
Changes in China's Foreign Investment Policy and the Response of Foreign-Invested Companies

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Summary

1. The ability to anticipate changes in China's economic situation has become increasingly important in recent years because of China's growing influence on East Asian economies. As part of the global economy, China is also more open to influences from other countries, especially its neighbors in Asia. Recent developments that are likely to have a key bearing on Asia's economic future include China's transition to stable growth, the emergence of the Indian economy, and moves toward economic integration in ASEAN.

2. While China continues to achieve growth in excess of 10%, it is also affected by growing imbalances, including overheated investment, trade friction and the expansion of disparity. The government has sought to solve these problems by achieving high economic growth. Recognizing that expanding disparity has the potential to cause political instability and impede sustainable growth, the government has also started to tackle the fundamental causes of this problem. The 11th Five-Year Plan contains specific numerical targets for this purpose. The plan also calls for the establishment of a more advanced industrial structure through measures that include the development of high-tech industries, and accelerated development of service industries.

3. We need to be aware that this situation has resulted in significant changes in China's foreign investment policy. Currently foreign investment policy is guided by three basic criteria. First, will investment lead to the introduction of advanced technology and management methods? Second, will investment contribute to environmental protection, resource conservation and progress on energy policies? Third, will investment contribute to the advancement of China's domestic industrial structure and technology standards? In general, there is a growing tendency to induce investment in areas that reflect the government's aims.

4. One of the changes that has occurred in China's industrial structure since the implementation of the reform and open-door policy is the development of more advanced manufacturing industries through the introduction of foreign investment. There are also problems, however, including the fact that the primary sector still accounts for a high percentage of jobs, and the slow pace of service industry development. The government is responding to these issues by working to develop service industries and increase their capacity to absorb surplus rural labor through measures that include the introduction of foreign investment and the construction of regional cities.

5. Changes in China's environment include new trends in the activities of South Korean and Taiwanese companies. South Korea's reliance on China in the areas of trade and investment began to expand in the 1990s. In 2006, however, its reliance on exports to China fell below the previous year's level for the first time. One reason for shift is the fact that the business activities of South Korean companies in China are approaching a plateau. Another factor is a growing focus on the development of other markets, including Vietnam, India and former socialist countries.

6. In contrast, the business activities of Taiwanese companies in China continue to expand. This reflects their continuing reliance on industrial clusters formed in China by the IT industries, which are the mainstay of the Taiwanese economy. However, there have been signs of change in recent years. First, factories are being built not in China's coastal regions, but in inland areas such as Chongqing and Wuhan. Second, factories in China are being automated. Third, companies in export-oriented labor-intensive industries, such as apparel, footwear and furniture, are increasingly investing in countries other than China. Fourth, companies in the semiconductor industry are tending to invest more within Taiwan.

7. At present there are no countries that can surpass China's overall attractiveness as a production base and as a market. Direct investment in China is therefore likely to remain high in the foreseeable future. However, the trend toward concentrated investment in China is likely to change gradually, in part because of the influence of emerging countries. Japanese companies will need to develop business strategies that exploit their technological leadership. Those strategies must also be based on a proper understanding of China's new foreign investment policy.

Introduction

The ability to anticipate the direction of change in the Chinese economy has become increasingly important because of China's expanding presence in the world economy and the increased depth of its economic relationship with Japan.

China's continuing high growth has caused imbalances. Within China, these include expanding disparity, overheated investment, and worsening energy and environmental problems. External imbalances, including trade friction, are also expanding. The government has responded to these problems by adopting the creation of a "harmonious society" as its long-term goal. It is working to realize this goal by raising rural incomes and implementing a range of major regional development and environmental programs, including the Large-Scale Development of the Western Region and Northeast Rejuvenation programs. At the same time, the government is working to bring about a transition to stable growth through the gradual reform of the currency system.

There have also been major changes in the Chinese government's foreign investment policy. Though China has remained faithful to its open-door stance, it now requires foreign-invested companies to contribute to industrial advancement and the solution of China's problems. New trends are also apparent in the activities of foreign-invested companies. For example, producers of some labor-intensive products have responded to rises in the value of the *renminbi* by shifting their production operations out of China or to inland regions.

This article examines the outlook for the Chinese economy and analyzes the significance of the foreign investment policies adopted by the Chinese government in recent years. The aim is to offer Japanese companies perspectives that will be of use as they develop their future business strategies toward China. Part 1 analyzes shifts in China's environment and traces changes in its development strategies and foreign investment policies. Part 2 looks at the ways in which foreign investment has contributed to China's economic development in the past and explores the intentions behind foreign investment policy changes by iden-

tifying the issues that have arisen. Part 3 examines trends in the activities of South Korea (South Korean companies) and Taiwan (Taiwanese companies). Companies from South Korea and Taiwan have invested heavily in China, and an analysis of their activities will offer lessons for Japanese companies. Part 4 sums up the discussion in the preceding sections and offers predictions for the future.

1. Changes in China's Environment

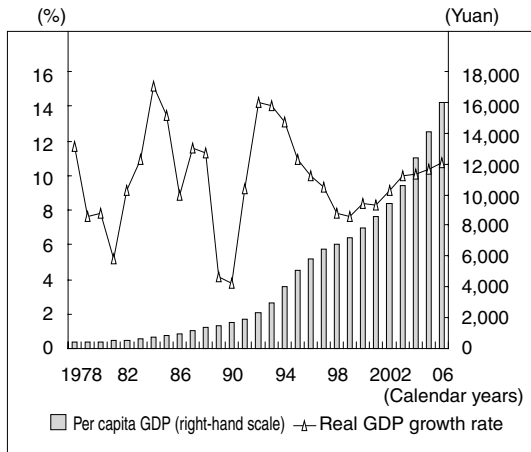
We will begin by examining recent developments that are likely to have an important bearing on Asia's economic future. This will be followed by an analysis of one of those developments: the shift in China's development strategies and foreign investment policies.

(1) New Developments in Asia

China's economic development is one of the most significant factors affecting the world economy in general and Asian economies in particular over the past 10 years. The Chinese government adopted the reform and open-door policy at the 3rd Plenum of the 11th Central Committee of the Chinese Communist Party in late 1978. Since then China has achieved rapid economic growth and emerged as one of the world's leading economic powers (Fig. 1). In 2005 China's nominal GDP reached \$2,234.3 billion. This is equivalent to 5.0% of the world total and is the fourth highest in the world after the United States, Japan and Germany (World Bank). China has overtaken Japan and moved into third place in the world in terms of the value of its trade (WTO, 2006). There is a strong possibility that China will move ahead of Germany and into second place in 2007.

As of 2006, China's per capita GDP stood at \$2,004, placing it ahead of two ASEAN members, Indonesia and the Philippines. This sustained high growth has been accompanied by a decline in the percentage of China's population below the poverty line. Ravallion and Chen developed their own poverty line in collaboration with the National

Fig. 1 China's Real GDP Growth Rate and Per Capita GDP (1978-2006)



Source: National Bureau of Statistics of China, *China Statistical Abstract 2007*

Bureau of Statistics. Based on this new yardstick, the percentage of people below the poverty line has fallen from 52.8% in 1981 to 8.0% in 2001⁽¹⁾. Poverty declined rapidly in first half of the 1980s because of a dramatic rise in agricultural production following the introduction of the contract responsibility system, and because of the industrialization of rural areas through the establishment of township enterprises.

The engines driving China's economic development are foreign investment and the resulting expansion of exports. First, industrialization in southern China accelerated as more and more factories were relocated there from Hong Kong. The subsequent expansion of zones open to foreign investment was accompanied by growth in direct foreign investment, especially from Japan, Taiwan and South Korea. This led to the formation of new industries and improvement in China's technology level.

China's economic development has also increased interdependence among the East Asian economies. One example of this trend is the export-inducing effect of increased direct investment in China. Japanese, South Korean and Taiwanese companies in industries ranging from footwear and apparel to electrical and electronic machinery and IT equipment have shifted their production operations to China. This has not only induced

exports of production goods from these countries and regions, but also exports of raw materials, including natural rubber and petrochemicals, and semiconductor, electronic parts and other items from members of the Association of Southeast Asian Nations (ASEAN).

This expansion of investment is a two-way process. Chinese direct investment in Asia (including the Middle East) amounted to \$1.5 billion in 2003. By 2005 this had increased 2.9 times to \$4.37 billion.

In addition to this process of integration at the real economic level, the past few years have also seen rapid moves toward regional integration at the institutional level. This suggests that flows of goods, capital and people are likely to accelerate still further in the future.

China's influence on the East Asian economies has intensified in recent years. and the evolution of the Chinese economy in the years ahead will have an extremely important bearing on the outlook for the entire region. As part of the global economy, China has meanwhile become more exposed to external influences, especially from its Asian neighbors. In this context, three recent developments are seen as especially significant for any attempt to predict future economic trends in Asia.

First, China itself is working toward a transition to stable growth. This is discussed in greater detail in Section (2). With its growth rate continuing to exceed 10%, China is experiencing a range of issues, including expanding disparity and overheated investment at home, and worsening external imbalances, including trade friction. The government has responded by adopting the creation of a harmonious society as its long-term goal, and by targeting a shift to stable growth. Efforts to alleviate external imbalances include the adoption of a more flexible currency system and measures to increase domestic demand.

In Japan, South Korea, Taiwan and elsewhere, economic development has led to increases in currency values and wage rises. For China, too, a substantial rise in the value of the renminbi and upward movement in wages are inevitable. There is strong possibility that this will result in the re-

location of production facilities for labor-intensive industries from coastal China to inland regions, provided that adequate infrastructure can be developed, and a growing emphasis on technology-intensive and capital-intensive industries in coastal regions. Another possibility is that the “flying geese” pattern of economic development will spread to less developed countries. In fact, labor-intensive industries have already started to shift to Vietnam, Cambodia and other less developed countries.

Second, there is the economic emergence of India, another population giant. India’s real GDP growth rate hit 8.4% in fiscal 2005 and 9.4% in fiscal 2006. The socialist-style development model adopted by India in the postwar era led to economic stagnation because of tight government controls on private sector economic activity. After experiencing a severe foreign currency shortage in 1991, India implemented major economic reforms. The key reforms were (1) the shrinkage of the public sector, (2) the abolition of industrial licensing, (3) trade and currency liberalization, and (4) the introduction of foreign investment. The impact of these reforms was comparable to that of the reform and open-door policy adopted by China at the end of 1978, and the Doi Moi reforms adopted by Vietnam in 1986.

With the easing of restrictions on foreign investment, India was gradually integrated into the global economy. This brought rapid growth in the area of IT services, including data processing, system development and call center operation⁽²⁾. More recently, the growth of the India’s middle class has been reflected in the expansion of domestic markets. This has triggered an upsurge of foreign investment targeting those markets. In 2006 motor vehicle sales increased by 23.7% year-on-year to 1,847,000 units.

Third, ASEAN has moved toward closer economic integration. In 2003, the six original ASEAN members (Thailand, Malaysia, the Philippines, Indonesia Singapore, Brunei) reduced tariffs on most of the items covered by the Common Effective Preferential Tariff (CEPT) scheme to 5% or lower. This signaled the real beginning of the ASEAN Free Trade Area (AFTA). Ultimately

tariffs will be abolished entirely, with a few exceptions, by the six original members by 2010, and by Cambodia, Laos, Myanmar and Vietnam (CLMV) by 2015⁽³⁾. At a meeting of economic ministers in August 2006, it was decided to bring forward the schedule for the establishment of an ASEAN Economic Community from the original deadline of 2020 to 2015. Other planned changes include the liberalization of services, the facilitation of people movements (including visa exemptions for tourism and reciprocal recognition of technical qualifications), the adoption of common certification systems (including the adoption of unified product certification systems and standards and safety standards), cooperation on the production and marketing of agricultural products, the linkage of stock exchanges, and studies concerning a common currency.

Moves to correct imbalances disparity within the region have also been intensified. Poverty alleviation and the reduction of disparity became major priorities for ASEAN after the admission of the CLMV group. There was a risk that expanding disparity within the region could become a barrier to economic integration, and members agreed at an unofficial summit in 2000 to launch the ASEAN Integration Initiative. They also decided to pursue economic cooperation in a number of fields, including human resource development, information and communications technology, and infrastructure. In addition, ASEAN members decided to establish the ASEAN Development Fund under the Vientiane Action Programme, a medium-term plan launched in 2005 with a view to creating an ASEAN economic community.

A key factor in the correction of disparity will be the development of the Mekong region. Many international frameworks have been established for the development of this region, but the plan that has attracted the most interest is the Greater Mekong Subregion (GMS) Program, which has the support of the Asian Development Bank. This program calls for cross-border development of areas in the Mekong Basin, including Vietnam, Cambodia, Myanmar, Laos and China’s Yunnan Province. There is particular interest in the implications for regional development in China.

Among the priority sectors identified in the GMS Program are (1) transportation, including roads, railways and canals, (2) telecommunications, (3) energy, (4) management of the environment and natural resources, (5) human resource development, (6) trade and investment, and (7) tourism. In the road development category, construction is already in progress on the East-West Corridor Project (Da Nang- Savannakhet-Mukdahan-Mawlamyine), the North-South Economic Corridor Project (Kunming-Chiang Mai, Kunming-Hanoi) and the Southern Economic Corridor Project (Bangkok- Phnom Penh-Ho Chi Minh-Vung Tau).

In December 2006, the Second Mekong International Bridge was completed, linking Savannakhet in Laos with Mukdahan in Thailand⁽⁴⁾. Japan provided a yen-denominated ODA loan for this project. International logistics firms are now developing overland transportation networks linking China and Southeast Asia.

Under their economic cooperation agreement, ASEAN and China began to reduce tariffs in July 2005. They had already kick-started the process by cutting tariffs in eight areas, including agricultural products, in 2004. The completion of the North-South Economic Corridor, linking China's Yunnan Province with the ASEAN countries, is expected to bring further trade expansion, and additional impetus for the development of less developed regions of China and ASEAN. Numerous trading companies have already been established in Hekou, a border town in Yunnan Province.

Trade Matrix Trends

The preceding observations are confirmed by data in world trade matrices for 1991 and 2005, which were compiled using export data (FOB prices) from the IMF *Direction of Trade Statistics* (Table 1). Export trends can be gauged by following the figures from left to right. (Shaded areas indicate growth by a factor of five or more during the period covered.) The following patterns emerge from this table.

First, China's presence is expanding. World exports expanded by a factor of 3.0, from \$3,448.1 billion in 1991 to \$10,343.1 billion in 2005. Chi-

na's exports increased 10.6 times over the same period, and its share of total world trade rose from 2.1% to 7.4%. Its share of imports meanwhile increased from 1.8% in 1991 to 6.1% in 2005, reflecting China's growing importance as a market.

Exports within the East Asian region increased 4.5 times, from \$298.7 billion to \$1,344.7 billion, and the intraregional trade ratio stood at 49.8% in 2005. This expansion reflects the spread of production networks in the region, and the resulting expansion of trade in intermediate goods. According to the 2006 international trade matrix compiled by the Institute for International Trade and Investment (ITI), intraregional transactions in motor vehicle parts in East Asia increased from \$11,488 million in 2003 to \$18,116 million in 2005, while transactions in semiconductors and other electronic parts increased from \$26,756 million to \$33,976 million over the same period⁽⁵⁾. Moves toward economic integration at the institutional level in the ASEAN region appear to have contributed to the expansion of intraregional trade among the ASEAN4.

Another significant factor is the emergence of the Indian economy. While exports to India are still not large in value terms, they have expanded dramatically. Of particular interest is India's growing reliance on trade with China. In fiscal 2005, the United States was India's biggest export market, accounting for 16.7% of total exports, followed by the United Arab Emirates (8.4%), China (6.5%), Singapore (5.4%), and the United Kingdom (5.0%). The main exports to China are iron ore and semi-finished steel products. In terms of import shares, China (7.5%) has moved into first place ahead of the United States (5.5%). There have been moves toward the establishment of economic cooperation agreements between India and East Asian countries, and East Asian investment in India is rising. These developments point to further expansion of East Asia's trade relationships with India.

(2) China's Economy at the Crossroads

China continues to achieve high growth. However, the Hu Jintao administration will need to rec-

Table 1 Trade Matrices (Top: 2005, Bottom: 1991)

(\$billions)

	Thailand	Malaysia	Indonesia	Philippines	Singapore	South Korea	Taiwan	Hong Kong	China	Japan	Total East Asia	India	U.S.A.	EU	All
Thailand		5.8	4.0	2.0	7.6	2.2	2.6	6.1	9.1	15.0	54.4	1.5	17.0	14.9	110.2
		0.7	0.2	0.1	2.3	0.5	0.5	1.3	0.3	5.1	11.0	0.7	6.1	—	28.8
Malaysia	7.6		3.3	2.1	22.0	4.7	4.7	8.2	9.3	13.2	75.1	4.0	27.8	16.6	140.9
	1.1		0.5	0.3	8.0	1.5	0.9	1.2	0.6	5.5	19.6	0.3	5.8	—	34.4
Indonesia	2.2	3.4		1.4	7.8	7.1	4.1	1.5	6.7	18.1	45.6	2.9	9.9	10.3	85.6
	0.3	0.3		0.2	2.4	1.9	1.1	0.7	1.2	10.9	19.0	0.7	3.5	—	29.2
Philippines	1.2	2.5	0.5		2.7	1.4	2.5	3.3	4.1	7.2	25.4	0.1	7.4	7.0	41.2
	0.2	0.1	0.1		0.2	0.2	0.2	0.4	0.1	1.8	3.3	0.0	3.1	—	8.8
Singapore	9.4	30.4	22.1	4.2		8.1	4.4	21.6	19.8	12.5	132.5	5.9	23.9	27.6	207.3
	3.7	8.8	1.5	0.7		1.4	2.1	4.3	0.9	5.1	27.0	1.0	11.7	—	59.2
South Korea	3.4	4.6	5.0	3.2	7.4		11.9	15.5	61.9	24.0	136.9	4.6	41.5	43.8	284.3
	1.3	1.0	1.4	0.7	2.7		1.6	4.8	1.0	12.4	26.9	0.5	18.6	—	71.9
Taiwan	3.7	4.2	4.5	4.2	7.6	5.6		30.7	40.9	14.5	115.9	1.6	28.5	—	189.4
	1.4	1.5	1.2	0.8	2.4	1.3		12.4	—	9.2	30.2	0.2	22.3	—	76.2
Hong Kong	2.8	2.4	1.3	2.6	6.0	6.2	1.7		130.3	15.3	168.6	2.8	46.5	42.1	289.5
	1.1	0.7	0.7	0.9	3.4	2.1	4.0		26.7	5.3	44.9	0.2	11.7	—	98.6
China	7.8	10.6	8.4	4.7	16.7	35.1	17.9	124.5		84.1	309.8	8.9	163.3	143.9	762.3
	0.8	0.5	0.5	0.3	2.0	2.2	0.6	32.1		9.2	16.1	0.1	6.2	—	71.9
Japan	22.6	12.6	9.3	9.2	18.5	46.7	41.3	36.0	80.0		276.2	3.5	136.0	86.8	594.9
	9.4	7.6	5.6	2.6	12.2	20.1	18.3	16.3	8.6		100.7	1.5	92.2	—	314.9
Total East Asia	60.7	76.5	58.4	33.6	96.3	117.1	91.1	247.4	362.1	203.9	1,347.1	32.3	365.8	306.2	2,705.6
	19.3	21.2	11.7	6.6	35.6	31.2	29.3	73.5	39.4	64.5	298.7	3.7	89.0	—	793.9
India	1.0	1.1	1.3	0.5	5.2	1.6	0.8	4.3	6.4	2.4	22.2		16.4	21.8	97.9
	0.2	0.3	0.1	0.1	0.4	0.2	0.2	0.6	0.0	1.7	3.8		2.9	—	20.7
U.S.A.	7.2	10.5	3.0	6.9	20.6	27.7	18.9	16.3	41.8	55.4	208.3	8.0		186.5	904.3
	3.8	3.9	1.9	2.3	8.8	15.5	13.2	8.1	6.3	48.1	111.9	2.0		—	421.7
EU	9.8	11.5	5.9	4.5	21.5	25.4	15.7	25.6	64.3	54.4	238.6	26.2	313.6		4,006.5
	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
All	103.8	109.3	57.6	52.5	173.8	238.2	163.4	310.5	586.5	464.4	2,260.0	99.5	1,617.0	4,008.0	10,343.1
	32.7	32.0	19.7	12.7	61.8	71.0	58.8	98.8	61.9	210.2	659.6	19.1	489.2	—	3,448.1

Notes 1: Shaded areas indicate growth of 5 times or more.

2: Exports from each country to Taiwan in 2005 were calculated by multiplying Taiwan's imports by 0.9.

3: Figures for the EU are 25-nation totals.

Source : 1991: IMF, *Direction of Trade Statistics Yearbook* 1993, 2005: IMF *Direction of Trade Statistics Yearbook* data base, Republic of China, *Monthly Statistics of Trade*

tify imbalances linked to investment-led growth. The following is a detailed analysis of China's new efforts to achieve sustainable growth.

Expanding Imbalances

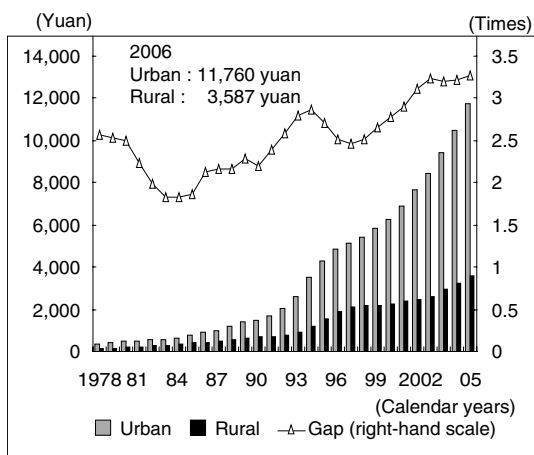
China's continuing rapid growth has spawned a number of imbalances. Three of these could have significant impact on continuing growth in the future.

First, income disparity is expanding. The gap between urban and rural incomes narrowed somewhat in the first half of the 1980s and the second half of the 1990s. Apart from these periods, however, disparity has expanded almost continuously since the implementation of the reform and open-door policy. In 2006, the per capita disposable income of urban residents was 11,760 yuan, which

is 3.28 times higher than the rural figure of 3,587 yuan (Fig. 2). This is the largest differential recorded between 1978 and 2006.

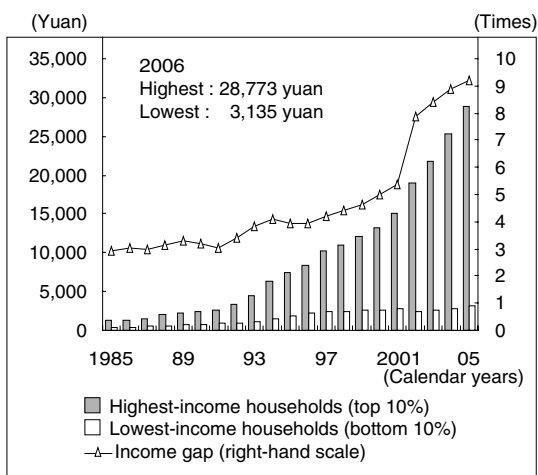
Income disparity is also expanding within the urban sector. In 2005, the per capita income of the top 10% of households was 28,773 yuan, which is 9.2 times higher than the 3,135 yuan figure for households in the bottom 10% (Fig. 3). This is the biggest gap recorded since China began to publish quantile data for household incomes in 1985. Asset disparity is even more conspicuous than income disparity. According to a household survey conducted by the National Bureau of Statistics in 2002, the top 10% of households owned 45% of total household assets (financial assets, real estate, durable consumer goods, business assets), while the 10% with the lowest incomes owned only

Fig. 2 Urban-Rural Income Gap



Source: National Bureau of Statistics of China, *China Statistical Abstract 2007*

Fig. 3 Income Disparity within the Urban Sector

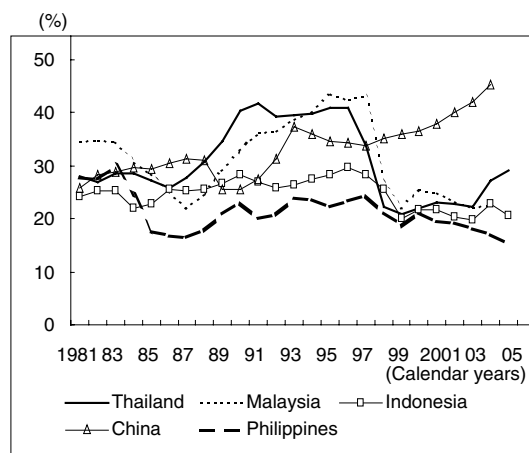


Source: National Bureau of Statistics of China, *China Statistical Yearbook* (various years)

1.4%.

If low-income people have hope and believe that they can escape from poverty by working hard, the expansion of income disparity will not necessarily lead to serious economic and social problems. However, the present situation has resulted from the accumulation of income and assets by a small minority using dishonest means, and the failure of disparity reduction mechanisms to function effectively. Many migrant workers from rural areas and their families are forced to endure harsh working conditions and are unable to access adequate public services. Protest movements have

Fig. 4 Fixed Capital Formation Ratios in Key Asian Economies



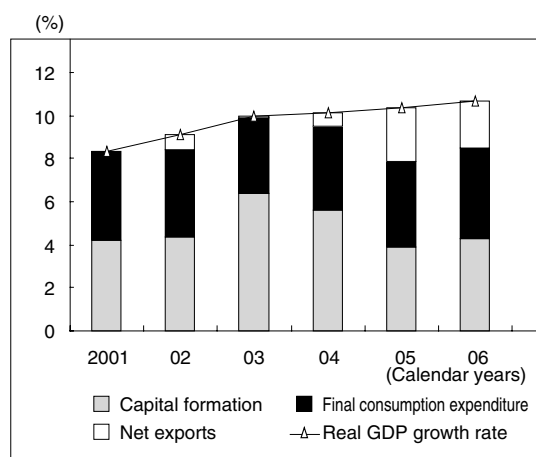
Notes: Fixed capital formation ratio = Fixed capital ÷ GDP
Source: World Bank, *World Development Indicators 2006 Online*

arisen among residents whose land has been appropriated without proper compensation to feed a construction boom driven by the rush to build industrial estates (development zones) and other facilities. Unless expanding income disparity can be alleviated, there is a possibility that China's ability to maintain growth will be compromised by serious social instability.

Second, investment is overheating. There has been evidence of overheating since around 2003, and the resulting distortions, notably power shortages and soaring urban real estate prices, have become increasingly apparent. In contrast with the decline in fixed capital formation in other East Asian countries after the currency crisis, China's fixed capital formation ratio (fixed capital/GDP) has risen further in recent years (Fig. 4).

The Chinese government has introduced a series of measures in an effort to curb investment overheating, including the reduction of construction bond issues, the tightening of lending conditions for real estate investment, the lowering of the deposit reserve ratio, an increase in benchmark standard interest rates for bank deposits and loans, a ban on new investment in overheated industries, and the introduction of personal income tax on real estate reselling. However, none of these measures have been sufficiently effective. This is in part because regional governments are reluctant to

Fig. 5 Contributions of Demand Items



Source: Same as for Table 1

discourage investment because of their desire to maintain high growth⁽⁶⁾. Other factors include excessive liquidity resulting from the efforts of the People’s Bank to limit the scope of increases in the value of the *renminbi* through currency intervention.

Demand item statistics compiled by the National Bureau of Statistics provide further evidence of overheated investment. Capital formation has been the most important driver of higher growth since 2001 (Fig. 5).

While the investment-led growth strategy delivers high growth rates, it also causes inflation and increasingly serious energy and environmental problems. In 2005, the then Commissioner of the National Bureau of Statistics reported, “China accounted for 4.1% of world GDP (4.7% after adjustment), 7.4% of world oil consumption, 30% of world iron ore consumption, 27% of steel consumption... and 40% of cement consumption”⁽⁷⁾. These figures indicate that China also needs to curb investment from an energy and resource perspective.

Third, trade imbalances are expanding. Widening trade deficits with China have brought increasing pressure, especially from the United States, for measures to correct this imbalance (Table 2)⁽⁸⁾. The government is simultaneously implementing reforms targeting state-owned enterprises and the financial system. While the pace of progress has been gradual, China is taking steps to address im-

Table 2 Trade Friction with the United States (Since 2005)

Year	Incident
2005	The Chinese government imposes specific taxes on exports of 148 textile tariff items in place of export quotas, which were abolished at the end of 2004 (January).
	The Office of the United States Trade Representative (USTR) places China on its priority watch list of countries that have violated the intellectual property rights of American companies (April).
	The United States initiates safeguard actions against seven Chinese textile products, including cotton shirts (May).
2006	Negotiations between the United States and China produce a compromise, under which China will impose specific limits on the growth of exports of 21 textile items to the United States until 2008, in exchange for the avoidance of safeguard actions against Chinese textile products. (November)
	The Office of the USTR places China on its priority watch list for the second consecutive year (April).
	While applauding China’s efforts since joining the WTO, the Office of the USTR criticizes its policies on intellectual property rights and protection of domestic industries (December).
2007	Topics discussed at the first U.S. China Strategic Economic Dialogue include currency reforms and problems relating to intellectual property rights (December).
	The Office of the USTR takes action against China in the WTO over its subsidy policy (February) and intellectual property rights (April).
	The U.S. Department of Commerce makes a preliminary determination to impose tariffs to offset subsidies on glossy paper imported from China and two other countries (March).
	The Office of the USTR places China on its priority watch list for the third consecutive year (April).
	The second U.S. China Strategic Economic Dialogue is held (May).
	A Chinese business mission signs agreement covering the purchase of U.S. manufactured goods worth a total of \$32.6 billion and investment in the United States (May).
The U.S. Department of the Treasury criticizes the pace of increase in the value of the renminbi but avoids citing China as a country that manipulates its currency. (June)	

Source: IDE-JETRO, *Ajia Doko Nenpo* [Annual Report on Trends in Asia] (Various Years), media reports and other sources

balances through various measures, including (1) currency reforms, starting with an increase in the yuan-U.S. dollar exchange rate, (2) the expansion of imports, and (3) the expansion of domestic demand, including domestic consumption expenditure.

The renminbi-dollar rate was raised by 2.1% on July 21, 2005. It has since risen gradually, reaching 7.65 renminbi to the dollar at the end of May 2007. On May 21, 2007, the range of movement in the value of the renminbi was expanded from

0.3% to 0.5% (allowing daily movement in the exchange rate to reach 0.5% above or below the standard rate issued each morning). The aim of this change was to curb investment by alleviating excessive liquidity.

Emphasis on Harmony and Promotion of Industrial Advancement

Like the Jiang Zemin administration, the Hu Jintao administration has repeatedly emphasized that prosperity is the most important principle. The government's policy has been to solve China's problems, including poverty, by achieving high growth⁽⁹⁾. At the same time, China's leaders have become alarmed at the danger that imbalances will damage political stability and prevent China from maintaining growth, and they have started to correct these problems. In fact, the government is now shifting away from the policies of the past, which focused exclusively on growth, and making significant moves toward the creation of a "harmonious society."

Under the 11th Five-Year Plan, which was introduced in 2006, China has divided its numerical goals for 22 items in four sectors into binding targets and outlook goals. There are eight binding goals, which must be achieved through government actions, resource allocation or other means. These goals, which place a greater emphasis on the government's responsibility than the outlook goals, focus on the improvement of living standards for ordinary Chinese. They include the reduction of emissions of major pollutants, the reduction of energy consumption per unit of GDP, and the expansion of social security coverage. The economic growth rate is not included.

Moreover, the growth outlook for the period to 2010 has been set at a yearly average of 7.5%, which is low compared with the actual rates achieved during the period of the 10th Five-Year Plan (8.3-10.4%). The plan also calls for changes in China's growth mode, including the correction of excessive reliance on investment, and the promotion of increased consumption.

Another feature of the 11th Five-Year Plan is the fact that it spells out quite specific guidelines in such areas as industrial development strategies

and priority industries. The preamble to Chapter 3 of the plan ("Optimizing and Upgrading Industrial Structure"), calls for efforts to maintain the competitiveness of labor-intensive industries (textile industries), while improving technology standards and adjusting and optimizing the locations of industries (Table 3). The plan goes on to identify a number of priority industries, calling first for the accelerated development of high-tech industries. It states that China's policy will be to focus on the development of information technology industries, including IC manufacturing, and biotechnology. One of the 22 numerical goals in four areas is the expansion of R&D expenditure as a percentage of GDP, which is classed as an outlook goal.

Outlook goals indicated in government policy concerning the service sector include an expanded contribution to employment and GDP. The government has also identified specific priority areas for development, including transportation and logistics.

The reversal of the expansionary trend in urban-rural and inter-regional disparities, the improvement of living standards, and the improvement of the living environment were among the key policies selected under the "harmonious society" concept at the 6th Plenum of the 16th Central Committee of the Chinese Communist Party in

Table 3 Economic and Industrial Development Strategies under the 11th Five-Year Plan

	Main Items
Economic growth and structure	<ul style="list-style-type: none"> • Average growth rate of 7.5% per annum (2006-2010) • Increase in R&D expenditure from 1.3% of GDP to 2.0% • Expansion of service sector's contributions to employment and GDP
Industrial policy	<ul style="list-style-type: none"> • Promotion of high-tech industries, including IT, biotechnology and aerospace • Promotion of plant-related and infrastructure-related process industries, reinforcement of automobile industry's ability to innovate and develop parts autonomously • Resource development, electric power infrastructure development • Promotion of energy and environmental protection industries

Source: *Outline of the Eleventh Five-Year Plan for National Economic & Social Development* (the 11th Five-Year Plan)

October 2006. The Communist Party leadership showed its commitment to the creation of a “harmonious society” by setting a specific deadline, 2020. Though the decision at the 6th Plenum did not refer directly to industrial advancement, there was indirect acknowledgement of need to promote the development of a more advanced industrial structure. For example, the decision highlights development as being essential to the “harmonious society,” and there are also references to the enhancement of educational systems with the aim of improving work skills and entrepreneurial abilities.

A new development slogan, “sound and fast,” was proposed for the first time at the Central Economic Conference in December 2006⁽¹⁰⁾. Previously China’s slogan has been “fast and good,” and the change is indicative of an increased emphasis on the qualitative aspects. The conference also confirmed that the economic management priorities for 2007 would be the expansion of consumption, the reduction of investment growth to a reasonable level, the balancing of international accounts, and the reinforcement of resource and energy conservation measures. These decisions indicate that the Hu Jintao administration is steadily moving away from policies that focus exclusively on growth. This transition is likely to accelerate with the presentation of a theoretical foundation for the “harmonious society” concept at the 17th National Congress of the Communist Party of China in the fall of 2007. There is a strong possibility that this will result in the legitimization of policies designed to achieve harmony through the process of pursuing development, including industrial advancement.

The Chinese government is intensifying its efforts to correct imbalances with the aim of creating a harmonious society and achieving industrial advancement. One of the measures used to curb investment in industries with excessive capacity, such as iron and steel, is the reduction of production facilities. These efforts are being implemented in conjunction with energy conservation and environmental measures. For example, the government is giving priority to the scrapping of obsolete facilities. Measures to stimulate in-

creased consumption include the abolition of the agricultural tax, and the introduction of a higher minimum threshold for income tax. Another focus is the reduction of the trade surplus. Related measures include the imposition of an export duty (including an increase in the tax rate), the reduction of the refund rate for valued added tax paid on exports, and large-scale purchasing of American manufactured goods.

(3) China’s Changing Foreign Investment Policy

Factors Driving the Shift in Foreign Investment Policy

Foreign investment policy has also changed dramatically under the policies contained in the 11th Five-Year Plan. In this section we will analyze the factors driving this transition in foreign investment policy and examine characteristics of the new foreign investment policy from various perspectives, including recent changes in foreign investment planning and laws.

Since the 1980s, the government has actively encouraged foreign direct investment in various ways, including the establishment of development zones and the introduction of preferential tax systems for foreign-invested companies. Regional governments have also provided investment incentives, and there has been intense competition to attract investment. However, recent developments point to changes in this welcoming attitude toward foreign investment. For example, in March 2007, the National People’s Congress (China’s parliament) passed a law reviewing tax concessions limited to foreign-invested companies and requiring the application of a uniform corporate income tax rate. The new law will take effect from January 1, 2008.

Regional governments are now requiring companies whose activities are incompatible with city plans or industrial policies to close or relocate their factories, and in some cases foreign-invested companies have been included in these measures.

One of the reasons for these changes was the pledge that China made when joining the WTO that it would apply the non-discrimination prin-

ciple, which means that all companies must be treated in the same way, whether they are Chinese or foreign. This principle provided legal grounds for the abolition of conditions that had disadvantaged foreign-invested companies in China, such as barriers to market access and tariff barriers. While China has generally fulfilled its pledge, there has been criticism that concessionary measures limited to foreign-invested companies also violate the non-discrimination principle. This is one of the factors that has triggered the shift in the foreign investment policy.

Another factor is the emergence of pressure within China for a review of foreign investment policy. Since around 2004, there has been criticism of the adverse economic effects resulting from the entry of foreign-invested companies into China. This criticism falls into three main areas. First, foreign-invested companies that have enjoyed preferential treatment are putting local companies under pressure and monopolizing markets. Second, the expansion of exports has caused escalating trade friction and had a negative impact on financial policy. Third, there is concern that environmental problems will worsen because an influx of foreign-invested companies, which are major users of land and resources. Articles raising these issues have appeared in a number of publications, including the *China Economic Times* (October 20, 2004) and the journal of the Japan-China Economic Association (October 2006) (Table 4). Some researchers in government agencies have presented similar arguments and called for a rethink of China's foreign investment policy.

Four straight years of growth in excess of 10% and the accumulation of currency reserves of over one trillion dollars have reduced China's need to maintain preferential systems for foreign-invested companies as a way of earning foreign currency, expanding exports and achieving growth.

Basic Foreign Investment Policy Guidelines

The Hu Jintao administration regards the continuation of the open-door stance as a fundamental government policy and has repeatedly emphasized the need to stay on the present course. The inclu-

sion of references to the "qualitative improvement of foreign investment utilization," and the "unification of corporate income taxes" in the 11th Five-Year Plan may reflect the administration's awareness of these calls for a review of the policy. In November 2006, the government formulated its first five-year plan for the utilization of Foreign Investment.

This plan provides a general framework for foreign investment in China in the period to 2010. It contains references to a wide range of areas, including appropriate risk management for external debt, and the promotion of multilateral cooperation on investment and trade. The basic criteria for the acceptance of direct investment are (1) whether the investment will lead to the introduction of advanced technology and management methods, (2) whether the investment will contribute to environmental protection, resource conservation and the solution of energy problems, and (3) whether the investment will help to enhance China's industrial structure and raise its technology standard.

These basic criteria are reflected in specific policy measures in the five-year plan for the utilization of foreign investment. Particular emphasis is placed on the following points from the perspective of companies' ability to influence the development of Chinese companies.

First, some aspects of the plan relating to the improvement of the investment environment merit

Table 4 Main Arguments for a Review of Foreign Investment Policy

①	Technology transfers through foreign investment are reducing the motivation of local communities to innovate, and key technologies are not transferred to China.
②	Local companies face unfair pressure because of the tax concessions enjoyed by foreign-invested companies.
③	Massive exports of cheap goods have caused trade friction to escalate, and the accumulation of foreign currency reserves has made control of the money supply impossible.
④	Foreign-invested companies are monopolizing markets and dominating core industries.
⑤	China is attracting concentrations of industries (companies) that cause pollution and are heavy users of land, resources and labor.

Source: *China Economic Times* (October 20, 2004), *Journal of the Japan-China Economic Association* (October 2006)

closer attention. There is an explicit commitment to fairness and the unification of corporate income tax rates. China deserves praise for its pledge to work toward the easing of regulations, including the reduction of permit and licensing requirements, the simplification of administrative procedures, and the improvement of protection for intellectual property rights. However, in reference to direct investment in China over the past five years, the plan also states that innovation by Chinese companies has been adversely affected by the misuse of protection for intellectual property rights by some foreign-invested companies. This suggests that there is still some doubt about the adequacy of protection for the intellectual property rights of foreign-invested companies in the future.

Second, the plan seeks to encourage investment that will contribute to the development of specific industries and regions and the improvement of technology levels. Specific industries targeted include agriculture, services and motor vehicle manufacturing by joint ventures. China will also encourage entry into sectors that contribute to improvement in residents' living standards, such as waste and sewage treatment. Foreign-invested companies will be encouraged to establish research and development facilities and undertake joint research and development with local companies. The plan also states that investment in industries that have excessive capacity will be discouraged, and that there will be closer monitoring of investment in sectors that are important to national security.

Priority regions identified in the plan include Midwestern and northeastern China, where there has been little investment by foreign-invested companies in the past. The plan states that China will encourage a shift from eastern (coastal) China, which has received concentrated investment, to these regions.

Third, there are measures designed to strengthen management of resource use and environmental protection. The plan states that the government will adopt standards concerning the use of water, energy and land, and that these standards will be applied to the screening of new investment proposals from foreign-invested companies.

There are explicit statements that all companies, including Chinese companies, will be monitored more closely to ascertain whether their production activities are environmentally responsible, and that factories using large amounts of water and energy will be subject to compulsory closure. In recent years, there have been many confrontations between local residents and the government over the expropriation of land for the construction of development zones. This has become a social problem, and the five-year plan for the utilization of Foreign Investment is believed to include measures to curb land use.

In March 2007, the General Office of the Chinese Ministry of Commerce issued a "guidance opinion" on the introduction of foreign commerce and investment. This guidance opinion contains a review of 2006 and basic guidelines for foreign investment policy in 2007. It is briefer than the five-year plan for the utilization of Foreign Investment, and it provides a clearer indication of current priority areas. For example, there are specific measures to encourage foreign-invested companies to shift to central-western regions, including (1) the easing of entry conditions for foreign-invested companies through changes to the list of preferred industries for central-western regions, and (2) initiatives to expand opportunities for business contacts between central China and foreign-invested companies, such as the 2nd Expo Central China.

The government has identified preferred industries as well as preferred regions. Investment in service industries (including outsourcing), high-tech manufacturing, and activities that contribute to energy conservation and environmental protection will be encouraged, and direct investment in low-productivity sectors that use large amounts of energy will be discouraged. Basically, the guidance opinion follows the five-year plan for the utilization of foreign investment. There are differences, however, including explicit restrictions on real estate investment by foreign-invested companies.

The guidance opinion issued by the Ministry of Commerce describes the effects of foreign investment on the economy in specific terms. This description, the main points of which are summa-

rized below, is a significant feature that was not included in the five-year plan for the utilization of foreign investment. The National Development and Reform Commission has overall control of economy policy, and its profile has started to rise again amid moves to tighten macro-level controls and industrial policy. While the Ministry of Commerce is responsible for commercial transactions within China, its work relates primarily to overseas trade and investment. That appears to be why the Ministry's guidance opinion contains a statement emphasizing the contribution of foreign-invested companies to the Chinese economy. When considering the impact that a review of foreign investment policy might have on foreign-invested companies, we also need to take into account the balance of power among government agencies.

New Foreign Investment Policy Reflected in Corporate Income Tax Law

As noted earlier, corporate income tax rates for domestic and foreign-invested companies will be integrated under the new Corporate Income Tax Law, which will take effect from January 1, 2008. Other provisions in this law also reflect the future direction of China's foreign investment policy. The following points are especially significant⁽¹¹⁾.

First, existing tax concessions for foreign-invested companies will be reduced. Under article 57 of the new law, the low income tax rates currently applied to foreign-invested companies (15% or 24%) will be phased up to the rate stipulated in the law (25%) over a five-year period starting from the date of enforcement⁽¹²⁾. At present foreign-invested companies enjoy an exemption from income tax for two years after the first year in which a profit is achieved, and their tax rate is halved for another three years after that. Article 57 of the law states that this and other tax concessions linked to specific periods will be terminated at the end of 2012. Foreign-invested companies that are not yet operating profitably will also be affected. Regardless of when they become profitable, 2008 will be treated as the first year under the concessional taxation system, and no concessions will be available after 2013. These changes suggest that the policy of the central government

is to apply the same tax system to Chinese and foreign-invested companies, regardless of when they were established.

Second, there will be incentives for companies that contribute to the achievement of policy goals, such as industrial advancement. Article 28 of the law states that a 15% income tax rate will be applied to high-tech and new-tech companies for which the government is providing prioritized support. The Corporate Income Tax Law provides specific incentives designed to advance industrial policy, including increased deductions for R&D expenditure relating to the development of new technologies, products or manufacturing methods (Article 30), tax deductions for the purchase of facilities for use in environmental protection, energy conservation, water conservation and production safety (Article 34).

The government is also able to provide tax concessions where this is necessary for the national economy or social development (Article 36)⁽¹³⁾. When the provisions of Article 25 concerning tax concessions for priority industries are taken into account, it seems likely that there will be cases in which income tax rates change dramatically and rapidly in step with changes in government policy.

Third, the government is reviewing tax concessions for foreign-invested companies in specified regions. At the end of Article 57, there is a sentence stating that companies eligible for other incentives as determined by the government will be granted tax exemptions or concessions as stipulated by the State Council.

During deliberations on the draft of the Corporate Income Tax Law, the Minister of Finance explained that this measure would target companies in regions covered by the Great Western Development program, and in industries that the government aimed to stimulate⁽¹⁴⁾. This indicates that foreign-invested companies that have moved into regions covered by the Great Western Development program will probably continue to receive income tax concessions even after the new law is in force. In addition, transitional tax concessions have been approved for newly established high-tech and new-tech companies in special economic zones and the Shanghai Pudong New Area⁽¹⁵⁾. We

can conclude from these provisions that the government will retain concessions that contribute to the reduction of inter-regional disparity, but will, in principle, abolish other concessions.

As described above, the government intends to use its foreign investment policy to guide foreign investment in directions that contribute to the reduction of disparity, industrial advancement, environmental conservation and environmental protection. China is moving away from its past policy of welcoming any foreign investment, and in this context Japanese companies in China will face new changes, including the reduction of tax incentives, and pressure to relocate their factories. They will need to adapt quickly to these environmental changes, and to explain or show that their activities are in line with China's new foreign investment policy.

2. Foreign Investment and Industrial Advancement

China's rapid economic development has been driven by foreign direct investment and the resulting expansion of exports. In this section, we will examine the intentions behind the Hu Jintao administration's decision to modify foreign in-

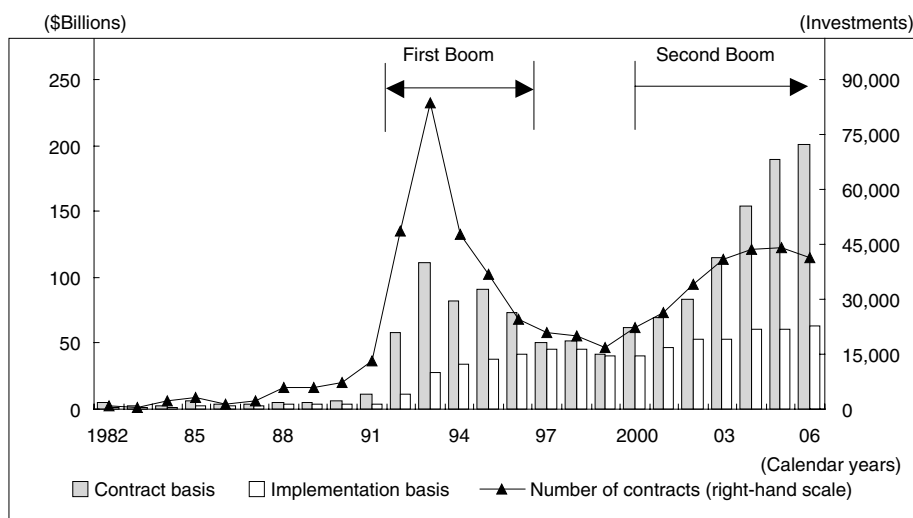
vestment policy, by identifying the ways in which direct investment has contributed to the advancement of China's industrial structure and the issues that have arisen.

(1) Trends and Qualitative Changes in Direct Investment in China

We will begin by examining the level of direct investment in China and qualitative changes in that investment between 1979 and 2006. After the decision to adopt the reform and open-door policy at the end of 1978, there was a gradual increase in the emphasis on economic construction based on the use of foreign capital and technology. During this process, some expressed concern that foreign investment might have a negative impact on the political system. However, the Chinese government established incentives at the both the central and regional levels and maintained a basic policy of encouraging foreign investment, resulting in sustained high growth. This and other factors have driven a continuing upward trend in foreign investment inflows.

There have been periods that can be described as "booms" in direct investment in China (Fig. 6)⁽¹⁶⁾. The first boom occurred between 1992 and 1996. Comments made by Deng Xiaop-

Fig. 6 Foreign Direct Investment in China (1979-2006)



Notes 1: The 1982 figures are cumulative totals since 1979.

2: The contract basis figures for 2006 only include investments in financial institutions.

Source : National Bureau of Statistics of China, *China Statistical Abstract 2007*, etc.

ing during his Southern Tour in 1992 caused the open-door process to accelerate. This motivated foreign-invested companies to expand their activities in China, with the result that foreign direct investment increased from \$4.37 billion in 1991 to \$27.52 billion in 1993. However, the contract-based figure, which is a leading indicator of foreign investment, shifted negative year-on-year movement from around 1996, and the year-on-year growth rate of the implementation-based figure also began to slow, falling to 8.5% in 1997 and 0.5% in 1998. A temporary upsurge of pressure to review China's foreign investment policy also caused implementation-based investment figures to stagnate.

The second boom, which began in 2000, has resulted from a combination of factors. First, the growing likelihood that China would join the WTO raised expectations of improvements in the investment environment, including the relaxation of regulations. Second, China began to be seen as a massive market. Third, business interest in investment in China began to recover from the downturn that followed the Asian currency crisis. These factors prevented a second consecutive year of decline in 2000, and continuing growth in subsequent years brought the total for 2004 to \$60.63 billion. New records in excess of \$60 billion were set in both 2005 and 2006.

Opinions are divided on whether or not this second boom is still continuing. However, there are indications that a plateau has been reached, including the deceleration of overall growth, and the fact that real estate investment from Hong Kong is offsetting declines in investment from other countries. There are three main reasons for this slowdown. First, labor costs, including minimum wages, are rising. Second, the problem of power shortages at peak demand times in some regions remains unresolved. Third, other investment targets, such as Vietnam and India, have emerged⁽¹⁷⁾.

A breakdown of investment in 2005 by industry shows that the manufacturing sector's share is by far the biggest at 58.6%. However, that share is 4.9 percentage points lower than the 2000 level of 63.5%. (Figures for investment in banking, etc., which were published only for 2005, have been

included.). After China pledged to join the WTO and began to liberalize its service sector, foreign-invested companies began to invest on a significant scale in related areas, such as commerce and specialist services. This caused a percentage decline in investment in the manufacturing sector. Statistics for individual provinces show a marked shift of foreign direct investment from secondary to tertiary industries during the second boom. In Shanghai, for example, investment in tertiary industries exceeded investment in secondary industries in both 2005 and 2006. In 2006, investment in tertiary industries increased, in contrast with a sharp decline in investment in secondary industries. This appears to reflect the policies of Shanghai's city government, which has actively sought investment in service industries while encouraging manufacturers to move out of the city through measures that have included the rationing of industrial land. Comparisons between 2000 and 2005 show that percentage of investment in tertiary industries has even risen in regions where there has been substantial investment by foreign manufacturers, such as Guangdong Province (contract basis) and Jiangsu.

According to *Statistics on FDI in China 2006* (published by the Ministry of Commerce), direct investment in the 11 provinces and directly governed cities of eastern (coastal) China accounted for 74.0% of total investment in 2005 (88.8% if investments for which there are no regional breakdowns are excluded). The tendency for investment to be concentrated in the east, which offers advantages in terms of income and education levels and infrastructure, remains unchanged. However, JETRO's analysis of trends in direct investment in China in 2006 also identifies new developments⁽¹⁸⁾. Though investment in Jiangsu, which was ranked first in 2006, continued to increase on an implementation basis, there was a 16.5% decline in the contract-based total. This contrasts with a dramatic increase in investment in provinces that have hitherto attracted little interest, such as Anhui and Henan.

(2) The Contribution of Foreign-Invested Companies to Industrial Advancement

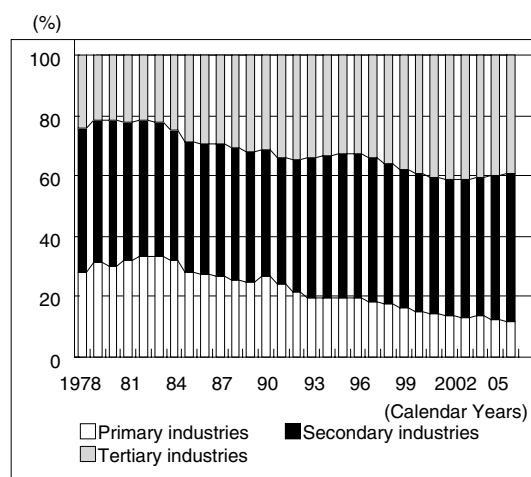
Direct Investment and Industrial Advancement in China

How has China's industrial structure changed as a result of foreign direct investment? In this section we will examine the role played by foreign-invested companies in industrial advancement from the four perspectives of production, trade, employment and fixed asset investment.

An analysis of China's industrial structure before the adoption of the reform and open-door policy shows that secondary industries accounted for 47.9% of GDP, primary industries for 28.2%, and tertiary industries for 23.9% (Fig. 7). This mix reflects the priority given to the development of heavy industries under the socialist approach to development.

Agricultural reforms, including the introduction of the contract responsibility system and the dissolution of the people's communes, subsequently brought an increase in the contribution from the primary sector, reflecting dramatically higher agricultural production. However, the contribution from primary industries has been falling since the second half of the 1980s and stood at 11.8% in 2006. The contribution from the secondary sector fell slightly in the 1980s but subsequently rose gradually in step with China's industrialization. In 2006 it reached an all-time high of 48.7%. The tertiary sector's contribution reached a peak of 41.5% in 2002 and has since remained basically static (39.5% in 2006).

Fig. 7 Sector Contributions to GDP



Source: Same as for Fig. 1

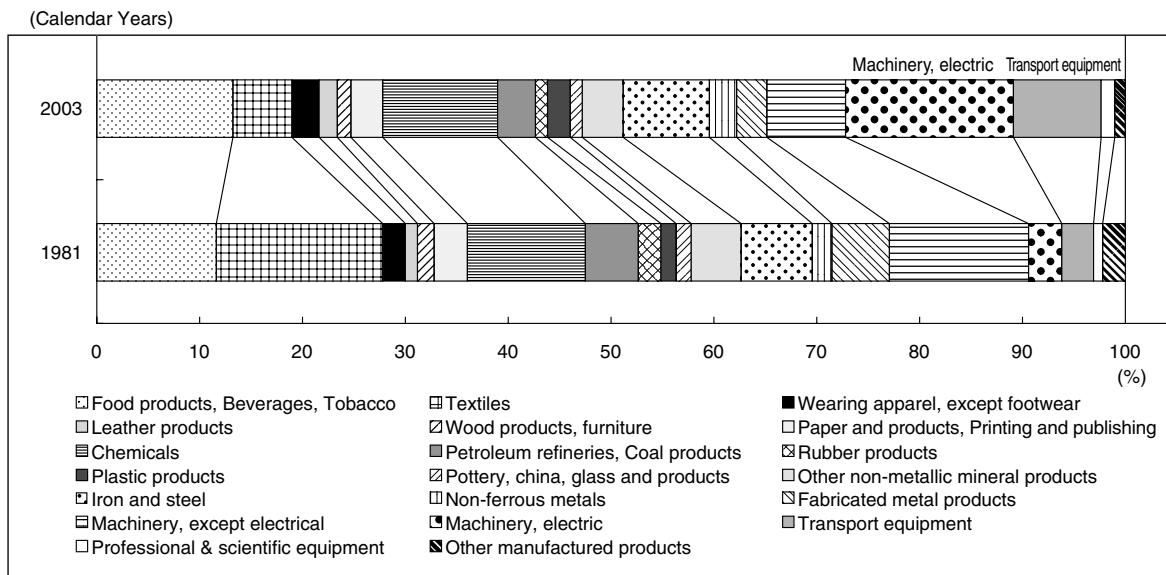
While China's overall industrial structure has become more advanced, the development of service industries, such as commerce, transportation and telecommunications, has been slow. This becomes more apparent when China is compared with other Asia economies (Table 5). One reason for this is the fact that service industries continued to be undervalued even after the shift to the reform and open-door policy because of the priority given to manufacturing under China's development strategy. In addition, the emergence of independent service industries was hindered by the integration of service functions within China's state-owned enterprises. As noted earlier, the government has started to focus on the development of services industries, and it is possible that the shift to a service-based economy will accelerate in

Table 5 GDP Contributions by Sector in Key Economies

Country/Region	Primary Industries			Secondary Industries			Tertiary Industries		
	1980	1990	2005	1980	1990	2005	1980	1990	2005
South Korea	14.9	8.5	3.0	41.3	43.1	35.9	43.7	48.4	61.1
Taiwan	7.7	4.2	1.8	45.7	41.2	24.6	46.6	54.6	73.6
Hong Kong	0.8	0.3	0.1	31.7	25.3	9.6	67.5	74.5	87.4
Singapore	1.3	0.4	0.1	38.1	34.4	32.5	60.6	65.3	67.4
Thailand	23.2	12.5	9.9	28.7	37.2	44.1	48.1	50.3	46.0
Malaysia	—	15.2	8.4	—	42.2	49.8	—	42.6	41.8
Philippines	25.1	21.9	14.4	38.8	34.5	32.6	36.1	43.6	53.0
Indonesia	24.8	19.4	13.4	43.4	39.1	45.8	31.8	41.5	40.8
China	30.1	27.0	12.5	48.5	41.6	47.3	21.4	31.3	40.3
India	38.1	31.0	19.0	25.9	29.3	27.4	36.0	39.7	53.6

Source: Asian Development Bank, *Key Indicators 2006*

Fig. 8 Composition of China's Manufacturing Sector (Added Value) in 1981 and 2003



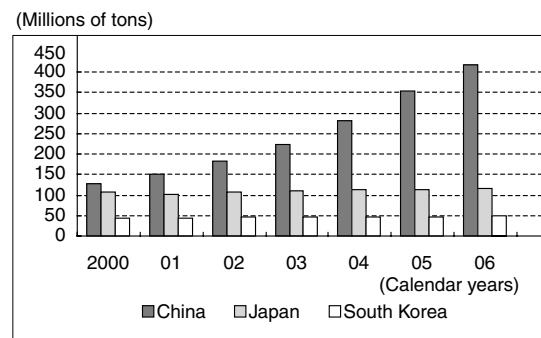
Source: UNIDO, *Industrial Statistics Data Base*

the years ahead.

Changes in the composition of China's manufacturing sector can be traced through changes in production and exports. Fig. 8 compares the value added by manufacturing industries in 1981 and 2003, using data compiled by the United Nations Industrial Development Organization (UNIDO).

The contribution from textiles has declined from 16.1% in 1981 to 5.6% in 2003, while the contribution from electrical machinery has risen from 3.3% to 16.2%, and that from transport equipment from 3.1% to 8.5%. These changes are evidence of the advancement of China's manufacturing sector. As a result of this rapid development, China is now the world's third biggest producer of motor vehicles and the biggest producer of crude steel (Fig. 9). The rapid expansion of crude steel production has been driven not only by steep growth in fixed asset investment, but also the rapid growth of electrical appliance and motor vehicle production. There have also been problems, including excessive investment in general manufacturing industries, shortages of high-grade steel, and the disorderly proliferation of SMEs. Measures contained in the steel industry development policy announced in July 2005 include (1)

Fig. 9 Production of Crude Steel in Key Asian Economies

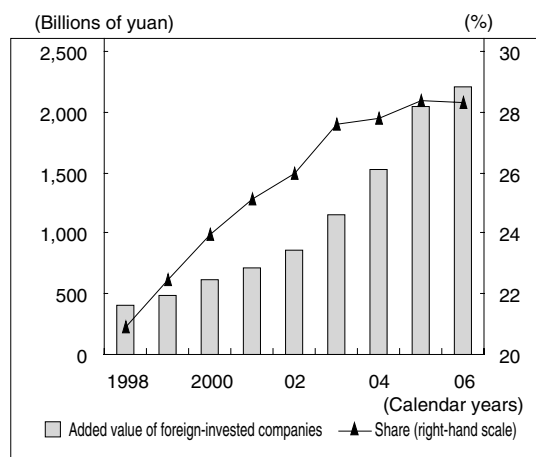


Source: International Iron and Steel Institute

the consolidation of domestic manufacturers into two or three companies with annual production capacity of 30 million tons and several companies with capacity for 10 million tons by 2010, (2) the closure of inefficient small-scale blast furnaces, and (3) restrictions on foreign investment in the construction of new factories. Overall, these measures constitute a shift to qualitative development.

The extent to which foreign-invested companies contributed to the dramatic development of China's manufacturing sector can be assessed from the added value of industrial production (*Gongye*

Fig. 10 The Contribution of Foreign-Invested Companies to the Added Value of Industrial Production



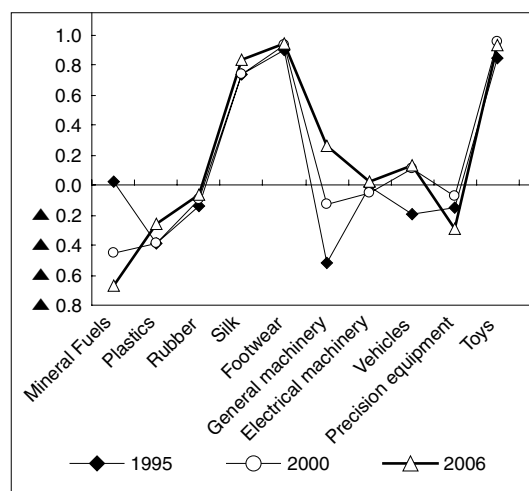
Notes: The 2006 figures are for January-November.
Source: National Bureau of Statistics of China, *China Statistical Yearbook 2006*

Zengjiazhi in Chinese) (Fig. 10). In 2005, the added value of industrial production by foreign-invested companies amounted to just over 2,040 billion yuan, or 28.4% of the total. This is an increase of 7.5 percentage points over the 1998 level. The figures for 2006 only cover the January-November period, but even on that basis the added value of industrial production by foreign-invested companies is already higher than the figure for the whole of the previous year. At 28.3%, the share of total added value is similar to the 2005 level. These figures indicate that foreign-invested companies are making a major contribution to the expansion of industrial products.

The Contribution of Foreign-Invested Companies to the Advancement of China's Trade Structure

Trade statistics point to the same conclusions as the production statistics. If we calculate trade specialization indices for key products in 1995, 2000 and 2006 (based on two-digit HS codes), we find that the number of export specialization items has risen year after year. The main export specialization items in 2006 were animal and vegetable products (excluding vegetable oils and fats and dairy products, etc.), spinning and weaving raw materi-

Fig. 11 Trade Specialization Coefficients for Key Items



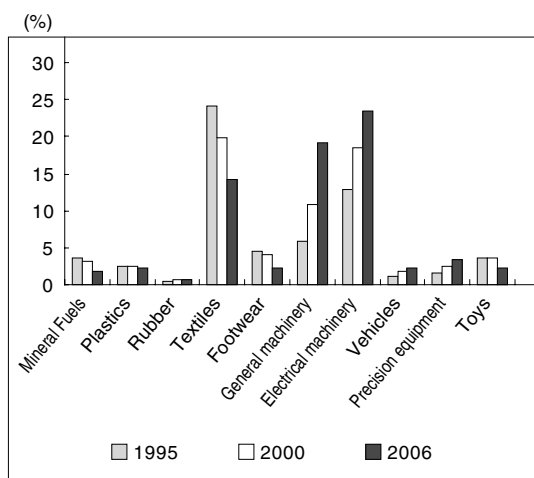
Notes: Based on two-digit Harmonized Commodity Description and Coding System (HS)
Source: World Trade Atlas

als and products, general machinery and electrical machinery. Particularly significant is the transition away from import specialization in electrical machinery (HS85) (Fig. 11). In the area of mineral fuels, China has shifted from export specialization in 1995 to import specialization today, and the value is approaching minus 1, which indicates zero exports and 100% imports. China's continuing high growth has caused a dramatic increase in domestic demand for oil and coal, leading to higher imports.

If we analyze the composition of exports (Fig. 12), we find first that textiles (HS codes: 50-63) and electrical machinery (85) have swapped places, second that there have been declines in the contributions from toys (95) and footwear (64), and third that the contributions from vehicles (87) and precision equipment (90) have risen. These changes match changes in production.

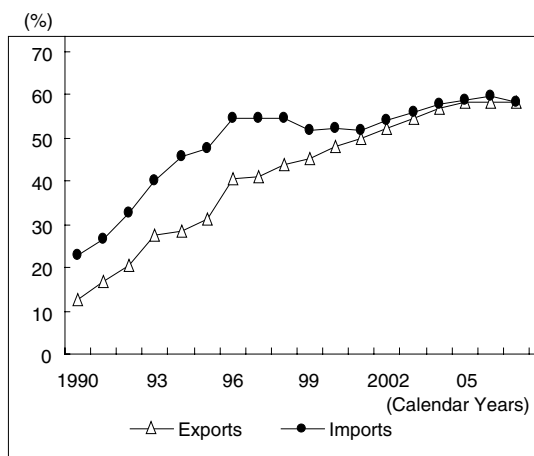
The contribution of foreign-invested companies to trade is greater than the contribution to production. Since the 1990s, foreign-invested companies have accounted for a continually increasing percentage of imports and exports. In 2006 they contributed 58.2% of exports and 59.7% of imports (Fig. 13). Foreign-invested companies today have

Fig. 12 Contributions of Key Items to Total Exports



Notes: The figures for textiles are totals for HS50-63.
Source: Same as for Fig. 11.

Fig. 13 Contribution of Foreign-Invested Companies to Trade



Notes: The figures for 2007 refer to January-April.
Source: Ministry of Commerce, *Statistics on FDI in China 2006*, General Administration of Customs, *China's Customs Statistics*

a major influence on trends in China's trade.

In response to trade friction in recent years, China has stated that it is not the only one to benefit from a trade surplus. There is some justification for this claim, given that foreign-invested companies account for almost 60% of China's exports.

There will be further growth in the shares of foreign-invested companies of exports of mechanical and electrical products and high-tech products, which are priority areas for the Chinese

government. According to data published by the Ministry of Commerce, foreign-invested companies accounted for 87.99% of exports of high-tech and new-tech products and 74.05% of exports of mechanical and electrical products in January-November 2006.

The influence of foreign-invested companies is also apparent from the list of the top 200 companies in terms of exports⁽¹⁹⁾. If we analyze the list by country/region using the results of a survey by the 21st Century China Research Institute (Key Number 29 on the Institute's website), we find that while local Chinese companies make up the biggest group (97), they account for less than one-half of the total. The next highest totals are for Taiwan, the United States, Japan and South Korea (Table 6). Of particular interest is the fact that four of the top 10 places are occupied by Taiwanese companies (all IT-related companies), including first-ranked Hongfujin Precision Industry (Shenzhen) Co., Ltd. (Table 7). Many of the American, Japanese and South Korean companies listed are also manufacturers of IT and electronic products, including mobile telephones.

The Hu Jintao administration appears to have adopted a range of policy goals in response to this situation, including the improvement of China's only development capabilities for core technologies relating to IT and electronics, and the devel-

Table 6 Analysis of China's Top 200 Exporters by Nation/Region (2005)

Country/Region	Number of Companies
Taiwan	32
Japan	19
South Korea	18
U.S.A.	17
Hong Kong	5
Singapore	4
France	2
Netherlands	2
Germany	1
Canada	1
Switzerland	1
Finland	1
China	97

Notes: A joint venture established by the South Korean company LG and Philips is included in the total for South Korea.

Source: Websites of the Ministry of Commerce and the 21st Century China Research Institute

Table 7 Taiwanese Companies among China's Top Exporters

Rank	Company	Activities	Name of Taiwanese Parent Company	Exports (\$millions)
1	Foxconn Hongfujin Precision Industry (Shenzhen) Co., Ltd.	Computer peripherals	Hon Hai Precision Industry Co., Ltd.	14,474.17
2	Shanghai Dafeng Computer Co Ltd.	Computers	Quanta Computer Inc.	11,454.68
4	Mingyan Diannao (Suzhou)	Computer parts	Asustek Computer Inc.	6,211.27
6	Yingshunda Keji	Computers and peripherals	Inventec Corporation	4,199.28
11	Compal Electronics Kunshan Co., Ltd.	Notebook computers	Compal Electronics Inc.	2,797.45

Notes: The ranks indicate the positions of the companies among China's top 200 exporters in 2005.
Source: Websites of the Ministry of Commerce and the 21st Century China Research Institute

opment of multinational companies with their own intellectual property rights and brands.

Slow Pace of Change in Work Force Distribution

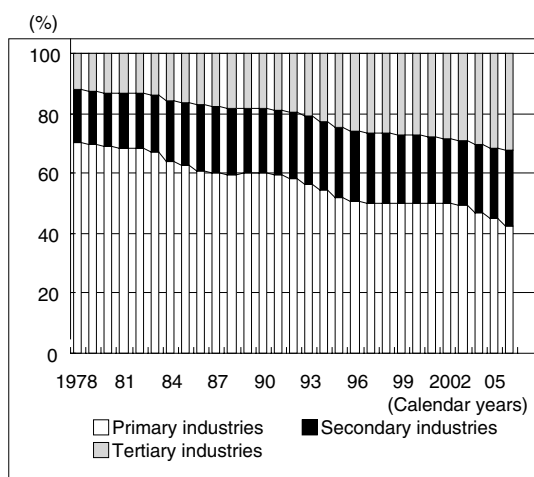
In contrast with production- and trade-related aspects, the pace of change in the distribution of China's work force among industrial sectors has been more gradual. In 1978 around 70% of the total work force, or 280 million people, were employed in primary industries. Secondary industries accounted for just under 20% of jobs, and tertiary industries for slightly more than 10% (Fig. 14). The number of workers in primary industries continued to rise until 1991, and the pace of decline in the primary sector's share of the total work force remained gradual. In 1991, primary indus-

tries employed 390 million people, or 59.7% of the total work force.

In the 1990s, workers began to leave the primary sector in significant numbers. However, in 2006 the primary sector's share of the work force (42.6%) remained higher than the percentages employed in the secondary sector (25.2%) and tertiary sector (32.2%). Moreover, the number of workers in secondary industries has continued to rise, together with the secondary sector's share of total employment, indicating that there has been no significant shift of workers in tertiary industries. Although there are labor shortages in some regions, Chinese society as a whole faces serious employment problems. The development of service industries, which have a high capacity to absorb labor, must be seen as an urgent priority. If regions with many farming communities can increase urbanization and accelerate the growth of various service industries⁽²⁰⁾, a number of factors can be expected to contribute to growth in the incomes of rural residents, including (1) labor migration (increased non-farming income from migrant work), (2) the expansion of arable land per household as the number of household declines, and (3) the cultivation of crops for urban markets.

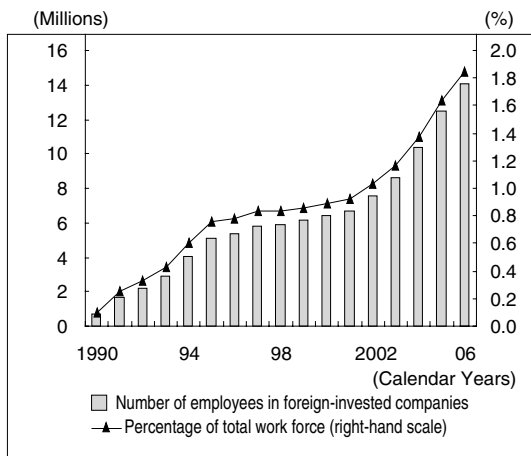
To what extent are foreign-invested companies contributing to employment? The number of people employed in foreign-invested companies has basically followed an upward trend, both in absolute terms and as a percentage of the total work, since the 1990s (Fig. 15). Despite this, the total in 2006 was 14.07 million, or just 1.8% of the total work force⁽²¹⁾, indicating that the direct contribution of foreign-invested companies to job creation

Fig. 14 Sector Distribution of China's Working Population



Source: Same as for Fig. 1

Fig. 15 Employment by Foreign-Invested Companies



Source: Same as for Fig. 1

has been limited, compared with private enterprises and other types of companies. However, it is important to recognize the indirect contribution made by foreign-invested companies, including the job creation effects of accelerated growth resulting from industrial development triggered by foreign investment, as well as human resource development and the spread of advanced management methods and technology.

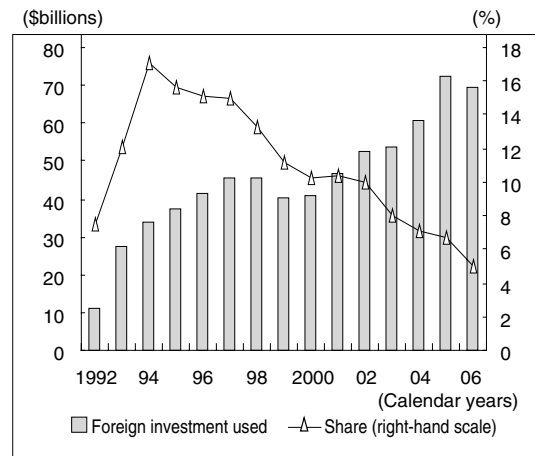
Declining Role in Fixed Asset Investment

As observed several times in this article (See Section 1.), overheated investment has become a problem for China. Total investment in social fixed assets has increased 3.3 times over the past six years, from 3.3 trillion yuan in 2000 to 11.0 trillion yuan in 2006.

The percentage of fixed asset investment by foreign-invested companies cannot be ascertained directly. However, if the amount of foreign investment on an implementation basis is deemed to equal fixed asset investment by foreign-invested companies, the share rose 7.5% to 17.1% between 1992 and 1994⁽²²⁾ but began to decline thereafter and stood at 5.0% in 2006 (Fig. 16). This appears to have resulted from the expansion of investment by regional governments and local companies.

Investment by foreign-invested companies continues to decline in percentage terms. Moreover, the government aims to curb investment overheat-

Fig. 16 Foreign Investment as a Percentage of Total Investment



Notes 1: Share = foreign investment implemented/(total social fixed asset investment/average exchange rate against U.S. dollar)

2: The figures for 2005 and 2006 include foreign investment in the financial sector.

3: The criteria for total social fixed asset investment differ between the period up to 1995 and the period since 1996.

Source: National Bureau of Statistics of China, *China Statistical Abstract 2007*, Ministry of Commerce, *Statistics on FDI in China 2006*

ing through measures that include a tightening of restrictions on foreign investment in real estate development. (An example of this approach can be found in a notice issued jointly by the Ministry of Commerce and the State Administration of Foreign Exchange in June 2007).

From the preceding analysis we can conclude that while China has achieved dramatic industrial advancement by means of foreign direct investment, foreign investment has been less effective as a driving force for service industry development and job creation. This situation is reflected in a shift in government expectations toward the role of foreign investment. The emphasis now is on the development of service industries, industrial advancement, and the introduction of advance technology, facilities and management methods that will contribute to the solution of environmental and energy problems.

3. Trends in South Korea and Taiwan

In this section we will examine developments in

South Korea and Taiwan in reaction to changes in the environment in China.

(1) South Korea's Changing External Economic Relationships

Reliance on Exporting to China about to Peak Out

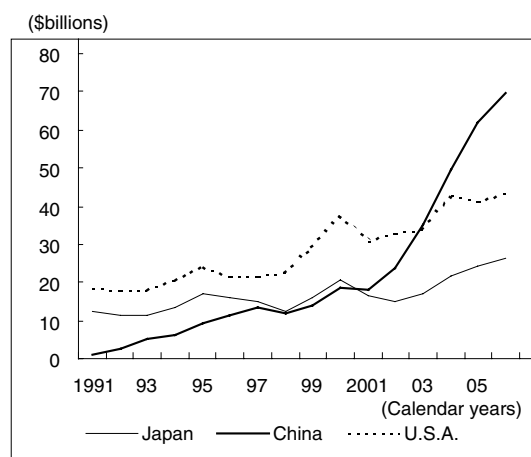
South Korea's trade structure began to change in the 1990s. Its reliance on trade with the United States and Japan declined, and there was a conspicuous rise in its reliance on trade with China. The reduced reliance on exports to the United States was linked to the rising value of the won and trade friction. South Korean companies responded to these changes by shifting to local production in North America⁽²³⁾, and by relocating their production operations to other parts of Asia to reduce costs.

Trade with China began to develop on a significant scale after the normalization of diplomatic relations in 1992. The pace of expansion has been rapid, reflecting the export-inducing effect of increased South Korean direct investment in China. The expansion of exports to China has been especially rapid since 2000, reflecting the additional impetus provided by China's admission to WTO membership (December 2001) and the growth of domestic markets. In 2001, China overtook Japan to become South Korea's second biggest export market, and in 2003 it moved into first place ahead of the United States (Fig. 17, Table 8). As the China boom continued, the training of staff for the China business became an urgent priority for South Korea's industrial conglomerates.

After the currency crisis, the growth rate of domestic fixed capital formation remained low (Fig. 18), prompting increasing concern that investment in China would cause the "hollowing out" of domestic manufacturing industries. Moreover, China's exports were becoming increasingly advanced and starting to compete with South Korean products in world markets. This raised another question: In which areas could South Korea secure competitive advantage in the future?

China has also become a major presence in South Korea's import trade. South Korea is unable

Fig. 17 Trends in South Korea's Exports



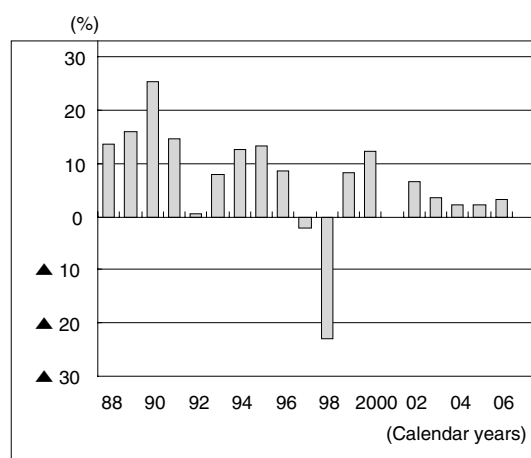
Source: Korea International Trade Association

Table 8 South Korea's Trade Reliance

	U.S.A.		Japan		China	
	Exports	Imports	Exports	Imports	Exports	Imports
1991	25.8	23.2	17.2	25.9	1.4	4.2
1996	16.7	22.2	12.2	20.9	8.8	5.7
2000	21.8	18.2	11.9	19.8	10.7	8.0
2001	20.7	15.9	11.0	18.9	12.1	9.4
2002	20.2	15.1	9.3	19.6	14.6	11.4
2003	17.7	13.9	8.9	20.3	18.1	12.3
2004	16.9	12.8	8.5	20.6	19.6	13.2
2005	14.5	11.7	8.4	18.5	21.8	14.8
2006	13.3	10.9	8.2	16.8	21.3	15.7

Source: Same as for Fig. 17

Fig. 18 Growth Rate of Real Fixed Capital Formation



Source: Bank of Korea

to produce all of the parts needed for its increasingly advanced export products domestically and is heavily reliant on Japan for key parts, precision equipment and high-quality materials⁽²⁴⁾. For this reason, Japan was until recently South Korea's biggest source of imports. However, in 2006 the import reliance ratio for China came close to the ratio for Japan at 15.7%, and in 2007 China is expected to become South Korea's biggest import partner.

The expansion of South Korea's trade with China has also brought major changes in the mixture of trade products. Initially the relationship was based predominantly on a vertical division of labor, with South Korea exporting capital goods and intermediate goods to China and importing raw materials and agricultural products. As production of electrical and electronic machinery and IT peripherals moved to China, South Korea began to export more electronic parts and import more machinery. In recent years, there has been conspicuous growth in imports of electrical and electronic machinery and IT products from China, leading to a rise in South Korea's import reliance on China.

Though China has become a major trading partner for South Korea, South Korea's export reliance on China fell year-on-year for the first time in 2006 (Table 8), indicating that the weighting of trade toward China may be about to change. Reasons for this include the fact that South Korean companies are reaching a plateau in the development of their business with China and are actively developing new markets in emerging economies. This focus on new markets reflects (1) the adoption of new strategies by South Korean companies in response to changes in the environment in China, and (2) the South Korean government's efforts to establish free trade agreements (FTAs) as a way of maintaining growth in an economy that is being transformed by a falling birthrate and an expanding aged population⁽²⁵⁾.

In 2006, South Korea's total exports grew by 14.4% year-on-year. However, there were conspicuous increases in exports to Russia (34.0%), Brazil (27.1%) and India (20.3%), though export reliance on these countries remained low at 1.7% for India, 1.6% for Russia and 0.9% for Brazil.

There was also significant growth in exports to EU members, including Poland and Spain⁽²⁶⁾. In 2006, South Korea's export reliance on the EU reached 15.1%, making it the second biggest export market after China. In April 2007, South Korea and the EU agreed to start negotiations over the establishment of a free trade agreement, and trade is expected to expand further in the future.

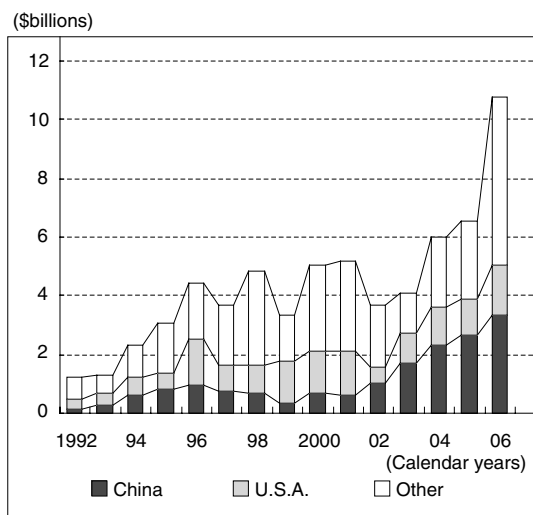
Overseas Direct Investment in 2006 — Expanding Range of Investment Targets

As described above, changes in South Korea's trade structure are linked to its overseas direct investment. The following analysis examines recent changes in South Korea's direct overseas investment.

Until the early 1990s, the United States was the biggest target for South Korean overseas direct investment. This reflects a shift to local production in the United States in response to trade friction. Subsequently there was an increase in investment in ASEAN, especially in the area of textiles, footwear and electronic parts. The push factors for this growth were major wage increases and a rise in the value of the won in the late 1980s. In the first half of the 1990s, investment in China also began to expand. This was prompted by China's geographical proximity and vast labor resources, as well as by the acceleration of the reform and open-door process.

In the first half of the 1990s, most direct investment in China was by SMEs seeking an export base for labor-intensive light industrial products, such as apparel, toys, footwear and sundries. A high percentage of these investments were in Tianjin City, Shandong Province and Liaoning. Factors influencing the selection of locations included the development of industrial parks by the South Korean government and regional governments in China, and the availability of ethnic Korean workers. Direct investment in China declined after the currency crisis, but it began to expand again in 2002, and the pace of expansion has since accelerated (Fig. 19, Table 9). According to Chinese statistics, direct investment from South Korea amounted to \$6.25 billion in 2004. This is higher than the Japanese total of \$5.45 billion and places

Fig. 19 South Korea Foreign Direct Investment (Implementation Basis)



Source: Export-Import Bank of Korea

South Korea third behind Hong Kong and the Virgin Islands. The scale of South Korean direct investment is significant, given the fact that South Korea's GDP is only one-tenth that of Japan.

We can identify several patterns in direct investment in China since the mid-1990s. First, there was an increase in investment by conglomerates. Second, this led to an influx of parts manufacturers affiliated to the conglomerates. Third, there was an increase in investment targeted toward sales in local markets. Fourth, products manufactured locally became increasingly sophisticated. These changes were driven in part by rising income and technology levels in China, and by progress toward the easing of restrictions.

The Chinese operations of Samsung Electronics began with the production of audio equipment for export, but there was a gradual shift toward production for local markets. It has developed its local market business in areas that are one rank above the areas in which local companies are involved, such as mobile telephones, telecommunications equipment, personal computers, wall-mounted televisions and digital appliances. Samsung has used products based on code division multiple access (CDMA) technology to boost its sales of mobile telephones. As with semiconductors, Samsung has shifted downstream (assembly) processing of liquid crystal displays (LCDs) to China. Products based on standard technologies are manufactured in China, while facilities in South Korea specialize in the development of next-generation products and mass-production.

In 2000 Hyundai Motor established a joint venture to produce compact vehicles. In 2002, a joint venture with the Beijing Automotive Industry Group began to produce passenger cars. Initially the venture had production capacity for 100,000 vehicles a year, but this is now being expanded to 300,000. In 2006, Hyundai Beijing had a market share of 5.4%.

According to South Korea statistics (Fig. 19), direct investment in China continue to expand in 2006. However, the diversification of South Korea's overseas direct investment is reflected in a decline in China's share of total investment, from a peak of 41.1% in 2003 to 30.9% in 2006.

One of the most significant trends is the growth of investment in less developed ASEAN members,

Table 9 Direct Investment in China (Implementation Basis)

	(\$billions)									
	1991	1993	1995	1997	1999	2001	2002	2003	2004	2005
Japan	0.53	1.32	3.11	4.33	2.97	4.35	4.19	5.05	5.45	6.53
Hong Kong	2.41	17.27	20.06	20.63	16.36	16.72	17.86	17.70	19.00	17.98
Taiwan	0.47	3.13	3.16	3.29	2.60	2.98	3.97	3.38	3.12	2.15
South Korea	0.04	0.37	1.04	2.14	1.27	2.15	2.72	4.49	6.25	5.17
Singapore	0.06	0.49	1.85	2.61	2.64	2.14	2.84	2.05	2.01	2.20
Germany	0.16	0.06	0.39	0.99	1.37	1.21	0.93	0.86	1.06	1.53
U.S.A.	0.32	2.06	3.08	3.24	4.22	4.43	5.42	4.20	3.94	3.06
Virgin Islands	—	0.01	0.30	1.72	2.67	5.04	6.12	5.78	6.73	9.02
Other	0.32	2.19	3.03	3.79	4.13	6.04	7.53	10.00	13.07	12.69
Total	4.37	27.51	37.52	45.25	40.32	46.85	52.74	53.51	60.63	60.33

Source: Editorial Board of the Yearbook of China's Foreign Economic Relations and Trade, *Yearbook of China's Foreign Economic Relations and Trade*

such as Vietnam and Cambodia (Table 10). South Korea was the biggest source of investment for both Vietnam and Cambodia in 2006. Reasons for this increase in investment in Vietnam include (1) the expansion of the Vietnamese market following several years of continuous growth of around 8%, (2) improvements in Vietnam's investment environment as a result of its admission to WTO membership in January 2007, and (3) its role as a receptacle for China risk. A survey of investment (and investment plans) by South Korea companies shows that Samsung Electronics is building a second plant to produce PC monitors, printers and other products, as well as a new mobile telephone plant. POSCO aims to capture expanding demand for sheet steel in Vietnam and has announced plans to build a series of plants to produce cold-rolled, hot-rolled and galvanized steel. With these plans, POSCO has overtaken Intel to become the biggest single investor in Vietnam. Lotte Shopping plans to open its first Lotte Mart store in Ho Chi Minh City in 2008.

Investment in Cambodia is also expanding. Much of the manufacturing sector's investment has been in the area of textiles (apparel). The rapid growth of sewn product manufacturing in

Cambodia over the past few years reflects the migration of production operations by Hong Kong, Taiwanese, Chinese and South Korean companies that were producing brand products for the U.S. market, including Nike, Adidas and GAP products. The migration of production from China is also attributable to curbs on exports from China because of volume restrictions under the Multi-Fiber Agreements (MFA), which lapsed at the end of 2004. Cambodia still has unused export capacity. Another positive factor is Cambodia's improving political stability.

Another important trend is the expansion of investment in the BRICs (other than China), including India, Russia and Brazil. After a prolonged period of economic stagnation, India implemented major economic reforms in 1991. These reforms have increasingly provided the impetus for growth, and India's real GDP growth rate reached 8.4% in fiscal 2005 and 9.4% in fiscal 2006. The rapid growth of IT service industries has brought growth in India's middle class. With continuing deregulation, India is becoming increasingly attractive as a market⁽²⁷⁾.

Hyundai Motor built a factory in India in 1996 and is currently building a second (completion scheduled for the second half of 2007). In addition to its plants at Pohang and Gwangyang, POSCO is now planning to build a third. It aims to complete a steel works with annual production capacity of 4 million tons by 2010, and an integrated steel works with capacity for 12 million tons by 2020. (There is concern that the start of construction may be delayed because of problems with the acquisition of land.)

Former socialist countries, such as Slovakia, Kazakhstan, Poland and the Czech Republic, have also tended to attract increased investment in recent years. Hyundai Motor completed a factory in Slovakia in 2007 and also plans to build one in the Czech Republic.

These trends can be summed up as follows. First, the expansion of investment in Vietnam and Cambodia can be seen as a China risk strategy. In the long-term perspective, the yuan can be expected to appreciate significantly against the dollar and other major currencies, and wages in coastal

Table 10 Overseas Direct Investment (Past Three Years, Implementation Basis)

	(\$millions)		
	2004	2005	2006
China	2,300.7	2,648.7	3,319.8
U.S.A.	1,338.6	1,243.3	1,758.8
Hong Kong	197.0	271.8	724.7
Vietnam	178.9	304.6	587.9
Canada	46.4	34.3	389.9
Singapore	164.2	122.1	303.9
Slovakia	82.4	223.3	286.9
Kazakhstan	22.5	25.3	250.1
Japan	288.8	176.2	245.9
Yemen	6.9	106.1	231.9
Poland	36.1	77.3	226.8
Australia	54.0	104.7	142.3
Netherlands	4.1	14.6	139.9
Cambodia	13.7	30.9	122.5
Czech Republic	0.0	10.1	111.8
Brazil	19.9	143.9	107.7
Russia	25.3	36.9	102.5
India	40.7	91.1	99.7
Other	1,170.6	894.8	1,606.4
Total	5,990.8	6,559.9	10,759.4

Source: Same as for Fig. 19

regions will almost certainly rise. In addition, China is taking an increasingly selective stance toward foreign investment, with the result that production of some labor-intensive products is tending to migrate to countries other than China. Second, companies are investing in regions that offer growth potential, as illustrated by the activities of Hyundai Motor and POSCO. As has happened in the past, these companies are pursuing a strategy of moving into countries ahead of their Japanese counterparts in order to seize market share. Third, individual companies are working to optimize their production operations on a global scale. Samsung Electronics has doubled the mobile phone output at its plant in China and plans to start production at a new plant in Vietnam with capacity for 100 million units a year. Its domestic plant at Gumi now specializes in the production of the most advanced models.

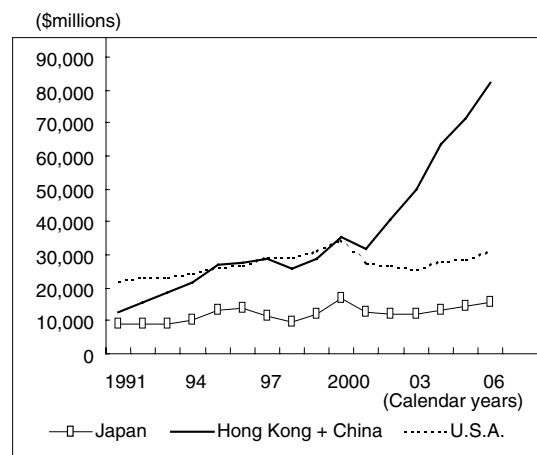
(2) Taiwanese Investment Still Heavily Weighted toward China

Hong Kong + China Taiwan's Biggest Export Market

In 1987, the Taiwanese government lifted its ban on indirect exporting to China (mainly through Hong Kong), and in the 1990s Taiwanese companies began to shift their production operations to China. These factors have brought rapid growth in Taiwan's exports to Hong Kong/China. As with South Korea, this trend has accelerated since 2002 (Fig. 20).

In 2006 Taiwan's imports from China amounted to around one-half of its exports to China. This is explained in part by the fact that Taiwan has long restricted imports from China. In 1987, it became possible to import goods indirectly, provided that there was no threat to national security or adverse impact on related industries, and provided that the goods in question would help to strengthen the competitiveness of manufactured exports. The range of permitted goods has gradually expanded since then, and in July 1996 Taiwan switched to a negative list system. Imports of agricultural products and consumer goods, including

Fig. 20 Trends in Taiwan's Exports



Notes: Re-exports are not included.

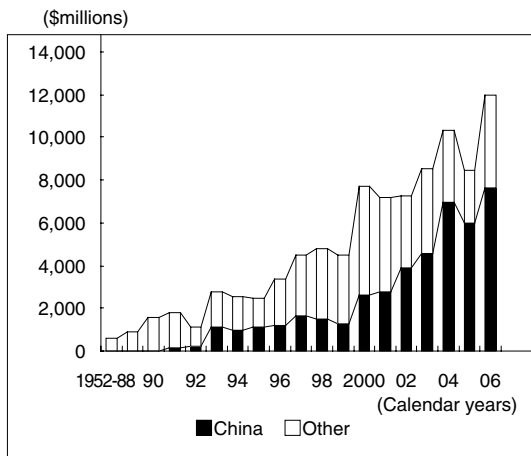
Source: Department of Statistics, Ministry of Finance, Taiwan, *Monthly Statistics of Trade*

apparel and footwear, are prohibited, but imports of semi-finished and intermediate goods that do not threaten domestic industries are allowed. There has been major progress toward the easing of restrictions since China and Taiwan joined the WTO. On January 16, 2002, Taiwan announced that imports of 2,126 Chinese agricultural and marine products would be allowed from February 15. Agricultural and marine products exempted from the ban included fish, shellfish, dried fruit, liquor and tobacco, and manufactured goods included chemicals, cameras and computers. These changes increased the range of goods that could be imported to 73% of all industrial products.

Continuing Growth in Investment in China

Taiwan's overseas direct investment (approval basis) has been expanding since the late 1980s (Fig. 21). Investment during 1989 exceeded the cumulative total for the period up to that year. Reasons for this growth include (1) the appreciation of Taiwan's currency against the U.S. dollar, (2) rising wages and labor shortages, and (3) a lack of suitable industrial sites in Taiwan. Under new foreign currency control regulations introduced in July 1987, companies and individuals were allowed to remit up to \$5 million overseas without prior authorization from the government. This pro-

Fig. 21 Taiwan's Direct Overseas Investment (Approval Basis)



Notes: The government is able to monitor only a small percentage of total investment in China, since much investment is implemented through third countries or not reported to the government. Additional registration was carried out in 1993, 1997 and 1998, but this is not included here.

Source: Investment Commission, Ministry of Economic Affairs

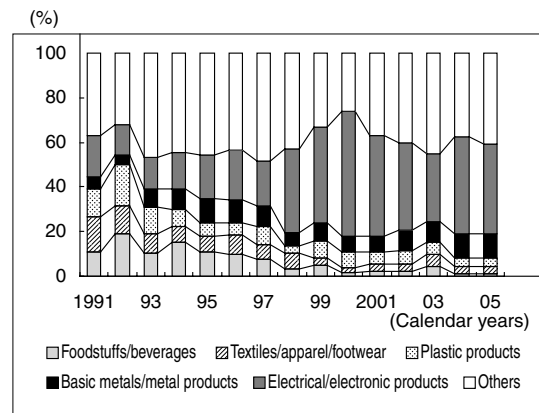
vided additional impetus for overseas direct investment.

Apart from the United States, the main targets for overseas direct investment until the early 1990s were ASEAN members, such as Thailand and Malaysia. However, investment in China was also starting to expand.

There were several reasons for China's emergence as a major investment target. First, in October 1990 the Taiwanese government introduced regulations governing indirect investment in Mainland China (amended to Regulations on Indirect Investment or Technology Cooperation with the Mainland Area in March 1993), which allowed investment in China via third countries/regions (indirect investment). Second, China accelerated its reform and open-door process. Third, many regions in China were actively seeking investment from Taiwan. Other factors that encouraged investment in China included the availability of vast reserves of low-cost labor, the latent growth potential of the market, and ease of communication⁽²⁸⁾.

Taiwanese direct investment in China began with labor-intensive industries, such as ap-

Fig. 22 Taiwanese Investment in China by sector



Source: Same as for Fig. 21

parel, footwear and plastic products. One after another, Taiwan's major sports shoe manufacturers, which produce shoes under contract for the world's leading brands, migrated their production operations to China. The focus subsequently shifted to industries catering to domestic demand, including paper and paper products, chemicals, metals, electrical appliances and foodstuffs. There was also a shift in the locations for these investments, from southern China to eastern China, including Shanghai, Jiangsu Province and Zhejiang Province.

By the second half of the 1990s, the main areas of investment were the electrical and electronic industries, including computers and computer peripherals (Fig. 22). In the early 1990s, the computer industry entered a price war era, symbolized by the emergence of Compaq. The key to competition in this environment was the ability to source parts as quickly and cheaply as possible and introduce products that would meet market needs. The computer industry grew through OEM production for American and Japanese manufacturers. This was possible because Taiwan was able to offer low production costs, high quality and speedy production. As cost competition intensified, however, the migration of production operations to China became inevitable.

The easing of government restrictions on investment in China also provided impetus. In

July 1996, the government announced the *Jieji Yongren* policy, which called for patience and the avoidance of haste with regard to investment in China. Under this policy, the government prohibited (1) investment in public infrastructure, (2) investment in high-tech industries, and (3) investment over \$50 million, as well as investment with the potential to cause “hollowing” of domestic industries. However, these restrictions put Taiwanese companies at a disadvantage, and the government came under pressure from industry to relax the regulations. In August 2001, the prohibition was lifted for 122 high-tech items, including digital televisions, mobile telephones and notebook computers. After the ban on investment in the notebook computer area was lifted, Quanta Computer and other Taiwanese manufacturers began to build factories in China. Unlike desktop computer manufacturing, production of notebook computers is concentrated in Shanghai and Jiangsu Province. This reflects the potential for market growth in eastern China, and the availability of engineering personnel.

The ban on investment relating to semiconductors was also lifted, subject to the condition that companies could not apply for approval until at least six months had elapsed after the start of mass-production of 12-inch wafers at a plant within Taiwan. Chinese-Taiwanese joint ventures were established. Grace Semiconductor Manufacturing Corporation (GSMC) in Shanghai was established jointly by the son of the president of Taiwan Plastic and the eldest son of Jiang Zemin.

Investment in China declined in 1998 and 1999 but returned to an accelerating growth trend in 2000 (Fig. 21). Reasons for this shift include (1) the approach of China’s admission to WTO membership, (2) the expansion of China’s domestic markets, and (3) the need to reduce costs because of the global escalation of price competition.

IT-related investment reached a plateau in 2005, and investment in China declined for the first time in six years. However, 2006 brought a return to growth. According to Chinese sta-

tistics (Table 9), investment from Taiwan peaked out in 2002 and has been declining ever since. However, it is necessary to take into account the fact that much Taiwanese investment is channeled through tax havens, such as the Virgin Islands.

As a percentage of total investment, investment in China has declined from 71.1% in 2005 to 63.9% in 2006, and there are signs that Taiwan is investing in a wide range of countries. However, the strong commitment of Taiwanese companies to their business activities in China remains basically unchanged. This emphasis can probably be attributed to the following factors.

First, many Taiwanese companies have moved into southern China, forming clusters of electrical and electronic manufacturing industries. Taiwanese companies would gain nothing by retreating from China. One of the biggest computer industry clusters is in Dongguan, where all PC parts other than CPUs, memory and hard drives can reportedly be sourced locally within 90 minutes. Over one-half of the monitors, cases, keyboards and mice produced by Taiwanese companies in Taiwan and overseas are produced in Dongguan. Delta Electronics has five plants there with over 20,000 employees.

Second, Taiwanese companies can use local personnel, in part because of the ease of communication. Twinhead has established R&D centers in Beijing, Shanghai and Guangzhou, where it has recruited talented local staff to work on communications software, IC design and computer software respectively.

New Initiatives by Taiwanese Companies

While Taiwan’s China business continues to expand, there have been a number of changes in the environment, including rising labor costs, power shortages, the rising value of the renminbi, and trade friction. These changes have triggered some interesting trends (Table 11).

First, new factories are increasingly being built in inland regions, such as Chongqing and

Table 11 Recent Initiatives by Taiwanese Companies

Company	Developments
Powerchip Semiconductor	<ul style="list-style-type: none"> · Fourth DRAM plant to be built in Taichung with Japanese company Elpida · \$370 million to be invested in new 8-inch wafer plant in Suzhou
Hon Hai Precision Industry	<ul style="list-style-type: none"> · Chinese administrative headquarters relocated from Shenzhen to Shanghai · \$1 billion to be invested in new plant in Wuhan
Taiwan Semiconductor Manufacturing Company (TSMC)	<ul style="list-style-type: none"> · Third plant (12-inch wafers) under construction in Southern Taiwan Science Park · Preparing to transfer more advanced technology to Shanghai plant
ProMOS	<ul style="list-style-type: none"> · \$360 million plant (8-inch wafers) under construction in Chongqing (following relocation of facilities of rival Chinese manufacturer from Shanghai to Chengdu)
Vedan (manufacturer of chemical flavorings)	<ul style="list-style-type: none"> · Two food additive plants to be built in Vietnam · Existing plant (outskirts of Ho Chi Minh City) to be expanded
Kingmaker Footwear	<ul style="list-style-type: none"> · Plant under construction in Cambodia (following imposition of EU anti-dumping tariffs on footwear from China and Vietnam)

Source: *Weekly Taiwan Tsushin* and other sources

Wuhan, rather in coastal areas.

Second, there is a trend toward the automation of factories in China. Faced with soaring labor costs, Hon Hai Precision Industry, one of the biggest companies in the Electronics Management Service (EMS) industry, plans to install 10,000 robots over the next five years.

Third, companies in labor-intensive industries, such as apparel, footwear and furniture, are increasingly starting new investment projects or expanding existing projects in Southeast Asian countries, such as Vietnam.

Fourth, companies in the semiconductor industry are increasingly giving priority to investment within Taiwan. As described above, Taiwanese companies in the semiconductor sector are conditionally allowed to invest in China. However, labor costs in China are rising, and it is difficult to recruit technical personnel, while in Taiwan the existence of semiconductor manufacturing clusters facilitates

the procurement of raw materials. Taiwan has 10 semiconductor plants capable of handling large silicon wafers with diameters of 300mm. This is already the highest concentration in the world, and there are plans to increase the number to 18 in 2008.

The business strategies pursued by Taiwanese companies in the future will have a significant impact on the future of the Chinese economy as well as the Taiwanese economy.

4. Conclusions

Over the past 10 years, there has been a dramatic increase in economic interdependence between China and the other East Asian economies, including Japan. This means that the development path followed by China will have a major influence on the future of East Asia.

While China has maintained growth rates in excess of 10% in recent years, it faces a number of problems, including expanding income disparity, investment overheating and trade friction. These issues have made China's traditional pattern of high growth driven by investment unsustainable. China needs a strategy for sustainable growth, and the Hu Jintao administration has adopted a basic policy that targets industrial advancement with the emphasis on harmony. This emphasis on harmony is manifested in environmental protection and energy conservation measures and initiatives to improve living standards and expand consumption. Industrial advancement policies, including the development of IT, biotechnology and other high-tech industries and services industries, are contained in the 11th Five-Year Plan.

China's foreign investment policy is also changing to reflect this stance. The basic policy on new foreign investment provides three basic criteria. First, will the investment lead to the introduction of advanced technology and management methods? Second, will the investment contribute to environmental protection, resource conservation and the solution of energy problems? Third, will the invest-

ment contribute to the advancement of China's industrial structure and the improvement of technology levels. As these criteria suggest, the Chinese government has strengthened its stance of guiding foreign investment in desired directions.

Two factors indicate that this emphasis on harmony and industrial advancement will continue to guide Chinese economic policy in the future. First, the government has implemented a series of policies designed to curb investment and reduce the trade surplus. In the first half of 2007 alone, the deposit reserve ratio was raised five times and interest rates twice. Other measures included the imposition of an export tariff and mass-purchasing of American products. In the run-up to the National Congress of the Communist Party of China in the fall of 2007, the Chinese government appears to have adopted a cautious stance and is limiting further increases. However, it continues to implement initiatives that reflect its emphasis on harmony.

Second, the Hu Jintao administration is expected to consolidate its power base at the National Congress. When the administration was formed in 2002, it was seen as being under the influence of former General Secretary Jiang Zemin and unlikely to implement policy changes that ran counter to Jiang's wishes. However, the new administration has since adopted its own policy line, in the form of an emphasis on harmony, and currently it enjoys the support of the regions, which generally tend to oppose central government policies⁽²⁹⁾. There is no evidence of an axis of opposition to the Hu Jintao administration in terms of either personalities or policies, and it is highly likely that key leaders will be re-elected at the National Congress, and that the emphasis on harmony and the pursuit of industrial advancement will be legitimized.

What are the implications for foreign investment policy? Changes to foreign investment were implemented temporarily in the mid-1990s. However, investment subsequently stagnated, and the growth rate was in danger

of falling below the target level of 8%. As a result, China again expanded the scope of its measures to encourage investment. In view of this historical background, it seems likely that the government will maintain its new foreign investment policy as long as there are situations that might push the average growth rate below the current target of 7.5%.

This shift in the foreign investment policy will inevitably have a significant impact on the flow of direct investment. Direct investment in China will also be impeded by other factors, including rising wage levels and a reaction to the boom that began around the time of China's admission to WTO membership. Even so, China remains an attractive target for investment, both as a production base and as a market, and currently there are no other countries that are more attractive. For these reasons, the level of direct investment in China is likely to remain high. However, increased investment in emerging countries, such as India and Vietnam, will bring a gradual shift away from the current tendency for flows of overseas direct investment to be concentrated into China.

Japanese companies will need to study China's new foreign investment policy carefully and develop business strategies that allow them to capitalize on their technology advantage. Japan has built extensive technology resources through its efforts to cope with pollution and the effects of the oil crises. As a result, Japanese companies enjoy an advantage in such fields as energy conservation, environmental technology, and various areas of manufacturing technology. They should therefore be able to benefit from concessional measures, even under the new corporate income tax regime.

Protection for intellectual property rights is vital when using advanced technology and knowledge as the basis for business development in China. However, China still lacks adequate systems in this area. Companies will need to strengthen their own countermeasures while also lobbying the government to tighten enforcement. There is also a need for public education initiatives focusing on the fact that

the protection of intellectual property is also vital to the future interests of Chinese companies.

Japanese companies will need to be aware of the direction of this shift in Chinese government policy so that they can adapt to the environment and develop China business strategies that allow them to maximize their technology advantage.

End Notes

1. The poverty line in 1990 was 300 yuan. The new poverty line is 850 yuan, based on 2002 prices. For details see Ravallion and S. Chen [2004].
2. Local companies, such as Tata Consultancy Services Ltd. and Infosys Technologies Ltd., are key players. Factors driving the growth of IT-related services include a deep human resource pool, and government support (including the establishment of the technology parks and the provision of tax concessions). Growth has also benefited from the outsourcing boom in the United States.
3. Under the Vientiane Action Programme adopted at the November 2004 summit meeting, tariffs will be abolished in 11 sectors, including motor vehicles, electronics and textiles, by 2010.
4. The First Mekong International Bridge, between Nong Khai in Thailand and Vientiane in Laos, was completed in 1994.
5. The 16 East Asian countries and regions in ITI's international trade matrix for 2006 are the ASEAN10, together with Japan, the South Korea, China, Hong Kong, Macao and Taiwan.
6. High growth is one of the factors taken into account in personnel assessments for senior regional officials. See Korogi [2005], P.130. The fact that investment under the control of regional governments has generally grown at a higher rate than total investment, and the fact that regional governments set high growth targets are evidence that regional governments are only pretending to comply with central government directives.
7. Judging from the context and other indications, these figures appear to provide a real picture of GDP and resource consumption in 2004.
8. According to China's trade statistics, the surplus in trade with the United States increased by 26.2% to \$144.3 billion in 2006. This is highest figure since the first surplus was recorded in 1993 and is equivalent to approximately 80% of China's total trade surplus. China's expanding trade surplus with the EU has caused trade friction in several areas, especially footwear and textile products.
9. Deng Xiaoping, as China's "Paramount Leader," is known to have made a statement to this effect during his Southern Tour in 1992. This is frequently used to justify the pursuit of high growth.
10. See Tanaka, O. [2007], P.41.
11. Comments on the Corporate Income Tax Law in this article are based on a Japanese translation published in the April 2007 edition of *Gekkan Chugoku Josei* [China Situation Monthly]. The original can be found on a Chinese government website (http://www.gov.cn/ziliao/flfg/2007-03/19/content_554243.htm).
12. When this article was written, there was still uncertainty about some aspects, such as the pace at which tax rates would be raised. This is discussed in an article in the May 30, 2007 edition of JETRO, *Nikkan Tsusho Koho* [Daily Trade Information]. Proper preparations will be needed, including careful reading of the implementation rules, which are expected to be announced in the fall of 2007, and consultation with legal, accounting and tax experts.
13. Article 36 states that preferential measures can be implemented on the basis of notifications to the Standing Committee of the National People's Congress.
14. This is based on a article on the draft of China's new Corporate Income Tax Law in the April 2007 edition of *Gekkan Chugoku Josei* [China Situation Monthly].
15. While this is not stipulated in the text of the law, statements at the National Congress of the Communist Party of China and other forums indicate that the measures will target special economic zones and the Shanghai Pudong New Area.
16. Unless otherwise stated, investment figures in this analysis are on an implementation basis (excluding banking, insurance and securities). Direct investment in the banking, insurance and securities industries has been excluded because statistics for these industries were not published until 2005.
17. For example, an article in the April 11, 2007 edition of JETRO, *Nikkan Tsusho Koho* [JETRO Daily] states that minimum wages in major cities in Guangdong Province in 2006 were 2-3 times higher than the 1995 level.

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18. The JETRO report lists figures announced by the governments of provinces, autonomous regions and directly governed cities. (Some do not publish statistics.) However, many regional governments include foreign trade and other investment (contract processing, compensation trade, international leasing, etc.) in their direct investment figures. For example, the positions of first-ranked Jiangsu and second-ranked Guangdong in terms of implementations in 2005 are reversed if foreign trade and other investment are excluded. For this reason, the sum of regional figures will be higher than statistics published by the Ministry of Commerce. In recent years, inward direct investment statistics for individual provinces, autonomous regions and directly governed cities have tended to be excluded from the *China Statistical Yearbook* and other publications.
 19. Because only company names and export amounts for the top 200 companies are included the raw data, the results of a survey by the 21st Century China Research Institute (Key Number 29 on the Institute's website) were used in the preparation of this article and the accompanying charts.
 20. The Chinese government is focusing on regional urbanization rather than urbanization in major cities for several reasons, including the limited capacity of major cities to absorb migrant labor, the emergence of new problems relating to rapid inflow of population, and the need to reduce regional disparity.
 21. An "opinion" published by the Ministry of Commerce states that 28 million people, or over one-tenth of the urban non-farming work force, are employed in foreign-invested companies. There are other data to support this statement, but because of the fragmented nature of these resources, it was decided to verify the contribution of foreign-invested companies to employment using data published by the National Bureau of Statistics.
 22. It is also necessary to take into account the fact that the 1994 devaluation of the yuan caused a temporary increase.
 23. After the North America Free Trade Agreement (NAFTA) came into effect in January 1994, manufacturers relocated their manufacturing facilities for color televisions and other products to Mexico.
 24. Examples include increased production of semiconductor fabrication equipment in response to the expansion of semiconductor production, and increased production of key parts in response to the expansion of mobile telephone production.
 25. FTAs have already been signed with Chile, Singapore and EFTA. An FTA was signed with ASEAN (excluding Thailand) in August 2006, and negotiations with the United States concluded successfully in April 2007.
 26. The addition of 10 Central and East European countries (Estonia, Poland, the Czech Republic, Slovenia, Hungary, Cyprus, Latvia, Lithuania, Slovakia, Malta) in 2004 brought the total number of EU members to 25.
 27. Retail sector deregulation has been slower. In January 2006, the government permitted investment (up to 51% ownership) in single-brand retailers (Nike, Chanel, etc.) but investment in supermarkets and department stores is still prohibited.
 28. The expansion of investment in China by Taiwanese companies prompted concern about Taiwan's growing economic reliance on China. This led to the adoption of a "go-south" policy designed to encourage investment in Southeast Asia. The expansion of investment in the Philippines in the second half of the 1990s was attributable in large part to this policy, as well as to improvements in the investment environment in the Philippines.
 29. The new situation is symbolized by the September 2006 dismissal of Chen Liangyu from his post as CPC Shanghai Committee Secretary, followed by a joint statement by the Shanghai Committee and the government that they would remain faithful to the central government's macro-control policies and measures.

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