# 11

# On the Role of Foreign Investment in the Development of a Market Economy in China

RIGAS ARVANITIS,
PIERRE MIÈGE and ZHAO WEI

In a speech to Chinese academics, Milton Friedman predicted that, "Anyone who can give a clear account of the reform process in China, will win the Nobel prize in economics." The main focus of all economic analyses is centred on the institutional changes, known as 'reform and opening' (*gaige kaifang*) promulgated by Deng Xiaoping from 1979 onwards. So, every discussion of the Chinese economy is concerned with trends in economic policy, and particularly with positing a contrast between the Chinese policy of gradual reforms[1] and the 'shock therapy' adopted by the Soviet Union.[2] But for all their very real interest, these perspectives remain at the macroeconomic level. There is a need to go further and examine the operations of the economic institutions and agencies responsible for wealth creation, such as the Chinese enterprises, public institutions, foreign investors, and organisations to promote technological development.[3] We propose

1. See Justin Yin Yifu, Cai Fang, and Li Zhou (2000). *Le miracle chinois, Stratégie de développement et réforme économique*, [The China Miracle], Paris: Economica.

2. Sachs, Jeffrey D., Wing Thye Woo and Xiaokai Yang (2000). "Economic Reforms and Constitutional Transition" (pp. 48). Harvard Business School, Center for International Development: *CID Working Paper* No. 43, April. Although not partisans of a shock therapy, Jeffrey Sachs and his team promote a highly aggressive modification of the constitution.

3. There is a large body of literature on Asian economic development. On Japan, see in particular Ian Inkster's excellent book, *Japanese Industrialisation 1603-2000: A Global and Analytical Approach*, London: Routledge, 2000; and on South Korea, A. Amsden's (1989) *Asia's Next Giant: South Korea and Late Industrialisation*, London, Oxford University Press. We have argued ourselves on the need to examine technological development as a centrepiece of economic development in a special issue of *Science, Technology & Society*. Rigas Arvanitis and Daniel Villavicencio (1998). "Comparative perspectives on Technological Learning: Introduction", *Science, Technology & Society*, Vol. 3, pp.1-9. Fieldwork was done under the projects of the Research Institute for Guangdong Development, Zhongshan University.

to take a new look at Chinese growth by examining more closely the operations of the systems of production, since these are the real producers of that growth. It is only on this basis that the veil of mystery surrounding the 'growth miracle' can be lifted, in China just like anywhere else.[4] We will take the example of Southern China, not because it is the most dynamic area in economic terms but because Guangdong contains a multiplicity of productive systems, thanks to its being the earliest to open up and therefore, the fastest to develop.[5]

China is a particularly interesting case for economic theory, and for a comparative approach to economic and socio-political analyses. It confronts us in a new way with questions over the role of government in economic development,[6] forcing a fundamental rethinking on the social bases of growth. Studies which restrict their analysis to the gradual transition of the socialist regime to the market economy, like those which focus narrowly upon 'privatisation', seem to overlook at least three relevant areas of investigation: the renewal of the oldest the systems of production, the role of the state as promoter and regulator of economic activity, and the degrees of efficiency achieved by the systems of production which appeared with the reforms. In this chapter we would like to offer a framework for thinking about these profound modifications that go, in our understanding, much beyond transition to a market economy. To this end, we will resituate the empirical studies of separate enterprises within a wider frame of reference, showing that Chinese economic expansion is largely due to its being investment driven, and that the economy itself is still quite away from being demand driven. This explains a considerable number of the practical difficulties encountered by all enterprises in China—

4. The view of this growth as miraculous arises from a macroeconomic perspective. See Robert E. Lucas' lecture, "Making a Miracle" in his collection *Lectures on Economic Growth*, Cambridge Mass.: Harvard University Press, 2002.

5. Ezra Vogel, *One Step Ahead: Guangdong Under Economic Reform*, Cambridge Mass., Cambridge University Press, 1989. Since the publication of this work, many others have also shown the persistence of certain economic and social structures. cf. Thierry Sanjuan, A l'Ombre de Hong Kong: le delta de la rivière des Perles, Paris, L'Harmattan, 1999. Examples are drawn from our own field research. A first immediate product of this research is our article: Rigas Arvanitis and Zhao Wei (2003). *Industrialization of South of China: Learning and Limits of a Succesfull Model*. In ALTEC (ed.), Proceedings of the "X Seminario Latino Iberoamericano de Gestión Tecnológica ALTEC 2003. Conocimiento, Innovación y Competitividad: Los Desafíos de la Globalización" (pp. 15). 22, 23 y 24 de octubre del 2003, Ciudad de México, D.F.

6. A critical overview of the role of politics in Asia is to be found in the collection by S. Rowen Henry (1998). *Behind East Asian Growth: the Political and Social Foundations of Prosperity*, London and New York: Routledge.

Chinese, joint ventures or foreign-owned, large or small. The main question is whether this new economy and its systems of production can sustain themselves. By 'systems of production' we mean the totality of plant and human resources contributing to a productive activity.[7] A system of production may include several enterprises; in fact, that is frequently the case in developing economies, where enterprises are subcontracted to those who place orders with them, and whose brand name appears on the finished product. To restrict discussion to the nature of the enterprises themselves would be to focus on the internal organisation of each one, and especially on the nature of its ownership, whereas all the evidence suggests that in China, the question of ownership is less important than how the links between the different units of production operate. Accordingly, our concept of a 'system of production' puts the emphasis on the arrangements made for the productive process and its development, as well as on the interrelationship between the sites of production and their users.

## The Three Waves of Investment

The history of the rapid growth of the Chinese economy can be broken down into three successive waves of investment. These waves, and the resulting growth, were not the fruit of an overall strategy of the government and its economic and financial bodies. They were, rather, the outcome of an accidental conjuncture of some perfectly identifiable factors.

The first phase of the expansion was the result of the industrialisation of the countryside, for initially the reforms were aimed at that sector in particular. The ability to grow and sell products outside the state planning system led to a rapid rise in agricultural production. In the early 1980s, the profits from the sale of agricultural produce were massively invested in the rural enterprises, the so-called 'township and village enterprises' (*xiangzhen qiye*). This growth phase lasted six years, from 1983 to 1988. The investments from it were like *manna* from heaven for the local authorities and the most adept among the inhabitants of the rural areas. They found themselves in quite exceptional circumstances, given the absence of any competition

7. Definition used by Jean Ruffier, *L'efficience productive: comment marchent les usines*, Paris, Editions du CRNS, 1996.

and the existence of a large demand hitherto unsatisfied by the planned economy. This new economic opportunity allowed the development of an economy out of the plan.[8] There was considerable demand for foodstuffs, clothing, and domestic durables. This demand was initially directed at light consumer producers, but it was later redirected towards heavy industry. So, at that stage, agricultural resources provided the motor for growth, but the period of rapid expansion was followed, in time-honoured fashion, by a period of overheating characterised by overinvestment. By the late 1980s, the purchasing power of the peasantry began to diminish, and the rural market, which represented 75 per cent of the population, could not sustain the growth in demand. At the same time, all the city families had already satisfied their basic need for durable domestic items, and the upward curve in demand for agricultural products and clothing flattened out. In the early 1990s, therefore, this slowing consumer demand could no longer function as the engine for economic growth. The investment patterns of the previous decade had been directed towards light industry, which is characterised by short term production and rapid returns. The consequence was overcapacity in the durable consumer goods industry, which meant that the current economic model was no longer viable.

The early 1990s saw the arrival of another source of investment, the so-called 'foreign' investments, which mostly came from Taiwan, Hong Kong, and overseas Chinese. In 1994, foreign direct investment (FDI) represented 20 per cent of the overall investment. In 2001, foreign investment from Hong Kong, Macao, and Taiwan continued to represent 18 per cent of the total (158 billion Yuan) and 47.5 per cent of foreign investments in Guangdong province (55 billion Yuan).[9] The Chinese government, wishing to take advantage of this capital inflow, set up a great number of economic development zones in the coastal regions. Everywhere 'hotels for overseas Chinese' sprang up to accommodate the influx, and these provided the engine for growth in the first half of the 1990s.[10] Some of them, like Shenzhen, are still major poles of attraction for foreign investment. Investors were

8. cf. Barry Naughton (1995). *Growing Out of the Plan: Chinese Economic Reform 1978-1993*, Cambridge: Cambridge University Press.

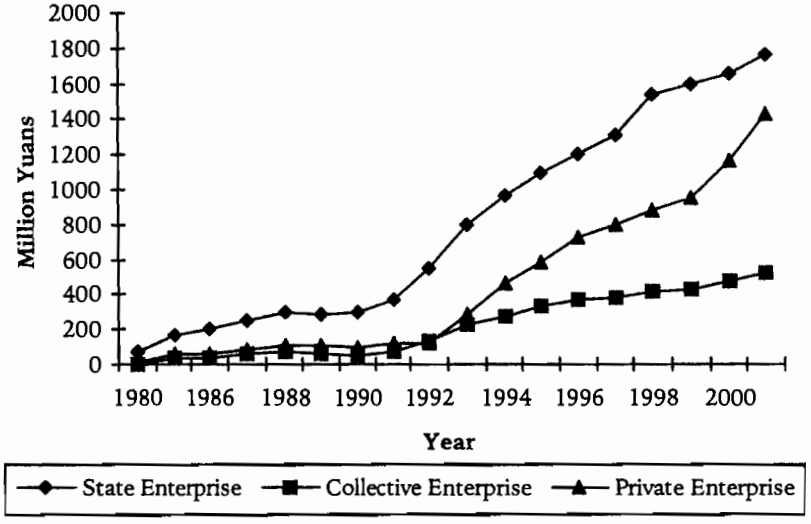
9. *China Statistical Yearbook, 2000.*

10. These special economic zones were established in the early 1980s, but their major expansion occurred in the 1990s.

attracted by favourable policies, the nature of the labour force, and the Chinese market. In addition, the common language and cultural proximity, along with shared attitudes towards combining political connections with business, encouraged this source of investment. During this phase, two-thirds of the foreign investments were in the hands of small and medium-sized firms from Hong Kong and Taiwan. These made use of labour-intensive production to assemble imported parts and re-export them to supply the international market. This system received the blessing of local officials, since such *manna* from heaven also blessed them with great decision-making powers. The enterprises involved did not represent direct competition, either with the China-based township and village enterprises or with the private or state-owned ones. On the other hand, they contributed towards improving the trade balance and towards increasing employment and incomes. Moreover, the demand arising from this poorly paid labour force was directed towards the low quality products from the communal and the state-owned enterprises. These benefited from the growth in domestic demand, and still do. That is why all these enterprises survived throughout this period, despite producing goods which were in many ways outdated (Figure 11.1).

**Figure 11.1**

*Evolution of Fixed Assets Investment (Million Yuans)*




*Note*: The category « private » entreprises comprises of individual entreprises (*getihu*), entreprises by shares and mixed capital entreprises. This is probably an overestimation of the private sector, notably so for entreprises by shares; also there is an overestimation of the "collective" economic type since collective entreprises are run like private entreprises. See Guiheux, 2002, for a good analysis of these categories.

*Source*: Annuaire statistique de Chine, édition 2002. Tabl. 6-2, p.176.

This growth model, which depended upon FDI from Taiwan and Hong Kong, could have lasted for at least 20 years, by following the set pattern of integration with foreign manufacturers. But the Asian crisis of 1997 modified the underlying situation. The developed economies reduced their orders placed with Chinese enterprises, while the latter remained essentially geared to the supply of overseas markets. Simultaneously, the new exchange rates restored a degree of competitive advantage to the other Asian countries, by making their production costs attractive again. So, this second engine for growth no longer worked.

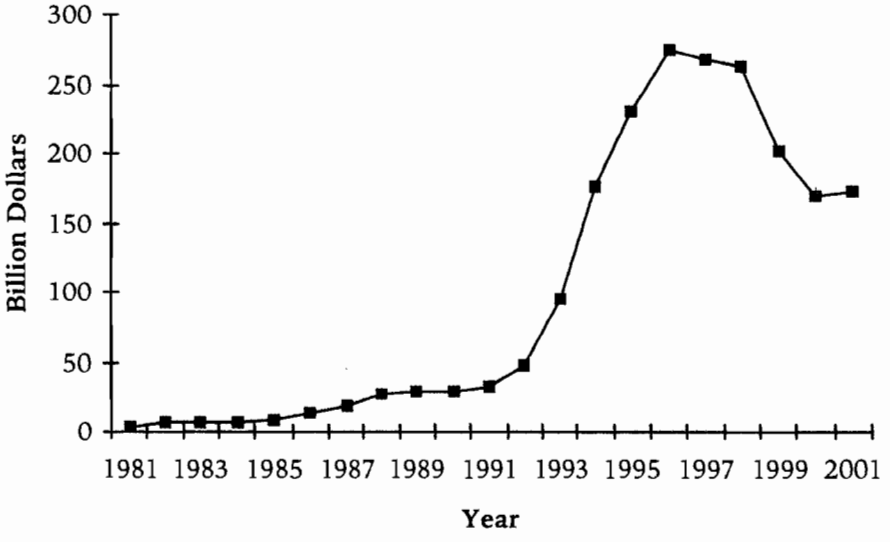
The third phase of development began at this juncture, with the arrival of FDI funds from industrialised countries like the United States, Japan, and Europe. The Chinese government reacted extremely fast, by adopting a whole range of measures to attract this foreign investment. The huge campaign in favour of entry into the WTO must be understood in this context. That is why WTO membership became the main objective of official policy. Since 1997, investment in real estate has greatly increased, and the big cities have become showcases for China's growth.[11] Forthcoming events like the Beijing Olympic Games in 2008, and the Shanghai Universal Exhibition in 2010, provide an additional seductive appeal to international investors. As a consequence of the spectacular take-off in international investment, capital inflow from Taiwan and Hong Kong has picked up again, and continues to be an important part of the overall FDI in China (Figure 11.2).

Between 1978 and 2002, the value of Chinese exports rose from 10 billion US dollars to 226 billion. In the 1980s, income from exports stimulated domestic demand for basic consumer goods. In the 1990s, exports gave a stimulus to the demand for sophisticated electronic consumer goods, particularly household equipment, making export trade a major engine for growth. In the second half of the 1990s, China set about stimulating demand in the sphere of tourism, real estate, and car production. In these ways, the reforms launched by Deng Xiaoping have paved the way for expansion in both consumption and production.

11. cf. the work of Guilhem Fabre, which shows nonetheless that the growth in real estate sales, encouraged by various means, has still been unable to efface the effects of the property bubble brought about by speculation in land values; Guilhem Fabre (2000). *Le miroir chinois de la transition: Genèse d'une crise 1989-2000*, Paris: L'Harmattan.

## Figure 11.2

*Evolution of Foreign Investments (Billion US Dollars)*




*Source*: *Annuaire statistique de Chine*, édition 2002. Tabl. 6-3 p. 177.

In a well-known article in *Foreign Affairs*, Paul Krugman defines the nature of the growth in East Asian countries as an effect of resource mobilisation, not of increasing productivity. He was commenting on a little known article by Alwyn Young[12] and his article concludes that Asia has achieved remarkable growth rates without any corresponding increase in productivity. In his view, these growth rates were more the outcome of mobilising available resources than of increasing efficiency. In short, it was a matter of "more perspiration than inspiration".[13] Essentially, China has been following this same model of accumulation, with some variants of her own.

Firstly, average individual income is low and the level of household savings is high. The rapid increase in China's GNP in the first stage of growth was accompanied by an increase in income disparities. Secondly, given the size of the Chinese economy and the importance of regional disparities, a single wave of investment is simply not enough. Thirdly, the Chinese state has a powerful capacity for mobilising resources, and has been able to make use of the structures

12. Young, Alwyn (1992). "A Tale of Two Cities: Factor Accumulation and Technical Change in Hong Kong and Singapore", *NBER Macroeconomics Annual*, MIT Press.

13. Krugman, Paul (2000). *The Return of Depression Economics*, London: The Penguin Press, p.32ff.

of production which were actually introduced to ensure social and political stability. This mode of economic organisation lies at the very heart of its current difficulties.

## Productive Systems Piled on Top of Each Other

To leave the analysis of the Chinese miracle at this juncture would be to make the error of looking only at the macroeconomic data—like the breakup of the economy into separate spheres, the decentralisation of power, and the return of former evils like corruption, gangs, prostitution, etc.—taking note only of the consequences rather than the causes of the economic changes.[14] Our view is that these causes are to be found within the systems of production. With each wave of resource mobilisation, there have arisen new enterprises with their own distinct systems of production. It is these which have engendered the growth in production and returns on investment.

### *The Rural Enterprise Systems of Production*

The first type of productive systems is the township and village enterprises. These enterprises grew up in the early 1980s, and they operate as private companies, but for reasons of ideological acceptability they are officially registered as collective enterprises.[15] They work on raw materials and employ low-cost labour, and they are concentrated in various sectors of production, which they quickly came to dominate.[16]

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14. A good journalistic account of the various opinions on the economic and political future of China is to be found in Gordon G. Chang, *The Coming Collapse of China*, New York, Random House, 2001. A recent special issue of the *China Economic Review*, December 2002, Vol. 13(4), also addresses the issue. See in particular the catalogue of problems drawn up by Thomas Rawski in "Will Investment Behaviour Constrain China's Growth?", *ibid.* pp.361-372. There is a fiercely critical analysis of the economic reality in China by He Qinglian in "China's Listing Social Structure", *New Left Review*, No. 5, 2000, pp.69-99. When this was republished in China, in the review Shuwu (Changsha, March, 2000), it cost the author her professorial post.

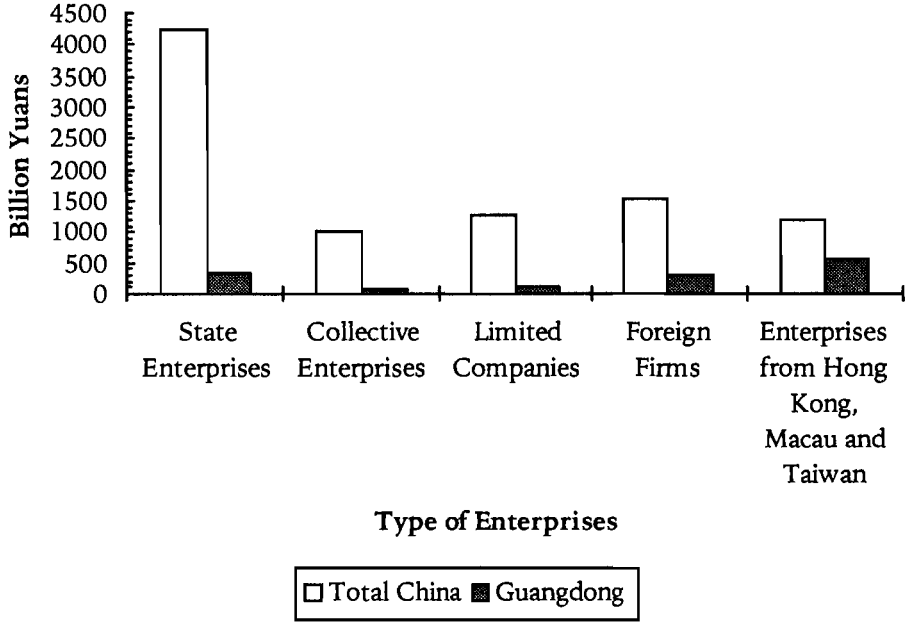
15. Gilles Guiheux (2002). "The Incomplete Crystallisation of the Private Sector", *China Perspectives*, No. 42, pp.24-35. Strictly speaking, collective enterprises do not include private enterprises, but actually a good many collective enterprises are 'lent' to a private enterprise management team. Often the most important enterprises are to be found in this category.

16. In nine sectors the total output increased in value by 10-15 per cent per year; these were domestic electrical goods, hand tools, paper, domestic chemical products, organic chemicals, furniture, textiles, agricultural products and beverages, and coal and ferrous metals.

At the same time, the larger collective enterprises already in place started to operate as 'private' firms. A good example of this is the Yueqing enterprise in Shuikou (Guangdong province). Starting as a tap manufacturing plant, it modernised and became the origin of a myriad of small plumbing firms. Consequently, Shuikou township is now at the head of a whole industrial sector, and Yueqing is just one among many new enterprises. A large number of other enterprises have set themselves up along the same lines, both in Guangdong and in the rest of China. Well known brand names like Legend, TCL, Haier, Konka, and Galanz are similar enterprises which arose with the first phase of expansion, and they prospered mostly because their status as collective enterprises gave them access to public funds (Figure 11.3).

## Figure 11.3

*Industrial Production by Type of Enterprises, 2001—Comparison of China and Guangdong (Billions Yuans)*




*Source: Annuaire Statistique de la Chine, Edition 2002. Tabl. 13.3 p. 425.*

These enterprises—mostly collective but also shareholder enterprises—were primarily suppliers to the domestic market, only turning later to production for export. Galanz in Shunde, a town close to Guangzhou, is typical. It started as an assembly plant for microwave cookers, whose step-up transformers and magnetron tubes were

imported from Japan for US$ 20. The same components imported from Europe cost US$ 30. The leaders of the enterprise made a quick visit to the European manufacturers and offered to buy transformers at US$ 8 and become the own equipment manufacture (OEM) producer for the European firm. The Europeans made their own rapid calculations and accepted the offer. They transferred all their equipment and production lines to Shunde, including their assembly technology. The Japanese offered the same OEM arrangement, with a purchase price for the transformer at US$ 5. Today Galanz produces the transformer *in situ* for US$ 4, and the enterprise claims to control 30 per cent of the world market and 70-80 per cent of the domestic market. How has that been possible? In an interview, the owner explained that in Europe the production line runs for six hours a day, and five days a week, adding: "Because of strikes, they actually only work an average of four days, or between 24 to 30 hours a week. I took over their production techniques and set up a system of three eight-hour shifts, which works out at a 160-hour week. My productivity is six to seven times higher than in Europe, but each wage bill is between 3 per cent and 5 per cent of the European wage."

But it should be added that the success of these enterprises is to be explained not only by the match between the foreign clients' search for low costs and Chinese productive capacity, but also by their entering into a stable exchange system along OEM lines. The Galanz factories produce on behalf of 200 multinational firms from every quarter of the globe. The Chinese enterprise takes care of the manufacturing end while the technology, brand name, and marketing remain in the hands of the foreign multinationals. It is striking how quickly the enterprise has grown, which is why it is a frequently cited example. The quest for increased turnover is a constant factor, with the enterprises taking advantage of their low production costs. In addition, such enterprises actively seek out foreign partners to ensure access to technology and market outlets. What the Chinese enterprises are looking for is this technology transfer, both material (in the form of products, equipment, and processes) and organisational (quality control and management skills).

*The Systems of Production Set Up by the Overseas Chinese Investment*

A second type of production system appears in enterprises which

were established by the second wave of investment from Taiwan and Hong Kong. Industries producing textiles and clothing, electronics and electrical household goods, were relocated to the Pearl River delta. These enterprises share some features with those of the first wave, but they also have some specifics of their own. Firstly, the investors not only established the enterprises, but brought with them their own networks of suppliers and customers. The Taiwanese and Hong Kong enterprises which set themselves up on the mainland to take advantage of low production costs, were backed by more than 30 years experience as suppliers to the multinationals. In addition, they have their own way of doing business, to which the entrepreneurs from Guangdong were quick to adapt. Secondly, they had more complex production techniques, even in the case of less sophisticated industries like shoes, clothing, and basic electrical goods. Thirdly, these overseas Chinese established strong ties with mainland officials and local government bodies. They involved the local power structures into the very operations of their own systems of production. More effectively still, in an increasing number of cases, the local authorities appealed to them to help strengthen technological development and to launch technical education initiatives (such as practical demonstrations, technical training, and apprenticeship schemes). In some cases, innovation centres were set up to promote technological innovation, aimed at providing technical know-how to enterprises in a particular sector of production (for example, shoes and underwear in Nanhai). In the industrialised world, such centres are usually organised by the chambers of commerce or public education bodies. In China, they are handled by the joint enterprises, to which a foreign partner brings both his expertise and his market.

In the Pearl River delta area, these enterprises owned by foreign capital employ 30 million workers from the most impoverished provinces of China. There are reckoned to be another 30 million potential migrants in the inland provinces, which guarantees continuing low labour costs. The foreign enterprises have easily been able to make use of this situation, turning the whole area into one huge factory, with intense local concentrations according to the type of products. Shunde is the main centre in China for the manufacture of electrical household goods, Ronggui is the largest centre in the world for producing air-conditioning units, Shaxi is the centre for

leisure wear, Humen (Dongguan) for clothing, etc.[17]

Dongguan, which is close to the border with Hong Kong, provides a good example for examining the operation of the systems of production financed by FDI from Taiwan and Hong Kong. Dongguan is a relatively small town which serves as a centre of production for a great number of specialised products: coffee, computer mice and other computer components. Its systems of production are known by the expression *sanlai yibu*,[18] and are similar to the Mexican *maquiladoras*, in which products are manufactured from imported materials, and assembled according to models provided by the foreign client. The industrialisation of Dongguan began in the early 1980s, well ahead of the surge in the second wave of investment in the rest of the country, thanks to the relocation of industries from Hong Kong.[19] The driving force behind its growth has been the manufacture of OEM products for its clients. Since 1989, Dongguan has attracted numerous Taiwanese enterprises specialising in information technology and in shoes, and these have built up a network of local suppliers to reduce the time and costs expended in purchasing raw materials and parts, while meeting the standards set by the needs of international clients. The supply networks provide a link between local and foreign enterprises. They are all members of a single constituted system of production: customers, suppliers, and manufacturing units are all closely integrated, and the whole system benefits from the comparative advantage of cheap labour. The parameters are set by the global market, and contributions from the local authorities in terms of innovations or technical support are minimal. The key question confronting these systems of production is

17. See Qiu Haixiong (2001). *Establishing Nanhai as a Technology Model City*, Guangzhou, Research Institute for Guangdong Development, p.234.

18. Literally 'three resources and one obligation': *sanlai* or 'three resources'; these are the raw material, the parts, and the samples provided by the foreign investor. *Yibu* designates the repayment by the local enterprise to the foreign investor in the form of the finished products.

19. In Dongguan, as in the rest of the province, the impossibility of setting up private enterprises at the time led to the flow of local investment into joint enterprises, thus showering the Hong Kong investors with an additional layer of riches. See the work of Huang Yasheng on foreign investments in China during this period, *http://www.people.hbs.edu/yhuang*. Maybe, part of today's difficulties—such as large competition coming from other regions of China—in these kind of developing zones is due to this artificial type of investment flows. Nonetheless, firms are created, people work there and there is now an industrial base in Dongguan, as is shown in the case of computer manufacturing, cf. Wang Jici and Xin Tong (2002). "Global-local networking of PC manufacturing in Dongguan, China" in R. Hayter and H.L.R. (eds.), *Knowledge, Territory and Industrial Spaces*, Ashgate.

## Table 11.1

*Basic Indicators on Foreign Firms, Investments and Exports (Million US Dollars)*

| *2001* | *Number of Foreign Enterprises* | *In Per Cent* | *Total Investment Foreign Enterprises* | *In Per Cent* | *Exports from the Province* | *In Per Cent* | *Exports of Foreign Enterprises* | *In Per Cent* |
|---|---|---|---|---|---|---|---|---|
| China | 202,306 | 100.0 | 875,011 | 100.0 | 266,155 | 100.0 | 133,235 | 100.0 |
| Guangdong | 47,102 | 23.3 | 221,823 | 25.4 | 95,828 | 36.0 | 54,374 | 40.8 |
| Jiangsu | 19,602 | 9.7 | 92,001 | 10.5 | 29,387 | 11.0 | 16,642 | 12.5 |
| Shanghai | 18,160 | 9.0 | 112,688 | 12.9 | 26,864 | 10.1 | 15,958 | 12.0 |
| Fujian | 15,403 | 7.6 | 51,259 | 5.9 | 13,926 | 5.2 | 8,288 | 6.2 |
| Shandong | 13,753 | 6.8 | 42,516 | 4.9 | 18,120 | 6.8 | 9,236 | 6.9 |
| Liaoning | 13,158 | 6.5 | 63,797 | 7.3 | 10,748 | 4.0 | 6,299 | 4.7 |
| Zhejiang | 11,194 | 5.5 | 34,064 | 3.9 | 24,261 | 9.1 | 7,099 | 5.3 |

*Source*: *Statistical Yearbook of China, 2002*. Total Exports: Table 17-10, p.626; Foreign Firms Exports: Table 17-12, p.628; Investments: Table 17-20, p.636.

how to move on from the stage of providing low cost assembly to foreign customers, to become complete OEM suppliers, or even achieve ODM (Own Design Manufacture) status.[20]

By the end of the 1990s this system had reached its limits.[21] Production costs were relatively high in comparison with other regions of China. Foreign enterprises were being set up in China with their own supplier networks, and some regions were becoming direct competitors. In Suzhou, which is close to Shanghai, a number of firms have taken advantage of the cheap local labour and the availability of direct links with the multinationals. Consequently, Suzhou is now

20. Under the Own Design Manufacture arrangement, the supplier designs his own production methods while still retaining the designation as supplier to a foreign customer. The most systematic study of the training delivered by this technological upgrading is provided by Gary Gereffi (1999). "International Trade and Industrial Upgrading in the Apparel Commodity Chain", *Journal of International Economics*, No. 48, pp.37-70.

21. This phenomenon can also be observed in the border regions of northern Mexico, here the *maquiladoras* developed from being simple low-cost assembly plants to become more complex systems of production, participating in the international flows of capital and commodities: the latter are in turn the source of investment capital for the factories located in Mexico or other foreign countries. Not only have the *maquiladoras* changed in form and function, but they have become part of a truly innovative economic and technological dynamism. Cf. Daniel Villavicencio (2003). "Le développement des maquiladoras du Nord Mexique et l'importance des réseaux binationaux d'innovation", a paper given to the IRD seminar, *Savoir et développement*, Paris, January 27th-28th.

about to overtake Dongguan as the world's largest producer of computer parts. The Shanghai and Zhejiang region has entered into direct competition with Guangdong.[22] The exhaustion of the model of production in Dongguan is due to the difficulty in upgrading the systems of production. This illustrates a key point in the theory of industrial development, namely that the creation of enterprises is a process quite distinct from their development (Figure 11.1).[23]

*The Systems of Production Set Up by FDIs*

The third wave of investment was provided by the industrialised countries. Currently, numerous 'third generation' systems of production are being piloted by foreign firms. The 400 largest of these have investments in China. The world's leading manufacturers of telecommunications and oil industry equipment, cars, and machine tools, have already set up their own production networks in China. These investments are often focused on the Shanghai region. Foreign firms begin by setting up a representative's office, and then establish their production sites. Foreign investors' objectives are no longer just to relocate the manufacturing process to cut costs and then re-export, but to develop a market in China itself (Figure 11.4).

These new systems of production are still at a preliminary stage, and the foreign firms involved are beginning to perceive the problems which any enterprise must encounter, in whichever country it first sets up operations.[24] Even those foreign firms which are already established are still finding it difficult to make any profit. For a foreign

22. It may well be that the current advantage enjoyed by Shanghai over Guangdong is due to the availability of skilled labour for managerial work. In Shanghai, foreign enterprises seem to occupy the more sophisticated sectors like pharmaceuticals. What we are witnessing in Shanghai is perhaps less the growth of a capacity for autonomous development in this region than the expansion of foreign direct investment in the technology-intensive sectors.

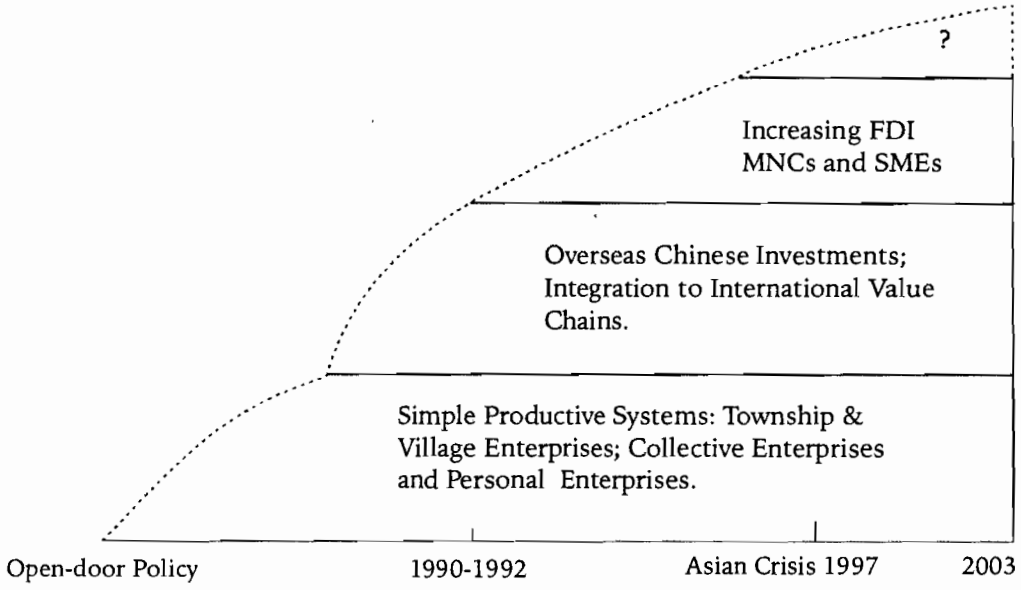
23. The more heavily industrialised areas bring about the dismantling of industries in the less advanced areas. This phenomenon, first noted in the case of 19th Century European industrialisation, is being repeated nowadays. Currently the 'winning' areas are those which have invested heavily in new technologies, even within the traditional industrial sectors. Cf. Georges Benko and Alain Lipietz (1992). *Les régions qui gagnent*, Paris: PUF.

24. This has again been verified by a recent enquiry on behalf of French firms, headed by the 'Mission Economique de Canton'; see the Report by Verillaud, "Les investissements étrangers en Chine", *Mission Economique*, Canton, April-May 2002. See also Xavier Richet, Wang Hua, and Wang Wei (2001). "Foreign Direct Investment in China's Automotive Industry", *China Perspectives*, No. 38, pp.36-42; and S.T. Walsh *et al.*, (1999). "Direct Foreign Manufacturing Investment Decisions for China", *Engineering Management Journal*, No. 11, pp.31-39.

firm everything is more expensive in China, from land purchase to building costs, installations, employee recruitment and training, communications with headquarters, relations with government offices handling labour and the environment, and commercial dealings with suppliers. It is more expensive to set up an integral system of production than to collaborate with a local supplier (Figure 11.5).

**Figure 11.4**

*Schematic Presentation of the Piling Up of Productive Systems*

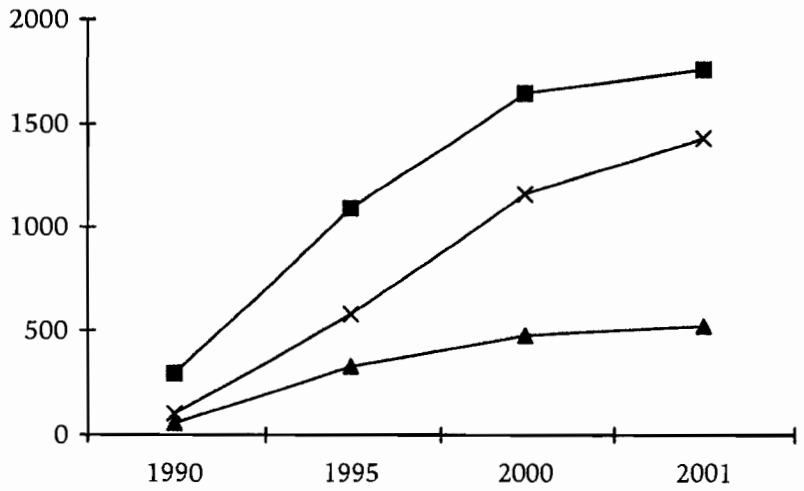



Unlike the systems of production established under the first two waves of investment, these firms have no difficulty in making use of efficient managerial techniques, and in setting up organisational structures geared towards their production goals and their market. Their difficulties arise solely from their relations with their social environment. The future legal and institutional setting within which they will operate, will be a decisive factor for these 'third generation' systems of production, and so the foreign investors who back them are relying on the complete opening of the Chinese economy in accordance with international agreements. It is still too early to make a full assessment of this third wave, and of the eventual outcome of the superimposition of these three different systems of production on top of each other.

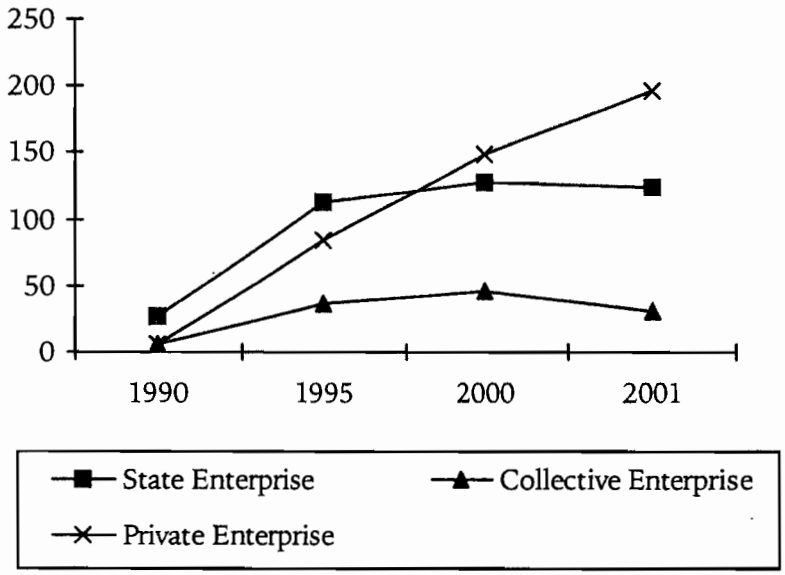
## Figure 11.5

*Investment in Fixed Capital, China and Guangdong*
*(Billions Yuans)*

(a) China




(b) Guangdong




*Source*: *Annuaire Statistique de la Chine*, édition 2002, Tabl. 6-2, p. 176.

*Do the State Enterprises Amount to a Distinct System of Production?*

Discussions of the modernisation process in China tend to focus mainly on the emergent systems of production, namely on those which arose after the opening-up reforms. But there is another system of production which is easily overlooked because it is out of harmony with all the talking of the 'miracle'. This system of production, namely the state sector, plays a very important role in the economic ethos of the country.

Before the reforms, China was a socialist country whose economy was based on the state enterprises. The enterprises, the Party administration, the schools, and the hospitals were all single 'work units' (*danwei*), and were in turn all completely integrated into the structure of the planned economy of the single-party state. These "work units" were there not only to produce goods, or supply services and training; they were also charged with major administrative, political, and socio-economic functions (like health, education, housing, and ration coupon distribution), fulfilling the role of different areas of state administration. This system still remains the social and economic basis of the so-called 'socialist market-economy system'. The different newly emergent systems of production have established themselves on top of this underlying economic and political basis of society. For over 20 years now, the reforms have been seeking to improve the operations and achievements of the state enterprises, while also making their property rights and management powers more transparent, but without dismantling the enterprises themselves, along with the political and administrative apparatus of which they are a part. So, even though the planned economy may have disappeared, this economic and political system still remains. As the new millennium dawns, this system still includes government administrative offices and Party organs, both central and local, along with social organisations, and state monopolies like banking, radio and TV, and the other media.

The state enterprises are the very heart of this system. Although, they have lost many of their markets to the new systems of production, they still enjoy privileged access to the financial resources of the country. Between 1985 and 1992, the share of the state enterprises in the GNP fell by 6 per cent, but their financial resources only went down by 4.7 per cent. Since 1992, the share of the state

enterprises in overall industrial production has continued to decline, but their investments have been increasing by 1.5 per cent. In the 1980s, the government transferred considerable resources to the state enterprises by reducing the taxes on their returns. Next, in order to continue its financial support to the state sector, in the early 1990s the government introduced the sale of public debt in the form of bond issues, and then, in the second half of the decade, it organised support through bank loans, making it easy for the state enterprises to obtain credit at preferential rates. More recently, the government has set up and supported the stock markets with the same goal of financing the state sector. In this way, the state enterprises benefit from public financial resources unavailable to the so-called 'private' firms, and at the same time they have greater ease of access to other types of resources like, for example, the publicly funded research centres and universities.[25] At the present time, the policy of supporting industrial giants (*zhuada fangxiao*), which is still far from successful, is centred on several very large-scale public enterprises.[26]

The state enterprises have not only used their privileged access to finance investment in production. Over the last two decades, a large part of their investments have gone into housing their employees, and into funding social security payments and pensions, that is to say, into the social benefits needed to maintain social stability.

With the coming of the reforms, the state enterprises underwent major transformations, but their basic nature has not changed. There is no question of entirely privatising the state sector, but rather selling off certain parts of it to procure new sources of finance. But the offers of shares for management buy-out did not deliver the promised results, and they have since then become the focus of intense debates over the chances for personal gain which they afford. A large proportion of these systems of production are in decline, and their future depends on the ability of the government to keep up the flow of investment towards them. The banks and the stock exchange seem only to exist to channel this flow in their direction. And despite

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25. According to informants in January 2002 in Shuikou, a Guangdong industrial centre for the production of plumbing installations, and in December 2002 in Jiangmen, in a collective enterprise producing washing machines. The traditional clientele served by the major industrial research centres has always been the large state enterprises.

26. Jean-François Huchet (1999). "Concentration and the Emergence of Corporate Groups in Chinese Industry", *China Perspectives*, No. 23, pp.5-17.

everything, these public enterprises still enjoy easier access to other major resources, of a technological nature, than the other kinds of enterprise.[27] So, to a large extent, the challenge facing the state enterprises is to improve their ability to produce more and to innovate.

## On the Role of Foreign Investment in Productive Systems

How long will these growth engines continue to perform? And how long can the present structure of the Chinese economy be sustained? Will foreign direct investment be an important component of the Chinese economy? These persistent questions dominate all the debates about China. To answer them, a fundamental reflection on the nature of the market economy is unavoidable. In a previous chapter, we proposed such a reflection in a way that does not focus exclusively on the question of property rights.[28] We could summarise our argument in the following way: Economic development requires trust, and the actual rules of the game in China seem not to encourage this trust. Everything indicates that a large amount of new enterprises will emerge in a rather more difficult business environment. As the new competitive pattern will be shaped, uncertainties about the behaviour of enterprises and other economic players will become conflictual points difficult to resolve. In the end, what will make the difference between enterprises is their ability to master larger and more sophisticated markets, by mastering more complex technologies.

The clearest indication, to our view, of this lack of trust is the fact that even in very small and well-structured industrial clusters in the coastal provinces of China, enterprises do not collaborate. Exchange of information between owners and managers of the firms is rather rare. Not only do enterprises look mostly for short-term profits, without bothering about long-term capital accumulation, but they also seek to avoid partnerships and external input, with the unique exception of partnerships with foreign enterprises. They focus on speed, rapid expansion, and competitive prices. Even when they know each other by name, which is often the case, the owners of enterprises

27. Here we have in mind the great number of research and technical development centres. cf. Gu Shulin (1999). *China's Industrial Technology*, Routledge.

28. Arvanitis, Rigas, Miège, Pierre and Zhao Wei (2003). "A New Look at the Development of a Market Economy in China", *China Perspectives*, Vol. 48.

producing the same items and in the same municipality never inform each other of their training needs or their labour problems. The large number of dinners which they attend, are merely intended to show that everything is alright, not to discuss together their technical, legal, or economic needs. A shared space for social intercourse is far from being established. As for the imposition of any official limitation, for whatever motive (including labour and environmental protection rights), this appears to such proprietors as an unacceptable state encroachment into private business, and an infraction of the mandate: "Enrich yourselves!". Finally, the interviews we have done in the Guangdong province have shown that the enterprises know their clients well enough, but they do not know the state of their market.[29] Only very few of the owners are able to say whether their market is rising or falling, and very few can give an indication of its size, whether at the national or regional level. This uncertainty is quite cearly at the heart of their behaviour.

Even the state enterprises are forced into this competitive pattern,[30] although it is in marked contrast to the known and respected rules which pertain in the political order. Both Chinese and foreign economists talk of an opposition between the market and the state. However, the crucial factor is not to be found in this opposition between the public and the 'private' sectors, but rather in the difficulty of even imagining the emergence of an economic sphere outside the political system, in which confidence in a shared respect for the rules would itself be the rule rather than the exception. At present, it even seems rather difficult to maintain that Chinese society is dominated by the market economy, because it lacks the essential ingredient of such an economy, namely respect for the rules which underpin mutual trust. In its place there is deep uncertainty, and this engenders opportunist behaviour, whatever the existing property laws or the kind of market in operation, private or public. That is why it seems vain to believe that the growth of the structures of production outside state control will eventually lead to the adoption of rules which will inspire trust in the proper workings of the market. All

29. See paper mentioned in footnote number 5.

30. And it seems this competition is the main source of their problems, not their budget constraints. See Dong Xiao-yuan and Louis Putterman (2000). "Investigating the Rise of Labour Redundancy in China's State Industry", *Working Paper* No. 9, Dept. of Economics, Brown University, June.

indications are that the rules based on the socialist system are still firmly in place. Such things as the laws restricting personal freedom of movement, budgetary rules, employment laws, purchase regulations in the public markets, and the lack of trustworthy statistics are all signs that there has been no change in the political system.

Now the role of foreign investments in these productive systems can be examined. For the enterprises set up by the first wave of investment, survival is achieved through meeting immediate demands, and this depends on extremely short-term calculations. Until now they mostly survive because of the very active support of the local authorities.[31] The very few enterprises which seem capable of reaching a higher level, in technical expertise and in relations with their suppliers and customers, are those which often just happen to have a joint agreement with a foreign partner, or those whose market conditions just happen to force them to make more dynamic choices, such as investing in research and development (R&D), or undertaking engineering improvements. But in any given town, such enterprises can be counted on the fingers of one hand, and in a whole region they amount to no more than a few dozen.

The enterprises belonging to the second wave of investment depend for their survival on their ability to offer their clients a range of OEM items, an ability which they have usually developed before setting themselves up in China. These are inside the globalised commercial world, have been set up mostly by Taiwanese and Hong Kong Chinese owners. This kind of foreign investment has been instrumental in creating some of the industrial clusters in China like Dongguan and Suzhou industrial park. A large part of the ability of the local industrial investors to enter in these kinds of industrial systems will depend precisely on the ability to make dynamic clusters.[32]

Finally, the Western, US and Japanese enterprises which have established operations in China have done so, precisely for long-term strategic goals, namely to be present as players on the Chinese

31. Peng Yusheng (2001). "Chinese Villages and Townships as Industrial Corporations: Ownership, Governance and Market Discipline", *American Journal of Sociology*, Vol. 106, pp.1338-1370.

32. Thompson, Edmund R. (2002). "Clustering of Foreign Direct Investment and Enhanced Technology Transfer: Evidence from Hong Kong Garment Firms in China", *World Development*, Vol. 30, pp.873-889.

market.[33] For these companies the improvement of the legal framework is of crucial importance.[34]

For its part, the state enterprise system of production is destined to continue. This is not because of any economic logic, but because of a decision to support them for political and social reasons. For these enterprises, modernisation is still on the agenda. Until now, the modernisation of the state sector enterprises has only been considered from the angle of the ownership of capital. It has been just a question of share sales, financial takeovers, and debt cancellations. But for the state enterprises themselves, as for the banks, productivity remains a key question. This involves improvements in management efficiency, the introduction of planning capabilities, the development of the engineering and R&D side, and the ability to actively adapt and improve products and procedures. All these aspects of innovation seem to us not merely useful but absolutely necessary. What is at stake is not the present sharing of the diminishing pile of goodies, but increasing these firms' capacity to produce real value.

## Conclusion

For all these reasons we believe that the key to future growth in China is not merely the financial aspects or the legal and political framework but rather on the ability of Chinese firms to adopt, adapt and develop technologies bought, 'borrowed' or copied from their foreign partners. In the immediate future, the new systems of production will still need to feed the political structure and the state enterprises financially. But they are no longer capable of sustaining the national growth by themselves. To achieve this, a new wave of investments must be encouraged. If growth is to continue in the future, new systems of production will have to appear on the scene. Moreover, the different systems of production will find themselves increasingly engaged in collaborative activities.

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33. Wang Pien, Kulwant Singh, and Tong Wenfeng (2001). "Determinants and Outcomes of Knowledge Transfer: A Study of MNCs in China", Singapore, Best Paper Proceedings, Academy of Management Conference.

34. The importance of the stakes here is reflected in Jefferson's hope that changes in the legal framework will be brought about by pressure from international agreements. See Jefferson, "China's Evolving (implicit) Economic Constitution", *op. cit.*

Foreign direct investment will be sooner or later caught in the strategies of national firms and cannot be developed only inside the strict walls of wholly owned foreign firms (which seems to be preferred by foreign investors as compared to the scheme of joint ventures). Sooner or later—and the economic literature tells us this is rather sooner than later—technologies and innovation would leak out of enterprises and get developed in companies other than the ones they were initially designed in. Maybe national and local authorities will take this as a new challenge and develop a solid support from the state to the new emerging productive systems, linked to a strategy for the various sectors, and to thorough-going training schemes, as the examples of Japan and South Korea amply demonstrate. Sustaining growth requires a strengthening of the systems of production currently in place.

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# Globalisation in China, India and Russia

## Emergence of National Groups and Global Strategies of Firms

Editors:

Jean-François Huchet

Xavier Richet

Joël Ruet

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