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Selling Foreign Investment Short

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Yasheng Huang is a thoughtful, articulate observer of China's political economy, who has gained international respect. Many high-level conferences benefit from his insights, and this reviewer is indebted on a variety of issues.

Selling China is essentially two books. One is a very impressive, very carefully documented review of the negative consequences for the Chinese economy of laws and policies that advantage state enterprises at the expense of private enterprises – particularly of a financial system that allocates financial resources overwhelmingly to relatively inefficient state enterprises, and proportionately disadvantages private enterprises. As Huang details, the current Chinese system allocates advantages and disadvantages to firms according to a political pecking order rather than by credit quality. China's markets are highly fragmented and locally protected. China's banks allocate capital disproportionately to state enterprises. Its stock and bond markets are largely restricted by policy, although not by law, to state enterprises. Implicit government guarantees of loans to the biggest state enterprises (SOEs), together with weak private-sector accounting standards, make it irrational for the banks to lend to private firms rather than to big SOEs. As a result, even though China's extraordinarily entrepreneurial economy creates new firms at an astounding rate, few of these firms grow quickly to become nationally or internationally competitive. A great Chinese restaurant chain usually cannot get the funding to become a Chinese counterpart of McDonalds; the great Chinese entrepreneur is more likely to end up with 8 restaurants than with 8,000. (There are exceptions. Goubuli, a dumpling chain, will list soon.) Chinese leaders have allowed foreigners to buy large numbers of smaller state enterprises, while restricting Chinese from buying them, and, particularly in the early days, they sought to maintain employment by enticing foreign companies to buy large shares of moribund state enterprises as a means to gain access to what was then a highly restricted market.

This book about the negative consequences of a skewed financial system is one every Chinese policymaker needs to read. Indeed, it should be read throughout

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the third world. Huang's findings are exactly what economic theory would suggest: misallocation of capital on a gigantic scale has gigantically negative consequences even for an economy that has performed as well as China's has. But Huang documents the consequences for China in such exhaustive detail, from so many angles, and with such methodological sophistication that he creates a tsunami of unmistakable policy implications. Chinese policymakers understand the problem and have been moving gradually in a better direction, giving private firms more equal rights, but if all of the top 100 economic policymakers in China had read Huang's book, they would surely move much faster.

The second book, intermingled with the first and given the title role, is about foreign investment in China. It is less connected to the first book than the author thinks. Professor Huang has long been a sceptic about foreign investment. In articles published before *Selling China*, he has argued that multinational firms were transferring too little leading-edge technology and that relatively protectionist India, with less foreign direct investment, is likely to outperform China over the long term because, most notably, it is more capable of generating locally produced global brands. These arguments were weak.

The view that, when a country is at low levels of development, a main goal from FDI should be to import leading-edge technology, has been understood to be wrong for several decades. I can recall debating that one at a conference in South Korea in 1972. FDI helps countries move up the technology ladder by transferring technology at an appropriate level, to generate jobs, create foreign market ties, accumulate experience in managing technology, and so forth. What has been distinctive about both the South Korean and the Chinese experience has been the rapidity with which these economies moved up the technology ladder – a rapidity that has frightened many of China's first world competitors and led to the (equally fallacious) argument that all global manufacturing of all kinds may be taken over by China. One simply cannot argue that China's technological development has been unreasonably slow, and one cannot argue that it could possibly have been this fast without huge assistance from foreign direct investment.

By attracting companies to produce in China, that economy has in fact acquired not just jobs, foreign exchange, management experience, market connections, and, yes, leading-edge technology, but also leading edge competitiveness in a wide variety of areas – computers, cell phones, refrigerators, and many others. Because of the intense competition between foreign car companies in China, those companies, first GM and then others, have increasingly been forced to transfer their latest technology to China. Moreover, to gain stature with Chinese authorities, foreign car companies have, for instance, funded major research centres on whole-car development and power train technology at leading universities in Beijing and Shanghai. Similarly, BP has funded a state-of-the-art energy research centre at Tsinghua University. Many Chinese electronics companies are near to the leading

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edge; Huawei matches principal Cisco products at a fraction of the price. China is second only to the United States in genetically modified foods – both technology and production. Even though Chinese reform started very late, no other developing country comes close in rapid development of advanced technology. Biotechnology, nanotechnology, and even art are developing rapidly thanks to superior Chinese willingness to assimilate foreign things.

Personal computers provide just one example of how this works. Foreigners joint ventured and subcontracted with Chinese companies to make most of the parts of modern computers; those parts became commodities in China. Hundreds of Chinese computer companies emerged, and competition among them eventually consolidated the industry to the extent that one giant – Legend, later Lenovo – emerged, based on superior distribution capability. That Chinese company became Asia's largest manufacturer and distributor of computers, displacing both the Western giants (IBM, Compaq) and the Asian ones (NEC). Eventually, Lenovo bought IBM's personal computer division.[1] Most of China's breathtaking technological advance has been achieved by inviting numerous foreign companies in, learning by experience how to manage the technologies, training the workforce, domesticating the manufacture of parts, and then creating Chinese companies that assemble and refine the parts and design. This is how Taiwan and South Korea moved to the leading edge of IT, but it took them much longer. China has moved faster because it has been more open to foreign investment.

Similarly, the argument, based largely on India's possession of more global brands than China, that India would outperform China over the long run, proved weak on examination. The argument largely ignored the consequences of vastly superior Chinese education of its people, construction of infrastructure, investment generally, domestic competition, economic openness, and institutional globalization. China builds more first-class freeways every month than India has built since independence. Huang's argument failed to apply appropriate discounts for the fact that China has been at the brand-building game for a much shorter time than India, or to note that China has a wide variety of emerging brands that could soon outnumber India's. To be sure, if China fails to confront its terrible banking-system weaknesses and suffers a financial catastrophe, it could fall behind. But that risk was not the core of Huang's argument. Huang's distaste for foreign investment led him to disregard other important aspects of the situation.

Selling China suffers from a similarly prejudicial narrowing of focus. A virtue of Huang's book is the clear structure of his argument. His axiom (p. xv) is that 'At a given level of macroeconomic fundamentals, such as an expanding market share or low labor costs, whether a country gets more or less FDI . . . depends on the relative competitiveness of foreign versus domestic firms'. In short, foreign investment and local investment are engaged in something approximating a zero-sum game. If FDI is very high, then the competitiveness of local firms must be low. FDI must in some sense be at the expense of local investment. To Huang this is

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axiomatic in two senses: he takes it to be so self-evident that he does not need to defend it in detail, and everything else in his foreign investment thesis depends on this assumption.

But this axiom is almost certainly false. Foreigners invest in the US economy primarily because it is so competitive and dynamic, and they do not invest in the Congo primarily because it is so uncompetitive and has so few local firms worth buying into. It is much easier to make the case for the exact opposite of Huang's axiom than it is to make the case for it. If China had a far larger number of extremely successful private enterprises, I believe that foreign direct investment could easily be double what it is today; Huang's axiom asserts, wrongly, that inevitably it would be less. Dramatically successful expansion of private enterprises in China would attract more FDI not just into manufacturing, but also into every aspect of the domestic market.

Huang's case is that FDI is high in China because of the socialist flaws documented in what I have called his first book. He builds this case by arguing that FDI is essentially displacing local investment, and his evidence for that displacement is based on five unusual characteristics of FDI in China (first summarized on pages 5–6 and then elaborated throughout the book).

The first of his 'unusual characteristics' is that FDI into China is proportionately higher than FDI into other Asian countries, and he criticizes China for 'FDI dependence'. Second, 'the sharp rise in China's reliance on FDI has been accompanied by a precipitous drop over time in contractual alliances, such as export processing and assembly, between foreign and domestic firms' (p. 5). The others are that FDI in China has spread to more industries and more regions than is typical of other countries, and a high proportion of the investments have been small or from small parent firms.

Let us take his second 'unusual characteristic' for more detailed examination. He says 'A fundamental contention in this book is that China's FDI absorption ought to be examined *in conjunction with* this simultaneous sharp decline in contractual capital inflows. The research question does not simply ask why China received so much FDI, but why FDI inflows seemingly increased *at the expense of* contractual capital inflows' (p. 14, emphasis in the original). His thinks this shows that FDI is displacing local firms, and he goes on to emphasize how this pattern increases foreign control over the Chinese economy. In both aspects, he is dead wrong.

As China began to open up, contractual alliances were the dominant form of relationships with 'foreign' (mainly Hong Kong) firms for three reasons. First, Hong Kong companies did not trust the communists to play fair. Second, they did not trust the local partners to play fair. Third, virtually all production was for export because there was no substantial local market. All three reasons had solid support. Most Hong Kong business people came from families displaced by the communists. They had enough contact with their relatives over the border to know

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that the concept of long-term partnership for mutual profit had largely vanished. Locals in China saw Hong Kong relatives and Hong Kong investors as aid donors rather than business partners. They saw loans as gifts. Most viewed 'foreign' investors as fools who should be parted from their money as quickly as possible. Moreover, they were too poor to buy the kinds of goods that Hong Kong companies produced. In the early years it was even difficult to persuade local workers that it was important for the buttons to match the button holes; such was the level of poverty that the criterion for good clothing was simply that it should cover the subject.

In these circumstances, the investor's goal was to avoid committing capital to China. For instance, a near perfect deal was an arrangement to make plastic bags in China for use by luxury foreign department stores. The Hong Kong entrepreneur provided sheets of plastic, something to cut the plastic with, and possibly something to heat-seal the creases. Basically, the capital costs were a scissors and an iron. If the Chinese partner did not perform, what was at risk was a scissors, an iron, and a few sheets of plastic. In short, extraordinary levels of distrust, together with the lack of a domestic market, inflated the number of processing deals and minimized direct investment.

Over a remarkably short period in historical terms, the communist system gradually began to come to terms with the requirements of business, including foreign business. Laws gradually came into favour. Politicians who sustained inflows of foreign business got promoted and those who scared it off got fired. Local people began to see that neighbours who did continuing business with McDonalds rather than just trying to rip it off got wealthy. In short, a subculture focused on long-term mutual profit began to develop in limited parts of Guangdong, and later started to spread to Shanghai and selected other parts of China. Finally, a local market developed; by the 1990s foreign investors were as interested in selling cell phones to Chinese as they were in manufacturing cell phones in China for export to elsewhere. At this point, investors began committing capital.

To summarize, China moved from a condition where abnormal levels of distrust and poverty forced an almost exclusive foreign focus on contractual arrangements for export to a more normal situation where trust and local market demand were sufficient for foreigners to put real money at risk in China. This is almost the exact opposite from Huang's portrayal of movement from a normal situation of a high level of processing activity to one of abnormal concentration of foreign ownership.

Huang has a very extensive theoretical discussion that queries why it would be rational for a foreigner to want to own the company rather than engage in a processing contract with a local partner. Anyone who was on the scene during the first quarter century of reform knew the answer to that. In the early days, you had a partner because the Chinese authorities required you to have a partner. But processing contracts and joint ventures were subject to innumerable vagaries. Local

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culture treated any change in the market as *force majeure* that invalidated a contract. In any case, a contract was not a final deal, but rather the initial phase of negotiation. Your relationship with your partner was highly personalized and therefore could change suddenly. Your contractor or partner was always looking for a way to steal your process or your product or, in the case of partners, for a way to seize control over your company. Hiring and firing depended on family relationships and local Communist Party whims. Eventually the régime discovered that companies would only become fully efficient if it allowed foreign ownership; foreigners could fire all those redundant relatives, but the SOE (government) could not. And when companies acquired opportunities to reduce the vagaries, they of course seized them.

Lastly, in reviewing this second of Huang's 'unusual characteristics', the move from processing agreements to some degree of foreign ownership did not necessarily mean a move from full Chinese control to foreign control. Huang says that control is proportional to equity, but in the situation he is addressing the opposite is true. Return to our example of the processing deal, where the local Guangdong contractor uses Hong Kong scissors, iron, and plastic to make shopping bags for Neiman Marcus. The Hong Kong businessman has absolute, total control over that business, with zero ownership. But when trust and the domestic market improve, and that business goes into an equity partnership (or even a wholly foreign-owned operation) manufacturing plastic, building an automated production line with local equipment, and selling into the local market, it becomes enmeshed in a series of arrangements where Chinese suppliers, Chinese buyers, Chinese partners, and Chinese regulators have significant control. In addition to greater control, Chinese gain access to a broad variety of additional benefits, including greater exposure to modern technology and modern management. Again, the reality is nearly the opposite of Huang's exposition.

I cannot in this brief review analyse Huang's other arguments in this level of detail, but similar problems affect each of Huang's major points. To a substantial extent, China is not 'FDI-dependent', as Huang's emotionally loaded phrase has it, but 'FDI-welcoming'. When Huang contrasts China's higher proportion of FDI with its neighbours, he fails to note how unfavourably most of those neighbours treat FDI, and how they have suffered for their decision to rely on debt rather than equity. China has made a decision to promote FDI. It promotes and rewards local officials to the extent they attract FDI. China builds roads and other infrastructure as the Philippines does not. It educates its people in a way that India and Thailand do not. Thailand has tax and ownership laws that effectively ban any foreign investment that does not receive 'incentives' (which simply lower the hurdles that the government has created). Thailand, Indonesia, South Korea, the Philippines, and (in a different way) Japan are weighed down by terrible indebtedness because of their preference for debt financing in order to limit foreign equity. Because China's policies lead to more rapid technological and managerial

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development, and to more balanced debt and equity financing, the neighbours are having to re-evaluate their policies, and will have to emulate China in building more infrastructure, educating more people, and welcoming more equity (FDI) rather than depending so heavily on debt to finance their modernization.

Because of foreign investment, China has moved up the technological ladder at a speed that many US, European, and Japanese executives find frightening. Had China followed India's policies, which Huang prefers, China's competitors would not be frightened at all. Because of FDI, China does not have the foreign debt burden of the Philippines, South Korea, Indonesia or Thailand. Because of FDI, China now has modern management experience in virtually every major industry, and it knows how to manufacture the component parts of most of the goods that comprise a modern economy. Because it allowed IBM and Volkswagen and Motorola and Whirlpool to invest, and because China learned from them how to make all the parts and manage all the processes, China has spawned an amazing variety of local firms that produce those parts and manage those processes. Those modern local firms would not exist if China had not opened itself to FDI in a way that its neighbours did not. This point goes to the heart of Huang's axiom that more FDI means less local corporate development. Nearly every modern, competitive Chinese firm is modern and competitive because of its connection to foreign investment. A large proportion of those modern, competitive Chinese firms would not exist at all without foreign investment. While it is true that China would have a lot more local, competitive firms if it provided a level playing field to its own private firms (Huang's Book 1), Huang's argument does not establish that FDI has substantially displaced or occupied the space otherwise available to competitive Chinese firms. FDI has actually enlarged the space.

In each area of the areas mentioned, China is beginning to take back its domestic market, and it is beginning for the first time to seize export markets. Huang begins his book with frightening statistics about foreign dominance of cell phones, but Chinese acquisition of foreign expertise has enabled Chinese companies to begin taking the market back so quickly that Huang's statistics, although correct when he collected them, are already obsolete. The really frightening statistics are the comparison between what happens when China opens up the cell phone market and India does not; China got to 200 million cell phones at the same time that India got to 10 million. The number of cell phones produced by indigenous Chinese firms hugely outnumbers India's. Huang does not understand or acknowledge this.

I will conclude with a reflection on one of Huang's three principal ways in which the Chinese system hobbles private investment, namely the fragmentation of the Chinese marketplace. China's provinces protect their firms against those of other provinces, counties against those of other counties, even villages against competitors from neighbouring villages. As Huang says, that does indeed hobble Chinese companies from growing and becoming internationally competitive. China's

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leaders know this, and they concluded that their political power was insufficient to overcome local protectionism and create a national Chinese market. The decisive tool for defeating local protectionism, and unifying a fragmented market, has been FDI encouraged by WTO. When I first did a study of the Chinese beer market, the typical market size was determined by how far a bicycle could ride in the morning to deliver the bottles and return in the afternoon to return the empties. In 2004 there were 125, mostly local, Chinese car companies; within the lifetimes of most readers of Huang's book that will come down to something between three and six national ones. Much (by no means all, but much) of the speed of such changes, and they are extraordinarily fast by any historical standard, is a story of FDI, of foreign beer companies, foreign car companies, foreign law firms, foreign accounting firms, foreign management processes, foreign technology, all successfully employed as battering rams by Chinese political leaders determined to acquire the benefits of a national market along with the benefits of modern technology and management. Huang misses this.

Huang's book has many valuable messages. To repeat, nobody among Chinese economic regulators should fail to read and understand Huang's analysis of the crippling effect on domestic entrepreneurship of China's politicized socialist financial management. But *Selling China* is not a balanced treatment of *Foreign Direct Investment During the Reform Era*. Huang provides piles of useful data about FDI. He makes many valid points about foreign investment. Certainly, patterns of FDI in China are influenced by China's socialist legacy and financial mismanagement. But Huang's obsession with the displacement axiom obscures as much as it reveals. In determining the volume of FDI, what is the balance between China's financial mismanagement and China's sounder mix between debt and equity as compared with its neighbours? In looking at the broader geographic dispersion of FDI in China and elsewhere, instead of using this as an example of how China is deviant, Huang should ask how China has achieved this beneficial result that Brazil and Indonesia have desperately sought but failed. How can China achieve more of it – a desperately important objective for the fourth generation leaders but something that Huang projects as abnormal and negative? All of Huang's analysis is so coloured by his negative attitude toward foreign investment, and by his unexamined axiom about the competitive relationship between foreign and domestic investment, that one cannot detect in the book the proper balance between the influence of socialist irrationality and the influence of unusually sound market-oriented decision-making. One cannot strike the balance between what is negative (suppression of financing for a Chinese McDonalds) and what is positive (widespread dispersion of the developmental impact of FDI) in the patterns Huang describes. One cannot distinguish what is temporary (foreign dominance of the cell phone and personal computer industries) from what could be permanent (foreign dominance of the car industry unless the regulators loosen up their socialist support of the Big Three and allow more free-wheeling foreign and local com-

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petition). One cannot know from this analysis how substantial are China's advantages from relying on a balance of equity and debt, as opposed to the periodically disastrous Latin American-South Korean-Thai-Filipino over-reliance on debt in order to exclude foreign equity. Although Huang persuasively documents the negative consequences of the Chinese system's financial bias toward state enterprises, he does not make the case that a rapid shift to bank financing of private enterprise is possible. Any banker in China will tell you that the accounting standards of virtually all of China's private enterprises are so much lower than the (already very low) standards of the SOEs that lending to them on any scale would be suicidal. How quickly such things could be changed is debatable, but Huang's displacement thesis is untenable in the absence of a persuasive argument that it can be changed very quickly.

Huang's documentation of patterns will lead us to greater insight. The strong negative political filter he employs in analysis of his data on foreign investment obscures rather than illuminates.

NOTE

[1] Ironically, another Chinese technological success, extraordinarily rapid internet development, allowed Dell to begin to challenge Lenovo's superior domestic distribution. Lenovo's purpose in buying IBM's Think* was to respond to Dell by purchasing a distribution network on Dell's home turf in the USA. It remains to be seen whether this will work. What is impressive is that Lenovo is able to try.

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