

Foreign Investment in China: Myths and Realities

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Since 1979, China's economic policies have been directed toward opening the economy to foreign trade, capital and investment. Like its open-door policy, China's determination to lure foreign investment has drawn worldwide attention. This research examines both the Chinese and foreign motivations, analyzes policies and incentives for attracting foreign investment and discusses foreign joint ventures' operating experiences in China.

I. Introduction

While much of the developing world disfavored foreign direct investment, China launched an ambitious program to attract foreign investment in late 1970s.¹ China's desire for foreign investment was an integral part of its overall effort to build the country into a modern and highly civilized society by the middle of the next century through a much publicized modernization program — modernization in agriculture, industry, science and technology and national defense.² In order to achieve these goals, China needs to acquire and use modern but suitable technology, know-how and advanced equipment. This will also shorten the development cycle of key industrial and infrastructural projects. Addi-

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¹ For studies reviewing why developing countries disfavor traditional form of foreign direct investment that involves full or majority foreign ownership, see IMF (1985) and Sion Raveed (1980).

² Throughout this paper, foreign direct investment and foreign investment are used interchangeably as there has been effectively no foreign portfolio investment in China.

tionally, China needs to obtain western managerial expertise and international marketing experience in order to overcome many serious developmental bottlenecks, such as its backward managerial system and foreign exchange shortages. Therefore, capital, technology and management were and are considered essential to narrow the technological and economic gaps with the newly industrialized and developed countries.

China began its acquisition of foreign capital, technology and management through the establishment of equity joint ventures, 100% foreign-owned subsidiaries, contractual joint ventures and compensation businesses in the four Special Economic Zones (SEZs) in 1979.³ Since then, China has rapidly accelerated the pace of absorbing foreign investment. Particularly, since 1983, China has placed an increased emphasis on the use of foreign investment, mainly in the form of equity joint ventures and contractual joint ventures, rather than on loans and credits from foreign governments, international financial institutions, and foreign commercial banks. From 1979 to 1987, a total of more than 3,000 joint ventures were established with foreign capital infusion of US\$20 billion. When combined with Chinese capital, the total amount of investment should be more than US\$40 billion.

Like its open-door policy, China's determination to lure foreign investment has drawn worldwide attention. The significance of China's vigorous foreign investment program is not limited to those who are interested in potential investment opportunities there, or to those who have an academic interest in China's progress. Rather, China's attitude toward, commitment to, and achievements made in, foreign investment in the past 8 years have provided a good example for other centrally-planned economies and developing countries. Already, the Soviet Union has followed its example and developed policies to attract foreign investment and open its economy to the outside world. On the other hand, the opening of the Chinese market, the Eastern European markets, as well as the markets of the developing world, provide additional opportunities for many internationally-oriented firms.

The purpose of this paper is to examine how foreign joint ventures perform in China. First, discussion will focus on why China encourages

³ The difference between an equity joint venture and a contractual venture lies in the distribution of profit made by the venture. Profit distribution for the equity joint venture is determined by the equity share of each investing partner. Profit distribution for the contractual venture, however, is determined in the venture agreement agreed upon by investing partners, rather than based on the share of ownership.

SEZs are areas designated by the Chinese government to attract foreign capital and technology by offering special economic policies and investment incentives. Three of the four zones are located in the southern part of China near Hong Kong.

foreign investment and why foreign companies are interested in investment in China. Second, the focus will be directed toward China's policies and incentives for attracting foreign investment. Finally, foreign joint ventures' operating experiences will be examined.

II. Chinese and Foreign Investors' Motivations

Foreign investment involves a great variety of political, economic, commercial, and cultural complexities of host countries, in addition to the internal strengths, resources, and constraints of each individual investing firm. Entering into a foreign investment arrangement, such as a joint venture in a non-market economy like China, presents additional problems and uncertainties. This is because the Chinese investing partner of a proposed joint venture is ultimately the State, whose motivations and purposes behind embarking upon the venture may differ vastly from those of a foreign investor.

The Chinese have little experience in conducting a joint collaboration project with foreign firms. More importantly, under a centrally-planned system, rigid political and economic systems, as well as different management practices may pose potential difficulties to such a "marriage" between a Western private market oriented enterprise and a state owned and operated organization.

Why have so many foreign firms invested in China, with still so many planning to do so? To understand this, one must first consider some of the motivations of each investing partner.

A. *Chinese Motivations*

China's motivations for the promotion of foreign investment are to:

- Obtain foreign technology
- Acquire foreign capital
- Obtain foreign management expertise
- Obtain foreign marketing experience and marketing network
- Increase foreign exchange generating capacity
- Develop and promote joint research activities
- Raise the standard of living for local communities

It was clear to the Chinese government in late 1970s that much of the country's technology and industrial facilities were out of date, if not obsolete.⁴ As a result, the acquisition of technology, especially in areas of

⁴ Much of China's technology and industrial equipment was imported from the Soviet Union in the 1950s, who was then China's major political and economic ally.

electronics, computer hardware and software, production processes, energy development, telecommunications and transportation were given high priorities in China's national economic development policy and program.

While China could develop some of these technologies independently, not only would it be time-consuming, but it would also be extremely costly in terms of research and development. Meanwhile, China has faced another key problem — a lack of foreign exchange — which has prevented it from importing the needed technology and equipment at will. Therefore, foreign investment, and joint ventures in particular, are considered logical alternatives to either the purchase or development of its own technological base.

From the 1950s through the 1970s, China obtained much of its foreign capital through credits from foreign governments and loans from foreign commercial banks.⁵ Most of these loans were in the form of trade credits and were used to finance China's imports of heavy machinery and equipment including entire industrial facilities and plants. In 1980, China resumed its seat at the World Bank and, therefore, began to gain access to this financial resource. It was not until 1982 that the Chinese government began tapping the international capital market by issuing foreign bonds and Eurobonds in Asia and Europe.⁶

In order to diversify sources of borrowing and obtain a desirable balance between debt and equity financing, the Chinese government saw foreign investment as an ideal source of overseas funding that would also attract desired technology and other production inputs including management experience. The heavy emphasis on technology transfer through joint venture agreements was made because Chinese authorities recognized that, not only could such a transfer increase production capacities, but appropriate transfers could also raise the quality of products being produced, making them more competitive in both domestic and foreign markets. Through their contact with foreign partners, Chinese managers are able to:

1. Gain first-hand exposure to modern management practices and production processes;

⁵ The Soviet Union was the major credit provider in the 1950s. In 1970s, however, Japan and several European countries were China's major creditors. Loans from these countries were mainly in the form of export credits which, in turn, were used to purchase industrial goods from them.

⁶ As of July 1986, there were a total of 17 foreign bond issues and 6 Eurobond issues by the Chinese financial institutions in Japan, West Germany, Hong Kong, Singapore and Luxembourg capital markets. They also issued a few floating rate notes in the same markets.

2. Gain insight into techniques for quality control and product design;
3. Gain a better understanding of international marketing and promotion techniques for market penetration;
4. Gain access to the marketing networks of foreign partners; and
5. Develop collaboration in third markets.

As a result, many of the goods and services developed by the joint venture can more effectively tap the international market place so as to increase foreign exchange earning capacity and improve China's trade balance through import substitution, export stimulation and export diversification.

In line with these motivations, foreign investment projects in China have been focused on one or more of the following:

1. Technologically advanced projects which are engaged in developing new products as well as upgrading and/or replacing present plant and equipment;
2. Export-oriented projects which can potentially export much of their production in third markets so as to generate a foreign exchange surplus after deducting foreign exchange expenditures incurred in joint venture production and operation;
3. Import substitution projects, which will produce goods and services China currently imports, thereby reducing foreign exchange expenditures;
4. Other projects which require substantial fixed capital investment, particularly in industrial sectors where China's technology lags behind the industrial countries;
5. Raw material exploration projects which locate and develop production facilities for oil, gas, coal and other raw materials; and
6. Service projects which are engaged in providing services mainly to foreign travellers, foreign business executives, foreign business offices, etc.

In addition, it is desired that any proposed joint venture contributes to the balanced development of China's foreign trade, industrialization and labor utilization requirements.

B. Foreign Investors' Motivations

Foreign investors' motivations for investing in China may vary, but certainly include one or more of the following:

1. Market-related factors: assurance of a share in China's potential

- market and rapid growth of the economy;
2. Cost-related factors: reduction of production, transportation and labor costs;
 3. Raw material-related factors: acquisition of raw materials that are available in the Chinese market;
 4. Competition-related factors: the intent to meet the competitors' move and to forestall or reduce the competition of other firms' operations in the same geographical area;
 5. Benefits connected with China's investment incentive programs to foreign investment; and
 6. Trial investment to test the market.

It is not surprising that China's market potential is considered a prime factor by foreign investors. With more than a billion people, and according to the World Bank, a 58% cumulative increase in per capita income during the period of 1980-1986, the market is indeed attractive. Furthermore, with incomes rising and discretionary income available, there is a strong demand for consumer goods. Because of China's import substitution policy, there is an equally strong market for industrial goods and infrastructure development in foreign investment projects.

In order to attract specific foreign investment projects that would assist in reaching planned goals, the Chinese government guaranteed that a certain percentage of the joint venture's production could be sold domestically, with the venture being paid in a hard currency.⁷ This guaranteed sales allowance in many cases has provided sufficient funds for local needs, including local purchases, wages and salaries, enabling the joint venture partner to take their profits in hard currency.

Since China lacks foreign exchange and is unable to import all it needs, foreign investment is considered by many investors as a vital alternative to enter into or penetrate the Chinese market. Many firms also hope to gain a foothold in the Chinese market and to build an industrial and operational base for the sales to other Asian countries.

Low operating costs not only attract investors from industrial countries, but also attract investors from Hong Kong and other nearby countries whose labor cost is much higher than that in China.⁸ Although the actual labor cost in China has turned out to be much higher than many had expected, it is still far less, for example, than that in Japan, the U.S. and Western European countries. The availability of local unused factory

⁷ This special allowance is particularly designed for technologically advanced projects and import substitution projects.

⁸ See "China: Hong Kong's Factory," *New York Times*, September 4, 1987.

facilities and a trainable, stable labor force provides additional incentive for a relatively labor-incentive operation in China.

China's rich deposits of oil, gas, coal and other raw materials are another attraction to foreign investors. Many truly multinational firms from major industrial countries have been actively involved in oil exploration in the South China Sea and gas and coal mining in the central part of the country.

In order to promote foreign investment, the Chinese government has made considerable effort in providing various investment incentives. Low tax rates are a good example. China's current corporate tax rate for joint ventures is 15% in most areas compared with an average tax rate of 30% or more in other developing countries (see Table 1). Many firms are, therefore, also attracted by the investment incentives provided in addition to those important factors discussed previously.

Table 1
A COMPARISON OF TAX RATES IN CHINA
AND SELECTED COUNTRIES

Country	Income Taxation
China	Corporate income tax: 15% in SEZs and opened cities and 10% withholding tax on remitted dividends; in other areas, corporate income tax is 30%
Hong Kong	Corporate income tax: 18.5% Other entities: 17% Taxes are levied on profits and interest arising in or derived from Hong Kong
Malaysia	Corporate income tax: 40% Development tax: 5% Excess profits tax: 3%
Singapore	Corporate income tax: 33% Withholding tax: 33% on dividends earned in Singapore
South Korea	Corporate income tax: 0-30%
Thailand	Corporate income tax: 35% Business tax: 1.5-40% Remittance tax: 20%

Some firms, however, may have invested in China without a specific reason or objective. Their investment may have been motivated by a similar move of their competitors, or they just have an investment project in China on a trial basis — if the first one operates smoothly, they may either expand the existing facility and operation or make new investments. This type of motivation explains the fact that a majority of joint ventures have been quite small in scale.⁹

The investment decision-making process of foreign investors for a possible joint venture in a non-market economy like China is undoubtedly a complicated one. The process will not only involve many factors analyzed earlier, but encompass many other environmental and organizational factors. Included among the environmental factors are the local business climate, the potential of the targeted markets and the effect of competitive influences. Among the organizational factors are the form of association, the quality of management and the partner's concurrence in business objectives. Therefore, the foreign investors' considerations on an investment must also be evaluated by the following additional factors:

- Prevailing corporate policies on investments in non-market economies;
- Potential risk inherent in the Chinese market;
- The cost of raising capital;
- The market's competitive pressure; and
- Other financial alternatives provided by return on a similar investment in other parts of the world.

III. China's Investment Policies and Incentives

A. *Special Economic Zones and Open Cities*

To encourage foreign investment, and with it appropriate technology transfer, China opened four SEZs in 1979. Similar to free ports in other countries, the SEZs provide incentives which include tax holidays, duty free imports of equipment and raw materials, infrastructure and housing support, concessions on the use of foreign exchange, and special concessions on regular labor policies. The SEZs have now become an integral part of China's policy of opening to the world.

When the SEZs were first established, many wondered why China

⁹ Based on statistics available, more than 50% of joint ventures in China are less than US\$1 million in size. Relatively few ventures have an investment exceeding US\$10 million.

should take such a step — unprecedented for a non-market economy. The Chinese believed that SEZs were a good form of international economic cooperation through which the Chinese could provide preferential treatment while foreign investors would build factories, create jobs, bring in foreign exchange and promote local economic development.

Augmenting the four SEZs are the key coastal cities that were opened in 1984 for foreign investment. The zones and the open cities offer exceptional flexibility and autonomy in conducting business and therefore are expected to serve as “windows” for foreign technology, capital, management techniques and market information.

However, China’s SEZs and opened cities did not develop without setbacks. In 1984, serious management problems were uncovered, including some illegal activities which forced major corrective action and a slow down in growth. The fourteen open cities were once reduced to four and some restrictions were imposed on the types of business allowed. In its move to attract foreign investment, China had to learn how to cope with the associated problems of moving from a closed economy to a more market-oriented society by utilizing western management and production technologies. Nevertheless, the overall initial experiments were for the most part successful and the SEZs and opened cities have become the symbol of China’s open-door policy.

B. Legal Environment

A good legal environment is one of the most important factors in promoting foreign investment. Since the adoption of the open-door policy in 1979, China has paid special attention to the drafting of economic and investment codes in order to provide the necessary legal environment for foreign investment. With many positive measures being taken, a series of codes regarding use of land, entry and exit procedures, labor and wage scales, assets and property, enterprise management, and high technology imports have been established.

These commercial laws and regulations were amended in 1986 with the aim of providing additional incentives to foreign ventures, particularly to those which are referred to as technologically advanced and export-oriented ventures. The new incentives include: further reduction in the income tax rate; easier access to financial resources available inside the country; easier access to the domestic labor market and more autonomy and flexibility in hiring and firing, as well as other related decisions. They also include granting management more autonomy in seeking raw materials from the domestic market and making production, financing

and marketing decisions. Additionally, less control over remittance of profits in foreign currencies abroad is exercised.

More importantly, the new regulations encourage the establishment of foreign exchange adjustment centers in each major city to assist those ventures which may have temporary foreign exchange balance difficulties in converting some of their Chinese-currency earnings into a hard currency. These centers will also help ventures adjust their foreign exchange surpluses and deficiencies on a more regular basis as needed.

Like stock exchanges, foreign exchange centers are physical locations where sellers and buyers of foreign currencies meet and conduct transactions. Exchange rates, however, are determined by the centers, reflecting market supply and demand conditions of the various currencies. Generally, the market rates tend to be much higher than the official exchange rates quoted by the Chinese government. Today's official rate is about RMB 3.70/US\$ while the market rate is around RMB 6.00/US\$. If a joint venture, for example, needs to purchase US dollars for working capital financing purposes, it has to pay RMB 6.00 for one US dollar. When it needs the Chinese currency financing, however, it can obtain 6 RMB by paying one US dollar.¹⁰

While China has been rapidly developing its legal system for foreign investment, many problems still confront foreign investors:

1. The legal system is still far from adequate. For example, China does not yet have well defined laws on patents and copyrights.
2. Foreign investors are faced with many difficulties in coping with the Chinese investment laws and regulations when investing in China. First, the Chinese legal system is being developed in a centrally-planned economy that has had internal rules and controls already in place for more than three decades. Second, the state bureaucracy, whose approval is needed for every venture (either the central or local government depending on the size of the venture), is still a key element. Third, the Chinese legal system for investment is being implemented within a broad network of social environments, including personal relationships and ties.
3. Chinese commercial law is developing within the context of a far less flexible political environment. Therefore, these factors will undoubtedly continue to influence the understanding and implementation of laws and regulations, and there will continue to be confusion between the concept of the "rule of law" and bureaucratic power. Understandably, during the transition phase,

¹⁰ RMB stands for the Chinese currency.

there will also be confusion between laws and cultural traditions. All this will continue to pose problems for foreign investors in the future.

C. Investment Incentives

Factors affecting an investment environment are numerous. First and foremost, a stable political situation, a stable social order and consistency in policy are essential. There should also be good profit-making opportunities, which are the prime concern for foreign investors. The legitimate rights and interests of foreign entrepreneurs should be protected while incentives should be offered. Incentives provided by the Chinese government for attracting foreign investment include:

- flexible investment ownership
- flexible investment duration
- free choice of investment sectors
- flexible size of investment
- free choice of investment location
- low corporate tax rate
- relatively flexible management, employment and wage system
- flexible policies on pricing system
- flexible policies on financing and remittance of profits

In contrast to some of the observations about foreign investment in developing countries, the claim that unilateral direct foreign investment is discouraged and investments which include some sort of local participation are emphasized does not hold true for China.¹¹ A unique characteristic of foreign investment in China is the acceptance of equity investments up to and including 100% ownership held by foreign investors. This is significant because foreign investors in would be joint ventures often face difficulties in selecting or even discovering experienced or appropriate joint venture partners and then later having to coordinate activities with them. Flexible ownership, depending on the type of venture, permits foreign investors to have a choice between a joint venture with a local partner and wholly-owned subsidiaries.

Flexible investment legislation allows investors to plan their investment on a short- or long-term basis. This is an essential requirement for certain large scale manufacturing and raw material development projects. These projects require a substantial outlay in the initial investment stage and a relatively long payback period. Also, for many investors, their

¹¹ See Raveed (1980), p. 2.

primary objective is to maintain a presence in the Chinese market over long periods. Flexible investment opportunities allow them to achieve this strategic objective.

Another unique characteristic of foreign investment in China is that the Chinese allow foreign investors to invest where they want and in any industry they consider best. In fact, foreign investment is particularly encouraged in coastal areas where the investment, business and social climate is generally better than that of more remote areas. This is substantially different from investment policies in many other developing countries whose intention is to promote foreign investment in poor rather than well-developed metropolitan areas.

Although some believe that tax concessions offered by host governments have a less than significant influence on foreign investment decisions of foreign investors,¹² it is still widely accepted that tax reduction is one of the major incentives for attracting foreign investment.¹³ China effectively utilizes this tool. It provides, for example, a very comprehensive tax incentive program for foreign investors. As shown in Table 1, the overall corporate tax in SEZs and opened cities in China is only 15%, substantially lower than that of other countries. The technologically-advanced and export-oriented projects are enjoying greater preferential treatment. For example, they are exempt from the profit remittance tax which usually is 10% and income tax may be reduced to as low as 10%.

The general management of a foreign venture in China is handled by the company's board of directors. For a joint venture, it is handled by both Chinese and foreign directors. The venture is guaranteed a "right of autonomy" in its operations, including the right to make and implement planning, production, marketing, financing, and labor decisions. Also, the investment laws allow the venture to recruit employees from anywhere in their locality or from other parts of the country. The laws further allow the venture to set its own wage scale so that it can use the wage as a motivational tool to promote its business. Furthermore, employment can be terminated if the workers are not productive.

Special pricing system incentives are also provided to foreign investors. Joint ventures, for example, can freely determine their prices for products exported to international markets. They can also negotiate prices of goods sold on the Chinese domestic market even though the general pricing system in China is fixed and can only be altered by the government. This provides foreign investors more advantageous treatment when compared

¹² See, for example, Agodo (1978).

¹³ Jian Hai Lin (1986).

with domestic Chinese companies.

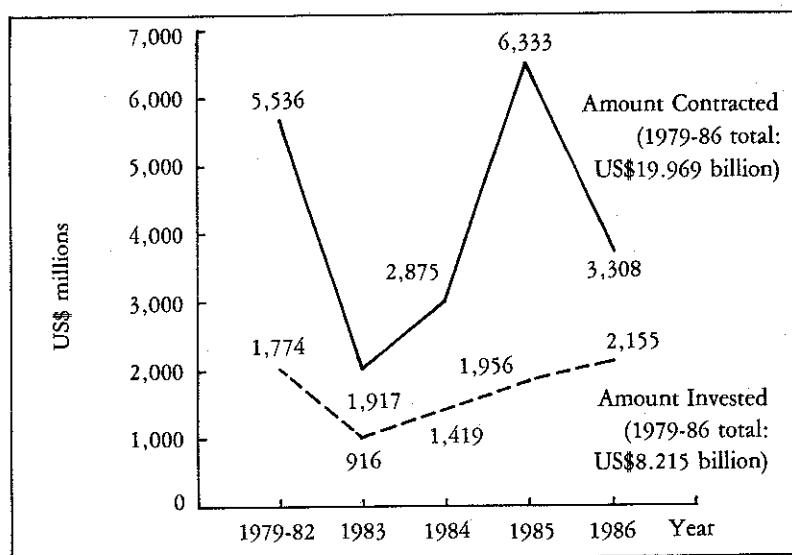
In addition, Chinese banks are very active in providing both Chinese-currency loans as well as loans in foreign currencies to help foreign ventures finance their working capital requirements. The banks also assist foreign ventures in gaining access to international borrowing, if required, and can assist them in remitting their profits made in China.

IV. Foreign Investment in China: Myths and Realities

A. Overview

Foreign investment inflow to China has been very erratic during the past eight years. As Figure 1 shows, 1985 experienced an investment boom, in which the total amount of investment contracted reached US\$6,333 million. But 1986 saw a sharp decline in foreign investment with total investment just half of that in 1985. The large drop in 1986 may be attributed to a decrease in oil investment and reduced investments in the

Figure 1
FOREIGN INVESTMENT IN CHINA: 1979-86



Source: *Business China*, Business International Corporation, June 22, 1987.

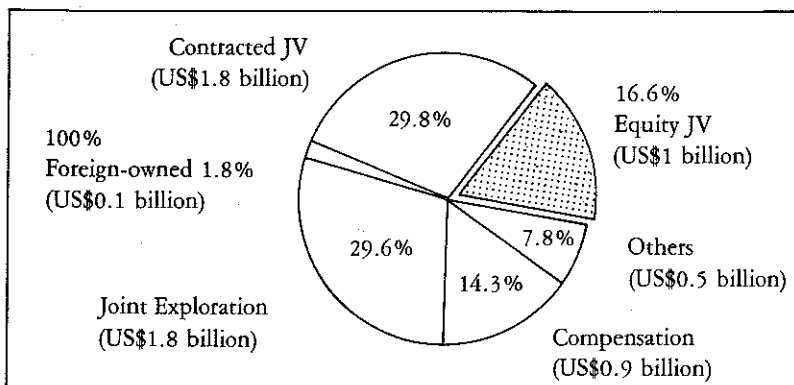
hotel industry. This also reflects flagging interest among investors which prompted the Chinese government to announce a series of investment incentives in 1986.

Among the different form of investment, foreign investors prefer contractual joint ventures over equity joint ventures (see Figure 2). Wholly foreign-owned subsidiaries have only accounted for 1.8% of total investment. The reason for the preference of contractual joint ventures is that this type of venture is very flexible. Both foreign and Chinese investors are free to lay down whatever clauses and articles they want in their joint venture contracts. Given the incomplete nature of the Chinese regulations in this area, it is understandable why investors prefer a less restricted form of investment.

Most of the contractual joint venture investments went into building hotels and apartments. Until now, this has been the most promising type of venture in China because of its foreign exchange-generating potential combined with a great shortage of comfortable accommodations in most Chinese cities.

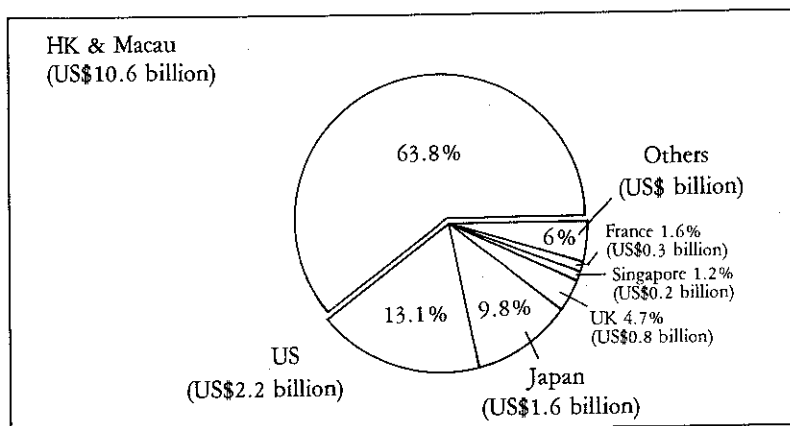
Among the major sources of investment, Hong Kong and Macau are the leading investors in China, accounting for 64% of all foreign investment contracted. American and Japanese companies make up the second and third largest contributors committing US\$2.2 billion and US\$1.6 billion respectively (Figure 3). U.S. investment in China is focused

Figure 2
FORMS OF FOREIGN INVESTMENT: 1979-86



Source: *Business China*, Business International Corporation, June 22, 1987.

Figure 3
PRINCIPAL FOREIGN INVESTMENT: 1979-85



Source: *Business China*, Business International Corporation, June 22, 1987.

Table 2
INTERNATIONAL COMPARISON ON EQUITY JOINT VENTURES

	Number of Equity Joint Ventures	Commitments (millions of US Dollars)	Average Commitment
United States	97	180	1.9
Japan	86	230	2.7
Other Western*	66	297	4.5
Asian Countries**	52	88	1.7

* Includes Europe, Canada, Australia, and New Zealand.

** Includes Singapore, Thailand, and Philippines.

Source: National Council on U.S.-China Trade (1987).

primarily on equity joint ventures (Table 2). This is vastly different from either Hong Kong or other investors. U.S. investors believe that the equity joint venture is the best way to penetrate the Chinese market in the long run, while Hong Kong and other investors regard other modes of investment as more effective at least in the present environment.

B. Operating Experience

Foreign ventures' operating experience in China is mixed. Although there are many successful joint ventures, nearly every venture faces complications in several areas of operation, including timing, market share, foreign exchange allocation and profit repatriation. While some of the problems are small and only lead to minor frustration and delays, others have been significant enough to threaten the existence of the operation.

The most conflict arises from differences in the Chinese motivations for attracting foreign investment and the motivations of foreign investors. By introducing foreign investment, the Chinese hope to attract capital, technology and managerial skills to develop the Chinese economy. They also aim to earn foreign exchange through the upgrading of existing export commodities and through the development of new export industries. The primary motivations for foreign investors, however, are to seek access to the Chinese domestic market. This basic conflict is responsible for some key problems and misunderstandings in the foreign venture operating experience.

Another reason for the problematic environment that exists for foreign investors is that joint ventures in China are still in the start-up phase of operations, a phase which typically is problematic in any developing country. Given the steps required to prepare a venture for actual operation, including constructing or renovating a local facility, installing equipment, hiring a workforce, etc., there has not been enough time for most joint venture partners and the Chinese government to gain positive operating experience.¹⁴

Finally, the Chinese are not yet experienced investors since they have been exposed to the outside world for less than eight years. The lack of experience of the Chinese in working with foreign investors from a different culture with different managerial styles has also created problems.

C. Problems Encountered by Foreign Investors

Foreign investment in China encounters the following major problems:

1. Lack of foreign exchange necessary to conduct business operations;
2. Extraordinarily high operating cost;
3. Shortage of trained personnel;

¹⁴ See the National Council for U.S.-China Trade (1987), p. 133.

4. Lack of market access for the joint venture;
5. Shortage of local personnel with marketing expertise and experience; and
6. Excessive bureaucracy at all levels.

The lack of foreign exchange necessary to conduct business operations is the foremost problem. This problem stems from the inconvertibility of the Chinese currency, which prevents the conversion of the Chinese-currency earnings from sales on the domestic market into hard currency. The problem has further been complicated by the fact that China's foreign currency reserves are always limited, forcing the Chinese government to take a cautious approach toward foreign exchange policies for foreign investment. As a result, many foreign ventures have difficulties in importing materials and industrial components as well as in remitting profits. Furthermore, many joint ventures did not correctly assess the rising costs during the start-up period nor did they allow for unanticipated production delays caused by infrastructure problems such as shortage of electricity, water supply, poor construction, etc.

On the part of foreign investors, many firms, particularly medium-and small-sized ones, failed to realize the time it would take from initiating the joint venture until production actually began. This resulted in greater foreign-currency expenditures. Furthermore, the cost for housing foreign executives and their families is extremely high, thus increasing unanticipated foreign-currency expenses. Still, many firms are unprepared to market products produced by the joint venture in third markets, or through their own channels to other markets, though they agreed to do so in the joint venture contracts.

Equally as important are the high operating costs. As pointed out earlier, one of China's attractions for foreign investment should be its position as a low cost manufacturing site. It is true that many foreign ventures in China, particularly labor-intensive projects are enjoying the advantage of lower cost. But for projects that involve a large-scale operation, advanced technologies, sophisticated inputs and a skilled workforce, China is not a cheap place to manufacture. The high operating cost is comprised of high production inputs, high overhead expenses, difficulties in sourcing materials and production components in China, poor quality control and high cost in infrastructure development such as transportation and telecommunications.

Many of the firms, depending on local suppliers for materials and components, are either unable to find them available locally and are forced to import more expensive goods from abroad, or find them of poor quality and short of industrial standards. Another factor is that the wage

costs are often much higher than anticipated. Labor is often unskilled and has to be trained or retrained, thus placing an additional cost and time burden on the joint venture operations.

Furthermore, when joint ventures begin their recruiting process, particularly for engineers and other skilled individuals, they are often handicapped by an inability to attract qualified candidates because they can not obtain government permission to move them from their current positions. Even when they can, they usually find that salaries demanded are much higher than what the local firm has to pay similar individuals. This factor, in turn, makes the joint venture less competitive with domestic firms.

Adding to the above problems are the high cost of overhead and infrastructure facilities. Indeed, even if labor cost may be much lower in China, the labor savings can easily be offset by the high cost of other production inputs. Table 3 shows a comparison of costs in Hong Kong and costs in Shenzhen, one of China's most developed SEZs. Although costs in the zone are generally higher than those in other parts of China, they are a reflection of actual cost calculations for foreign investment in some parts of China.

In assessing the rationale for the lack of market access for joint ventures, many firms find themselves facing significant foreign import competition in the local market. This ties into the high costs of doing business in China as analyzed above and the fact that the cost of production in some of the Asian countries may be even less than in China. Also, many of the Chinese companies feel that the image and quality of foreign-produced goods are superior to any of those produced within China. Therefore, they prefer imported goods from foreign countries over goods produced by local joint ventures. Compounding the problem even further, many joint ventures find that they face a high degree of local competition from Chinese firms that are heavily subsidized by the government. As a consequence, they find their products are not price competitive in the marketplace.

While there are bureaucratic procedures in most countries of the world, China certainly ranks at or near the top. Most joint ventures experience long delays in receiving supplies from domestic sources. Production lines, for example, are often stopped because goods and services are not delivered on schedule.

There are also long delays in receiving responses from government officials. Often there are several administrative layers that have to be consulted without any clear lines of responsibility for decision making. Thus, "passing the buck" is often done with each layer of the bureaucracy plac-

Table 3
A COMPARISON OF COSTS IN HONG KONG AND SHENZHEN SEZ

	Shenzhen SEZ	Hong Kong	%
1. Labor			
(Salary)			
Worker	US\$109/mon	US\$283/mon	38
Technician	US\$192/mon	US\$411/mon	46
Manager	US\$830/mon	US\$1,160/mon	70
(Total Cost)			
Worker	US\$3,005/yr	US\$3,468/yr	87
Technician	US\$4,020/yr	US\$5,022/yr	80
Manager	US\$12,845/yr	US\$14,129/yr	90
(Total cost includes salary, bonus, housing allowance, insurance and medical fee)			
2. Industry			
Water	US\$0.086/sq.m	US\$0.27/sq.m	32
Electricity	US\$0.118/kwh	US\$0.08/kwh	148
3. Land			
Factory space	US\$2.8/mon/sq.m	US\$4.0/mon/sq.m	70
4. Residence (Rent)			
Apartment (50 sq.m)	US\$128.5/mon	US\$449.6/mon	28
Hotel	US\$42.4/day	US\$103/day	41
5. Transportation			
Patrol (car)	US\$128.5/mon	US\$128.5/mon	100
Maintenance	US\$385.3/yr	US\$192.7/yr	200
6. Telecommunication			
Long-distance (first 3 min)			
HK-Shenzhen SEZ	US\$0.96/min	US\$0.31/min	310
U.S.-Shenzhen SEZ	US\$2.3/min	US\$1.58/min	146
Phone installation	US\$770	US\$77	1,000
Monthly fee	US\$16	US\$7.7	207
Telex installation	US\$642	US\$101	635
Monthly fee	US\$112	US\$68	165

Source: "Counting the Cost of Shenzhen Production," *Sunday Morning Post*, September 20, 1987. The exchange rate of HK\$7.785/US\$ is used in this table.

ing the blame somewhere else. A part of this can be attributed to the lack of incentives on the part of Chinese executives and staff personnel, because there is no reward for efficiency of operations. In addition,

Chinese reward for being successful, but the penalties for making the wrong decision are very stiff.

In addition to the five key factors that are considered negative for foreign investment in China, several other problems are also considered important. For example, there are many infrastructure problems, including a lack of communication networks, port facilities, and efficiency in operations. There is a lack of reliable information systems available in China to determine local market needs and supplies.

Joint ventures also face a lack of adequate housing for the foreign executives and their families as well as for the local Chinese staff and workers. There is a lack of schools for children of the foreign executives, a lack of first class hospitals and service facilities, as well as a lack of recreational facilities. In short, joint ventures have difficulty in recruiting executives to come and work in China, particularly if they have families with children of school age who will accompany them.

D. International Comparison

Despite the problems discussed for foreign ventures' operations in China, the operating experience for each joint venture is unique. Also, there is a notable difference in the operating experience of joint ventures based on the foreign partner's nationality. This is particularly true with foreign ventures from Hong Kong and Macau as compared to other countries like the U.S. and Japan. Hong Kong ventures are more profitable and successful than other ventures in dealing with China for several reasons. Among the most important are the following:

1. They are mostly interested in industries with export potential; therefore, they are able to reduce the risk of converting the local-currency earnings into hard currency. In fact, the majority of Hong Kong joint ventures manufacture in China and export the products to Hong Kong or other Asian countries.
2. Most Hong Kong ventures are small sized investments, thereby minimizing the difficulty of acquiring the local raw materials, labor and other production inputs. Also, their requirements on infrastructure supplies, such as electricity, water, gas, etc. are less of a problem.
3. Most Hong Kong ventures are in labor-intensive industries, including textiles and light industrial products as well as in hotel and tourist industries; therefore, they are able to take the advantage of lower labor costs available locally, have a ready market for their goods and services, and thus are assured of convertibility of earnings.

4. Hong Kong managers share a common cultural background with the local Chinese. They speak the local dialect, know the customs and can often bargain more effectively with local officials. The cultural advantage also helps them work through the layers of bureaucracy and allows more flexibility in their operations. It also helps them recruit more qualified managers and workers for their operations. In fact, Hong Kong joint ventures frequently hire relatives in China to supervise their operation, which helps to eliminate many management problems that joint ventures from other countries experience.

In contrast to Hong Kong ventures, American and European companies face more problems. The major issues — foreign exchange, high production costs, marketing difficulties, etc. — confront all these investors, except in key areas where there is a strong interest on the part of the Chinese government for the project. The degree to which a problem is experienced by a particular venture depends on the size of the venture, technological level, industry sector, as well as its contribution to China's goals of modernization.

These ventures tend to be larger in size when compared to other investments. It appears that the larger the size of the venture, the more problems the venture tends to face. For example, problems such as production input requirements, infrastructure supplies, and labor recruitment are the biggest issues faced by these ventures. Also, balancing foreign exchange earnings and expenditures is more difficult for large-sized ventures compared with small ones.

On the other hand, however, large ventures can usually draw immediate attention from the Chinese government when problems occur. They can obtain more support either politically or financially from all levels of the government officials if needed, and therefore can have a better working relationship with the bureaucracy. This is particularly true with the case of Jeep Corporation, Foxboro Company and Occidental Petroleum Corporation's joint ventures in China. Operating problems, if any, can always be dealt with in a more timely manner because of their visibility and high-level government intervention.

These ventures are also more high technology-intensive and may require precision components and parts. This presents difficulties as many have to import a higher percentage of their production content, driving up costs and foreign exchange expenditures. Also, their products have to compete against those of foreign manufacturers who are always more price competitive. Ventures involving advanced technology have higher requirements for labor, technicians, and managers. This creates two prob-

lems: higher cost in training the labor if it is not experienced, and substantial difficulties in recruiting qualified personnel from Chinese domestic companies.

The high-technology ventures, however, enjoy at least one advantage that other types of ventures may not have. If they are categorized by the Chinese government as technologically-advanced projects, they can market their products locally and the earnings can be converted into hard currency. Also, they can enjoy better investment incentives as discussed earlier.

The third major difficulty faced by western ventures is the cultural barrier, including language, traditions and customs as well as dissimilar ways of doing business. Many times, the reason western companies fail to conclude a deal or fail to solve operating problems more timely and effectively is that they lack a necessary cultural understanding of the Chinese marketplace. Language barriers can create problems as easily as the difference in ways of doing business.¹⁵ For example, through gifts or presents, a problem may be taken care of more quickly in an oriental society like China, but this may be regarded as illegal and immoral in the American concept and environment.

The success of Japanese ventures is positioned between that of Hong Kong and western companies. On one hand, Japanese firms share a similar cultural background with the Chinese just as Hong Kong companies do. This provides a basis for greater understanding and more common goals for the Japanese ventures. On the other hand, however, Japanese ventures face similar problems with western ventures as they tend to be more technologically oriented and larger in size. These similar problems, in fact, have made Japanese companies very reluctant to invest in China. Up until very recently, the Japanese have adopted a very conservative policy toward investment in China in contrast to their aggressive approaches toward the Chinese export market. This explains why Japan is by far the most important trading partner for China while still remaining in the third position for investment.

However, the Japanese "wait-and-see" policy toward investment in China has been changing recently. They are now making bold moves toward investment in China as they are becoming less concerned about

¹⁵ As one of many real cases that indicate a problem with the language barrier, a U.S. firm negotiated an agreement with China, agreeing to provide technical assistance in the first 18 weeks. But the interpreter from the U.S. side made a mistake by saying that the American firm would provide the assistance in the first 18 months. This cost the firm about half a million dollars for a deal of less than US\$4 million.

the possibility of political upheaval in China. Also some Japanese companies have been shut out of the China market due to the imposition of import restrictions on a wide range of products.¹⁶ It is not unreasonable to anticipate that the Japanese will come on strong in investment in China in the foreseeable future rather than lose their share of this promising market.

E. Prospects

According to Chinese theory and publicity, China is an open market and there are many great opportunities. If one listens to those doing business in China, particularly investors, the problems seem manifold. Certainly, the Chinese market is far better understood by most today than it was five or ten years ago. Not only have many companies invested in China, and their experiences been noted in the press, through conferences, symposia, and word of mouth, but also Chinese by the tens of thousands have visited the outside world, individually or in delegations. As a result, there is a better understanding between the Chinese investors and foreign partners as to what the realities are and what can be anticipated when starting up a joint venture operation.

Much of the criticism on the part of foreign investors has been well founded. The Chinese government has taken the initiative and responses have been made. The rapidity with which regulations and practices have been adjusted in recent years reflects their determination to meet problems as they are identified. It should be noted that perhaps there is a tendency for foreign investors to expect too much too soon. Even joint ventures between the United States and Japan, for example, often suffer operating difficulties and problems.¹⁷ Many of the difficulties associated with Chinese practices and regulations are equalled or exceeded in Hong Kong, Japan, U.S. or elsewhere.

It should also be kept in mind that the whole idea of foreign investment is relatively new to China, and it has only been in the past eight years that China has opened its door to foreign investment. The transformation progress, although remarkable, will take many years before it reaches the level of other developed and newly industrialized countries. Also, joint ventures are new in China and the learning process for both the Chinese and their joint venture partners is still underway. It is, therefore, unlikely that foreign investors would become discouraged

¹⁶ "Pressured, Japan Sinks Money into China," *Wall Street Journal*, February 18, 1988.

¹⁷ "Joint Venture with Japanese Is Ironic for Firestone's Nevin," *The Washington Post*, February 21, 1988.

because of the presence of operating problems in the Chinese environment.

While China has a long way to go before it will be considered an "economic miracle" like Japan and the other four "small dragons," most investors are optimistic about the Chinese market since both the Chinese and foreign investors have learned considerably in the past few years and both appear anxious to increase cooperation in the future.¹⁸ As a Japanese investor put it: "China will become important in the next century. It has resources and a huge market. The future lies with China, not with other place."¹⁹ But at present, one needs three P's — politeness, patience and persistence — to conquer the Chinese market.

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18 Four "small dragons" are referred to as Hong Kong, Singapore, South Korea and Taiwan.

19 "Pressured, Japan Sinks Money Into China," *Wall Street Journal*, February 18, 1988.