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China and Foreign Investors
The End of a Beautiful Friendship ?

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Introduction

Major concerns have been expressed lately as to the risk of a rise in economic nationalism in China. Two categories of developments are usually cited as symptoms of such nationalism. The first category has to do with Government's initiatives to aggressively push the country's interests, either through the promotion of Chinese national champions or through the encouragement of Chinese investments abroad. Such moves are exemplified by the so-called strategic approach to energy security for instance, as well as by the "go global" campaign which encourages both state-owned enterprises and smaller private and collective enterprises to invest abroad. The decision to set up a sovereign wealth fund (China Investment Corporation) along the lines of the Singapore Government Investment Corporation may be seen as another facet of this strategy of state-led expansion.

The second category relates to the alleged change in China's stance towards foreign investors. Rising signs of hostility towards foreign investors, and more generally towards foreign products (campaign against food products for instance) tend to substantiate the view that China is increasingly reluctant to let foreigners dominate some sectors of the economy and that it is seeking as a result to reduce its dependence vis-à-vis foreign investors. In this respect a major issue pertains to the recent revision of the Catalogue for Guidance of Foreign Investment Industries which is thought by some to reflect a turnaround in China's approach towards inward direct investment.

These two sets of policies both aim at boosting China's overall involvement in the global economy. The present paper will address the second issue while a companion paper will address the former.

The promotion of FDI has been an important component of China's economic reform process and China has become one of the most important destinations of FDI.[1] Chinese economic success can thus be said to be heavily dependent on outward orientation and on foreign capital. Although heavy-handed interventionism is nothing new in China, the direction of state-interventions seems to have shifted lately away from opening up to foreign investment towards a

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[1] China overtook the US as the first destination of FDI world-wide in 2003.

more careful and selective stance with a view to promoting the emergence of national champions. A number of policy decisions are said by some to reflect this change and the willingness to keep foreign investors at bay.

The objective of the present paper is to examine the evolution in the Chinese Government's approach to inward FDI, as well as a number of other economic policy decisions which may impact on foreign investors operating in China. It will seek in particular to show how these new provisions fit in the country's overall development strategy.

The paper is divided in two parts. The first section provides an overview of China's experience with inward direct investment, highlighting in particular the successive policies adopted since the launch of the open door policy. It will also briefly assess the pattern and trends of FDI inflows as well as examine the possible link between the two. The second section examines the recent policy changes which have an impact on foreign investors, including regulations on FDI, as well as provisions on corporate income tax, M&As or anti-monopoly. The point is to determine whether the recent reform is indicative of a major shift in policy or the mere pursuit of a former strategy The rationale for these changes will be assessed together with their potential impact on foreign investors.

A brief review of China's experience with foreign investment (1978-2005)

Starting in the late 1970s China embarked on a wide-ranging economic reform based on deregulation and on "opening to the outside world". While export promotion was a key component of the development strategy, foreign direct investment (FDI) has been seen by Chinese authorities very early as a means to develop the country and to ease outward orientation. The present section will examine in details the different provisions regarding foreign involvement in the Chinese economy, including regulations on establishment by foreign firms (sectoral restrictions, ownership limits, etc.) and operations by foreign firms (tax, tariffs).

1.1. Past policies regarding FDI

The encouragement of FDI has been a key component of China's reform and open door policy launched in the late 1970s. However, China has chosen to gradually open its economy to foreign investors both as a result of ideological considerations and because of a lack of experience (Wei 2003).

Three major stages can be identified:

- gradual and limited opening (late 1970s early 1980s),
- active promotion through preferential treatment (1986 – 95),
- and promoting FDI in accordance with domestic industrial objectives (1995 – 2005).

Gradual and limited opening (late 70s to mid-80s)

The first period can be seen as an experimentation period starting with the liberalization move in 1978. In the late 1970s and early 1980s, the Government issued new regulations to permit joint ventures using foreign capital and to establish Special Economic

Zones (SEZs). At first, foreign enterprise participation was restricted to Joint ventures and export-oriented activities, and Guangdong was the first province to be targeted.

The *Law of the PRC on Joint-Ventures using Chinese and Foreign Investment* was enacted in 1979 and four SEZs were set up: three in Guangdong province (Shenzhen, Zhuhai and Shantou) and one in Fujian province (Xiamen). The concept of SEZs was extended to fourteen additional coastal cities in 1984, and to Hainan Island in 1988. In 1985, twelve of the fourteen cities were designated as Economic and Technology Development Zones (ETDZs)[2], and various (6) "development triangles" were opened to foreign investors. Finally, Pudong District in Shanghai was designated as a new development zone in 1990.

Active promotion (mid-80s to mid-90s)

Starting in the mid-80s, Chinese authorities embarked on a more aggressive policy vis-à-vis foreign investors. In particular a preferential treatment was granted to foreign-invested enterprises (when compared to domestic enterprises) under given circumstances. The differential treatment depended on the region and on the industry. Also different FDI performance requirements were attached to these distinctions.

Through the enactment of the *Provisions of the State Council of the PRC for the Encouragement of Foreign Investment* (1986), more favorable regulations were applied to foreign investors, especially export-oriented Joint Ventures (JVs) and JVs using advanced technology.[3] Foreign JVs benefited from preferential tax treatment (in the form of preferential tax rate and tax holidays), as well as freedom to import inputs, simpler licensing procedures, etc. They also enjoyed privileged access to supplies of water, electricity and transportation. In 1986, under the *Law of the PRC on Enterprises Operated Exclusively with Foreign Capital,* wholly foreign-owned enterprises were also allowed, but again under the condition that they be either export-oriented or using advanced technology and equipment.

In 1990, the 1979 Joint Venture Law was amended, with the removal of the upper limit to the proportion of the registered capital contributed to by the foreign partner.

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[2] These were also known as "opened cities".
[3] These provisions are referred to as the "22 Regulations".

Chinese authorities supervising foreign investments

The main Chinese authorities dealing with overseeing foreign investments in China are the following:

Ministry of Commerce (MOFCOM), the State Administration for Industry and Commerce (SAIC), the National Development and Reform Commission (NDRC).

MOFCOM is responsible for both domestic and foreign activities, including encouraging qualified domestic firms to invest abroad and foreign firms to invest in China. MOFCOM is also responsible for drafting the regulations that govern foreign trade and investment in China, as well as overseeing all investments that are valued at more than USD 30m.

SAIC is responsible for issuing business licences, as well as overseeing industries that are not connected to specific ministries, such as advertising.

NDRC along with MOFCOM is responsible for the "State Council, Guidance of Direction of Foreign Investment"; a catalogue that gives guidelines as to which areas are open or restricted to foreign investment. It is important to adhere to these guidelines as you subject yourself to legal prosecution or a withdrawal of the business license, if they are not followed.

Promotion cum domestic development (mid-90s onwards)

Starting in the mid-1990s, China moved away from special regimes restricted to specific areas toward encouraging FDI inflows in general, but especially high-tech and capital-intensive FDI projects. In 1995, the Chinese government issued the *Provisional Guidelines for Foreign Investment Projects* including the *Guiding Catalogue of*

Foreign Investment Projects (providing the basis for the examination and approval of FDI projects). The initial objective was to “guide the orientation of foreign investment, to keep the orientation of foreign investment in line with the national economy and social development planning of China, and to protect the lawful rights and interests of investors”. The guidelines are indicative but the final decision is most of the time in the hands of local authorities.

Guidance is based on a negative list approach. The Projects with foreign investment that are encouraged, restricted and prohibited are listed in the "Guidance Catalog of Industry with Foreign Investment". And the projects that don't fall into any of these categories are by default permitted.

The first releases, the 1995 Catalogue and the 1997 Catalogue, divided foreign investment into four categories: Encouraged, Restricted Category A, Restricted Category B and Prohibited. Starting with the 2002 Catalogue, investment projects are classified into three categories: Encouraged, Restricted and Prohibited. The catalogue also set foreign ownership limitations on specific types of investment projects. In broad terms, projects are encouraged and permitted in designated industries that introduce new and advanced technologies, expand export capacity, raise product quality, and use local resources in the central and western regions. Restricted and prohibited categories are projects in designated industries that make use of existing technologies, compete with domestic production or state monopolies, make extensive use of scarce resources, or are deemed to be a danger to national safety and the environment (Tsang and Zebregs 2002).

How the investment is classified in the catalogue determines whether the project is possible, and if so, what level of ownership is allowed, what type of tax and other incentives may be available, as well as the complexity and duration of the regulatory approval process. If particular projects fall under the “encouraged”, “permitted” or “restricted” category, foreign investors can invest into those projects as long as appropriate level of government approval can be obtained and applicable restrictions on foreign ownership are complied with. The major differences between the categories relate to the approval procedures to which the investment projects are submitted. For instance investing in a project classified as “encouraged” means that provincial as opposed to central authorities have greater authority over the project. Conversely, categorization of a project as “restricted” for foreign investment does not mean, at least in principle, the project is off-limits but that it may be subject to heightened regulatory scrutiny (see table).

Table 1: Differences in the treatment of foreign investments

	Encouraged investments	Permitted investments	Restricted investments
Approval Procedure	Quicker and easier compared with the other categories	"Normal" approval process	Slower and more difficult to secure approval
Approval Authority	Provincial or municipal authorities can approve projects with an investment of less than USD 100 million. Projects in excess of this amount require approval of the central government. State Council approval is required if total investment exceeds US$ 500 million.	Provincial or municipal authorities can approve projects with an investment of less than USD 100 million. Projects in excess of this amount require approval of the central government. State Council approval is required if total investment exceeds US$ 500 million.	Projects with a total investment of less than USD 50m. can be approved by provincial or municipal authorities. Projects in excess of this amount require approval of the central government. State Council approval is required if total investment exceeds US$ 100 million.
Ownership Structure	Most projects may be wholly foreign-owned. There is no requirement to involve a Chinese joint venture partner	Projects may generally be wholly foreign-owned or joint ventures	Most restricted projects require a Chinese joint venture partner. In certain industries, foreign investors may only hold a minority interest
Duration	There is no time limitation	Depends on the individual project	Approval is usually only granted for a short term
Import of Equipment	Free of import duties and import stage-value added tax (VAT) if within the project's total investment (i.e. less than USD 30m)	Import duties and import-stage VAT levied on imported equipment	Import duties and import-stage VAT levied on imported equipment

The catalogue has been revised in 2002 and again in 2004, not only so as to include commitments associated with WTO accession[4] but also to adjust the provisions to the development needs of the Chinese economy. As a result more high-tech and more capital-intensive activities are gradually encouraged. An important provision of the catalogue, as early as 2002, is that permitted foreign invested projects whose products are to be wholly exported are encouraged.

Compared to the 2002 version, the 2004 catalogue exhibited relatively modest changes, although it further opened up the Chinese economy to foreign investment. It tried in particular to accommodate China's need to further liberalize its industries and attract advanced technologies. By way of illustration, in the communication and transport equipment industries research and development, key parts and electrical auto-parts were upgraded into the encouraged category. In contrast, manufacture of complete motorcycles and their engines was excluded from the encouraged category, as a result of the technology maturity already obtained in these activities. Similarly, in the electronic and telecommunication industries, the encouraged category was expanded so as to include manufacturing of devices such as key optical engines, light sources, projection screens, high definition projection tubes, LCOs module used in large screen color projection display and read-only compact disks.

It also widened the scope of foreign investment in the services sector, with films production and the production and broadcasting of TV programs being moved from the Prohibited to the Restricted, category although they still required a Chinese majority stake. This can be seen as a positive, albeit modest, signal that China was starting to open the door to foreign investment in media. Some other industries that are no longer in the Restricted or Prohibited categories include leasing of goods, courier services, goods inspection and transport agency services.

In contrast, no major or specific amendment was made to those sectors which are of interest to foreign investors, such as financial services, insurance, securities, wholesaling retailing, transportation information and consultancy services (Qiao 2004). In the 2005 Catalogue, most of these services still belonged to the restricted (or even the prohibited) category.

The 2005 Catalogue also reflected some concerns regarding China's national security. There are two noteworthy changes pointing in this direction: (1) market research, which was not mentioned in the former catalogues, was put into the Restricted category with a

[4] Upon its accession to the WTO, China promised, over a five-year period from 2002 to 2007, to fully open major service areas to foreign competition, including distribution, telecommunications, financial services (banking, insurance, securities), motion pictures, accounting, law, architecture, construction, environmental services, travel, and tourism.

limitation to Equity Joint Ventures (EJVs) and Contractual Joint Ventures (CJVs); (2) social investigation, which was not mentioned in the former catalogues but practiced by a few foreign firms, was listed in the Prohibited category. The rationale for these restrictions has to do with the fact that these methods might be used to obtain secret information related to Chinese political and economic security.

Further changes are in line with changes in the Government's stance with regards to investment in some industries. In 2004, The State Development and Reform Commission (SDRC), the Ministry of Commerce (MOFCOM) and other government branches issued a series of circulars in order to prevent over-investment in the iron and aluminum industries. As a result, manufacturing of more than 300,000 tons of aluminum per year was deleted from the Encouraged category; and the scope of business for the non-ferrous metal smelting and rolling processing industry and some iron-related projects in the Encouraged category was greatly narrowed or deleted. (from Zhang and Cheng 2005, China Law and practice).

Similarly, in line with the issuance by the State Council of an urgent notice to control the land market, construction and management of theme parks were restricted because of their large land requirements.

A final feature of the 2004 catalogue is that it aimed to limit low-level investment in some industries. As a result those sectors where allegedly excessive low-level investment had taken place were removed from the Encouraged Category. A further goal of this provision was to prevent economic overheating.

Other policies affecting foreign investors

A number of additional laws and regulations impact on foreign investments. First in an attempt to make the best of FDI inflows, China made extensive use of various performance requirements imposed on foreign investors. As recalled by Liu and Wei (2002), the policy of export requirements was implemented through China's Joint Venture Law with a view to protecting domestic firms, creating employment for domestic labor force and earning foreign exchange. These requirements were relaxed to a large extent after Deng Xiaoping's well-known "Southern tour" and after the further opening up of the Chinese economy to inward direct investment. They had to be definitely dropped after China's accession to the WTO in 2001. Indeed, upon its accession, China agreed to assume the obligations of the TRIMs Agreement which requires elimination of measures requiring or providing benefits for the incorporation of local inputs (local content requirements) in the manufacturing process, as well as of those restricting a firm's imports to an amount related to its exports or related to the amount of foreign exchange a firm earns (the so-called trade balancing requirements). Since that date FIEs no longer have to source locally and wholly-foreign-owned firms no longer have to export a minimum share of their production.

With a view to enhancing technology transfers, Chinese authorities also enacted a number of specific provisions including performance requirements for instance. They also sought to encourage foreign investors to establish R&D centers in the country by granting them tax rebates and other tax preferential treatment for their R&D activities. (Long 2005). While the TRIMs agreement rules out forced technology transfer, there is an extensive set of practices "encouraging" technology transfer that are arguably permissible under TRIMs, and many of these practices appear to persist in China (Branstetter and Lardy 2006).

Finally, a number of tax incentives have been used extensively by Chinese authorities so as to guide FDI into designated regions or economic sectors. By way of illustration, the tax incentives offered in the SEZs and the ETDZs are generally much more favorable than in other regions. Moreover, the tax incentives are more favorable for technology and export-oriented FIEs.

Another long-standing policy refers to so-called processing trade. This term refers to certain government-approved transactions where a foreign party purchases Chinese manufactured goods, or has raw materials and components processed on a consignment basis in China, in both cases with the inputs imported free of duties and VAT. There are two types of processing trade: i) with imported materials (PTI) and ii) with materials supplied by clients (PTS). Under the PTS system FIEs provide domestic firms with intermediate materials such as spare parts.

Rules governing processing trade are scattered in a series of regulations promulgated since 1979. On May 27, 1999 the Ministry of Foreign Trade and Economic Co-operation ("MOFTEC"[5]) summarized and restated existing regulations and practices by issuing the *Provisional Measures on the Administration of the Examination and Approval of Processing Trade* (the "*Provisional Measures on Processing Trade*"), which expressly defined "processing trade" and set forth the requirements for such arrangements. Generally speaking, processing trade involves imports of raw materials and components which the Chinese party commits to process into finished goods and export in the quantities and within the time limits specified in the application approved by the government. As long as these export commitments are adhered to, the processing company enjoys special customs duty and VAT exemptions. Because of these tax exemptions and the possibility for abuse, however, the government imposes strict supervision over the imported inputs and the products to be exported, which are described as "bonded." (Chao *et al*. 2003). Import goods for processing trade are divided into three categories (prohibited, restricted and permitted). All goods not listed in the first two lists are deemed permitted.

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[5] The Ministry of Foreign Trade and Economic Cooperation (MOFTEC) was replaced by the Ministry of Commerce (MOFCOM) in 2002.

As outsourcing manufacturing for original equipment manufacturers (OEMs) has become increasingly the norm in particular in the electronics sector, many such relationships have been structured in the form of “export processing” arrangements. The benefits to foreign companies are quite significant. They are able to obtain low-cost manufacturing in China without the need to pay for any Chinese duties or import VAT on imported inputs going into the product, and often without the need for any capital investment. These types of arrangements began in the early 1980s, and were responsible in large part for southern Guangdong Province’s development and export success. (Chao et al. 2003).

1.2. FDI Patterns and Trends

Overall trend

The growth of inward FDI into China has never been even (see graph 1). FDI in China has grown rapidly since the mid-1980s but at first FDI inflows were not very significant. The real take-off dates back to the early 1990s, at the time of the more proactive FDI encouragement policy. Since 1993, China has been the first destination of FDI flows in the developing world. China even overtook the US in 2003. It ranked number three worldwide in 2005 (behind the US and the UK), and number 4 in 2006 behind the US, the UK and France (WIR 2007). China’s world market share increased in the early 2000s and reached 8 per cent in 2005.[6] 2007 was another peak year, with $ 80 billions FDI inflows, of which 70 billions are directed to the non-financial sector.

It is worth reminding at this stage that the volume of FDI in China reported by official agencies is likely to be overestimated for a number of reasons having to do with the quality of the data but especially because of the so-called round tripping phenomenon.[7] According to some sources (Wei 2003), this may amount to close to one fourth of China’s FDI inflows. However, even after netting out, FDI inflows to China remain substantial.

A major feature of these inward flows relates to their unbalanced distribution in terms of sources, of types, of regional location as well as of sectoral orientation.

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[6] It amounts to 12 per cent if Hong Kong is included.

[7] A substantial share of officially recorded FDI flows to China may in fact not be FDI at all. These flows correspond to Chinese funds that have left the country and return as apparent FDI to take advantage of fiscal incentives and improved investor protection granted by Chinese authorities to foreign investors. The rising share of FDI from various tax havens substantiate the presumption that round tripping is real.

Origin of FDI

In the early phase, Asian investors (and in particular ethnic Chinese) were a majority among foreign investors. Over the period 1978 – 98, the bulk of FDI flowing into China originated from neighboring economies, in particular from Hong Kong, Japan, Singapore and South Korea. The share of Asian investors remained at about 80 per cent until the late 1990s but there was a redistribution among the different sources, with a decline in the role of ethnic Chinese and a rise in the role of Korean investors in particular. At the same time the share of European investors has been rising at the expense of US investors (see Table).[8]

Broadly speaking, there seems to be a coincidence between the source of FDI and the nature of investment, with FDI from emerging Asian economies (Hong Kong and Taiwan in particular) being more heavily concentrated in labor-intensive and low-tech activities while FDI from industrial countries are in capital-intensive and high-tech industries. Moreover, while Western and Japanese MNEs tend to settle in China to sell to the domestic market, the bulk of Asian MNEs from emerging economies are more often export-oriented and tend to export back to their national market (Branstetter and Foley 2007).

Regional concentration

Another characteristic of inward direct investment relates to the high geographic concentration in coastal areas. The East and southeast coastal regions amount to 88 per cent of the total inflows over the period 1985 – 2005. Guangdong and Fujian provinces, which were the first to be open, attracted the bulk of FDI flows until the mid-1990s. Guangdong province concentrated 24 per cent of total inward DI over the period 1985-95. Over the most recent period, its share has declined while that of Jiangsu province has risen in parallel.

These two features (regional concentration and investment from neighboring countries) are not in line with the standard explanation for inward FDI which suggests that there is a trade-off between fixed costs for setting up a plant abroad and transport costs. In the case of China, the role of institutional factors, including policy factors, has undoubtedly been more substantial than in the case of developed economies (see Liu and Wei 2002 on this point).

Form of FDI

As far as the form of FDI is concerned, there has been a shift over time from JVs to wholly foreign-owned enterprises, reflecting the rising permissiveness of the system. At first the most popular form of FDI was contractual joint ventures. Since the late 1980s, equity joint

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[8] For more details see Branstetter and Lardy (2006).

ventures and wholly foreign-owned enterprises are predominant, while the latter have proliferated over the most recent period. Most recent foreign direct investments in China take the form of wholly foreign-owned enterprises. In 2002, 69.2% of contracted foreign direct investments were wholly foreign-owned (Fung *et al*. 2002).

It is worth stressing that the dominance of JVs in the earlier stage happened to fit both the Chinese and the foreign investors' goals. JVs were perceived by the former as the best way to ease technology transfers but to also avoid losing control over important industrial activities while they were thought to be necessary by the latter in order to maintain a stable long-term relationship with Chinese partners and to get an easy access to the Chinese market (Naughton 2007).

Sectoral concentration

Finally, in terms of sectoral concentration, labor-intensive manufacturing activities were dominant until the late 1990s when the share of capital and technology-intensive sectors started to rise. Manufacturing FDI is still overwhelmingly dominant[9], however, while FDI in services is clearly under-represented, when compared to what is being observed elsewhere in the world.

Over the past few years, the service sector has been gradually gaining ground, especially the real estate sector. According to the MOFCOM, FDI flows into this area surged to US$ 5.4 billions in 2005. More recently, the real-estate market has become the second-biggest target for foreign investors after the information technology and electronics sector. Statistics from the National Statistics Bureau stated that in the first nine months of 2007, developers pumped RMB 2.54 trillion into housing projects across the mainland, of which RMB 42.3 billion was from foreign investors, a rise of 60% year on year (Xinhuanet.com, 11/8/2007).

Similarly, foreign investment in the financial sector is still a relatively new (but expanding) phenomenon.[10] As recalled by Leigh and Podpiera (2006), "increasing foreign participation has been one of the key trends in the Chinese banking system in recent years. Foreign banks do business in China either directly through their own branches and subsidiaries or indirectly as minority investors in Chinese banks. The indirect participation has grown rapidly in recent years, particularly in 2005, as almost all major Chinese banks now have a foreign strategic investor."

[9] At the end of 2005 it accounted for 63 per cent of the total.

[10] When China joined the World Trade Organisation (WTO) in 2001, Beijing agreed to open up its banking and insurance sector to foreign investors by the end of 2006. Beginning in December of 2006, foreign banks must in principle receive equal national treatment in China's domestic banking markets.

At the end of 2003, foreign equity stakes in Chinese banking institutions were just $500 million or 0.3 percent of total banking capital. Foreign banks held only about 1 percent of total banking assets. By contrast, China's five largest State Commercial Banks—the Industrial & Commercial Bank of China, the Agricultural Bank of China, the China Construction Bank, the Bank of China and the Bank of Communications—controlled over 60 percent of the country's loans and deposits. Since 2004, however, the situation has been rapidly changing, with the entry of foreign strategic investors in four of the largest five banks. The 2004 purchase by Hong Kong and Shanghai Banking Corporation (HSBC) of a stake in the Bank of Communications, China's fifth largest bank, was the first major transaction. Since June 2005, foreign investors have invested or committed to invest over US$14 billion in the three large state-owned commercial banks, and all three have acquired strategic investors: the Bank of America (BOA) in China Construction Bank (CCB), a consortium led by Royal Bank of Scotland (RBS) in the Bank of China (BOC), and Goldman Sachs led investor group in the Industrial and Commercial Bank of China (ICBC) (Leigh and Podpiera 2006). Foreign ownership participation in smaller Chinese banks has also increased substantially.

Despite these various moves, there is still a strong reluctance on the part of China to let Chinese banks go. For instance, while Citigroup (together with Carlyle) was supposed to purchase 85% of Guangdong Development Bank (GDB), it did finally get its deal, but its share of GDB is limited to only 20%. The vast majority of the bank is owned by State Grid, a Chinese utility, China Life, the mainland's biggest insurer and Civic Trust.

1.3. An interim assessment

Drivers of FDI inflows

Prima facie, there is an obvious correlation between the changes in the policy stance vis-à-vis foreign investors and the dynamics of FDI inflows (see graph 2). As a result, the presumption that the policies described above impacted trends and patterns is strong. A number of econometric studies and surveys do confirm this presumption.[11]

A dissenting view on the role of FDI policy is however worth mentioning. According to Huang (2003), the large FDI inflows into China are not primarily due to policy incentives but rather to ineffective financial mechanisms. In particular, by favoring inefficient

[11] See Poncet (2007) for a succinct review of the literature.

State enterprises financially,[12] the Chinese government has deliberately (by legal and financial means) created an environment which encourages a disproportionate expansion of FDIs. It is argued for instance that these investments play a much larger role in China than elsewhere because foreigners participated in privatization measures to an extent denied to Chinese firms. Through an empirical analysis, Havrylyshik and Poncet (2007) confirm Huang's hypothesis and show the restrictive access to external funding imposed on private firms has been a key determinant of FDI inflows into China.

Impact of FDI inflows

To be sure, FDI has greatly contributed to transform the Chinese economy from a rural, backward and inward-oriented economy to a dynamic industrial economy tightly integrated in regional and global production networks. In particular FDI has been a major engine of export growth in China, with FIEs playing a key role in the rise in the country's export-orientation. FIEs can be shown to account for close to 60 per cent of China's total exports[13] and for about 80 per cent of high-tech exports. As stressed by Gilboy (2004), in 2003 foreign firms accounted for 79 per cent of exports in high-tech sectors such as industrial machinery, 92 percent of China's exports of computers, components, and peripherals and 74 percent of China's $89 billion in exports of electronics and telecommunications equipment.

China's processing trade policy has clearly encouraged export orientation. The policy of encouraging export processing trade has been another key to China's becoming an international manufacturing base and export star performer. This policy has helped China attract FDI and expand exports. Processing trade, which has been the main mode of exports of FIEs, still accounts for a substantial share of their exports (about 80 per cent in 2003). Domestic (Chinese) firms are usually behind ordinary exports while FIEs are involved in processing exports. However, this policy has also helped raise the local content of China's exports in the processing trade.

According to the MOFCOM, FIEs have become an important part of China's socio-economic development. As of 2007, FIEs contribute about one third of the country's total industrial output value, one fifth of China's all tax revenue, and over 20 million jobs.

Despite these positive developments, the overall assessment of FDI policy effectiveness is rather mixed. Several issues have emerged recently in relation to FDI inflows. The country is

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[12] It may be worth recalling that in 2003, private companies accounted for 27 per cent of outstanding corporate bank loans although they produced 52 per cent of GDP, while SOEs accounted for 35 per cent of outstanding loans and 23 per cent of GDP (Farrell et al. 2006).

[13] The share of exports due to FIEs was less than 2 per cent in 1983.

increasingly being perceived as excessively dependent on foreign investors, while dissatisfaction is being expressed with regards to technology transfers and to serious regional imbalances in economic development.

As far as technology transfers are concerned, compulsory technology transfer provisions have had mixed effects and the “swap market for technology” strategy has produced disappointing results (Long 2005). Similarly although the establishment of R&D centers was actively encouraged, R&D centers’ activities have usually more to do with development than with pure research.[14] The magnitude of technology transfers through FDI is thus a matter of intense debate. Empirical evidence on this point is inconclusive, with some empirical studies confirming a limited impact of FDI on technology development, and others pointing to a positive impact. (Wei 2003).

Finally, the impact of FDI policies on regional development is another major source of debate. China’s central government remains the largest contributor to economic growth in Western provinces in particular, with FDI trailing behind. Actually, FDI may even be said to account for rising imbalances between the different regions.

On the Chinese side, the desire to upgrade FDI is clearly linked to the dissatisfaction with the impact of FDI in the earlier periods. Finally, from the Chinese authorities’ perspective, an excessive reliance on FDI may be perceived as all the more problematic because it may fuel the risk of overheating.

Is FDI into China excessive?

FDI inflows into China are usually deemed to be exceptionally high. The figures need to be put in perspective. First, while the absolute figures are large, they need to be related to the overall size of the Chinese economy. When taken as a percentage of GDP, FDI inflows are less dramatic, except for the period of active promotion (early 1990s). As shown in Table 3, China’s inward FDI performance index[15] rose sharply in the early 1990s before dropping in the second half of the 1990s. Although higher than the US index, it is substantially lower than other East Asian economies’ index such as Malaysia.

Similarly, in relation to total gross capital formation, the FDI/investment ratio tends to be lower in China than in a number of other Asian emerging economies (again such as Malaysia for

[14] Branstetter and Foley (2007) even argue that some of these centers’ activities “were as much about public relations efforts directed at a mainland regime reluctant to enforce intellectual property rights as they were about “real” research and development.”
[15] The inward FDI performance index is the ratio of a country’s share in global FDI inflows to its share in global GDP. A value greater than 1 indicates that the country receives more FDI than its relative size would suggest. A value below 1 that it receives less.

instance). In contrast, FDI inflows to China are indeed quite large when compared to what was observed in a number of other East Asian economies, and in particular with the 1st generation miracle economies such as South Korea.

Moreover, when measured in terms of stock, FDI in China merely accounts for about 3 per cent of the total FDI stock in the world (against 6 per cent for France and 16 per cent for the United States). Likewise, with about 11 per cent[16], China's ratio of FDI stock to GDP is much lower in 2006 than what is observed in the rest of East Asia (29.1 per cent) or in developed economies (24.2 per cent). The high level of FDI flows and the relative weakness of FDI stock mean that China is still lagging behind as a destination for FDI and that it still has some catching up to do, but it also suggests that the scope for further expansion is substantial.

The sharp regional imbalances highlighted earlier certainly account for the overall impression: because of the very high concentration of FDI inflows in the coastal areas, the FDI/GDP ratio in these provinces is exceptionally high (13 per cent in the case of Guangdong and 11 per cent for Fujian, while the national average is a mere 4 per cent; Poncet 2007).

[16] This ratio was 5.4 per cent in 1990 and 17.9 per cent in 2000.

China's "new approach" to FDI

2.1. New policy provisions (2006-07)

Recent policy moves can be perceived as the next logical step with more emphasis placed on domestic development. This is in line with the directions indicated in the 11th Five Year Plan issued in 2006. In accordance with the country's development needs and WTO commitments.

The latest amendment is perfectly in line with China's overall development strategy, the objective of which is to promote quality of investment rather than sheer quantity. As a result, technological development is now prioritized together with environment friendly activities, while export-oriented foreign investments are, if not discouraged, not as actively encouraged as was the case in the past.

Official rationale for the reform

In early November 2007, China's NDRC and the MOFCOM jointly released a substantially revised Catalog for the Guidance of FIEs.[17] The revised catalogue, which was approved by the State Council and will take effect on December 1, 2007, reflects a major shift in China's FDI policy away from outright encouragement to more selectivity. This change is in line with the NDRC's 11th FYP on Foreign Capital Utilization issued a year earlier (November 10, 2006), which stated that China was to move from emphasizing the quantity of foreign investment to emphasizing the quality of that investment. The rationale for the policy shift is described as follows:

> *"(...), during the 10th Five-Year Plan, there were still some problems in China's foreign capital utilization worth paying attention to. First, the problem of "stressing quantity but ignoring quality," which has existed in absorbing foreign capital for long, is still prominent. Some local governments and departments absorbed foreign capital blindly without caring costs and pursued the*

[17] An English version of the text (provided in an appendix) can be found at: http://www.fdi.gov.cn/pub/FDI_EN/Laws/law_en_info.jsp?docid=87372. The Chinese version can be found at: www.mofcom.gov.cn

> *quantity of foreign capital unilaterally, and the phenomenon that the state industrial policies were broken occurred frequently. Second, <u>the leading enterprises in some industries were acquired and merged by foreign investors more frequently</u>, <u>and in some fields, the symptom of foreign investment monopoly arose or even expanded rapidly, which might threaten the state economic security,</u> particularly industrial security. Third, the overall absorption scale and level of foreign direct investment in the central and western regions were comparatively low, and the gap from the foreign direct investment utilization in the eastern regions has been further widened. Fourth, <u>the technology spillover of foreign-invested enterprises was not prominent</u>, and some foreign-invested enterprise abused intellectual property protection, which were against domestic enterprises' independent innovations. Fifth, the existing administration system of foreign capital utilization urgently needs to be improved, and part of presently applicable policies are not favorable to create an environment for fair competition between domestic enterprises and foreign-invested enterprises. Sixth, a small number of projects of foreign loan utilization were not strictly administered, the fund utilization efficiency was low, and the debt repayment was difficult. Seventh, the proportion of short-term foreign debts increased rapidly, and the potential risks of foreign debt were increasing."*

The general directions for FDI policy are defined as follows:

> *"During the 11th Five-Year Plan, the overall strategic objectives of foreign capital utilization of China shall be: to further propel the fundamental transformation of foreign capital utilization from "being quantity-oriented" to "being quality-oriented," conscientiously transfer the emphasis of foreign capital utilization from making up the shortage of funds and foreign exchanges to introducing advanced technologies, management experience and high-quality talent and focus more on ecological construction, environmental protection, conservation and comprehensive utilization of resources and energies. By way of introducing advanced foreign technologies and management experiences, we shall exert the functions of leading and radiating of foreign-funded enterprises to domestic enterprises, promote the improvement of the integrated innovation ability and the re-innovation ability after introducing new technologies; we shall strive for the further extension of foreign investments from the simple processing, assembly and production and manufacturing at a low level to research, development, high-end design, modern circulation and other new areas, and propel China to become one of the manufacturing bases of high value-added products in the world; we shall greatly improve the level of opening up to the outside world in the service industry; we shall markedly improve the*

scale, quality and level of foreign capital utilization in the old industrial bases in the central and western regions and those in northeastern regions and further intensify the economic globalization extent and international competitiveness in eastern regions; (…)"

A detailed analysis of the 2007 Catalogue

The objective of the new strategy can be said to be threefold: i) to cool an allegedly overheated economy, ii) to encourage resource conservation and environmental protection, and iii) to enhance the level of technological development of the economy. As a complementary objective, the new catalogue also aims at protecting national economic security.

As a result, in comparison with the 2004 Catalogue, the Revised Catalogue places more emphasis on the three following areas: i) upgrading the country's industrial structure through technology transfers; ii) protecting rare and non-renewable resources, and preserving the environment in general; and iii) enhancing control over the direction and pace of economic development.

Encouraged activities

In the revised catalogue, the encouraged section is much longer than in the 2004 catalogue: 350 activities are now encouraged against 254 in the 2004 catalogue. The most important changes relate to the manufacturing sector, with a rise from 191 to 282 encouraged investment activities.

Foreign investments are especially encouraged in activities that are expected to contribute to the <u>industrial upgrading of the Chinese economy</u>. Broadly speaking, foreign businesses are encouraged in high-tech equipment, the manufacturing of high-end technology, advanced materials, equipment manufacturing, and the manufacturing of new material.[18] By comparing the 2004 and 2007 versions of the catalogue (see table), we can see that the larger changes pertain to the non-metal mineral products processing industry, the general machine-building industry, special equipment manufacturing, communication and transportation equipment industries, and machinery industries for instrument and meter, culture and office.

In the communication and transport equipment industry, the emphasis is placed on R&D activities in the manufacturing of key spare parts for automobiles and of automobile electronic devices. Moreover, investment in equipment for railway transportation is now limited to equity joint venture s or contractual joint ventures. Similarly, the Chinese part is to hold the majority of shares in the design, manufacturing and maintaining of civil planes. Finally the production

[18] By way of illustration, the list of encouraged investments in the general machine-building industry is almost three times as long as in the 2004 catalogue.

of spare parts for civil helicopters as well as the design and manufacturing of civil rocket launcher have been added to the encouraged category. In the latter case the Chinese part is also to hold the majority of shares.

In the communication equipment, computer and other electronic equipment manufacturing, manufacture of digital televisions has been dropped from the encouraged category while manufacture of flat panel display such as TFT-LCD, PDP, OLED, etc as well as manufacture of high performance single-lens reflex have been added among other high-tech activities.

The production of a number of new-type pharmaceutical products is also now encouraged, such as new-type compound pharmaceuticals or active component pharmaceuticals, new-type diagnostic reagent, etc.

Among the newly encouraged investments, of note are activities which comprehensively use the high chemical additional value technology to distill chemical potassium, bromine, magnesium from dense sea water after desalination and its deep procession.

Foreign investments are also encouraged in areas that can help the country to <u>protect its environment and its scarce non-renewable resources, reduce pollution and develop the renewable energy sector</u>. Among further additions to the "encouraged" category, of note is the development and application of new technologies in the area of crude oil production for instance. By the same token, the concern with energy-saving and environment-protecting technologies is stressed in the list of encouraged investments in non-metal mineral products processing industry.

As for investments in the textile industry, they are now specifically encouraged when they involve high and new technology or when they satisfy the requirement of comprehensive utilization of ecology and resources and environment protection.

Moreover, a number of changes are in line with China's effort to <u>fulfill its commitment to the WTO</u>, with respect to service liberalization in particular. Among the newly encouraged service activities, of note are the following:

- investments in information technology and business flow outsourcing services;
- comprehensive maintenance of infrastructure of high-speed railway, special railway line, inter-city;
- modern logistics;
- operation of the performance site and operation of gymnasium, body-fitting, competition performance, sports, training and agency service.

In contrast, investments in banking and insurance industries are still not encouraged.

The new regulations also reflect an attempt, by the Government, to regain control over some activities and to quiet the concerns over national economic security: as a result, detailed ownership restrictions are now imposed in venture prospecting and exploitation of petroleum and natural gas as well as in the exploitation of oil and gas deposits with low osmosis for instance. In these areas investment is now limited to equity joint ventures or contractual joint ventures, while in the past the only constraint pertained to the cooperation with a Chinese partner.

The prospecting and development of oil and natural gas and coal bed gas and utilization of mine gas are included in the encouraged category but the operations must be in the form of equity joint ventures or contractual joint ventures. Similarly, while the production of mass coal chemical industrial products is still encouraged, the Chinese party must now hold the majority of shares.

In contrast, a number of activities have been downgraded from "encouraged" to "permitted". [19] Among other investment activities, such is the case for

- the prospecting and exploitation of copper ores, aluminum ores, or the production of hard coke and dry coke quenching or production of heavy traffic road asphalt;
- ferrous metallurgical melting and rolling processing industry;
- the production of high-quality paper;
- the production of new type dry process cement;
- and in the real estate sector, for the development and construction of ordinary residential houses.

Other activities have been shifted to the restricted category (see below).

Finally, in a complete turnabout from its previous orientation, in view of China's growing trade surpluses and fast expanding foreign reserves, projects whose products are to be wholly exported have been removed from the encouraged category. Similarly, for those traditional sectors, where the domestic enterprises have developed advanced technologies and high production capacity, foreign investment is no longer encouraged by the government.

Finally, in line with the strategies of developing the western region, boosting the rise of central China and rejuvenating old industrial bases in the northeastern provinces, all references to a specific treatment granted to foreign investment in the Central and Western regions have been dropped in the 2007 catalogue. This is

[19] This is inline with earlier changes: for instance due to technology maturity in the motorcycle industry, manufacture of complete motorcycles and their engines were excluded from the Encouraged category in 2005 (see Zhang and Cheng 2005).

the case for a number of mining activities (which are no longer encouraged anyway) as well as for non-metal mineral products processing industries or non-ferrous metallurgical smelting and rolling processing industries.

Restricted and prohibited activities

The restricted and prohibited categories are not substantially changed in terms of overall number but the content of the categories reflect some changes in priorities.[20]

First, with a view to fostering a cleaner environment, foreign investments are restricted or prohibited in industries that contribute heavily to pollution. This is consistent with the aforementioned encouragement of foreign investment in high-tech and environment-friendly areas.

Secondly, stricter provisions are designed to encourage resource conservation. As a result some activities which have high natural resource demands have been moved from the encouraged category to the restricted category; such had already been the case in the past (2005) for tamp tar and dry cooling tar processing for instance (see Zhang and Cheng 2005). This is the case for foreign investments in the exploration and mining of copper, lead, zinc and aluminum. Similarly, all gold projects now fall within the restricted category.

Some other activities, such as the exploration of certain important non-renewable mineral resources is now off-limits to foreign investment. This is the case for the exploration of rare metals such as tungsten, tin, antimony which are now categorized as prohibited (rather than restricted in the 2004 Catalogue).

Third, in order to help cool down an allegedly overheating economy, further restrictions are introduced on foreign investment in real estate and real estate brokerage firms. Overseas capital has been regularly blamed for soaring housing prices in China in recent years. As a result, real estate transactions in second-grade market and medium and brokerage companies are now explicitly listed among the restricted activities while they were not mentioned in the previous catalogue. Moreover, foreign investment in the construction and operation of high end real estate such as high-end hotels, villas, high-end office buildings, and international exhibition centers is classified as "restricted" while the construction and operation of golf courses have been moved from the restricted to the prohibited category. Also foreign investment in the development and construction of ordinary housing is no longer classified as "encouraged".

[20] It has also been clarified that the items under the restricted category in the Catalogue for the Guidance of Industrial Restructuring will also apply to foreign investment.

Fourth, as a result of the commitments associated with WTO accession, openness is being gradually enforced in sectors that had been closed so far, in particular the financial services sector. By way of illustration, futures companies have been shifted from the prohibited category in the 2005 Catalogue to the restricted category (under the condition that Chinese should hold the majority of shares). The ratio of foreign funds will be capped at 50% for a life-insurance company, a third for a securities company, and 49% for a funds-management business specializing in stocks. Similarly, the limit on foreign ownership in domestic and international basic telecommunications business is restricted but it is raised from 35 per cent to 49 per cent.

Fifth, other important changes pertain to the geographic targeting of FDI. While China had previously adopted a policy of confining foreign investment to central and western China, as well as giving preferential treatment to foreign investment in western China, both policies have been dropped from the revised catalogue in order to spread development more evenly across China’s regions. In line with the strategies of Development of the western region, Resurrection of central China and Revitalization of the Northeast Industrial Base, the provision "apply only to the central and western regions" has now been removed from items under the encouraged category in the catalogue.

Finally, the need for protection of national economic security is also reflected in some provisions. Prudence will be exercised in the liberalization of certain strategic and sensitive industries with an important bearing on the nation's economic security. Various Internet based businesses have been added to the prohibited category. Foreigners are prohibited from investing in “news websites, online audio and video programs, business sites of Internet surfing services, Internet culture operation”. The Revised Catalogue also makes a greater effort to protect China’s traditional industries and national products. As a result, foreign investments are prohibited altogether in these activities.

To sum up, the new Catalogue improves access of foreign investors to commercial and financial services, to activities contributing to environmental protection and to advanced manufacturing activities, while increasing restrictions on foreign investments in real estate, in media-related activities and in production activities for which foreign investment is no longer considered necessary to assure future development.

Additional policy provisions affecting foreign investors

The revisions to the Investment guide catalogue are consistent with recent changes in other Chinese laws and regulations, in particular in the tax law for domestic and foreign-invested firms or provisions on processing trade, as well as the limitation on foreign M&A activity and the elimination of many supports for export oriented enterprises.

Tax issues

On March 16, 2007, China ended almost 30 years of favorable treatment for foreign companies with the approval of a New Enterprise Income Tax Law designed to equalize corporate tax rates paid by local and overseas enterprises. The law will immediately benefit Chinese companies, which have long complained about discrimination in favor of foreigners, since a single tax rate of 25 per cent is levied on all companies, while under the current system, Chinese companies have been taxed at up to 33 per cent while foreign enterprises have paid as little as 15 per cent.

Although the detailed implementation guidelines and interpretations of the new law have yet to be announced, the principle is that tax breaks may still be granted according to the type of activity rather than according to the nationality. The focus of tax incentives have been shifted from general manufacturing and location-specific incentives for foreign investors to benefits based on the type of industry and on the level of technological sophistication. In particular preferential treatment may be granted to high-technology projects, energy conservation and environment-friendly industries, whatever the investor's nationality. In particular incentives are offered for key high-tech companies registered in special economic zones, including Shenzhen, Zhuhai, Shantou, Xiamen and Hainan, as well as in Shanghai Pudong New Area, on and after Jan. 1, 2008. These companies must have proprietary technology and must comply with a range of requirements to be classified as high-tech enterprises.

The implementation of the new law will be gradual.[21] Moreover, companies in the western part of the country will not be affected by the new law but will continue to enjoy preferential rates under regulations jointly issued by the Ministry of Finance, State Administration of Taxation and China Customs.

Sector-specific provisions

In 2006, the State Council issued its *Opinions on the Revitalization of the Industrial Machinery Manufacturing Industries*, which calls for the expansion of domestic companies' market share in 16 equipment manufacturing sectors. To that end, several measures limit foreigners' ability to participate in the domestic market. For example, preferential import duties on parts needed for research and development are granted to domestic producers, thus encouraging domestic procurement of major technical equipment. The policy suggests that China will implement controls on foreign investments in the sector, including requiring approval when foreign entities seek majority ownership or control of leading domestic firms.

[21] Companies that currently face an income tax of 15 percent will pay 18 percent in 2008, 20 percent in 2009, 22 percent in 2010, 24 percent in 2011 and 25 percent from 2012.

Changes in processing trade policy

In September 2006, the Ministry of Finance, NDRC, MOFCOM, General Administration of Customs, and State Administration of Taxation jointly issued a circular on adjustments made to tax rebate rates for certain exports and the expansion of the prohibited category under export processing trade (Circular No.139 [2006]). Based on this circular, the MOFCOM, General Administration of Customs and State Environmental Protection Administration jointly issued Circular No.82 on 3 November 2006, announcing the detailed list of products coming under the prohibited category in processing trade and for which export tax rebates have been removed. According to Circular No.82, the list of products under the prohibited category in processing trade will be adjusted from time to time in line with the relevant policies of the state.

In line with other laws highlighted earlier, the newly revised list primarily covers high energy consumption and high pollution chemical and metallurgical products as well as products that consume large quantities of domestic resources. The list further classifies products under the prohibited category into three sub-categories, namely "prohibited from export", "prohibited from import" and "prohibited from import and export". Among these, the 77 items prohibited from import are mainly products barred from import under international conventions and products causing serious pollution during processing. Examples include tiger bones, mineral ores, slag, and fiber waste. The 503 items prohibited from export are mainly primary raw materials used in deep processing, such as boards, sulfur, earth, stone and metals. Processing enterprises importing these raw materials are still entitled to bonded treatment. The 224 items prohibited from import and export are mainly low value-added, high energy consumption and high pollution products, such as mineral water, coal, asphalt, combustible gases and pesticides.

M&A regulations

In recent years, more and more foreign companies chose to enter the China market by mergers and acquisitions (M&A),[22] which allowed them to quickly realize the profit of their investment when compared to the traditional avenue of direct investment into domestic or joint venture enterprises. The rapid increase of foreign companies' domestic market share through M&As has caused concerns in both Chinese government and domestic industry sectors.[23] Large foreign corporations making such inroads are often also mentioned in

[22] According to Thomson Financial, foreign companies spent $2.7 billion on completed acquisitions in China in 2001, and $13.2 billion in 2005, which represented over 20 percent of all FDI inflows into China.

[23] For instance, Li Deshui, the head of the National Bureau of Statistics, was quoted as saying: "If we allow the free development of malicious acquisitions by multinational companies, the autonomous brands and innovative ability of China's national industry will gradually disappear." (quoted in China Business Services, March 15, 2006. <www.chinabusinessservices.com/blog/>).

connection with monopoly concerns in Chinese press and industry publications.

As recalled by the OECD (2006), the new policy towards cross-border mergers and acquisitions is explained in the 11th five-year plan for utilizing foreign investment. This states that "priority will be given to quality rather than quantity of foreign investments, that emerging monopolies by foreign-invested enterprises are posing a potential threat to China's economic security and that foreign businesses are harming Chinese enterprises' capacity for independent innovation." As a result, the plan sets forth a clear industrial policy prioritizing geographical areas, industrial sectors, levels of technology, environmental protection and efficient use of natural resources. In response to perceived rising concern over foreign acquisitions of leading Chinese firms in critical sectors, the plan provides for increased supervision of sensitive acquisitions to ensure that what are termed "critical industries and enterprises" remain under Chinese control.

As a result, the Chinese government significantly increased its effort to regulate foreign M&As. In 2004, the MOFCOM established its Office of Antitrust Investigation and in 2006 it issued its "*Regulations on Merger and Acquisition of Domestic Enterprises by Foreign Investors*". At the same time, the State Security Exchange Commission (SSEC) issued its "*Regulations on Acquisition by Publicly Traded Stock Corporations* (2006)". All these regulations aimed at increasing government supervision of foreign corporations' M&A activities in China. Under these provisions, the MOFCOM has the power to reject the acquisition of Chinese domestic companies relating to important industries that may affect the national economic security or result in the transfer of actual control of companies having famous or well-established Chinese brand names.

The new law can be seen as the culmination of years of efforts by the Chinese government to regulate the merger and acquisition practice in China by foreign companies, and is likely to have a wide impact on future deals. From the perspective of foreign investors, the major concern has to do with the vagueness of many provisions and with the broad discretion granted to the central government.

Anti-monopoly law

In the same vein, Chinese authorities also chose recently to draw a new Anti-monopoly law (AML), which will become effective on August 1, 2008. As is the case with similar antitrust laws in other countries, the AML prohibits three main types of activity: monopoly agreements, abuse of dominant market position, and concentration. However, the AML also includes additional scrutiny of foreign-financed deals for national security concerns.

Although the criteria specified in the law for allowing or blocking concentrations are mostly economic and apply equally to Chinese and foreign acquiring parties, there is a general "public interest" ground on which competition-restricting concentrations may be allowed to proceed, and the identity of the acquiring party may conceivably be regarded as relevant to that issue. More specifically, acquisitions by foreign capital are also to be made subject to a national security review quite apart from any economic issues. Again the problem pertains to the definition to be given by Chinese authorities to "national security".[24]

2.2. An assessment

A predictable move

The recent changes in various regulations of importance to foreign investors should not come as a surprise for a number of reasons. They are indeed consistent with earlier policy moves, as well as with other industrial policy objectives, and they are not that different from experiences observed in neighboring economies.

First, the new provisions on FDI are perfectly in line with the 2005 11th Five Year Plan which called for a shift of the development strategy away from its over-concentration on resource and energy-consuming industry, and towards a more knowledge-intensive and environmentally-friendly growth path (Naughton 2007a). They may be seen as an attempt to put an end to the "growth at all costs" strategy and to give some substance to the Government's new economic mantra emphasizing the achievement of a harmonious society and a better balanced economy.

The new provisions are also in line with earlier changes. Compared to the previous revisions of the catalogue, the reform introduced in 2007 brings much more substantial changes. However, it can be seen as a logical sequence of the earlier moves rather than the reflection of a major shift. In particular the objective of a better balance in economic development was already part of the former provisions.

From a long-time perspective, the policy has simply shifted gradually from restriction to full permission and to a more selective approach. These successive stages in FDI policy also correspond to approaches observed elsewhere (in Korea for instance[25]).

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[24] The inspiration for the new law is traced by many back to the failure of the CNOOC/Unocal take-over in 2005. Actually, China is not the only country to show concern about national security issues associated with foreign takeovers. The US for instance has recently expanded the scope of its national security review for cross-border deals by its Committee on Foreign Investment in the US (CFIUS) to include new criteria to assess an acquirer is foreign-government controlled. And the same holds true for Germany or Japan (Kwan 2007).

[25] See Nicolas (2003) for more details on Korea's FDI policy.

Second, FDI has always been used by the Chinese government as an instrument of industrial policy and the policy change reflects a resolute attempt to make the best of FDI rather than maintain a passive approach to FDI.

Third, the direction of the reform is consistent with the macroeconomic situation of China. In response to China's high levels of foreign exchange reserves and its mounting trade surplus, the guidelines overturned a previous policy that foreign investment should be solely poured into export-oriented industries. Similarly, the objective of attracting more technology and more environment-friendly activities makes perfect economic sense if the country is seeking to climb up the global value chain.

Some changes are more difficult to understand however. This is the case in particular for restrictions on foreign investment in the construction and operation of high level hotels, villas, high level office buildings and international convention centers.

Fourth, restricting foreign investments in sectors which are deemed strategic or sensitive in terms of national security is easy to grasp and not that different from what is being done elsewhere (in developed and developing economies alike). To some extent, they may even be perceived as a response to steps taken elsewhere. As indicated earlier, such is most probably the case for restrictive regulations on foreign M&As for instance, for which inspiration may be traced back to the failure of the CNOOC/Unocal takeover in 2005.

Implications for foreign investors

While the new policies may not be interpreted as clear signs of outright protectionism, a number of additional signs point in this direction. In the energy sector for instance, such signs are reflected in project bidding restrictions, such as for the Three Gorges dam hydro-electric project, in technology transfer pressures for technologies that foreign investors would rather keep in-house (such as for Areva nuclear plant project), or in antitrust protection against foreign ownership for big state power firms. As a result, the concerns expressed by foreign investors are certainly warranted.

The broad discretion left to national and local authorities, the vagueness of some provisions, as well as the substantial scope for interpretation can be legitimately perceived as sources of concern. As with M&A regulation, the risk of unfair implementation cannot be excluded.

When it comes to the details of the changes in FDI regulations, restrictions in a number of areas are likely to affect East Asian investors more heavily than Western investors because of the differentiated orientation of their involvement in China. As recalled earlier, Western FIEs operating in China are primarily domestic market-oriented. As a result, they are less likely to be impacted negatively by the reduction in incentives granted to export-oriented activities, when compared to Asian firms which tend in contrast to be more often export-oriented. The key issue for Western investors has to do with technology transfers and renewed pressures in this direction on the Chinese Government's part.

In contrast large opportunities are open to some activities where Western investors have a comparative advantage, and in particular in advanced technologies.

Moreover, the change in the tax treatment is likely to affect East Asian investors most and in particular so-called round tripping investments. For other investors, by contrast, the change is unlikely to have a major impact. This is because the determinants of FDI into China have to do with the size of the market, the cost of labor in particular and not with the tax regime.

Chances of success

Whether China can successfully implement the new policy remains an open question. First it remains to be seen whether the policy changes can be effectively implemented at the local level. Actually an uneven implementation may be expected, because the new regulations may be to some extent contradictory with other objectives pursued by local authorities. It is worth stressing at this stage that one should not rely entirely on the Catalogue itself, because regulations, rules and policies of local government branches may be free to impose additional requirements.

Secondly, to be sure, the new regulation was enacted with domestic objectives in mind and it reflects in particular an attempt by the Government to show and prove that it seeks to control the quality of development (and not merely growth at all costs). However, the fact that all other attempts to cool down the economy have been to no avail so far, suggests that administrative guidance has its limits and that the chance of successful implementation may be relatively bleak.

Finally, it remains to be seen whether the Chinese Government is merely paying lip service to the notion of more sustainable development and of more efficient use of foreign capital or whether it really means it. The likely contradiction with the goal of creating jobs for hundreds of millions of unemployed migrant or rural workers may be a source of difficulty for the Government, and discrepancies between the law and the way it is implemented can be expected.

Conclusion

In China FDI policy has traditionally been an instrument of industrial policy and more generally of development strategy. Also, given the centralized and authoritarian nature of China’s governance, it is natural for the country's leaders to plan and execute economic policy, be it trade or FDI policy, as an instrument of larger political and security goals. It should thus not come as a surprise that China is gradually shifting away from unrestricted openness to FDI to more selectivity. As the economy gets richer it is thought to be in a position to gain autonomy vis-à-vis foreign investment. The policy move is actually in line with other policy provisions issued by Chinese authorities over the past couple of years. And it is also consistent with practices observed in a number of other dynamic Asian economies such as Korea or Malaysia.

However, the recent policy shift should not necessarily be a matter of concern for foreign investors for two major reasons. First, the successful implementation of these provisions is not guaranteed for a number of reasons having to do in particular with the possible diverging interests between central and local authorities. Moreover, China’s economic policy is subject to two, to some extent contradictory, pressures which will make the implementation of the policies rather delicate. On the one hand there is the need to go ahead with liberalization in line with international commitments, while on the other hand the temptation is strong to seek to rein in FDI and steer economic development. Secondly, the new provisions provide interesting opportunities for foreign investors in a number of high-tech niches where they may have a strong competitive advantage or in numerous service activities.

The most serious source of concern relates to the high degree of discretion that can be expected in the implementation of the new provisions. Already, even in the absence of a law, Chinese government officials still consider factors such as export performance, and local content when deciding whether to approve an investment. Because such notions as “national security” are extremely vague, the scope for interpretation is broad and the risks of friction can be expected to be high. It is of course too early to tell how the new regulations will impact foreign investors but what is for sure is the increasingly tougher stance of Chinese authorities vis-à-vis their foreign partners.

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Appendix

Table 2: Foreign Direct Investment in China, by source countries (in percentage)

	1991	1995	1999	2004	2005
Hong Kong	55.3	53.4	41.0	31.3	29.8
Japan	13.1	8.5	7.2	9.0	10.8
Taiwan	10.1	8.4	6.5	5.1	3.6
Singapore	1.2	4.9	6.2	3.3	3.7
Korea	0.0	2.8	3.0	10.3	8.6
Total 5 Asia	79.7	78	63.9	59	56.5
United States	7.1	8.2	9.9	6.5	5.1
European Union	5.7	5.7	11.0	7.1	8.6
Others	7.5	8.2	15.1	27.4	29.8
Of which Cayman and British Virgin Islands	n.a.	n.a.	n.a.	14.5	18.2

Source: *China Statistical Yearbook*, various issues.

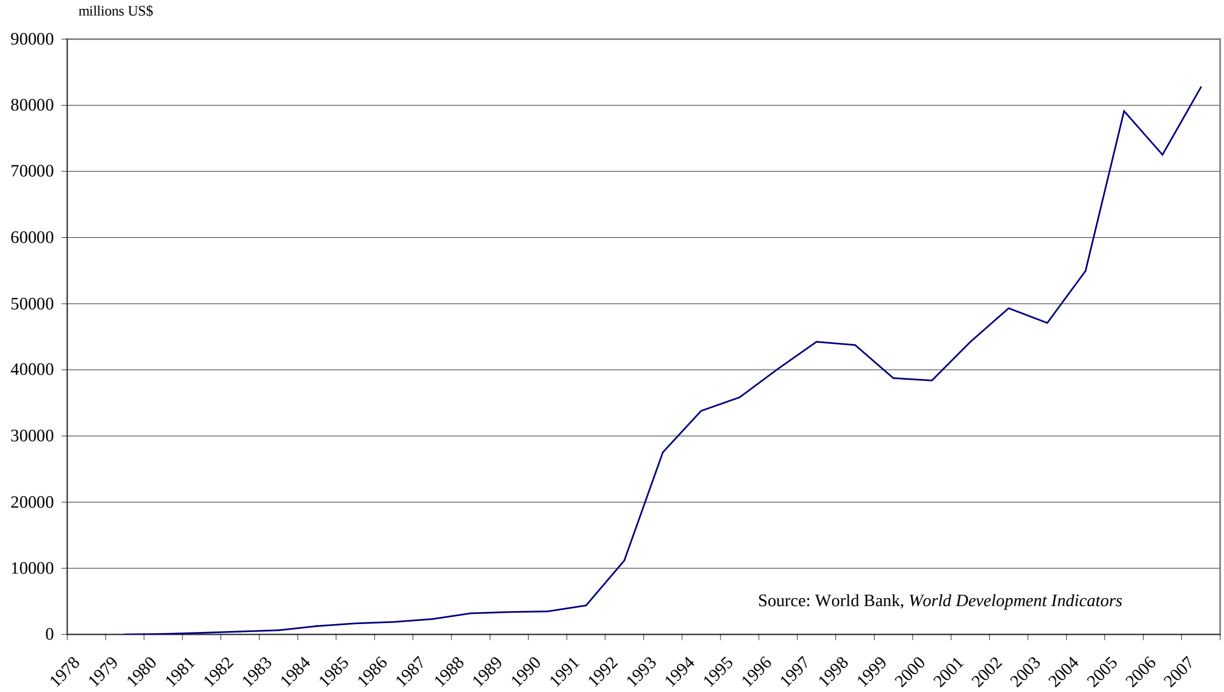
Table 3: Inward FDI Performance Index

	China	Malaysia	Ireland	United States
1988-90	1.033	4.349	0.911	1.115
1990-92	2.162	10.20	3.049	0.664
1992-94	6.127	9.099	2.523	0.684
1994-96	4.667	5.862	2.213	0.746
1996-98	2.761	3.428	3.327	0.840
1998-2000	1.198	1.248	5.614	0.805
2000-02	1.331	0.923	6.265	0.589
2002-04	2.134	1.803	7.865	0.376
2004-06	1.472	1.768	-2.202	0.505

Source: UNCTAD

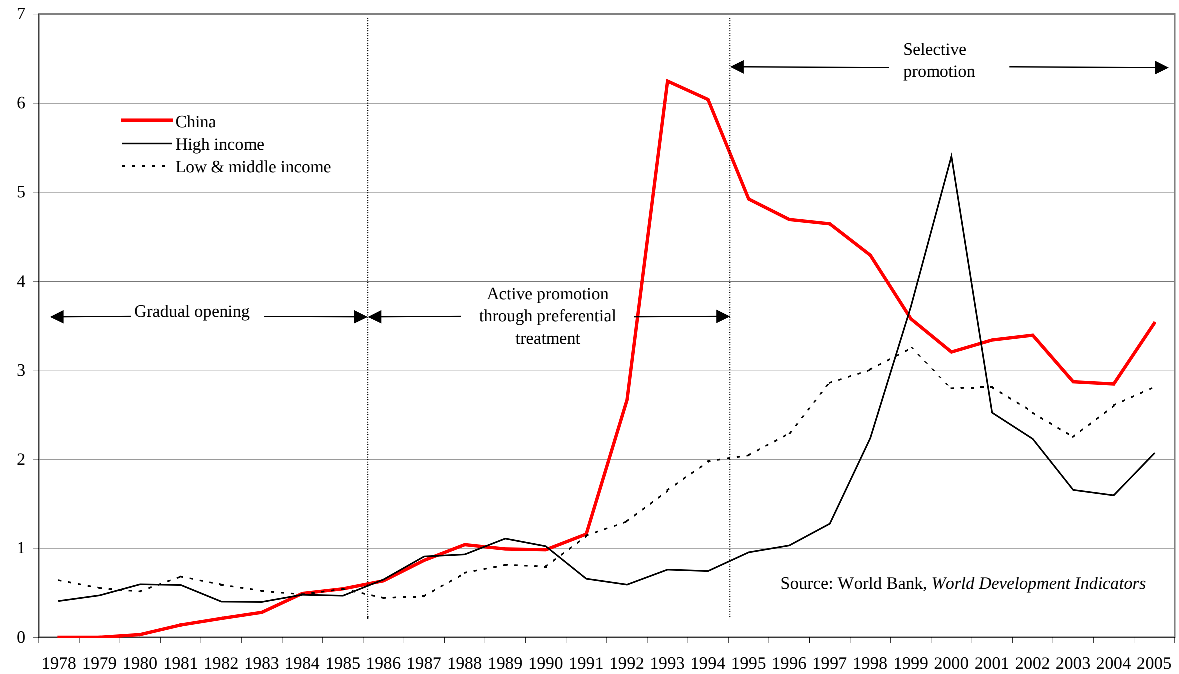
Graph 1

China, FDI inflows (current US$), 1979-2005



Graph 2

FDI net inflows (in per cent of GDP)
1978 - 2005



Graph 3

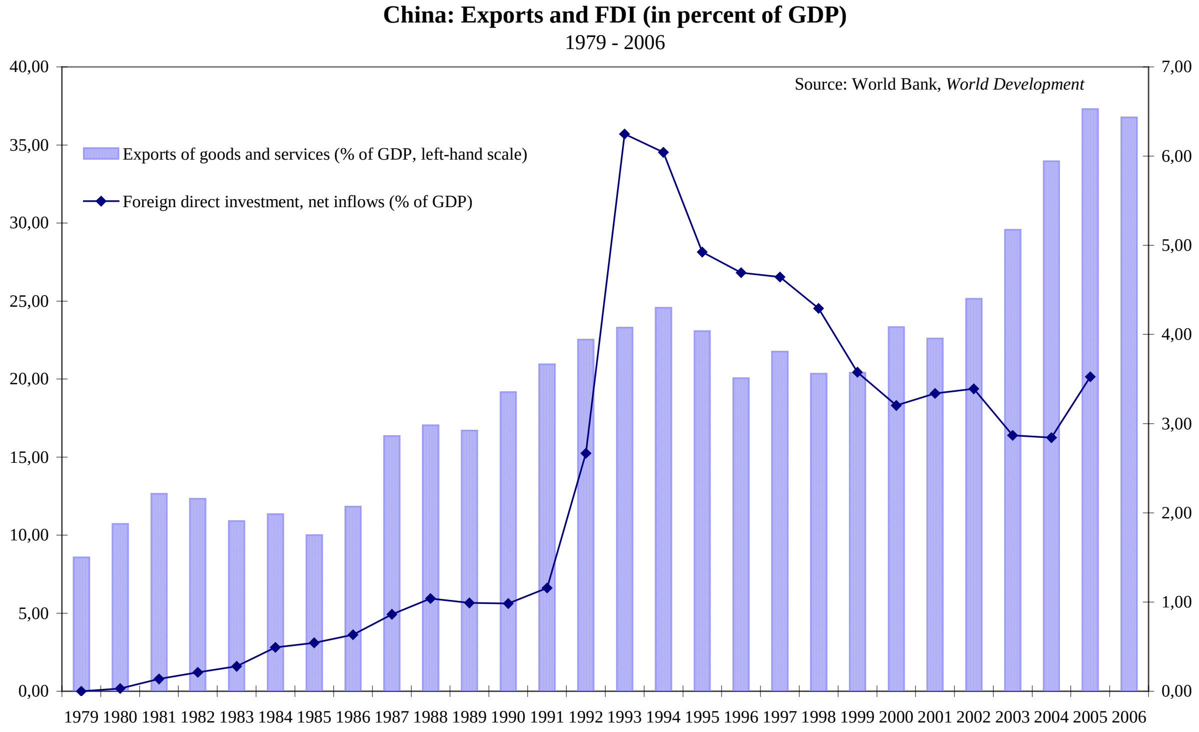

China: Exports and FDI (in percent of GDP)
1979 - 2006
Source: World Bank, World Development
Exports of goods and services (% of GDP, left-hand scale)
Foreign direct investment, net inflows (% of GDP)
40,00
35,00
30,00
25,00
20,00
15,00
10,00
5,00
0,00
7,00
6,00
5,00
4,00
3,00
2,00
1,00
0,00
1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006

Table 4: Catalogues for the Guidance of Foreign Investment Industries (compiled by the author)

2004	2007
Encouraged foreign investment industries	
(254 investment areas)	(350 investment areas)
I. Farming, Forestry, Animal Husbandry and Fishery Industries (11)	I. Farming, Forestry, Animal Husbandry and Fishery Industries (12)
II. Mining and Quarrying Industries (11)	II. Mining and Quarrying Industries (9)
III. Manufacturing Industries (191 see details below)	III. Manufacturing Industries (282 see details below)
IV. Production and Supply of Power, Gas and Water (8)	IV. Production and Supply of Power, Gas and Water (7)
V. Water Resources Management industry (1)	V. Communication and Transportation, Storage, Post and Telecommunication Services (14)
VI. Communication and Transportation, Storage, Post and Telecommunication Services (13)	VI. Wholesale and Retail Trade Industry (2)
VII. Wholesale and Retail Trade Industry (1)	VII. Rent and Business Service (3)
VIII. Real Estate Industry (1)	VIII. Scientific research, technology service and geological exploration (14)
IX. Social Service Industry (2)	IX. Water, environment and public facility management industry (4)
X. Public Health, Sports and Social Welfare Industries (1)	X. Education (1)
XI. Education, Culture and Arts, broadcasting, film and TV industries (1)	XI. Public Health, Social security and Social Welfare (1)
XII. Scientific research and Poly-technical services industries (12)	XII. Culture, Sports and Entertainment (2)
XIII. Permitted foreign invested projects whose products are to be wholly exported directly	
Restricted foreign investment industries	
(78 investment areas)	**(84 investment areas)**
I. Farming, Forestry, Animal Husbandry and Fishery Industries (2)	I. Farming, Forestry, Animal Husbandry and Fishery Industries (3)
II. Mining and Quarrying Industries (6)	II. Mining and Quarrying Industries (8)
III. Manufacturing Industries (35)	III. Manufacturing Industries (14)
IV. Production and Supply of Power, Gas and Water (1)	IV. Production and Supply of Power, Gas and Water (2)
V. Communication and Transportation, Storage, Post and Telecommunication Services (7)	V. Communication and Transportation, Storage, Post and Telecommunication Services (7)
VI. Wholesale and Retail Trade Industry (8)	VI. Wholesale and Retail Trade Industry (6)
VII. Banking and Insurance Industries (6)	VII. Banking and Insurance Industries (5)
VIII. Real Estate Industry (3)	VIII. Real Estate Industry (3)
IX. Social Service Industry (2)	IX. Leasing and Commercial Service Industry (3)
X. Public Health, Sports and Social Welfare Industries (2)	X. Scientific research, technology service and geological prospecting (3)
XI. Education, Culture and Arts, broadcasting, film and TV industries (3)	XI. Irrigation, environment and public utilities management (1)
XII. Scientific research and Poly-technical services industries (2)	XII. Education (1)
XIII. Other industries restricted by the State or international treaties that China has concluded or taken part in	XIII. Public Health, Sports and Social Welfare Industries (1)
	XIV. Arts, Sports and Entertainment Industries (4)
	XV. Other industries restricted by the State or international treaties that China has concluded or taken part in

Prohibited foreign investment industries	
(35 investment areas)	(40 investment areas)
I. Farming, Forestry, Animal Husbandry and Fishery Industries (3)	I. Farming, Forestry, Animal Husbandry and Fishery Industries (3)
II. Mining and Quarrying Industries (2)	II. Mining and Quarrying Industries (3)
III. Manufacturing Industries (11)	III. Manufacturing Industries (12)
IV. Production and Supply of Power, Gas and Water (1)	IV. Production and Supply of Power, Gas and Water (1)
V. Communication and Transportation, Storage, Post and Telecommunication Services (2)	V. Communication and Transportation, Storage, Post and Telecommunication Services (2)
VI. Finance and Insurance Industries (1)	VI. Leasing and Commercial Service Industry (1)
VII. Social Service Industry (5)	VII. Scientific research and Poly-technical services industries (2)
VIII. Education, Culture and Arts, broadcasting, film and TV industries (8)	VIII. Irrigation, environment and public utilities management (2)
IX. Other industries (1)	IX. Education (1)
X. Other industries restricted by the State or international treaties that China has concluded or taken part in	X. Arts, Sports and Entertainment Industries (11)
	XI. Other industries
	XII. Other industries restricted by the State or international treaties that China has concluded or taken part in

Encouraged foreign investment in manufacturing industries

2004 (191)	2007 (282)
Food Processing Industry (6)	Farm products Processing Industry (3)
	Food Manufacturing Industry (3)
	Drinks Manufacturing Industry (1)
Tobacco Processing Industry (2)	Tobacco Processing Industry (3)
Textile Industry (2)	Textile Industry (5)
Leather, Coat products Industry (2)	Leather, Coat and Feather (Down and Feather) Products Industry (3)
Lumber Processing Industry and Bamboo, Bine, Palm, Grass Products Industry (1)	Lumber Processing Industry and Bamboo, Bine, Palm, Grass Products Industry (1)
Paper Making and paper Products Industry (2)	Paper Making and paper Products Industry (1)
Petroleum Refining and Coking Industry (2)	Petroleum Refining and Coking Industry (1)
Chemical raw Material and Products Manufacturing Industry (25)	Chemical raw Material and Products Manufacturing Industry (26)
Medicine Industry (16)	Medical and Pharmaceutical Products Industry (16)
Chemical Fiber Manufacturing Industry (3)	Chemical Fiber Manufacturing Industry (6)
Plastic Products Industry (3)	Plastic Products Industry (3)
Non-Metal Mineral Products Processing Industry (9)	Non-Metal Mineral Products Processing Industry (20)
Ferrous Metallurgical Smelting and Rolling Processing Industry (1)	
Non-Ferrous Metallurgical Smelting and Rolling Processing Industry (4)	Non-Ferrous Metallurgical Smelting and Rolling Processing Industry (2)
Metal products Industry (3)	Metal products Industry (3)
General Machine-building Industry (7)	General Machine-building Industry (19)
Special Equipment Manufacturing (42)	Special Equipment Manufacturing (71)
Communication and Transportation Equipment Industries (17)	Communication and Transportation Equipment Industries (26)
Electric Machinery and Equipment Industries (4)	Electric Machinery and Equipment Industries (13)
Electronic and Telecommunications Industries (30)	Communication equipment, computer and other electronic equipment manufacturing (35)
Machinery Industries for Instrument and Meter, Culture and Office (8)	Machinery Industries for Instrument and Meter, Culture and Office (18)
Other Manufacturing Industries (2)	Other manufacturing industries (3)