and as efficient as you can make it," he said. "This all shows that this idea we have in the West that only privately owned companies are efficient is nonsense."58

58 Rod Mickleburgh, Toronto Globe and Mail, 10/21/94.
The essential point here is that China had sufficient bargaining power over the local content terms of the construction project (which involved foreign construction firms and foreign financial institutions) so as to be able to pursue its own model of utilizing its surplus source of low-cost labor. Project costs were not less than Canadian contractors estimated for an identical project in the US (such projects are notorious for overruns anyway) but the Chinese state firm managing the job employed more than ten times as many workers.

In joint venture relationships with state owned enterprises, Chinese partners traditionally control personnel and physical plant issues which gives them leverage to influence the number of Chinese workers employed—which according to numerous American managers involved in joint ventures is usually too many.

The government’s role is to balance economic development goals with the creation of realistic standards and expectations in environment that it creates for foreign investment. An excessive regulatory environment discourages foreign direct investment, as was seen in India for several decades as its government pursued an aggressive import substitution strategy. Investment has increased dramatically there since relaxation of joint venture and licensing restrictions in early 1990’s.

Foreign direct investment becomes important in countries who represent examples of "late industrialization." Without the benefit of original technology China is dependent upon foreign technology to make future transitions toward a more advanced economy. China is a part of the same world market as the majority of its neighbors and shares certain regional traits and influences with its neighbors which has contributed to the evolution of its industrial policy which liberals promotes exports (which will be examined in the next section on subcontracting) while seeking to guide the terms of foreign direct investment.

Foreign direct investment is not the sole means by which a country can capture foreign capital for economic development; investments from abroad have proven to amount to a fraction the of aggregate capital requirements needed by
developing countries. Furthermore foreign capital typically lags rather than leads the industrial development process.\textsuperscript{59}

The technology transfer China received during the 1980's in almost every case was not technology at the world's frontiers.\textsuperscript{60}

China has pursued a two-fold strategy in promoting development of its foreign trade sector. The State played an active role in bargaining the terms of foreign direct investment and joint venture participation until 1992. Recent contracts in sectors outside of China's "pillar" or strategic industries, show increasingly less government involvement. Aggressive bargaining on local content issues facilitated opportunities for domestic firms to establish supply and service linkages with Western partners. Chinese firms were not always positioned to take advantage of these opportunities given their own limitations in terms of management and training skills, as well as the quality of local products. The standard forms of technology transfer—designs, blueprints, and production equipment have often proven insufficient to overcome productivity gaps.\textsuperscript{61} Additionally, foreign owned joint ventures take longer to become profitable than foreign firms using Chinese manufacturers as production subcontractors.

China's second strategy has been to capitalize upon low wages and its comparative advantage in light industries manufacturing through developing a niche in subcontracting production for export. China currently produces goods for the rest of the world in its factories.

Recent corporation laws liberalizing restrictions on ownership structures gives foreign firms increased flexibility. Many foreign firms are choosing to go with wholly owned subsidiaries as their choice of business organization solely because they can now use their own management systems in the venture.\textsuperscript{62}

\textsuperscript{59} Amsden, p. 10.

\textsuperscript{60} Schnepp et al., US-China Technology Transfer. Prentice Hall 1990.

\textsuperscript{61} Amsden, p. 8.

SECTION 2
Subcontracting in China's Foreign Trade Sector

In addition to direct investment, export oriented manufacturing is the other means by which China has generated successful export earnings. Subcontracting is an attractive alternative to direct investment for firms who do not wish to make long term investments in a country but wish to capture the low wage advantages of their export goods.

China's entrance into international subcontracting markets in the late 1970s challenged the previous regional "market equilibrium" in many product sectors: heavy, light industries and textiles because of the export price advantages of Chinese goods. Companies that had been sourcing from Hong Kong, Taiwan, Korea had to decide whether or not to enter or switch to China for the cost savings. China posed a direct challenge to many firms' previous sourcing relationships. Once a company started sourcing from China, other competitors often felt compelled to as well because of the 20-40% cost differentials offered by China to other Asian countries. As Chinese producers have become more integrated into the value chain in a number of product categories, they have begun to make the transition from manufacturing subcontractors to key industry players. Richard Forte of Forte Industries, the US's largest importer of cashmere products, who recently entered into two joint ventures in China made the comment that "We decided that we had better go with them or get left behind."64

Although China's reform strategy has been described as evolutionary, production subcontracting in its foreign trade sector resembles other developing countries' experiences of dependency and disarticulation more than what one observes in its joint ventures and equity invested firms.

Scholars on the subject argue that the "big bang" approach to reform pursued in East Europe cheapens wage labor and disposes an economy toward development along patterns observed in the "new international division of labor,"

64 Forbes, 5/15/95 p. 5.
as countries specialize in low tech industries and low domestic wages. China has
done just this in establishing itself as a subcontracting center for Asia.

China's subcontracting center is in Guangdong Province, which had over 3
million workers engaged in working exclusively for Hong Kong firms in 1992. The
total number of local workers in manufacturing in Hong Kong for the same year
was 680,000.65

China's Subcontracting Production Model for Global Markets

China's development strategy has been distinctly Asian66 and reminiscent of
the trajectories followed by its neighbors, South Korea, Taiwan, Singapore, Hong
Kong.

China offers low cost labor intensive manufacturing, and an industrial base
that is significantly larger than most other developing nations'. Its extensive
system of trade corporations trained to work with foreign customers makes them
well suited to meet the needs of international firms which choose to subcontract
out all or a portion of their manufacturing. Companies subcontract for three
different rationales: for reasons relating to increasing capacity, specialty (products
requiring specialized skills or equipment that the firm does not have in-house),
and cost-cutting.67

China's successful entry into global subcontracting markets can best be
viewed through an analysis of how it has created a niche for itself in networks of
global commodity chains. Commodity chains are defined as "a network of labor
and production processes whose end result is a finished commodity"68

Global commodity chains consist of operations that comprise pivotal
points in the production process: supply of raw materials, production, export and
marketing - in effect covering the entire spectrum in the world economy. Each

65 Economist.

66 Overholt, p. 3.

67 Harrison Kelley, p. 20.

68 Appelbaum and Gereffi, p. 43.
operation is itself a network linking to other operations with related activities.\textsuperscript{69}

The global commodity chain approach argues that surplus accrues to different operations or "nodes" in the commodity chain depending upon how they are organized and controlled, rather than accruing in a single core country.

Buyer driven commodity chains describe those industries in which large retailers, brand named marketing companies and trading companies play the central role in setting up decentralized production networks in a wide range of exporting countries.

Buyer-driven commodity chains find China particularly attractive as a low-cost producer of labor intensive textiles and consumer goods such as footwear, toys, and electronics. The structure of foreign trade corporations with the extensive networks of manufacturers that they represent enables them to offer all of the specialized tasks involved in producing and shipping products for a single price to the foreign buyer. The customer does not have to employ any production workers nor deal with wage unionization or plant safety issues. Foreign firms can thus "externalize" many of the costs and risks associated with the production process.\textsuperscript{70}

Department stores and retailers are also often able to avoid the expense of building a department within headquarters of individuals who are experts in international production management issues. The off-shore production process is rendered much simpler when one has contracted almost all aspects of it to a single party for the transaction. Once the goods have been ordered, buyers do not want to learn any further information about the order other than that it has been shipped. Hence foreign buyers are able to save significantly at two key points in the production process: at headquarters in terms of training and size of staff managing overseas production, and at the production source itself.\textsuperscript{71}

\textsuperscript{69} Ibid.

\textsuperscript{70} Appelbaum, p. 45.

\textsuperscript{71} One of the leanest subcontractors I have encountered in the literature is "Topsy Tail," a $35 million company with only three employees, but numerous links with other firms who perform all essential production and distribution activities.
Chinese foreign trade corporations are particularly well suited to doing business under these circumstances. They have managers who have been trained (at state's expense) in foreign languages institute and often have travelled internationally. The Ministry of Foreign Trade and Economic Relations (MOFTEC) has an extensive network of agencies linked together to handle every aspect of import and export transactions. Shipping rates available to Chinese foreign trade corporations are often well below international competitors due to state subsidies. Additionally, MOFTEC has a freight forwarder based in the U.S. who offers subsidized rates to Chinese companies shipping goods back to China to support state foreign trade corporations doing business in the U.S.

The implications of decentralization for the subcontracting relationships between foreign trade corporations and producers are multifold. Reforms have encouraged further separation of the two entities rather than closer linkage. Decentralization has de-linked foreign trade corporations from shared values and goals with Chinese factories.

In a major reversal from previous allegiances, foreign trade corporations' loyalties now lie primarily with their foreign clients. Foreign trade corporations' profits are variable and depend upon successfully serving foreign customers. Who makes the goods is no longer relevant to foreign trade corporations as they are now free to arrange production anywhere in China where they can secure a competitive price.

Chinese producers on the other hand, prefer to work directly with their customers, without foreign trade corporations playing a middleman's role. When their profits were limited to 5% of the contract price by the government, there was no incentive for foreign trade corporations to try to encourage manufacturers to lower their export prices.

In fact brokers working on commission benefit from higher prices on a sales contract. Now that foreign trade corporations are buying and reselling goods to the highest bidder they have an incentive to keep buyers and sellers apart from each other. Manufacturers resent not knowing who their customers are, or how much their products are being sold for on the international market, which explains
the burgeoning of producers seeking independent trading rights.

It is not unusual to find foreign trade corporations price squeezing manufacturers, seeking to increase their own profit margins, to the point where manufacturers will only break even on a deal, but will choose to accept it in order to keep their production lines operating. Producers complain that sometimes they even lose money on deals that foreign trade corporations make a profit on. De-linkage to this extent did not happen until widespread decentralization lead to an explosion in the number of trading companies authorized to do export orders.

The immediate result of this phenomenon is that foreign trade corporation representatives are part of an emerging entrepreneurial elite in China whose profit niche is the difference between the export and international price of Chinese goods. Quota traders niche is the differential between what Chinese exporters charge for goods without quota and the international price of the goods with quota.

Chinese exporting firms that do not have their own marketing and distribution capabilities are in a sense captive to not only foreign trade corporations but also to foreign buyers. Manufacturers that do not have alternative selling channels for goods produced to order other than that offered by the foreign trade corporation (for export) are more dependent upon the success of the transaction than are either of the other two parties. Producers depend upon foreign trade corporations for a favorable outcome but do not have much bargaining power or control.

A case in point from my work experience as an import agent illustrates this situation: I was working with a foreign trade corporation in Shanghai which represented a manufacturer who produced for export but did not have independent trading rights. At my insistence I was taken to the factory and met with the factory manager and the others who were to be involved in the order (and was served the best meal I have ever had in China—which made the unfortunate outcome all the more disappointing). Our agreement with the foreign trade corporation, who’s signature was on the contract, not the factory’s (which is standard procedure when using an foreign trade corporation) was that samples
had to be approved prior to shipment as the goods being produced for us were not in the factory's standard product line. We did not receive samples, but got word from the foreign trade corporation that they wanted us to make arrangements to pay for the goods right away as the goods were finished and ready to ship. The foreign trade corporation representative had forgotten to arrange samples production and approval, but had told the factory the order was confirmed, advising them to buy the raw material and produce the goods.

As it turned out the goods were not correctly made and the buyer refused them. The loss was born by the factory who with the foreign trade corporation tried to find alternative buyers for the goods. But because the goods were not correctly made to US market standards they were difficult to sell to other buyers.

In order to save face for his error the foreign trade corporation representative blamed us, saying we had cancelled the order at the last minute for no reason. Had buyers and sellers been able to work together on the order it is likely we would have achieved a more successful outcome. But communication and transportation problems in China make it difficult to work directly with factories. The factory did not have a telex, fax, or phone with international connections - in such instances one is obligated to use foreign trade corporations who have the infrastructure in place for conducting international business. Unfortunately the losses from the order would have more than covered the costs of installing all of the needed infrastructure to do the business directly, had international links been available to that district at the time.

**Does Subcontracting Bring a Loss of Bargaining power?**

While on the one hand Chinese entrepreneurs are experimenting with economic opportunities and access to new technology and forms of business organization, the literature on dependent development continues to offer insight into the role played by these new entrepreneurs in the new international division of labor.

Lenin referred to the solid bonds created between foreign capital and the
bourgeoisie in less developed countries. In a decentralized system the relationships of trading corporations are primarily with their foreign customers—former links with domestic suppliers have loosened considerably with decentralization and new manufacturers (or suppliers) are easily substituted when problems arise. Chinese suppliers who are engaged in subcontracting production have increasingly little bargaining power with either foreign buyers or foreign trade corporations who represent them, unless they offer a niche product that is not substitutable—which is rarely the case. In fact, it is to the advantage of the brokers to keep suppliers in fierce competition with one another. Decentralization during the early and middle 1980's gave provincial foreign trade corporations exporting rights for the products sold by their province. A second wave of decentralization began post 1989 which greatly increased the number of firms with trading rights. Previously foreign trade corporations and factories were more closely linked in the course of a transaction as the foreign trade corporation handled the foreign exchange transfers, paid for the transportation of the goods from the factory to the foreign trade corporation warehouse, assisted in paying for raw materials, especially if they required foreign exchange. As Chinese foreign trade corporations have made their alliances with foreign clients, Chinese manufacturers if they don't have the rights as well as the ability to trade on their own lose bargaining power in the new more competitive environment.

This loss of national bargaining power with the resulting benefits of a competitive environment accruing to foreigners was soon noted by Chinese officials after decentralization policies went into effect. As local officials competed for export markets they slashed prices (supported by the two price system) gave away land and tax preferences, and overall created an environment in which Chinese firms' leverage weakened as they sought to outcompete and underbid rivals in order to conclude export contracts with foreign firms.

My experience in working with foreign trade corporation managers who

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72 Evans, p. 19.

73 Shirk, p. 63.
have spun off their own firms supports the view that the new entrepreneurial class works in tandem with foreign capital to keep the prices of locally produced goods low. Low prices and low wages lead to the stagnation or depression of living standards as inflation reaches annual rates of 25%.

As a result of large scale decentralization we are seeing intense competition in many markets which drives export prices down in an economy in which the Chinese are already world's least cost producers. Before decentralization reach its current scale of thousands of firms with trading rights, each province had its own foreign trade corporation in each product category which kept a measure of bargaining power in the hands of manufacturers.

Chinese firms in the most competitive sectors claim that their profits are directly linked to the price differential between what they pay local manufacturers and what they charge for the goods they sell directly to foreign firms. These profits can easily be as high as 400% as local firms often have no idea of the prices their goods command on the world market. They also do not know how to find and develop customers for their goods on their own. The majority of local manufacturers view foreign trade corporations as parasites who keep market information and their buyers' identities hidden from them deliberately as a means of profiting as middle men.

"Internal disarticulation" is a term used by dependency theorists to describe the development of a new bourgeoisie whose tastes and values do not reflect those of the majority of the population in the country in which they live. This phenomenon is occurring in China's foreign trade sector as entrepreneurial Chinese managers enter a new class of bourgeoisie elite compradors who fit the description of members of a transnational "kernel" who share similar living standards and cultural affinities with the bourgeoisie in other countries.

These managers are individuals who for the first time are able to trade as individuals on the basis of information and experience they have acquired over years' working in the state's foreign trade corporations. These assets previoU.S.ly

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74 Evans, p. 30.
had no commercial value for individuals in China, as managers were not able to offer their services as paid "consultants" in addition to the jobs they held with the State. Much of the rent seeking behavior which managers currently employ in China today would be labelled consulting services here if not for the fact that Chinese managers are already on the state's payroll and are not supposed to sell information they are already being paid to distribute free. The rub is that these state managers often did not do a very effective job of disseminating this information until there was a chance for them to profit individually from it. As one managing director of a foreign trade corporation told me, "Employees here have the very unfortunate condition of being both busy and lazy. This really hurts our effectiveness and success."

There have been reports that Chinese enterprise managers are engaged in large-scale asset stripping and corruption, often to the detriment of their parent companies. This new class of elite business managers have been developing at the same time the mass majority of China's population is increasingly isolated from political participation.

Yet China's new international entrepreneurs are contributing to new activities, employment and accumulation at the local levels. Given that the exchange rate is no longer overvalued and decentralization has brought increasing levels of competition with it; the prices of goods in many sectors are going down bringing greater demand for China's exports.

Sales of cashmere sweaters in the U.S. are a good example. When China decentralized its cashmere buying and selling agency in 1992, many private traders got involved in the market driving per kilo prices of cashmere fiber down by 67%. Sales of cashmere sweaters more than doubled over the next two years to nearly two million pieces. Production and selling networks in China expanded dramatically, clearing out inventory stockpiles, and bringing the retail prices of cashmere sweaters down by more than half in some cases, to under $100 from $300. Western manufacturers have moved into China as joint venture partners, investing in plants and equipment, and the Chinese have replaced the Scottish as the world's biggest buyers and and manufacturers of cashmere products, with 75%
control of the global market.\textsuperscript{75}

In luxury textile items like cashmere it’s possible for each component of the value chain to benefit from decentralization of a government monopoly over manufacturing and distribution. But this does not hold true in most export product categories. What I have observed occurring with increasing frequency is a "race to the bottom" as Chinese producers lower prices below cost while engaging in price wars. The agents or contractors who receive the orders from the U.S. importer or branded marketing firm (like Nike or Reebok or Liz Claiborne) control the price paid to the factory producing the order; their profit is the difference between what Nike pays for the goods and what the factory charges. When U.S. firms claim that they try to pay market prices or above for the goods they purchase in Asia they are not really making credible assurances, because they rarely know what the factory is earning on the order. Contractors have the freedom to specify who manufactures the goods and they typically go with the lowest bidders. While Reebok etc. may be paying above market prices for goods, the women on the factory floor in fact may be earning below market wages. The difference is in the contractors’ pockets.

China’s foreign trade entrepreneurs maneuver within this system by selling their services as contractors directly to foreign firms as independent and free agents. Some still happen to be on the state’s payroll, others are not. The difference is that those who are on the payroll are taking a risk, the seriousness of which seems to be based upon the amount of money being earned. This is where the big profits in manufacturing are being made today by Chinese entrepreneurs.

Local officials who help smooth things along the way rarely get paid a commission on each order. They typically get a finder’s fee unless they have an ownership interest in the factory—in which case commission on each order becomes a possibility. Commission has appeal over and above ownership profits because it is a flat percentage distributed before taxes and costs are deducted.

One of the more extreme examples of the race to the bottom occurred

\textsuperscript{75} Forbes, April 10, 1995 p. 84-85.
simultaneously in the U.S. and China was in 1992-1993 in the market for handmade cotton quilts in traditional American designs. Handmade American quilts have traditionally been a very expensive item because of the amount of labor involved in their production. Quilts date to 18th century colonial New England. The traditional designs developed by women who made quilts at home for their families have endured for over two hundred years. Until they started being produced in China U.S. retail prices ranged from $450-900 per piece for new quilts.

American firms started having handmade quilts produced successfully in China around 1990, and the category quickly became one of the most competitive of all textiles items. The category was 100% filled and closed by the third of March this year, the only category to do so. When U.S. firms began importing quilts they were buying them for approximately $30-50 each (prices varied, however) from China and sold them chiefly in department stores and better retailers. Importers made healthy profits selling these goods for about $100 each. This pricing strategy served the importers well and offered tremendous savings to consumers, who on average previously were not able to afford to buy any quilts. American made quilts had very limited distribution, and generally were never sold in department stores until they came in as imports.

Former managers from China’s foreign trade corporations who are now entrepreneurs based in the United States saw an opportunity. These new entrepreneurs are subcontracting production with their former suppliers in China. They began pirating the printed fabrics used by the largest New York textile firms to improve upon the design content of the goods coming from China. Stock Chinese prints do not generally fit into the contemporary home furnishings markets here, and the pirated factrics made quilts even more popular. It took awhile before the U.S. firms organized and launched a lawsuit to halt the imports of their pirated fabric because they had to first determine who was involved in the copyright infringement and the goods distribution on both sides of the Pacific. Some former manager/entrepreneurs entered into joint ventures with Chinese textile producers (which gave the factories direct exporting rights if they did not
have them previously). These firms knew the former managers well from their earlier incarnations as state corporation representatives. Unfortunately for them they did not know that most of these former managers are playing by entirely new, cutthroat trading rules today, aimed strictly at maximizing profits. The entrepreneurs proceeded to drive the down the prices they paid the factory for the quilts. Prices to Chinese factories went as low as $10 per piece (producers did not make profits at that price, but because they had a single sales outlet for their goods due to lack of information about the U.S. market) and quilts started showing up in mass market discount chains for $25. One especially innovative Chinese entrepreneur registered the 6 or 7 most common quilt designs, including Prairie Star, Double Wedding Ring, Ninepatch and Basket of Flowers and registered them as his private copyrights with U.S. Customs via the Treasury Department’s Intellectual Property Division. All of the designs are over one hundred years old, and have been designs in the public domain used by thousands of American women quilters for several generations. It was a particularly cynical twist on the U.S.-China intellectual property dispute that went entirely unnoticed by the public.

The short term effect of placing the country’s most popular quilt designs, which were used by the majority of U.S. quilt importers, under the control of a single firm threw the market in an uproar. The Customs agents who oversee textiles imports are almost entirely women. They recognized the absurdity of allowing a Chinese company sole rights to import traditional American designs that have been in the public domain for over a century, but they had no jurisdiction to overturn a bad ruling. The Treasury Department had approved the application for the quilt design copyrights as a routine matter, lacking either textile experts or women in the positions from which rulings are made. Most American women can recognize traditional quilt patterns and would have questioned the application for a copyright. (This was divulged to me by the chief U.S. Customs agent for textiles rulings in San Francisco.)

For the cost of $25 per design, Arch Imports was able to capture control of the U.S. quilt market temporarily. The importers whose goods were in production
or already on the water en route to the U.S. were in serious trouble. Their goods were not allowed to enter the U.S. All arriving quilts had to be held at Customs for examination to make certain they did not contain designs which now belonged to Arch Imports. Those that did had their goods impounded, with daily storage fees assessed by U.S. Customs.

Those firms who did clear their goods through Customs found that Arch, along with other new Chinese entrepreneurs had started a price war, driving mid-range quality goods' prices down to the bottom of the market. They were in fact selling quilts in the U.S. below cost, in several cases because they had not paid Chinese producers for the goods. Those who did pay had driven the price to the factories so low that the producers were not earning profits, but merely breaking even. By driving the prices to their lowest point in each market (China and the U.S.), new entrepreneurs were briefly able to capture market share. Their profit is the difference between what they pay the factory in China (if anything) and the market price in the U.S. Chinese firms' strategy in this go-go period of economic growth appears to be "do business with everyone in the world, once." I learned from Chinese factory sources who worked with some of the "new foreign trade entrepreneurs" that the factories were not getting paid for the goods. Many Chinese factories offer former foreign trade corporation managers extremely favorable payment terms and in many cases goods on consignment in the hopes that these new entrepreneurs will serve as the factories' independent marketing agents abroad. What then happens is that the entrepreneur receives a shipment of "free" goods he/she does not have to pay for if he/she is now based in the U.S.A. or Hong Kong. A few transactions like this can quickly place a recent immigrant squarely in America's middle class.

There is an axiom circulating among Chinese foreign trade entrepreneurs that goes." Buy at 10, sell for 7, pay 4 (having gotten the goods on consignment from factories who are former customers who trusted you under the old system, and now have no bargaining power since the goods are in your hands.) and keep 3. The problem is that goods whose contract price is 10 should be sold at 20 not 7, but a mass marketing strategy that targets discount chains as distribution outlets
enables a single agent to profit on each transaction with minimal overhead. Few "new entrepreneurs" have the capital required to build systematically a distribution network for goods selling at standard mark-ups. Selling to mass merchants offers the simplicity of dealing with a single buyer who does not have the same quality concerns shared by retailers in the middle and upper markets. In point of fact, there is only room for one agent in these types of transactions. The manufacturers are "slaughtered" (xia hai) in these types of deals as their goods are sold below cost overseas by a single maximizing entrepreneur enriching himself at the State's expense (or others, if the factory is a township village enterprise).

The problem is that the factories and the workers suffer when contracts go awry in this way; the state loses revenues as well. The example of the footwear manufacturer in Section 3 below will discuss factories' ineffective and hence unsuccessful efforts to track down errant customers when they lose goods they have shipped on consignment. Former managers based outside China have little reason to fear retaliation as long as they have a green card, usually obtained with sponsorship by their corporation prior to their exit.
SECTION 3
Reforming China’s Foreign Trade Corporations:

China’s foreign trade corporations are linked closely with the nations state owned enterprises. The state enterprise system is how the Chinese government controls general economic activity in its heave and strategic industries sectors: steel energy chemicals and machinery. There are more than 100,000 state owned enterprises, employing 110 million workers—a number nearly equal to the entire US work force.\textsuperscript{76}

SOEs, of which foreign trade corporations are an important subset, provide institutional stability to the political regime as well as form the economic/social structure in workers lives. It is the point of contact between citizens and the government. Government policies are often implemented through the workplace, as state owned enterprises take responsibility for the disbursement of subsidy coupons, childcare, health, living spaces, retirement benefits, etc. Jobs in foreign trade corporations have always been considered plum positions that enable people to travel outside the country, buy foreign consumer goods while abroad (often with their expense account funds) and frequently attend extensive banquets for foreigners paid for by the State.\textsuperscript{77}

Some theorists argue that the degree to which the economy has been liberalized can be seen in the share of the economy controlled by state enterprises. Estimates differ depending on how broadly one defines the state enterprise sector, with its many kinds of ownership structures, but China’s state enterprises control between one-third to a little more than one-half of the

\textsuperscript{76} Forbes, May 8, 1995.

\textsuperscript{77} In a nation in which many foods were rationed for the past several decades, being able to eat at the top of the nation’s food chain is no small achievement. Many times when I have been travelling in China with foreign trade corporation reps we will leave a lunch banquet completely stuffed, unable to eat any more, yet the first topic of conversation when we return to the car invariably is where we should eat next and what delicacies we should order in advance for dinner.
economy and their share is declining.\textsuperscript{78} The reasons for the decline are the privatization of agriculture and the growth of township village enterprises (TVEs), and firms owned privately either by Chinese or foreigners. My focus on state owned enterprises in the foreign trade sector reflects the view that the ability to upgrade an economy depends in part upon domestic firms’ abilities to compete in the portion of the economy exposed to international competition.\textsuperscript{79} China’s foreign trade sector resembles Japan’s with its large import/export cartels. China’s cartels have been exclusively state-owned firms, which traditionally has been a way of capturing the bulk of national foreign exchange revenues. The decentralization of foreign trade corporations has meant the government no longer exerts tight controls over foreign exchange flows except through macro-policy directives.

One of the major focuses of the reforms was the promotion of quasi-private TVEs and privately owned firms. Their share of the economy has steadily expanded while the state’s portion has declined. Foreign enterprises were expanding at the rate of 50% per annum in 1992, followed by independent ownership at 22%.\textsuperscript{80}

\textbf{Role of State Owned Enterprises in Chinese Society}

Party rule and centralized control of Chinese society has been maintained primarily through the workplace, the administrative unit, \textit{danwei}. State owned enterprises perform several different essential roles as economic organs of the Chinese state. In the foreign trade sector, they are also the repositories for the majority of China’s best trained managers, many of whom have worked overseas, speak Western languages, and have business experience that spans the last three decades.

SOEs also provide a set of benefits to workers akin to state subsidies in the

\textsuperscript{78} Overholt, p. 12.

\textsuperscript{79} Michael Porter, 1990.

\textsuperscript{80} Ibid.
areas of housing, transportation, day-care, pensions, as well as public goods and commodities that are not available from other sources.\textsuperscript{81}

For the last 30 years Chinese state owned enterprises have functioned as socio-political communities, providing workers and their families with housing, education, childcare, transportation, recreation, healthcare, and burial. As such they are the focal point for what remains of communist party control.\textsuperscript{82}

Beijing wants to keep as much control as it can over the foreign trade sector, which has already been compromised with decentralization of foreign trade corporations. Periodically throughout the 1980’s China’s authorities would call for re-centralization of trading as an attempt to reassert what they viewed as a loss of China’s bargaining power with foreign trading partners. But the state monopoly over trade once dissolved was never re-established.\textsuperscript{83} Beijing was a distinct loser in the mid-1980s as a site for much of China’s foreign and subcontracting direct investment. Many overseas Chinese and US firms chose to invest in southern China instead of Beijing due to the bureaucratic difficulties of doing business in the north. Beijing was seen as a difficult place to do business by foreign investors, due to the excessive monitoring and slow to move bureaucracy of the state owned firms there. Nike and other footwear manufacturers struggled in efforts to do business in Beijing and Shanghai for several years before finally deciding to locate in Fujian and Guangdong. Nike cites an ancient Chinese cheng yu, "Tian gao, huangdi yuan" ("Heaven is high and the Emperor is far away") as reason for their departure to the South.\textsuperscript{84}

The goals of reforming China’s foreign trade administration were to promote exports while reducing the government’s financial burdens from trade. Under the previous system, the Ministry of Foreign Trade and Economic Relations (MOFERT) worked with a few national foreign trade corporations to

\textsuperscript{81} Walder, 1986.

\textsuperscript{82} Walder, ibid.

\textsuperscript{83} Shirk, p. 63.

obtain the imports and exports set by the central planning authorities. Foreign exchange was controlled exclusively by MOFERT, (now named MOFTEC), giving local enterprises no incentive to improve their volume of trade given that they could not use the foreign exchange that international transactions generated. Further, imports of food grains and fertilizer purchased at international market prices were sold at fixed domestic prices, costing the state renminbi. The same held true for exports. The disparity in domestic and international prices of numerous products produced currency earnings but financial losses from trade.  

Decentralization

China introduced new forms of international trade in 1987-1988 with a shift from national foreign trade corporations to decentralized corporations. Provincial and municipal governments were permitted to establish their own trading companies in competition with the MOFTEC corporations.

Previously about a dozen companies (based in Beijing, Shanghai, and Guangzhou) managed all of China's foreign trade, by 1990 there were more than 5000 trading companies established by ministries, provinces, and cities. Guangdong alone had nearly 900 foreign trade corporations by the end of 1987.  

The burgeoning of trade extends beyond China's geographical borders as managers running spin-off companies often have the goal of establishing a subsidiary in the USA for immigration and investment purposes. A recent estimate put the number of Chinese trading companies (including Taiwanese) based in Los Angeles conducting trade with China at over 2000.  

The new system allowed local firms and governments to retain a share of their foreign exchange earnings. Foreign exchange retention rights became valuable commodities due to the overvalued exchange rate, making imports both affordable and in great demand. As a result of the foreign exchange retention

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85 Shirk, p. 58.

86 Shirk, p. 47.

system provinces and exporters were able to increase their shares of foreign exchange from zero in 1978 to 42% in the mid-1980's.\textsuperscript{88}

These modifications to the old system meant that Beijing, Shanghai and Guangzhou foreign trade corporations would no longer be responsible for the export of goods from all of the other provinces. While the centralized system had enabled a high level of control, it was very inefficient from the point of view of the provinces outside those trading centers who felt the national trading corporations did not adequately represent their interests. Additionally, they felt stifled in their efforts to develop relationships with buyers and sellers outside of China. In practical terms it was rare for managers from the central trading cities to travel outside their local areas to China's interior or hinterland provinces to visit the majority of the factories they "represented" in foreign trade. Consequently they tended to promote the products from the local firms with whom they shared close relations, a common dialects, and had the opportunity to develop clientelist relationships.\textsuperscript{89}

These clientelist relationships are very important because the closeness of the relationship between foreign trade corporation and manufacturer often determines to whom the foreign trade corporation gives an export order. In most cases the direct link to the foreign buyer is the foreign trade corporation. Foreign trade corporations generally have between twenty and fifty factories that they represent in a provincial area.

\textbf{Continued Challenges for Foreign Trade Corporations}

While decentralization represented a major restructuring of relationships between foreign trade corporations and Chinese producers, the reforms were not comprehensive for foreign trade corporations. They were not given unilateral powers to operate independently of the center. There was no introduction of factor markets for labor—personnel could not quit or be fired, state firms were

\textsuperscript{88} Shirk, p. 51.

\textsuperscript{89} Oi, p. 214-219.
forced to hire excess workers. (In contrast, the Joint Venture Law specifies that Chinese-foreign cooperative ventures may select and dismiss employees.\textsuperscript{90}

Furthermore, local governments frequently asserted their new freedom by intervening in markets within their jurisdiction to force local firms to buy locally produced goods. While this type of directive may benefit Chinese enterprises seeking to increase their contribution of local content to export orders, this can jeopardize a foreign trade transaction which requires imported inputs. Local officials often desire enterprises' tax revenue to stay within their local jurisdictions, which can hamper factories who are subcontractors from purchasing the components for an order required from abroad.

Local governments also wished to limit outside firms from selling to local customers as a means of keeping profits in the community. Localization issues of this type contribute to what has been termed the "block economy" in China in which goods cannot freely flow to areas in which they are in greatest demand.

Localization issues can strongly affect foreign trade corporations as they cannot always source goods locally in order to meet the quality standards for export orders.\textsuperscript{91}

Foreign trade corporations and entrepreneurial firms now increasingly disperse their production contracts geographically, depending upon the breadth of their personal networks. This is a relatively recent phenomenon. For example, it used to be very unusual to find a foreign trade corporation in Shandong, say, handling an export order of a manufacturer in Guangxi. Today it is not so unusual. But it is more common for remote or interior producers to still maintain traditional relationships with their own provincial foreign trade corporations in addition to new local foreign trade corporations. Provincial foreign trade corporations have more experience and a wider spectrum of connections to foreign buyers and sellers than the new entrepreneurial firms.

Infrastructure limitations present challenges to doing business across

\textsuperscript{90} Schnepp et al., p. 251.

\textsuperscript{91} Gordon, p. 205.
spatially dispersed areas of China. Telephone connections to rural areas are often unreliable, transportation to many areas is difficult and inconvenient enough to serve as a disincentive for foreign trade corporation staff to go regularly to out-of-the-way locations to check production and quality. Working with foreign trade corporations whose manufacturers are very far afield from their offices is rarely a good strategy. Relationships between foreign trade corporation and factory (increasingly strained as foreign trade corporations develop goals which do not always serve the interests of the manufacturers) are often already tenuous, to factor in distance sometimes has disastrous results.

Rural producers with export rights however have emerged as China's export powerhouses in the 1990's. Rural companies are leading the nation as an export sector, increasing the number of firms with exporting rights from 2000 enterprises in 1990 to 134,000 in 1993. These firms are predominantly in the coastal regions of Jiangsu, Zhejiang (previously represented exclusively by Shanghai foreign trade corporations) and Guangdong,\(^2\) areas which traditionally have produced for export markets. Local firms now have more control of marketing and distribution channels where before they depended upon Shanghai and Guangzhou to bring orders to them.

\(^2\) FBIS 7/25/94, p. 46.
Limits to Restructuring Efforts

Aging capital stock in state owned enterprises limits the depth of China’s industrial restructuring efforts, which in turn affects the capability of foreign trade corporations to sell advanced products abroad.

In a recent study of firms during the reform period, 30% of factory equipment was found to date to the 1950-1960s. Automated or semi-automated production lines in Shanghai only total 9.24%. This situation caused Chinese enterprises to seek to import complete assembly lines and purchase complete plants from Western firms during 1980s. China will not be able to rely upon former emphasis of mining and raw materials’ production and exports in the future. China is facing depletion of its productive mines—a situation which is already hurting Liaoning Province. China’s mineral reserves standing has been downgraded reflecting Liaoning’s inability to meet its own industrial and energy needs—at same time that China is selling large quantities of petroleum on international markets.

The 3rd regime syndrome finds factories in regions jigsawed in their geographic location to suppliers and customers. Factories in the north are incompatibly located to allow them to develop industrial clusters. This makes it logistically difficult for industry consortia to develop and engage in and manage foreign trade transactions themselves.

Lack of industry clusters puts the Chinese at a competitive disadvantage, which is exacerbated further by 3rd regime factories in potential high tech categories that are located in mountainous, difficult to reach locations in Western and central China. These firms have had limited ability to enter the foreign trade sector due to poor roads and lack of infrastructure. But it is precisely in China’s former defense firms that high tech innovations and spin off firm potential resides. Firms in mountainous regions in interior provinces have difficult challenges to enter export markets—due to transportation, information barriers, and infrastructure issues.

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93 Naughton, pp. 351-386.
Special economic zones benefit from their location in the south with proximity to the eastern coasts for shipping and Greater China regions and its overseas Chinese business communities. The industrial centers of central and northern China do not have these advantages. Porter argues that nations succeed not in isolated industries, but in clusters of industries connected through horizontal (common customers, technology, channels) and vertical (buyer/supplier) relationships.94

Industrial clusters are a central feature of many advanced national economies, yet because of the arbitrary location of many of China's 3rd regime firms as well as the aging capital stock in northeast cities such as Liaoning, Shenyang and Changchun, industrial districts face numerous challenges to development.

Spin-off Firms

Foreign trade corporations are spinning off small firms as a competitive strategy to deal with increased rivalry from independent trading companies and producers with exporting rights. Spin-off firms are usually run by a manager from the parent foreign trade corporation who is a veteran foreign trade expert.

Big firms in many industries are typically slow to move, innovate or re-engineer themselves without specific incentives offered either by government or financial institutions. The structural inertia which large organizations face can be applied to former Soviet-style command economies as well as to large Western organizations. It is with this in mind that we should view the increased decentralization of State foreign trade corporations and the spinning-off of subsidiaries as an innovative effort to promote competitive flexible firms from largely overstaffed and slow to move enterprises.

Shanghai Petrochemicals, a large state owned firm, recently reported that 40% of its workforce is not directly engaged in productive activities, but rather in the service and 'non-core' activities—in the company's clinic, nursery, cafeteria

94 Comp Adv of Nations, p. 73.
and other human-resource departments.\textsuperscript{95}

In a study of the laundry-detergent industry, McKinsey & Co. concluded that mainland producers employ ten times as many workers as Western factories with the same capacity.\textsuperscript{96}

The operational and bureaucratic systems that have evolved over time to manage overstuffed Chinese state-owned enterprises are viewed by many as too big to reform efficiently. Hence we are observing spin-offs and mergers of single departments with the departments of other state-owned enterprises.

Spin-off firms are building their competitive trajectories, by expropriating the firm's human capital, client and supplier networks in order to re-engineer a more efficient new organization.

The opportunities presented to many experienced managers of Chinese corporations in recent years has been to start their own small spin-off firms, often with colleagues or handpicked employees from their former foreign trade corporation to develop a specific niche, specializing in one particular product category, service, or core competency that the parent foreign trade corporation was unable to utilize fully in the face of market opportunities. These firms are created with the goal of adding value and operating with a level of flexibility not formerly possible under the weight of foreign trade corporations' characteristic organizational structure of excessive employees, innumerable administrative procedures and numerous prohibitions in general. The restrictions on foreign trade corp staff during the 1980s were extensive: individual employees were not allowed to meet with foreign customers one on one privately out of the government's fear that corruption would be the result. Trade corporation representatives would be required to travel in groups, with no one allowed to attend a meeting alone. As a result when travelling in the US on business trade corporation employees were required to bring along "associates" to meetings with foreign clients who had no relationship to or knowledge of the transaction, but

\textsuperscript{95} Time, international edition, June 27, 1994.

\textsuperscript{96} Time, ibid.
were there solely as a watchdogs. Trade corporation representatives were also forbidden from going to meals alone in China with customers.

Spin-off firms do not mirror the spontaneously privatized firms of Eastern Europe and the Soviet Union, because they continue to operate under the state's control through the contract responsibility system which offers incentives to spin-off firms. But the fact that these spun-off new firms are often referred to in Chinese as "xia hai" firms (killed companies) gives credence to the assertion that asset stripping is going on in China as well as the Soviet Union. MacMillan and Naughton\textsuperscript{97} argue that because productivity went up in the spin-off firms they studied and these firms are operating in an increasingly competitive environment drops in profit levels are justified. They also point to productive investments made by the state owned firms following increases in their autonomy as evidence that they are not asst-stripping. The key questions to ask in this regard are what kind of investments are these firms making and are there rent seeking opportunities for them in these state-financed investments? Simply increasing ones investments does not imply that returns will increase automatically. Subsidies to these firms rose after autonomy—as expenditures for banqueting and business entertainment also rose, exceeding over $1 billion in 1993.\textsuperscript{98}

In the foreign trade sector what we see emerging is widespread entrepreneurship among managers who have been educated and trained by the state and who as agents of state enterprises developed extensive client and supplier networks over the past fifteen to twenty years. These managers are now going into business for themselves using those networks and access to resources to build their own successful firms, often which are registered in the USA. Experienced foreign trade corporation managers typically have spent the majority

\textsuperscript{97} MacMillan and Naughton, p. 136.

\textsuperscript{98} Having worked with several of these spin-off firms who have New York offices I can report that many of these investments are in the US real estate market that managers live in rent-free while they take 2nd jobs or enroll in English classes full time while ostensibly representing their company's or province's trade relationships in NYC full time.
of their careers working in the same corporation, often within the same approximate product categories. Their business and informal networks of contacts are extensive and are the basis upon which the new quasi-private entrepreneurial firms build their core competencies.

Competing Solely on the Basis of Connections

Company no 1, Pudong Global Trading is run by a manager in his early 40s who spent several years living in Europe working for one of Shanghai’s oldest and largest state-owned exporters. In 1992 he was allowed to spin off a smaller more flexible firm which is a subsidiary of the parent company. He spent 15 years working in the same department handling export orders for about 30 factories and workshops in Shanghai, Jiangsu and Zhejiang. Although decentralization gives the Jiangsu and Zhejiang manufacturers freedom to work with their own regional foreign trade corporations they often keep their old relationships intact and continue to produce for Shanghai export firms. Shanghai foreign trade corporations have more experience than regional start-up firms who have at most been in business now only ten years.

In being given his own export firm to run in one of Shanghai’s fastest growing foreign trade areas Manager Nan was expected to develop closer relationships with the foreign buyers who had been his clients in his previous job at the parent company. His new firm emphasizes flexibility in the types of products handled, no longer being locked into a particular category or range of goods they can offer. (They claim they can obtain any product from any firm in China as long as they have a friend or a friend of a friend working there. If they do not have a friend in the sought-after company or office issuing the required export licenses they regretfully inform they cannot handle the order.) They compete solely on the basis of networks and informal links as a foundation for building their business. Foreign trade corporations have numerous advantages that smaller spun-offs do not have; for example, they have more employees to dedicate to an order, more resources to offer manufacturers in terms of input suppliers, assistance with financing, and they can better afford in many cases the
costs of building relationships with foreign buyers.

The firm's clients for the first two years were almost exclusively customers that he had worked with in his previous job. Because the spin-off firm is officially state-controlled there is no concern over issues of trade secrets or proprietary information. The view of the parent company is that spin-off firms are able to overcome some of the structural inertia problems plaguing China's largest foreign trade corporations.

This view holds true only as long as entrepreneurial managers of publicly owned trade corporations continue to work in the state sector. Once they start their own fully private businesses the state can become very proprietary of the networks and customers private entrepreneurs seek to serve.

Another entrepreneur, Madame Tang, has worked for China's largest textiles foreign trade corporation for nearly twenty years. Her job is to provide the textiles quota needed by Chinese manufacturers around the country in order to export to foreign markets that restrict textiles imports. In highly competitive categories there is always more quota needed than there is available. The allocation of quota is largely based upon the amount of business shipped the previous year in the category in question, and is also a political process, with firms and provincial bodies lobbying hard for as much quota as they can get. There is always a balance left in each category after the initial round of allocation, which occurs in November for the following year, so as to give manufacturers some flexibility in accepting orders. Most textiles categories are not highly competitive, and do not close early. Yet in the categories that are in great demand, those who allocate quota or licenses have unique rent-seeking opportunities. During the early and mid 1980s if one needed quota and happened to be fortunate enough to know one of the few people in Beijing who did this sort of work a phone call was all that was needed to secure the necessary documents. Today, those who allocate quota are either in business for themselves or are linked to private entrepreneurs who work with them to sell quota to the highest bidders. Quota is not officially for sale in China, and if one is importing textiles into the US one of the documents required by US Customs is a statement that quota was not purchased.
Madame Tang has left her job at the state owned corporation and has gone into a private endeavor using her networks from her former job to link US textiles buyers with quota, for 5% of the contract price. Her commission on one order from 1993 was over $100,000 (U.S. dollars). This is not an easy business to run because it is illegal in China and requires the complicity of friends still working for the state to operate. Tang is only able to do it as a result of having emigrated to Hong Kong to avoid Beijing's jurisdiction. Those who operate this type of business in China do so at great risk. Tang is not an isolated individual taking advantage of the system for her own gain, she is part of an extensive network of top managers and bureaucrats working at the top of China's textiles industry.

One of Tang's main sources of textiles quota, Li, was accepting side-payments directly from buyers in addition to working through Madame Tang and was arrested in 1994. Authorities found $300,000 (U.S. dollars) in Li's family's house. At age 27, Li is now in jail, facing possible execution for corruption and theft of state property.

Rent seeking in the distribution of quota and export licenses is widespread throughout China in part because there are no transparent institutional linkages between Beijing and the provinces to handle allocation in an efficient non-particularistic manner. Particularism is a term used by Susan Shirk to describe the ad-hoc arrangements negotiated by the government for various provincial and regional organizations. Given that many of China's reform policies appealed directly to the incentives of both communist leaders and subordinate officials, traditional patterns of patronage and bargaining have not only been maintained, but strengthened.

Many regulations in foreign trade corporations that previously would have been enforced are (under decentralization) routinely ignored, inspiring many bureaucrats to now ask payment for what was once supplied free of charge as part of one's job. This phenomenon inspired one manager of a state owned firm to comment that the individuals making the most money in foreign trade today are those daring enough to break the most rules. Madame Tang's strategy conforms to what I call a "frontier bargaining model" of economic relations. Her business is
based upon China's traditional social system of patronage, which best serves those with wide and deep informal networks based upon years of apprenticeship and practical experience. As a former negotiator for the Chinese government on the MultiFiber Arrangement, she knows she is testing the dynamic outer margins of foreign trade liberalization. Having moved her base to Hong Kong she believes she is sufficiently distant from the occasional purges which target a few unlucky scapegoats before everyone returns to business as usual. Even if she is correct, she has only two more years until 1997 returns Hong Kong to China's control.

In my experience these new managers who are running spin off firms, or fully private endeavors (many times whose businesses are registered in Hong Kong to avoid prosecution in the People's Republic of China for their activities), domicile their firms' as well as their own private assets overseas.

Too Many Middlemen

In some cases decentralization has exacerbated the difficulties in conducting business because excessive numbers of middlemen get involved with no government intervention restricting their participation. Agents often seek to charge fees for providing informal services that require no effort on their part but may be helpful to the transactions' success. I was once involved in helping to put together the sale of used textile machinery for a small trade group that had come to the US from one of China's special economic zone's. The General Manager of the special economic zone was along on the trip and they had brought cash, enabling them to purchase the goods immediately upon approval, and not wait for financing to come from China (which is often the case in SOEs efforts to purchase goods from abroad); the result being that the goods are frequently sold to others while the Chinese wait for final approval and funds disbursement.

I was asked to help the Jinjiang group who spoke no English and had never been to the U.S. before. I had no knowledge of any other agents working with them—and neither did they. Somehow between the time when I was hired and the group's arrival in the U.S.A. 2 "commission agents" in the role of "friends" got inextricably involved in the group's affairs and could not be
persuaded to leave despite having no value to add and they were not sourcing the equipment in question.

I had contacted one local agent in North Carolina to line up factory visits to firms wishing to sell goods still in use on production lines. He said he had another agent to whom he was obligated to pay commission who had introduced U.S. Altogether there were 4 agents (not including me) wanting between 5-10% of the final total of the goods, which the Chinese buyers expected to be in the area of $650,000. The Jinjiang group's travel and accommodations were being handled by a Chinese receiving organization who presents themselves as a non-profit state owned marketing firm based in New York City, China Network, that assists Chinese foreign trade corporations and manufacturers to do business in the U.S.A. They contacted me privately to let me know they expected a 10%, non-negotiable commission on any equipment bought by the Jinjiang representatives. They mentioned that they had also been in touch with a local equipment agent in North Carolina (who I had never heard from and never met) whom they had promised an additional 5% commission on any equipment purchased.

Excessive middlemen do not make trade transactions more efficient; they make them more likely to fail. Chinese organizations do not like to work through middlemen when they are the end users. When foreign trade corporations seek bids on equipment or commodities they wish to import it is common for them to prepare a very detailed specifications sheet with an offer price 10-15% below world prices.

Has the Center Lost Control?

Reforms have meant that the share of the government going to central coffers has become increasingly smaller. Prior to tax reform in China the center was sequestering almost half of growth national product (GNP) annually. At the end of the first decade of reform, Beijing’s share of GNP had dropped to below one-fifth of previous levels. Efforts to revive the government's revenue bases have been unsuccessful, as provinces have refused to accept new tax reforms which
would increase their taxation rates.\textsuperscript{99}

Political institutionalists argue that the administrative decentralization of authority increased the power of and benefitted provincial and local officials to such a degree that Beijing did not reassert itself when it was clear that the provinces were violating central govt edicts to stop accepting foreign investment and accepting new industries due to inflationary pressures.\textsuperscript{100} Provinces out of jurisdiction of the center pursued their own agendas which further increased the amount of foreign investment coming into the country.

"Particularistic contracting" emerged, which is a phenomenon in which rules and regulations regarding reform policies are implemented on an ad-hoc basis. In this way the implementation of the reform policies fit in well with the former communist system of patronage for production supply and quota allocations.\textsuperscript{101}

Rent seeking opportunities emerge as a response to insufficient institutions at provincial and central levels to uniformly apply reform policies. New institutions have not been created to effectively handle the rent-seeking opportunities presented by the reforms. Things that previously did not have market value are now worth a lot of money to managers who handle the dispensation of quotas, contracts, etc.

Yet institutional systems of control are lacking, as observed by the rise in quota trading, increased license trading, and every other kind of trading. The frontier bargaining model of economic relations applies to China's new entrepreneurs who trade in state information and assets that prior to the reforms had no market value, yet today represent a percentage of a contract's total value. There are efficiency losses to the state, as payments often go directly into bureaucrats pockets rather than into state coffers for quota fees etc. Reports of spontaneous privatization in which managers claim state property for their own

\textsuperscript{99} Overholt, p. 12.

\textsuperscript{100} Shirk, p. 31.

\textsuperscript{101} Shirk, p. 32.
private use is also on the rise.\textsuperscript{102}

The state recognizes the need for entrepreneurial skills and has tried to promote education, but evidence points to people still using the old system of informal networks and back-door access, \textit{guanxi, menlu and chulu}, in absence of emerging institutions to support transition to a market system. Research shows that age and education do not significantly influence one's chances for success in the new economic system. The market system thus far is poorly developed and with insufficient institutions to support the advancement of qualified individuals. Respondents in a survey of 20,989 successful specialized household in rural areas attributed their success to experience and connections. Those who had been former cadres and were using their influential networks, experience, and economic management skills totalled of 48\%. Those with higher education, returned intellectuals and demobilized soldiers; those without extensive connections that had been developed in previous positions numbered only 42\%.\textsuperscript{103}

\textbf{State Enterprises Continue to Lose Money: The Evidence}

Between 1980 and 1992, Chinese industrial enterprises lost 168.2 billion yuan (about 19.3 billion dollars at 1994 rates), with 126 billion yuan lost between 1989 and 1992. In 1989, 16\% of state industrial enterprises lost 18 billion yuan, jumping to 27.6\% and 34.9 billion yuan in 1990 and to 23.4\% and 36.9 billion yuan in 1992.\textsuperscript{104}

In the first four months of 1994, 45.2\% of large and medium state enterprises were losing money and facing current liabilities of $281.7 billion yuan and 56.2 billion yuan in sales costs. The net fixed assets of loss-making large and medium state enterprises were set at $256.4 billion yuan and circulating assets at $279.3 billion yuan, representing 39.8\% and 35.6\% respectively of the country's total assets of large and medium enterprises. 11.7 million workers are employed

\textsuperscript{102} Sachs and Woo, p. 44.

\textsuperscript{103} Oi, p. 217.

\textsuperscript{104} Kyodo News Service, October 27, 1994
in the large and medium state enterprises, some 43.9% of the total number of workers in that sector, according to the report.\textsuperscript{105}

In the thirty-eight major industrial sectors, the number of loss-making enterprises exceeded 50% in eleven sectors, including coal, petroleum, ferrous and nonferrous mining, the paper industry, nonferrous production and the military industry.

Losses were partially due to a change in the enterprise accounting system, the unification of China’s exchange rate, reform of the country’s tax system, a tight credit policy and growing stockpiles at enterprises. According to neoclassical economists these are the growing pains of transforming from a state planned economy to a market economy. The challenges of ill-defined ownership, government interference in enterprise management, internal labor-management disputes as well as between departments over profits and responsibility for liabilities all had a negative influence on the balance sheet.

Chinese economists have called for the bankruptcy, merger, restructuring or conversion of more than two thousand non-key enterprises which lose more than 15 yuan per 100 yuan of production value.

The biggest money losers are the paper, chemical, fertilizer and food-processing industries which employ 2.9 million workers and have current liabilities of $93.3 billion yuan against fixed assets of $67.4 billion yuan.\textsuperscript{106}

Despite the mounting losses in the state enterprise sector, China has proceeded very slowly with privatization. If privatization occurs before price reforms go into effect, many firms may become bankrupt, not because they are inefficient, but because their product prices are below market prices or because their sources of credit disappear with the reforms. Many raw materials in China such as coal and energy are priced well below market prices (see following tables).

\textsuperscript{105} Ibid.

\textsuperscript{106} Kyodo News Service.
Table 10. Subsidies and Central Bank Credits to State-Owned Enterprises, China, percent of GDP

<table>
<thead>
<tr>
<th></th>
<th>Price Subsidies</th>
<th>Enterprise Loss Subsidies</th>
<th>Total Subsidies</th>
<th>Central Bank Credits to Banks</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>0.31</td>
<td>3.21</td>
<td>3.52</td>
<td></td>
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</tr>
<tr>
<td>1984</td>
<td>3.14</td>
<td>2.87</td>
<td>6.01</td>
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<tr>
<td>1988</td>
<td>2.25</td>
<td>3.17</td>
<td>5.43</td>
<td>5.14</td>
<td>10.57</td>
</tr>
<tr>
<td>1990</td>
<td>2.15</td>
<td>3.27</td>
<td>5.42</td>
<td>7.55</td>
<td>12.98</td>
</tr>
<tr>
<td>1991</td>
<td>1.88</td>
<td>2.57</td>
<td>4.45</td>
<td>6.76</td>
<td>11.21</td>
</tr>
</tbody>
</table>

Notes and Sources: For purposes of calculating the total resource flow to the state-owned enterprises, we assume that all central bank credits not directed to financing the central government budget deficit are used for financing of state-owned enterprises. China Financial Statistics, 1950-1991; China Statistical Yearbook 1992; Almanac of China's Finance and Banking 1991; and Annual Report 1991 of The People's Bank of China.

Source: Jeffrey Sacks & Wing Thye Woo
Real Provincial Growth, 1985-90

<table>
<thead>
<tr>
<th>Province</th>
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</tr>
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<tbody>
<tr>
<td>Guangdong</td>
<td>78.44</td>
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<tr>
<td>Yunnan</td>
<td>73.71</td>
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<tr>
<td>Fujian</td>
<td>72.39</td>
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<td>Xinjiang</td>
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<td>China</td>
<td>14.88</td>
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<tr>
<td>USA</td>
<td>45.59</td>
</tr>
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</table>

China: State Statistical Bureau

RELATIVE REAL GROWTH
Selected Provinces

% of Guangdong's Growth Rate

- 100%
- 87%
- 67%
- 45%
Ironically, planning has traditionally favored or promoted capital intensive industries against labor intensive industries despite China's natural comparative advantage in its light industries sector.\textsuperscript{107} The granting of favorable subsidies and preferential treatment to manufacturers of capital intensive exports that labor intensive manufacturers have not received is indicative of Beijing's commitment to its heavy industry sector (dominated almost entirely by SOEs) over its light industries sector which is increasingly represented by firms under private or quasi private ownership.

Government continues to be aware of labor concerns and able to successfully negotiate high labor content in its joint ventures. As the government anticipates further future mobility and enterprise autonomy in labor relations, the indications are that it is mindful of the political consequences and societal insecurity engendered by initiatives that favor capital intensive investment when labor intensive investment could perform equally well.

The Chinese government continues to support heavy industry as part of its industrial strategy to sustain firms in this sector for the future industrial transition to high-tech dynamic industries. China has a long ingrained belief that long term capital accumulation is dependent upon the development of heavy industry.\textsuperscript{108}


China has been able to delay action on state owned enterprises largely because it has one of the worlds highest savings rates.\textsuperscript{109} China has been able to use its high savings rates to cover state enterprise deficits for many years. China has embarked on a program of corporatization as an attempt to separate the state's production units from the government, which as legally nominal autonomous units enables them to accept outside private investment, with the goal

\begin{flushright}
\textsuperscript{107} Weimer, Jan 1992. \\
\textsuperscript{108} Solinger, p. 115. \\
\textsuperscript{109} Overholt, p. 18.
\end{flushright}
of increasing their efficiency. Failing enterprises are also being merges with better managed ones, giving the latter the debts and responsibilities of the former. This strategy has succeeded in raising average productivity of state enterprises but in the short term has simply limited the rate of increase of enterprise losses.

State owned enterprises are the only firms positioned and sufficiently capitalized to promote the Chinese government’s national development strategy which in several areas reflects strategies successfully pursued by the Japanese and its other East Asian neighbors. The parallels between China’s strategy and that of and its close neighbors (Japan, Taiwan, Korea) can be seen in its policies of protection of domestic firms from foreign competition, its creation of decentralized export/import cartels (Chinese foreign trade corporations), promotion of domestic firm rivalry through decentralization in industries China competes in internationally (textiles, machinery, electronics, and semiconductors).

Also reminiscent of Japan, the Chinese government has promoted increased exports and competition in the form of oligopolistic rivalry between state owned enterprises via decentralization. Eliminating state owned enterprises altogether would have created a vacuum while new firms were being formed, as well as instability in the foreign trade sector. A national development strategy requires intact state owned enterprises in advanced industries who can make the transition to the next stage of development, which in Michael Porter’s model is investment driven, while still giving the state an unambiguous measure of de facto control at the industry level.

China has announced that it wishes to reserve sectors integral to the development of competitive high tech industries for limited foreign investment participation. Widespread enterprise failures are anticipated if China chooses to restructure its heavy industries sector following strategies urged by western experts. If this happens, China’s firms will lose opportunities in important growth

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111 Overholt p. 18.

sectors supporting infrastructure development, which is another serious challenge China faces in the coming decade. In order to meet the demands of industrialization in the next decade China is expected to spend $300 billion on infrastructure projects.

Further, a soft budget constraint (as discussed by Kornai, Walder, Cui) which is advantageous in terms of promoting capital investment as well as in financial and taxation issues.\textsuperscript{113} A soft budget constraint also gives firms tacit permission to sell goods below cost in some cases where it is deemed that retention of market share is more important. At least one Chinese state owned weapons dealer operating in the U.S. has been selling inventory below cost since the spring of 1993, when the Clinton administration placed strict controls on several types of Chinese weapons imports.\textsuperscript{114}

In high-tech sectors the top performing firms are state owned enterprises. Recent years have seen mergers, spin-offs and major management changes in many of the more prominent firms in industries China considers key to its national development strategy.

China's growth is still at the stage where it is "factor driven" to use Porter's terminology. In the foreign trade sector, labor and capital remain firmly embodied in the country's state owned corporations.

According to Porter's model, China is currently at a stage of factor-driven economic growth. In order to trade their way to the next stage of economic development domestic firms in would-be advanced industries must be able to export their products and be able to compete successfully against imports. There is a clear role for state owned foreign trade corporations whose managers have the requisite years of experience, numerous linkages with Western firms, and the qualifications to conduct business at the scale required when building national industries.

The Chinese government's experiments with market reform in agriculture

\textsuperscript{113} Granick, 1990.

\textsuperscript{114} Interview Los Angeles, Tang Zhong China Weapons, Inc.
have been extensive. Current estimates put the number of displaced peasants leaving the land in searching of jobs in cities somewhere between 50 and 100 million. Final figures are estimated to reach 200 million people by the time agriculture has been fully converted to market-driven policies.

Dismantling its heavy industry sector would have risked widespread urban/rural dislocation and potential political problems as well. There is significant employment and capital stock invested in this sector. (See Table??) State-owned enterprises in the heavy industry sector are expected to merge and restructure themselves into China’s high-tech or "pillar" industries. These industries include telecommunications, automobiles, and transportation. In building advanced industries in these sectors, the Chinese government has announced that it will seek to maintain control and autonomy free from foreign domination.

China has also been able to delay action on its state owned sector because it has one of the world’s highest savings rates, which can be used to cover state owned enterprise's deficits.

China has not created the public institutions that can yet offer effective decentralized alternatives in the place of state owned enterprises' almost complete social systems.\textsuperscript{115} Institutionally, regardless of the speed and privatization, state enterprises are likely to be given a reprieve for the forseeable future.

\textbf{Impact of a Soft Budget Constraint}

During the 1980's Chinese foreign trade corporations operated under a soft budget constraint\textsuperscript{116} that essentially insulated them from the financial consequences of making poor business decisions. Soft budget constraints also served to protect foreign trade corporations from the full extent of losses from shipping poor quality goods—operating expenses were never at risk, just the profits from the transaction. The excessive availability of bank credits enables foreign

\textsuperscript{115} \textit{Forbes}, May 15th issue.

trade corporations to hide their losses for long periods of time.\textsuperscript{117}

Walder argues that a soft budget constraint has made manufacturing success possible in China in recent years. At the micro level, in my experience with Chinese foreign trade corporations, I too would argue that it has been essential. SBC subsidizes the overemployment found in all Chinese state owned trade corporations. (Worker productivity in general is much lower than that found in Western industrialized countries - have to find a source - ) It also supports the development of international marketing and distribution networks the Chinese have been building steadily since the mid-1980s. market

In 1992 I accompanied a trade group from a spin-off firm that is a subsidiary of a large state owned corporation in Shanghai on a research and marketing trip around the U.S. They had brought an order of cultured pearls for one of their San Francisco customers on the flight from China at their client's request. The morning of their appointment with the customer they asked me how to get to public transportation. I said surely you don't want to bring the pearls on the subway? It's possible that you might get robbed. Why don't you call a taxi?" They said they would not hear of wasting their expense account money on a 1/2 hour taxi ride. (Foreign trade corporation employees try to live as close to expense-free as possible when on trips abroad so as to be able to spend their per diem funds on personal items to take home.) "We don't care if we get robbed. The pearls don't belong to us personally - they belong to the government. We prefer to save the taxi fare."

The group took the subway without incident, and delivered the goods safely, having carried them in a dingy canvas sports bag. The retail value of the pearls was $500,000.

In other cases foreign trade corporations eschewed (at their peril) standard business practices based upon a promise of performance that people operating under hard budget constraints cannot consider.

For example, export terms for foreign trade corporations are usually

\textsuperscript{117} Overholt, p. 18.
payment by letter of credit in advance of the shipment of goods. I knew of many cases in which Chinese sellers (foreign trade corporations) had shipped goods to foreign customers who had disappeared upon receipt of the order. Despite the regulations mandating L/C payment, because neither the goods nor the money belonged to them foreign trade corporations sometimes took excessive business risks that occasionally left them empty handed or worse.

As a case in point, I met with 3 members of an foreign trade corporation from Heilongjiang Province in San Francisco in 1983 who were there trying to track down a company formerly based in Los Angeles who had stopped responding to their requests for payment and could no longer be found in the phone book or at their former address. The LA company had received on consignment $1 million of Chinese shoes and had not paid for the goods. The manager of the shoe factory in China was in jail near Harbin awaiting the outcome of the foreign trade corporation's fact finding visit to California. Managers are held personally liable for their companies' losses when they have not adequately followed trade regulations.

The foreign trade corporation "team" of experts was hardly qualified for the job of finding the factory's money. None of them had ever been in the U.S., and two out of three spoke no English at all. One of the three had no business experience either. She was from the foreign trade corporation's political department and been assigned to the group for surveillance purposes and to make sure they didn't defect or cut any side deals if the customers were in fact found. The Heilong jiang group did not get very far on their mission. After a week in Los Angeles the best they came up with was a meeting with a private detective found in the Yellow Pages. They paid him a deposit to track down their errant customers. They showed me his card which mentioned that he was a former FBI agent. They never found the customers, the detective simply took their money, and I do not know what became of the shoe factory manager.
CONCLUSION

China's foreign trade reforms have had wide ranging implications for its state corporations and manufacturers. Decentralization has increased competition and freed provinces to trade independently, with a corresponding rise in GDP that places China among the fastest growing economies today.

China's foreign trade authorities continue to play a role in negotiating the terms of foreign direct investment in high tech sectors and in sectors it deems crucial to the country's economic development goals, but generally it is less dirigiste than observed during the 1980's. The approval process has become less complicated and bureaucratic, but government officials continue to evaluate projects along established guidelines relating to a project's contribution to export revenues, managerial training, or technology transfer.

The government's dirigiste presence has been relatively unfelt in the export subcontracting sector, but it is beginning to make its presence known with the implementation of a new labor law which took effect in early 1995. 1994 saw a record number of industrial accidents in China's subcontracting sector, with work-related deaths in Guangdong exceeding 8500. Future challenges include enforcement of existing laws protecting workers in foreign invested firms.

Chinese enterprises face management obstacles at both macro and micro levels. Current Chinese management systems failures retard both economic growth and the technology acquisition process. This will make it difficult for China to achieve its goals of building "pillar industries." Chinese leaders have supported the introduction of numerous management training programs and establishment of management training institutes in with Western partners and development agencies. The attraction of joint ventures with foreigners has in part been the opportunity to receive training in foreign management techniques.\(^{118}\)

Chinese enterprise managers consistently point to lack of information as one of their most difficult challenges. Government financial support continues to

\(^{118}\) Schneppe et al. p 250.
be an important factor in overcoming problems of information asymmetries. Despite the growing US-China trade deficit, Chinese firms, particularly manufacturers maintain that they do not have sufficient knowledge or understanding of the US market. The leading Chinese export categories of footwear, toys, and and textiles are dominated by subcontracting manufacturers who generally are not involved in the marketing or distribution of their products. Marketing and distribution are the most profitable components of the value chain, and continue to be dominated by US firms.

Yet in the area of foreign direct investment and the management of joint ventures, China has developed on its own a model of bargaining that while subject to periodic policy changes and fine tuning, has succeeded in boosting exports. The new automobile Industrial Policy directive (July 1994) continues to stress the same national development goals initiated during the late 1970's. Localization, import controls on inputs, parts, and components, and the promotion of exports. Joint ventures are encourages, but foreign partners must provide technology at 1990's levels, funding for technology resource centers, and a maximum 50% ownership interest. These policies are the central focus that other countries seeking to emulate East Asian models of industrialization must also emphasize in building competitive national industries.
SELECTED US-CHINA TRADE STATISTICS

U.S. PCT OF CH IMPORTS 10.3 PCT

PRC MANUFACTURED IMPORTS:
TOTAL 89,055
FROM THE U.S. 9,273
U.S. PCT OF TOTAL 10.4 PCT
BALANCE WITH U.S. 7,133
PROJECTED AVERAGE ANNUAL GROWTH RATE THROUGH 1996:
MANUFACTURED IMPORTS FROM WORLD 30 PCT
MANUFACTURED IMPORTS FROM U.S. 24 PCT

PRC AGRICULTURAL IMPORTS (2):
TOTAL 6,849
FROM THE U.S. 974
U.S. PCT OF TOTAL 14.2 PCT
BALANCE WITH U.S. (294)

PRC 1993 TRADE BALANCE WITH TOP THREE TRADE PARTNERS:
JAPAN (7,474)
HONG KONG 11,591
UNITED STATES 6,276

PRINCIPAL U.S. EXPORTS TO PRC (1993):

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PRINCIPAL U.S. IMPORTS FROM PRC (1993):

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<td>6110</td>
<td>KNIT SWEATERS</td>
<td>1,118</td>
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SOURCE: CHINA GENERAL ADMINISTRATION OF CUSTOMS, EXCEPT
(1) U.S. DEPARTMENT OF COMMERCE. NB: U.S. TRADE DATA DIFFER FROM CHINESE DATA BY INCLUDING ENTREPOT TRADE THROUGH HONG KONG.
(2) AGRICULTURAL IMPORTS INCLUDE HS SECTIONS 01-24, 41, 43-45, 47.
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