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# China's Compensation Trade: A New Source of Foreign Investment

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**An Intelligence Assessment**

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# China's Compensation Trade: A New Source of Foreign Investment [redacted] 25X1

**An Intelligence Assessment**

This assessment was prepared by [redacted] 25X1
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# China's Compensation Trade: A New Source of Foreign Investment [redacted] 25X1

## Key Judgments

*Information available as of 1 December 1982 was used in this report.*

Since 1978, China has acquired approximately $380 million in foreign investment through compensation trade, a term used to cover a variety of nonequity investment vehicles available to foreigners. Compensation trade attracts capital to China by allowing foreigners to exercise considerable control over their projects without the long-term commitments, legal uncertainties, and other problems associated with equity investment in China. Last year's compensation trade exports were valued at $1.2 billion—approximately 5 percent of China's total exports—and netted Beijing over $200 million in foreign exchange.

For the Chinese, compensation trade offers an opportunity to develop its light industrial exports without expending substantial foreign exchange. To date, China has signed nearly 20,000 compensation trade contracts, involving some 8,000 factories. Most are small-scale processing or assembly operations for light industrial goods and almost exclusively involve overseas Chinese businessmen. The typical deal entails foreign supply of raw materials, equipment, and technology in return for Chinese provision of land and labor. Notwithstanding its successes, Beijing must show additional administrative flexibility, develop more sophisticated managers, and demonstrate that compensation trade can produce greater profits before investors other than overseas Chinese will be willing to use the mechanism to any great extent. The long-term potential for expanded compensation trade is also constrained by internal Chinese political factors. Chinese proponents of compensation trade must be sensitive to domestic political criticism stemming from a stricter attitude toward foreign influences in China. In addition, the lack of Chinese control over these projects makes them particularly vulnerable to bouts of xenophobia.

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# China's Compensation Trade: A New Source of Foreign Investment [redacted]

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## The Setting

Since 1978, compensation trade has quietly but steadily become an important conduit for foreign investment in China. China's experiment with compensation trade in that year was one of the first signs that Beijing was making a major change in its foreign economic policy. Prior to 1978, foreign investment in China had been a forbidden topic because of Beijing's adherence to the principle of self-reliance. In July 1978, the State Council published a series of experimental rules that opened the door to this type of investment. These rules were never strictly enforced. In July 1979 they were superseded by Beijing's decision to approve the establishment of special economic zones (SEZs) and to encourage the promotion of compensation trade and equity joint ventures. Guangdong Province was given the lead in this effort and was authorized to sponsor any compensation trade deal involving only locally produced materials. [redacted]

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Although Beijing considers compensation trade to be an integral part of its foreign investment program, these credits cannot be treated as actual foreign investments by Western standards because no foreign claims on real assets located in China exist. Beijing defines foreign investment rather loosely and claims—partially in an effort to overcome Western reluctance to invest in China—to have received a total of $1.8 billion in direct foreign investment. Less than 25 percent of this total, however, constitutes paid-in foreign capital for actual "equity" and "contractual" joint ventures. Beijing also includes loans to Chinese enterprises and the over $300 million spent by Western oil companies in service contracts for geophysical surveys under the offshore oil program as part of foreign investment. Most of the oil ventures eventually will be taxed under the Foreign Enterprise Income Tax Law rather than under the Joint Venture Tax Law. [redacted]

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***Defining Compensation Trade***

*Compensation trade can be divided into three categories—processing and assembly deals, direct compensation trade, and cooperative production. In the first two categories, the foreign firms supply the raw materials, semifinished goods or components, and frequently the production machinery. The Chinese provide the land and labor inputs. In processing and assembly deals, the Chinese are paid a fee for producing the final product, which is then returned to the investor. Direct compensation trade deals usually involve larger investments by foreign firms which the Chinese either compensate directly with the goods produced by the project or indirectly with alternative goods agreed upon by both sides. In both cases, the Chinese side retains any machinery and equipment provided by the investor. Cooperative production involves the transfer of technology with the foreign firm assisting a Chinese enterprise under license. The Chinese side usually imports most of the necessary components during the project's initial years, repaying the foreign investor either totally or partially in finished products.*

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## Current Status

According to Chinese press reports, all but about 1,000 of the almost 20,000 compensation trade contracts signed have been for processing raw materials or assembling components. This figure may be somewhat inflated by Chinese double-counting renewals of previously unpublicized contracts. The Chinese press

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also reports that these processing and assembly deals have involved total imports of $156 million worth of equipment and have earned $352 million in foreign exchange. Most of the remainder of the projects are the over 500 direct compensation trade deals which involve some $120 million worth of equipment. [redacted]

Beijing began its experiment with compensation trade largely because it offered a chance to use China's most abundant resource—labor—to earn foreign exchange for the modernization program. We believe the break with the principle of self-reliance and the image of foreign exploitation associated with compensation trade troubled some hardline elements in the Ministry of Foreign Trade. But their view was not shared by local factory managers, who saw an opportunity to retain and employ a share of the foreign exchange earned by their enterprises. Moreover, Beijing for the first time allowed local officials to deal directly with foreign businessmen, exposing these officials to international business practices. These relationships furthered Beijing's policy of decentralizing bureaucratic controls and offered a potential for expanding China's overall access to foreign technology and equipment. [redacted]

**Advantages of Compensation Trade**

For the investor, the central attraction of compensation trade has been the availability of low-cost labor and land. Almost all compensation trade deals have integrated foreign-supplied equipment and technology into existing factories in need of renovation. This has reduced the cost and startup times and has avoided the considerable bureaucratic hassles involved in setting up a new factory in China. In addition, existing factories can readily supply a pool of semiskilled labor. Foreign contributions of machinery, equipment, and raw materials have almost always been at unsophisticated levels—primarily for producing textiles and other light industrial goods. The Chinese nevertheless have acquired a few high-technology imports or production processes through compensation trade. For example, under a cooperative production agreement with McDonnell-Douglas, China makes landing gear doors for the DC-9 aircraft. [redacted]

For the Chinese, the principle of mutual benefit is the keystone of compensation trade. The arrangements provide them access to production technology and equipment that generate products to earn foreign exchange, create employment, and establish foreign links that can help transfer marketing and managerial skills and, eventually, may pave the way for equity joint ventures. We believe Chinese managers have been particularly attracted to this "over the shoulder" learning experience because it has enabled them to acquire some knowledge of marketing a product while leaving the responsibility for that function in the more experienced hands of the foreign investor. [redacted] 25X1

For the foreign investor, the primary benefits of low production costs—cheap land and labor—are complemented by other intangible advantages. Most important, perhaps, compensation trade allows investors to establish solid business ties with their Chinese counterparts without a substantial financial commitment. In any event, both the Chinese and the investors appear to believe that successful compensation trade deals will create a favorable investment climate for further foreign participation in modernization. [redacted] 25X1

About two-thirds of the compensation trade deals have been signed with organizations located in Guangdong Province. Guangdong's geographic proximity to Hong Kong, the close ties between its residents and the overseas Chinese in the colony and in Macao, and its control over three of China's four special economic zones, all have contributed to the proliferation of deals in the province. Beijing acknowledged the unique nature of these economic ties in South China by giving both Guangdong and Fujian a special autonomous status to conduct their own foreign trade. Essentially the two provinces are allowed to sign almost any deal without prior approval from Beijing. By contrast, official guidance to other provinces requires officials there to have the central government's approval for deals—depending on the locale—involving from $1 million to $5 million. [redacted] 25X1

Compensation trade has been a major source of foreign exchange for China's special economic zones. Eighty-four percent of the foreign exchange earned since 1979 in Shenzhen—the most successful zone by far—has been generated from activities associated with compensation trade including processing fees, wages, and land leases. Here, too, the vast majority of

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compensation trade deals are consummated with overseas Chinese who are inclined to seek out their mainland relatives as business partners.

### Adapting to New Environs: The Learning Curve

Beijing has altered its original terms for investment in compensation trade deals as Chinese experience in dealing with foreign businessmen has produced a "learning curve" that has underwritten the program's success. Nonetheless, in the view of foreign investors many problems remain, and China will need to become more bureaucratically flexible before businessmen, other than overseas Chinese, are willing to make substantial commitments to China through compensation trade.

### Labor Force Concessions

Labor force deficiencies—particularly the caliber and selection of local Chinese workers—have been one of the most serious problems for the compensation trade program. Beijing initially stipulated that local labor bureaus would provide the labor force for these projects and that they would do so without involving the enterprise management in the process. Improper selection procedures quickly led to poorly qualified work forces, low productivity, and substandard output. Despite investor complaints, however, Beijing only made concessions on the labor issue when exasperated foreign investors shut down one of China's best known projects (see box).

As a result of the episode, Beijing gave local factory managers authority to promote, transfer, punish, and fine workers and allowed the factories to recruit and select their own workers. Workers who failed to meet standards after being trained could be dismissed if management chose. Compensation trade factories could also use a bonus system to spur production. The Chinese did not formally adopt these concessions until December 1981, when Guangdong Province included them in its regulations for the special economic zone. These concessions have alleviated some investor frustrations, although China's labor productivity remains low by world standards.

### Cracking the Domestic Market

Although some foreign investors believed that they could use compensation trade to break into China's domestic market, especially in consumer goods, Beijing until recently has essentially maintained that compensation trade products are only for the export market. At the UN-sponsored Investment Conference in Guangzhou last June, Wei Yuming, the Vice Minister of the Ministry of Foreign Economic Relations and Trade, announced that foreign investors could sell up to 80 percent of their products in China. However, the Vice Minister stipulated that the foreign firms must generate sufficient foreign exchange from its exports to be able to earn its own profits, pay its foreign employees, and buy any imported material needed for its operations because Chinese yuan are not convertible.

Despite this attempt to offer opportunities in China for foreign investors, there are countercurrents that may curtail efforts to further liberalize the format for

***The Unraveling of China's First Direct Compensation Trade Deal***

*The Xiangzhou Wool Spinning Mill was constructed in 1978 opposite Macao in Guangdong's Zhuhai municipality. It was China's first direct compensation trade project. Overseas Chinese investors financed the importation of the equipment under an agreement that called for the production of finished yarn from the raw wool provided by Hong Kong and Macao firms. After months of low and inferior production, the investors reluctantly cut off the material supply in September 1980 and detailed their concerns in a letter to several senior Chinese officials. Beijing's embarrassment over the plant's closure produced a* mea culpa *in two* People's Daily *articles, in which the government took full responsibility for the shutdown and stressed that China intended to learn from the cutoff. The mill resumed production a few months later following a number of concessions designed to improve the quality of labor force used in compensation trade.*

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compensation trade. Recently, for example, the Chinese have discovered that some processing deals have been illegally manipulated to circumvent trade regulations—a discovery that has already led to closer surveillance of the domestic market to spot the products of compensation trade deals. [redacted]

In late June, State Councilor Gu Mu stated in a speech, subsequently published in the Chinese press, that some Chinese were colluding with foreign businessmen to smuggle goods by falsely reporting the quantity of raw materials imports and exaggerating the quantity of finished export products in their processing deals. Gu said that other Chinese enterprises were also selling their imported raw materials for processed products on the domestic market, resulting in the disruption of the local marketplace. He later told a national conference on smuggling that the rules on the use of imported raw materials would be tightened and specified that finished products would require import permits as well as payment of duties and taxes if they were sold domestically. [redacted]

While Gu's comments were targeted primarily at abuses of processing and assembly deals, his guidance indicates a basic Chinese reluctance to follow a generally more liberal policy on domestic sales of compensation trade products. A recent article about the special economic zones in the Guangdong press also reflected that attitude in calling for strict control of domestic sales of goods produced in the special economic zones, although the author did suggest that certain needed items of technology, especially those in short supply at home or only available as imports, should be excepted from these strictures. [redacted]

In fact, there are at present only a few successful compensation trade deals that involve large-scale domestic sales. Two of the most well known are with US firms—Coca-Cola's soft drink bottling plant and R. J. Reynolds's Camel cigarettes project—that sell their finished products exclusively on the domestic market. They are in a class by themselves, however, because the bulk of their products are sold to foreign visitors, who use foreign exchange coupons to pay for them. The Beijing Camera Company's agreement with Canon to produce 35-millimeter cameras of Japanese design is more typical. Here, the Chinese have designated 80 percent of the production for export to repay the Japanese investment, with the remainder available for either the domestic market or additional exports. [redacted]

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High-level concern about corruption in China has been reflected in an apprehension over the disruptive effects that foreign goods can have in the domestic market. We believe that Beijing will keep its approval for domestic sales limited and that in the longer run, these arrangements may not endure; at a minimum, the recent warnings from Gu Mu will not encourage foreign investors who hope that compensation trade will provide them an entree into the domestic market. [redacted]

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**Compensation With Alternative Goods**

Beijing's unwillingness to offer alternative goods to foreign investors in cases where the investors do not want to accept the output of a compensation trade project has been a major stumblingblock to growth of this investment vehicle. [redacted] potential foreign investors have been reluctant to provide equipment and technology for Chinese factories whose exports have a potential for competing with the investor's own output at home. [redacted]

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**Curtailing the Use of Compensation Trade for Plant Modernization**

Perhaps the most significant adjustment Beijing has made in its compensation trade program was the decision early this year no longer to pursue compensation trade as a major source of direct foreign investment in plant modernization. Because of the need to conserve foreign exchange, the Chinese initially viewed compensation trade as an inexpensive way to acquire foreign equipment and technology. The effort, however, was hampered from the start by the concern of foreign investors that the programs would create new competition. Moreover, many foreign investors, [redacted] are reluctant to assist the Chinese in modernizing their factories if the only payoff is to be in Chinese goods. [redacted]

Beijing appears to have concluded that it can more efficiently acquire desired foreign and technology equipment by direct purchases. Direct purchase, in any event, eliminates the need to depend on compensation trade for help in the plant modernization effort and places the primary focus of the compensation trade program on developing deals where the foreign investor actually wants the project's output. [redacted]

**Other Problems**

China has attempted to blame foreign investors for a variety of other difficulties with compensation trade. Processing and assembly agreements have come under particular criticism because in these deals the foreign investor, who provides the raw inputs, has most of the control over the project. A recent article in Hong Kong's *Ming Pao* referred to these deals as putting Chinese enterprises into a "passive position." Moreover, an article in June in Guangzhou's *Nanfang Ribao* criticized investors for providing rudimentary and obsolete equipment and for falling behind in payment of workers' wages. [redacted]

In August, *People's Daily* published a signed article that leveled more serious criticisms against the compensation trade program, claiming that the lack of marketing and management experience available in some deals makes them failures and worth avoiding. The author encouraged greater Chinese control of the supply and marketing functions so that China could gain a better understanding of international economic activities. [redacted] 25X1

Other Chinese officials have complained that the prices investors charge for equipping and managing these projects are too high. [redacted] 25X1 25X1 25X1

Beijing is also concerned about the effects of shady 25X1 business practices, including the use of bribes, on its program. While this form of corruption has been only one of several illicit activities under scrutiny, the government's desire to maintain an "open door" for foreign investors has limited its willingness to expose such cases. Moreover, most foreign investors involved 25X1 in compensation trade are ethnic Chinese who often 25X1 deal with relatives, making "corruption" more difficult to spot. For example, "incentives" that facilitate 25X1 trade deals, such as television sets, can easily be 25X1 disguised as gifts. [redacted]

In general, the Chinese have tried to handle investor problems by issuing laws or regulations that often raise as many questions as they answer. Beijing is now preparing to issue regulations covering compensation trade deals that will define and describe the execution of contracts, as well as lay out procedures to settle disputes. While the new regulations are likely to present problems in themselves, several American 25X1 lawyers are working with Chinese legal experts on them, indicating a Chinese willingness to consult with foreign experts in order to reach compromises that can help satisfy the needs of investors. [redacted] 25X1

A critical problem not yet addressed by the Chinese is the lack of coordination between local Chinese enterprises and higher authorities—a failing that has derailed or slowed several important compensation trade deals with US firms. For example, a $2.5 million deal signed in 1980 between the Singer Sewing Machine Company and a Shanghai firm was canceled several months later by Shanghai's municipal government, which based its belated decision on its own estimate of negative effects of the deal on the domestic market. More recently, the R. J. Reynolds Company's two-year-old compensation trade deal to produce Camel cigarettes in Xiamen, Fujian Province, ran into trouble after Beijing doubled its tariff on imported tobacco to protect the domestic industry. As a result, the Camel factory has temporarily stopped production. In both cases local officials who set up the projects expressed their irritation with actions of the higher authorities. In the Camel deal, they are appealing to Beijing for reconsideration. [redacted] 25X1

**Prospects**

China needs to demonstrate additional flexibility in its compensation trade policy and greater management skills before Beijing develops a reputation that can attract substantial investment from non-Chinese sources. Given the large number of compensation trade projects already under way, as well as the over 40 equity joint ventures in China, potential foreign investors already have an assortment of investment options to evaluate in making new investment decisions. Nonetheless, the obvious contradiction between Vice Minister Wei's statement at the UN-sponsored Investment Conference and Gu Mu's concern over the infiltration of unwanted goods in the domestic market must be corrected if China hopes to develop its reputation as a reliable investment site. [redacted] 25X1

We expect that recent moves to recentralize control over economic policymaking highlighted at China's 12th Party Congress will not have much effect on the compensation trade program. Beijing is anxious to attract foreign investment and can hardly afford to limit the effort to such key provinces as Guangdong and Fujian. In addition, the small scale of most compensation trade deals currently excludes them from central review, a policy that Beijing probably realizes facilitates their consummation. [redacted] 25X1

In political terms, compensation trade will remain vulnerable to domestic criticism because Chinese partners generally lack control over the venture and because the investment has similarities to the pre-1949 economic exploitation in China. Moreover, the level of control that foreign investors have over compensation trade deals, even to the point of being able to shut them down, almost certainly disturbs some segments of the Chinese leadership. While the current climate for foreign investment in China is good, a return to greater economic self-reliance or a broad revival of antiforeign campaigns could precipitate attacks on compensation trade. However, the small, short-term nature of most compensation trade deals almost automatically protects foreign investors from substantial losses even if the political climate or leadership changes. [redacted] 25X1

## Appendix

## Two Examples of Compensation Trade

These examples of compensation trade are typical of arrangements negotiated in the past few years.

**Shantou Watch Parts Factory**
This factory originally produced clockwork springs and watch parts, but, under a processing and assembly-type deal signed with a Hong Kong partner in 1978, it began assembly of electronic watches and transistor components. The partner, who provided $16,000 in secondhand equipment, pays a processing "fee" ranging from 40 cents to $1.20 for each item produced—a fee some 30 percent under the factory's original price because of the agreement to compensate the investor for the equipment. With 250 workers, the factory assembled 78,000 watches and earned $91,000 in fees in its first 18 months of operation. 25X1

**AMF–Shanghai Number Three Rubber Products Factory**
Under a 1979 direct compensation trade agreement, AMF provided the Shanghai factory with $1 million worth of equipment to produce sports balls. The factory, which received the machinery in mid-1981, can use the equipment free of any payment to AMF for 10 years; after that period, it can purchase the equipment at a negotiated price. AMF is supplying some raw materials to make basketballs and soccer balls in return for an annual output from the factory of at least 340,000 balls per year. The project delivered 50,000 balls to AMF during its first quarter of operation in 1981. AMF expects it to generate approximately $10 million in export products over its 10-year term. 25X1

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