Introduction

The open-door policy that has evolved in China since the death of Mao Zedong and the Purge of the Gang of Four in 1976 has had far-reaching repercussions for the Chinese economy as well as for the world economy. The open-door policy is a vital part of China's new development strategy of intensive growth — growth through adaptation and diffusion of technology, especially foreign technology. Although China imported foreign technology, including capitalist technology, in Mao's era, the novelty of the 'open door' is the willingness to acquire technology through foreign investment. Moreover, foreign technology is broadly interpreted to include not only technology embodied in plant and equipment, but also knowledge, including management skills and even the practices and ideas of a modern society. The traditional mechanism of 'arm's-length' trade cannot adequately promote the transfer of this knowledge, and consequently closer interaction with foreigners through direct foreign investment has become a central element of the new development strategy. This recognition of the importance of direct foreign investment has accounted for the willingness of the Chinese to utilize special trade and various forms of industrial cooperation agreements.

Another vital aspect of China's modernization drive is the reform and partial marketization of China's Stalinist economic system. The open-door policy and the reform drive are mutually reinforcing. The commitment to the open-door policy forces China to modify a rigid economic system to facilitate economic interaction with world markets. Successful foreign enterprises in China, and ideas and examples from the outside world, have had significant demonstrative effects; the external sector has been a leader in China's reform drive. However, as East European experiences indicate, reform of a Stalinist economy is a long and tortuous process. The effectiveness of the open-door policy is limited by the lack of such reforms; China's door to the outside world will not be genuinely open until there has been a successful reform of its economic system.

Many of China's economic problems in the domestic as well as external sectors can be attributed to the inconsistencies in China's reform measures (Lin 1989: 1–24). Though China has decentralized economic power to local authorities and enterprises, the interest rate, exchange rate and the prices of many essential raw materials are still fixed at beneath equilibrium levels by planners. This implies chronic shortages, and a rationing of credit, foreign exchange, and essential raw materials. In the pre-reform era of the Stalinist system, planners favoured capital-intensive and heavy industrial projects in the rationing of resources. If interest rates, exchange rates and prices of essential materials are deregulated, many heavy industrial projects will show losses because they use large amounts of capital, imported equipment, energy, and materials. Such rationing benefits not only the heavy industrial sector but also the planners themselves who, in their enforcement of rationing, have acquired more power. In the thirty years of the pre-reform era, the interests of heavy industries and economic planners have been so firmly entrenched that the deregulation of interest rates, exchange rates and prices of essential materials has failed, despite the decentralization of economic power. In a decentralized regime, controlled interest rates imply inflation because loans are artificially cheap, while controlled exchange rates imply trade deficits because the value of imports (exports) is kept artificially low (high). Furthermore, controlled energy and raw material prices imply chronic shortages and inefficiency in resource allocation. Though the focus of this book is the open-door policy, it is clearly important to bear in mind the close link between the open-door policy and economic reforms.

Economic liberalization and the open-door policy have also introduced ideas of democracy and political reforms. One manifestation of this was the growth of a fully-fledged pro-democracy movement in Beijing, a movement which was suppressed on 4 June 1989. At the Fourth Plenum of the 13th Central Committee of the Chinese Communist Party held on 24 June 1989, Zhao Ziyang, the liberal general secretary of the Party, was ousted and replaced by former Shanghai mayor Jiang Zemin. The Party pledged to continue the policy of economic reforms and opening to the outside world, but communist principles and the leadership of the Communist Party would be strictly upheld. In other words, the policy of China's government would be one of political repression and economic liberalization. The choice of the new Party secretary, Jiang Zemin, reflects this policy. Jiang is a moderate technocrat who speaks English and French and has extensive experience in economic management and economic reforms. He has also proved to be strong in ideological control and stern in countering the student movement in Shanghai.

Events since June have demonstrated China's commitment to political repression and economic liberalization. By July 1989, up to 7000 supporters of the pro-democracy movement had been arrested (*South China Morning Post* 21 July 1989) and Western newspapers and magazines were banned, even in hotels for foreigners.

The Tiananmen incident has brought world condemnation and economic sanctions against China. The United States, the European Communities and Japan have suspended military sales and official loans to China, and Australia, New Zealand, Canada, Austria, Switzerland, Finland and the Scandinavian countries have suspended official contacts with China. In such an environment, it is perhaps not surprising that the Chinese Government has been eager to make gestures of further economic liberalization to assure investors. The Party chief Jiang Zemin and Prime Minister Li Peng have given their full support to the controversial plan to develop the Yangpu freeport in the Hainan SEZ (*South China Morning Post* 17 July 1989). According to a preliminary plan arrived at in mid-1988, the Hainan Government would lease 30 square kilometres of Yangpu, the island's best deep sea port, to a consortium headed by the Japanese construction giant Kumagai Gumi. The consortium would run the 'super-special zone' along Western lines, though sovereignty of the area would still be vested with China. The plan had been held up by conservative opposition in the autumn of 1988, but after the suppression of the pro-democracy movement, was approved in order to convince the world of China's commitment to the open-door policy. Whether the plan will come to fruition is still unknown because Kumagai Gumi was reported to be having second thoughts about the plan after the Tiananmen incident. However, Yangpu port officials have since told Kumagai executives that Beijing might grant them more favourable terms (*South China Morning Post* 17 July 1989). After the Tiananmen incident, Chinese officials have also been more flexible in their negotiations with foreign investors, even proposing terms favourable to them (*Hong Kong Economic Journal* 12 July 1989). Beijing has also ordered Shenzhen to accelerate its development (*Ming Pao* 2 July 1989).

After the suppression of the pro-democracy movement, Beijing was quick to re-emphasize the strategic role of Hong Kong in China's open-door policy. The heads of China's trading companies in Hong Kong met Zheng Tuobin, the Chinese Minister for Foreign Trade in mid-June 1989. He stressed that the role of Hong Kong in relation to China had become more significant, as China's foreign economic relations were under severe stress after the Tiananmen incident. He emphasized that tourism, foreign loans and commodity exports were the three major sources of China's foreign exchange earnings, and that the first two sources had dwindled after the Tiananmen incident. (China relies mainly on commodity exports and Hong Kong is one of the major channels of China's commodity exports.) He also stressed that China would not punish the employees of China's companies in Hong Kong, even though many of them had openly supported the pro-democracy movement (*Wen Hui Pao* 30 June 1989).

The Chinese clearly view Hong Kong as a 'window' or a 'bridge' to the outside world. They value this 'window' so much that they have promised (in the Sino-British joint declaration) to preserve the capitalist system in Hong Kong for fifty years after 1997. Capitalist and free-wheeling Hong Kong has become the key in the opening of the socialist and rigidly regimented Chinese economy.

In terms of the provision of foreign capital to China from 1979 to 1989, Hong Kong has contributed over 59 per cent of all foreign investment (including direct foreign investment and commercial credit) and over 48 per cent of foreign commercial loans. Hong Kong is also China's foremost trading partner. In 1989, China's exports to and imports from Hong Kong were 48 and 32 per cent of total Chinese exports and imports respectively. Of these exports to Hong Kong, 17 per cent were consumed in Hong Kong, and 83 per cent were re-exported; of the imports into China, 29 per cent had been produced in Hong Kong and 71 per cent were re-exports. Hong Kong also played an important role in trans-shipment. The estimated shares of China's exports and imports trans-shipped through Hong Kong in 1989 were both 10 per cent. Thus, China–Hong Kong trade and trans-shipment accounted for 58 per cent of Chinese exports and 42 per cent of Chinese imports.

Besides trade and investment, Hong Kong facilitates China's open-door policy in many indirect ways. Hong Kong serves as a contact point, a channel for information and technology transfer, and a market and production training ground. Given the efficiency and versatility of the Hong Kong economy, the effect of Chinese policies on trade and investment will be manifested quickly, and Chinese planners can avail themselves of the rapid feedback mechanism of the Hong Kong economy to gauge the effectiveness of their policy.

Chapter 1 of this book traces the development of China's open-door policy. Chapter 2 outlines the multi-faceted roles of Hong Kong in China's open-door policy and develops an economic theory of middleman which is important in explaining the significance of Hong Kong in China's open-door policy. Chapter 3 outlines the new institutional setting that has evolved to handle China's international trade and investment. Chapter 4 evaluates the achievements of the open-door policy and its prospects. Chapters 5 to 7 focus on the roles of Hong Kong as financier, trading partner and middleman respectively. Chapter 8 contains concluding comments and an evaluation of future prospects.

1

The open-door policy

Antecedents of the open-door policy

Many elements of the open-door policy, including technology imports, foreign aid, loans and investment had been accepted in Mao's era. In the 1950s, China relied heavily on Soviet loans, technicians, turnkey projects and blueprints, and at least 150,000 Chinese technicians and workers were trained in the USSR. Joint stock companies with the USSR also existed.

The importance of maintaining an economic relationship with the capitalist world was not ignored in Mao's era. For example, China recognized the importance of maintaining ties with the capitalist world through Hong Kong, and left the colony in British hands in 1949 at a time when China could easily have taken it by force. When the Korean War broke out in 1950, China imported most of her strategic supplies from Hong Kong. Although the American-led United Nations trade embargo against China (after China's entry into the Korean War) prevented a rapid development of ties with the capitalist world, China continued to export to the capitalist world through Hong Kong. Chinese imports arriving via Hong Kong dwindled because of the United Nations trade embargo; nevertheless, significant quantities of strategic supplies were smuggled into China through Hong Kong.

After the Sino-Soviet rift of the early sixties, China became isolated. The much-publicized policy of self-reliance made a virtue out of necessity and was more in line with Mao's ideology. At a pragmatic level, China re-oriented her trade from the Soviet bloc to the Organization for Economic Cooperation and Development (OECD) countries, and began to import complete industrial plants from Japan and Western Europe during the period 1962–65. This process was halted in 1966 with the outbreak of the Cultural Revolution.

As the Cultural Revolution receded in 1970, Mao Zedong and Zhou Enlai initiated the *rapprochement* with the United States, and

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imports of industrial plants from OECD countries resumed on a large scale. In 1973, the State Council approved a plan to spend US$4.3 billion (the 'Four Three Program') on plant imports over a four-year period. However, this policy of massive plant imports, financed by oil exports, was resisted by the 'Gang of Four', and the campaign against Deng Xiaoping in 1975 cast doubt on the Four Three Program. It was not carried out thoroughly, but in 1978, Hua implemented an even larger import program, in the main based on the earlier program.

After the downfall of the Gang of Four in 1976, Hua Guofeng started his over-ambitious modernization plan which involved an unbalanced growth strategy, massive imports of industrial plants and an explicit commitment to an open-door policy. In 1978 alone, foreign contracts worth US$6.4 billion were signed. A program of massive plant imports was grafted onto the Stalinist strategy of extensive (and unbalanced) growth characterized by forced savings, high investment (especially in heavy industry), and neglect of efficiency and consumption. Hua's plan soon led to structural imbalances in the form of bottlenecks and a balance of payments deficit. The neglect of efficiency led to hasty and inappropriate plant imports. Very often, contracts on plant imports were concluded without feasibility studies and without estimations of the demand for complementary domestic inputs, as in the case of the giant Bao Shan General Iron and Steel Works near Shanghai.

Characteristics of the open-door policy

The failure of Hua's over-ambitious plan led to a fundamental re-orientation of China's developmental strategy. At the Party's historic Third Plenum in December 1978, Hua's Stalinist strategy was abandoned and a program of readjustment and reform was introduced to achieve balanced and intensive growth. Economic reforms and marketization were initiated to improve economic efficiency. Readjustment was introduced to rectify the imbalances engendered by the strategy for unbalanced growth, involving a shift of emphasis from heavy industry to agriculture and light industry, and also a lowering of the savings rate. The willingness to accept foreign investment, the most often noted feature of the open-door policy, can be explained by the change in development strategy. The rise in consumption following readjustment reduces the resources available for investment and exports, and the Chinese thus accept foreign investment to relieve savings and balance of payments constraints. As debt financing can lead to repayment problems in hard times, equity financing is also accepted.

Equity financing is also more effective in technology transfer. Under the new strategy of intensive growth, attention is being paid to the form and effectiveness of technology transfer. The importing of complete plants, as in Hua's era, eased, with priority being given to technology imports intended to modernize China's existing plants. The fact that much of this technology was 'disembodied' and undocumented illustrates China's willingness to cope with the frictions and tensions typical of joint ventures.

The open-door policy should not be confused with free trade. Strict foreign exchange controls exist and China is trying to avoid importing goods which could be produced domestically. However, the novelty of the open-door is that China has to expand her exports rapidly to finance technology imports. International trade has thus become an active instrument in China's development strategy. The positive effects of exports on efficiency have also been important for the strategy of intensive growth. Zhao Ziyang emphasized that 'Putting China's products to the test of competition in the world market will spur us to improve management, increase variety, raise quality, lower production costs and achieve better economic results' (*Beijing Review* 21 Dec. 1981:24). Chinese exports as a proportion of national product rose to the record level of 13.5 per cent in 1987, compared with 5.3 per cent in 1977 and a low of 2.9 per cent in 1970.

Evolution of the open-door policy

The open-door policy has gone through three cycles of liberalization and retrenchment. Decentralization of the trading and investment systems was undertaken simultaneously with domestic economic reforms in 1979–80, 1983–84 and 1988. In each reform drive, selected regions of the country were opened up, i.e. given substantial autonomy in international trade and investment. All three reform drives led to inflation and balance of payment difficulties, and each was followed by a period of retrenchment. The Tiananmen incident dealt a severe blow to the open-door policy; this is analysed in detail at the end of the chapter.

(i) The first reform drive of 1979–80

Hua Guofeng's modernization plan led to a trade deficit in 1978 (Table 1.1). Hua's plan was replaced by a program of readjustment and reform at the Third Plenum in December 1978. In 1979 the reform drive gained momentum: the Ministry of Foreign Trade was reorganized and industrial ministries were given more power in foreign trade. Moreover, special autonomy in trade and investment was given to the provinces of Fujian and Guangdong and the three central municipalities, Beijing, Tianjin and Shanghai. Guangdong and Fujian were given the authority to operate Special Economic Zones (SEZs). Guangdong operates three SEZs: the Shenzhen and Zhuhai SEZs which are adjacent to Hong Kong and Macau respectively, and the Shantou SEZ which has close links to overseas Chinese populations, including a community in Hong Kong that originated in Shantou. Fujian operates the Xiamen SEZ which is opposite Taiwan and only a few miles from two coastal islands controlled by Taiwan. However, the reforms in the domestic and external sectors led to a loss of central control and internal and external balances continued to deteriorate during 1978–80 (Table 1.1). China's leaders concluded that the 1979 policy of readjustment had failed and severe retrenchment was needed (Sung and Chan 1987:8). In December 1980, a

Table 1.1 *Value and growth rates of Chinese trade*

Year	Exports		Imports		Trade balance US$m
	US$m	Growth rate (%)	US$m	Growth rate (%)	
1970	2,260	2.5	2,326	27.5	–66
1971	2,636	16.6	2,205	–5.2	431
1972	3,443	30.6	2,858	29.6	585
1973	5,819	69.0	5,157	80.4	662
1974	6,949	19.4	7,619	47.7	–670
1975	7,264	4.5	7,486	–1.7	–222
1976	6,855	–5.6	6,578	–12.1	277
1977	7,590	10.7	7,214	9.7	376
1978	9,745	28.4	10,893	51.0	–1,148
1979	13,658	40.2	15,675	43.9	–2,017
1980	18,272	33.8	19,550	24.7	–1,278
1980	18,120	—	20,020	—	–1,990
1981	22,007	21.5	22,015	10.0	–8
1982	22,321	1.5	19,285	–12.4	3,036
1983	22,226	–0.5	21,390	10.9	836
1984	26,139	17.6	27,410	28.1	–1,271
1985	27,350	4.7	42,252	54.1	–14,902
1986	30,942	13.1	42,904	1.6	–11,962
1987	39,437	27.7	43,216	0.7	–3,739
1988	47,540	20.4	55,251	27.8	–7,710
1989	52,486	10.4	59,142	7.0	–6,656
1990	62,070	18.3	53,360	–9.8	8,710

Sources: Data since 1980 were obtained from *Chinese Customs Statistics*; 1970–80 data were obtained from the Ministry of Foreign Economic Relations and Trade in Beijing.

second readjustment was announced, involving recentralization with emphasis on slow and balanced growth. Despite the second readjustment, export decentralization remained basically intact, although foreign exchange controls were strengthened and the Ministry of Foreign Trade regained control over a few commodities (Kueh & Howe 1984:832).

(ii) The second reform drive of 1983–84

Balance of trade was restored in 1981 and China accumulated a sizeable surplus in 1982–83. Internal balance was restored in 1982 and China embarked on another reform drive in 1983–84 (Sung & Chan 1987:11). In 1983, Hainan island, an island only slightly smaller than Taiwan, was granted a degree of autonomy exceeding that of the Special Economic Zones. In April 1984, fourteen coastal cities along the entire Pacific coast were declared open.[1] These cities provide virtually all of the port facilities in China, and accounted for 97 per cent of turnover in Chinese ports in 1983. They are also relatively industrialized, providing nearly one-quarter of China's gross value of industrial output, although their population share was only 8 per cent (Kueh 1986:15). In January 1985, China announced its intention of opening the entire Chinese Pacific basin. The first step was the opening of the Changjiang delta, the Zhujiang delta and the south Fujian triangle comprising the historic ports of Xiamen, Zhangzhou and Quanzhou in February 1985. The opening of the Liaoning and Shandong peninsulas was originally on the agenda for March 1985 (Kueh 1986:11), but the speed of events led to confusion, and the opening of the two peninsulas was shelved. In September 1984, the State Council approved a radical proposal to reform the foreign trade system, decentralizing autonomy in foreign trade to foreign trade corporations which were to become responsible for their own profits and losses. In view of the sizeable foreign exchange reserves built up since 1982, foreign exchange controls were relaxed in 1984 (Qi 1985a:47).

The radical reform proposals had barely been implemented when a massive trade deficit and runaway inflation forced planners to recentralize domestic reforms leading to a loss of control over investment and monetary expansion. The trade deficit was caused primarily by the relaxation of foreign exchange and import controls, especially in the open areas, leading to a surge of imports (Qi 1985a:47). To rectify the imbalance, planners imposed severe administrative controls on bank loans, foreign exchange and investment in early 1985.

[1] They include Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Quangzhou, Zhanjiang and Beihai.

Although the 1984 proposed foreign trade reforms remained largely unimplemented, there was active discussion on economic and political reforms in 1984–85, and the reformers appeared to be preparing for another reform drive. The renminbi was devalued twice in 1985–86, and another devaluation was reportedly scheduled for 1987. However, the radical economic and political reform proposals and student unrests in December 1986 provoked a strong conservative backlash, culminating in the forced resignation of the Liberal leader Hu Yaobang. Following student demonstrations, price reforms and the planned devaluation of the renminbi were shelved to pacify social discontent over inflation (Sung & Chan 1987:19).

(iii) The third reform drive of 1988

The campaign against 'bourgeois liberalization' only held up reforms temporarily. At the Thirteenth Party Congress in November 1987 reforms gained the upper hand, and a third reform drive was launched in 1988. Hainan island became a separate province in mid-1988 with a higher degree of autonomy than before. The opening of the entire Chinese Pacific Basin continued with the opening of the Liaoning and Shandong peninsulas, the entire provinces of Guangdong (previously limited to the Zhujiang delta) and Fujian (previously limited to the south Fujian triangle), parts of Guangxi province and Hebei province, and eighteen additional coastal cities (*Hong Kong Economic Times* 14 June 1988). The areas opened in 1988 were as large as all the areas opened in the years from 1979 to 1987. By 1988, the population in the opened areas totalled 160 million. The open areas form a three-tier structure in terms of increasing degrees of autonomy: coastal open areas, coastal open cities and SEZs. The huge trade deficit of 1984–86 declined rapidly in 1987 and China's trade was close to balance in the first half of 1988. The radical 1984 trade reforms that were stalled in 1985 were resumed in 1987–88.

The most noticeable event of 1988 was price reforms. However, the price reforms were carried out in an overheated economy plagued by excessive investment and monetary growth. The price reforms precipitated panic buying and runs on the banks. In September, price reforms were shelved and the State Council imposed severe controls on investment and credit. A trade deficit again emerged in the second half of 1988 and trade controls were stiffened. As the macroeconomic imbalance was very severe, further reforms will have to wait until the economy is successfully stabilized. The official policy was that stabilization would last two years.