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BUREAU OF INTELLIGENCE AND RESEARCH

ASSESSMENTS AND RESEARCH

(U) CHINA'S SPECIAL ECONOMIC ZONES: LESS PROGRESS THAN MEETS THE EYE[1/]

Summary

(C) China's special economic zones once again are drawing fire from orthodox critics of reforms. Top reformers continue to support the zones but are echoing some of the charges. They are pressing zone officials to improve management and to reduce smuggling and black-market currency exchange, activities that have flourished in the zones and surrounding provinces since controls over foreign trade were relaxed in 1979-80.

(C) Although the special economic zones were created to give China windows to the West, they have served the West equally well as windows to China. In addition to a preview of some individual reforms considered by the leadership, they provide an indication of the direction and speed of the reform program. A strong resurgence of conservative influence in the leadership probably would lead to efforts to roll back some of the more controversial aspects of the special zones policy.

(C) Reformers remain committed to using the zones as an economics laboratory. For example,

1/ (C) Subsequent to the drafting of this paper, the Chinese press on June 29 quoted Deng Xiaoping as telling a visiting Algerian delegation that the Shenzhen special economic zone was a pilot project and that its success remained to be proved. Mounting criticism of the special zones, particularly their level of corruption, may have induced Deng to moderate his support of the experiment. Deng's comments may presage a tightening of control over business activity in the zones.

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foreign banks in April were authorized to operate branches in the zones. Obtaining the consensus needed to conduct such experiments, however, continues to be difficult. Implementation of two other measures poised to go into effect in the Shenzhen zone bordering Hong Kong--issuing a convertible zone currency and establishing a customs control line between Shenzhen and the interior--has been delayed indefinitely.

(C) Visitors to the zones, especially to Shenzhen, reportedly are struck by the extensive construction under way. Available evidence suggests that China's leaders, however, are disappointed with zone results, even though the zones have proved useful for demonstrating economic reform programs. In particular, the zones have had little success in attracting technologically advanced industry. Their development into the foreign exchange profit centers envisioned by the reformers is proceeding slowly.

(C) Earlier this year the government may have increased the amount of funds earmarked for infrastructure projects needed to make the zones more attractive to foreign investors. Competition for foreign investment has sharpened since other coastal areas last year were authorized to offer concessions similar to those available in the special zones. Without improvements in infrastructure, interest in the zones would likely wither.

Approval of a higher budget allocation for the special zones would indicate that the reform coalition is maintaining its influence in this area, despite the problems encountered in developing the zones. But slight changes in policy emphasis are probable. Stronger efforts will be made to develop the zones as export bases, and less attention will be directed toward improving their role as diffusers of advanced technology. Current debate appears to center on the value of increasing their orientation toward foreign markets versus the benefits of forging more internal linkages. 25X1

(C) Although it is possible that the introduction of new policies to enhance the development of China's special economic zones may stall this year, the prospects for a retreat by the leadership seem remote in the near term.

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(U) Contents

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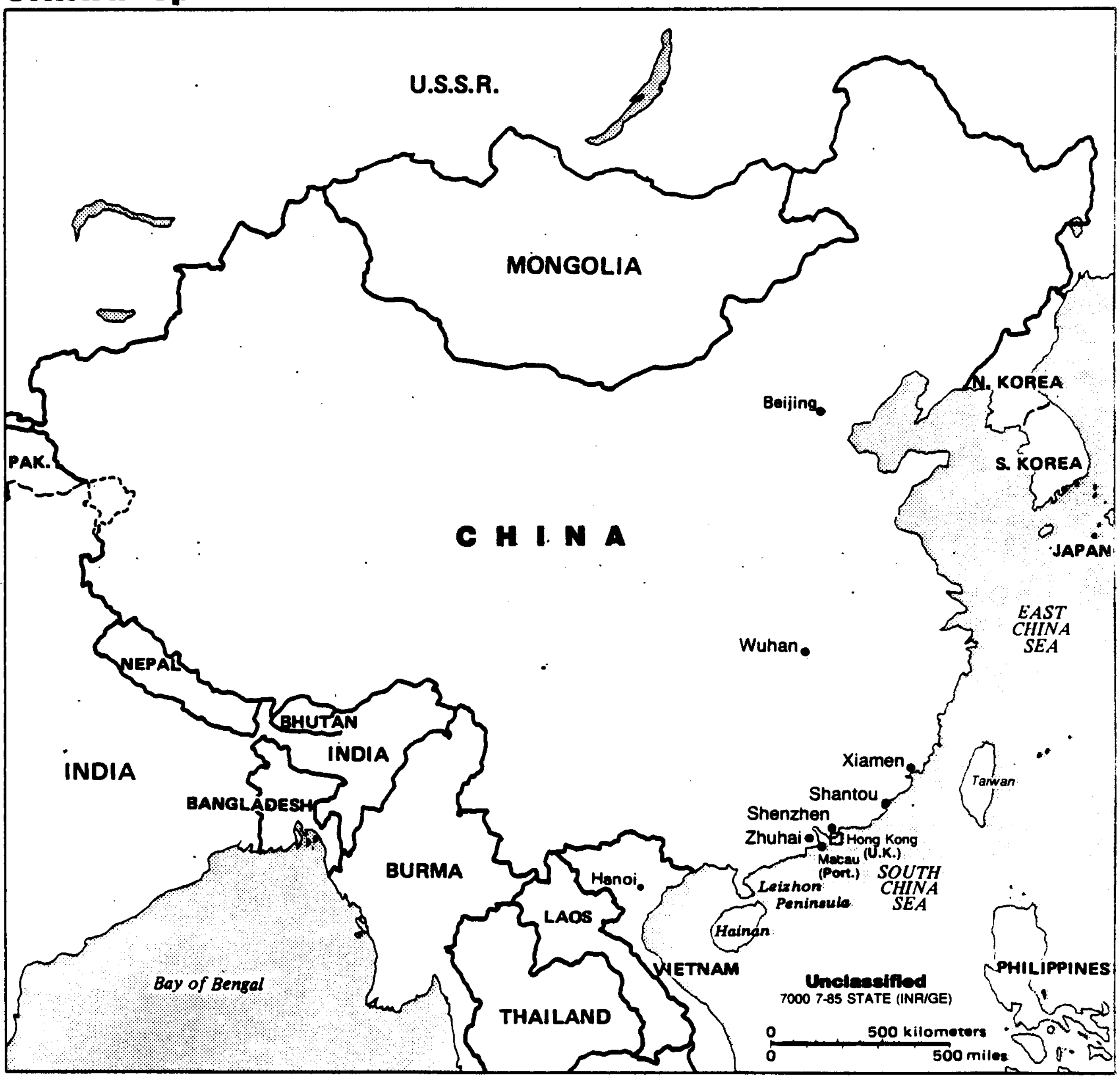
CHINA: Special Economic Areas



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Background

(C) China's State Council, at the reported urging of Deng Xiaoping, in 1979 authorized the creation of special economic zones as part of a policy directed at liberalizing the foreign trade system and opening the economy to the West. Four zones were established to spur and concentrate foreign investment. The development of these zones subsequently became well publicized in the world press--and hotly debated in the ranks of China's leaders as well as by lower level party cadre. The first major (and recurring) criticism was the inevitable comparison of the zones with the old treaty ports.

(C) In some respects the comparison had at least superficial validity. Two special economic zones--Xiamen and Shantou--were designated to concentrate on developing export processing industries and were fashioned after similar zones elsewhere in Asia. Xiamen and Shantou sought to attract foreign participation--particularly by Hong Kong and overseas Chinese--in modernizing existing industry. This program was counter to the deeply ingrained policy of self-reliance and raised concern over the possibility of foreign economic exploitation of Chinese labor and resources.

[redacted] The other two zones--Shenzhen on the border with Hong Kong and Zhuhai on the border with Macao--were scheduled for more diversified development. The industrial base in those areas was meager, and foreign investors were encouraged to set up new industries. Shenzhen and Zhuhai were to focus on production for export of electronics equipment, light industrial goods, and construction materials. At the same time, the program called for development of tourism, farming, and fishing. 25X1

(C) All four zones offered investors low-cost labor, reduced rents and taxes, and scaled-down or waived customs duties. And they sought to attract foreign investment in infrastructure projects as well as in industries that would promote exports and enhance technological development. Reformers tried to quell criticism of concessions by pointing out that foreign investment was encouraged only on China's terms, unlike conditions prevailing when treaty ports were forcibly opened.

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[redacted] Political considerations figured in the leadership's decision to open special economic zones and gave weight to its defense of the policy. Emigration had been an irritant to the leadership for years. In 1979 the residents of an entire commune--including cadre--had defected to Hong Kong. Some officials thought that it was vital to create a prosperous area on the Hong Kong border if discontent and consequent out-migration were to be reduced. 25X1

(C) A demonstration of tolerance toward capitalist methods was another objective of the zones, partly pointed at easing concern in Hong Kong over the city's approaching reabsorption by China. Shenzhen and Xiamen specifically were directed to increase contacts with Taiwan. Chinese officials in 1983 openly invited Taiwan investors to participate in the special zones on the same terms offered foreign investors. As recently as last year, Deng reportedly reaffirmed the objective of increasing contacts with Taiwan through trade when he held discussions with Fujian province officials in the Xiamen zone.

(C) Finally, creation of special economic zones provided the leadership with a laboratory where it could experiment _in vitro_ with market-oriented economic reforms. Reformers actually have used the zones more like a zoo and have encouraged (sometimes directed) unconvinced senior officials to visit and view it for themselves.

(C) The reformers' strategy has won enough support that last year 14 coastal cities were authorized to offer foreign investors a similar set of concessions. A 15th city received approval earlier this year. More liberal policies also have been applied to Hainan Island and are being used to entice foreign participation in developing several large coastal regions.

(C) Officials from interior provinces are lobbying effectively for expansion of their authority to offer investment concessions. Consequently, as China opens to foreign investment, much of the "specialness" of the special economic zones is vanishing. The remaining distinguishing characteristic is an extraterritorial status, a difference that will remain nominal until the leadership opens customs control lines between the zones and the rest of China.

Performance

(C) Development of the special economic zones has picked up momentum during the past two years, following a slow start.

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Investors initially were enthusiastic but reportedly became skeptical of their prospects after assessing the physical and legal infrastructure and encountering a cautious, bureaucratic attitude on the part of zone officials, according to soundings taken in the early 1980s by US officials in Hong Kong. By mid-1982, the leadership had begun to tackle those concerns by investing in infrastructure projects to improve transport, power supply, and communications; by fleshing out laws on foreign investment; and by publishing regulations on the operation of the zones. Most of the physical improvements were concentrated in the Shenzhen zone; progress elsewhere was much less apparent.

In 1983-84, Chinese officials redoubled efforts 25X1
to make the zones work. Investment in infrastructure increased significantly in 1983, and a fact-finding visit by Deng to Shenzhen in early 1984 was followed by further escalation in government funding for all four zones. Deng's visit allayed concerns that the experiment would be short-lived, although Deng reportedly was troubled by slow progress. Up to the time of his visit, stuttering economic performance and continuing opposition by conservative elements in the leadership reportedly had contributed to uncertainty over future government policy.

(C) Efforts to fill gaps in the legal code in such important areas as patent law have continued. The absence of guarantees on patent protection and lack of recourse in cases of patent infringement have been identified by many potential investors as primary factors preventing high-tech firms from setting up in China. New laws covering patents and terms of foreign contracts which come into effect this year do not answer all of the foreign investors' questions, but they provide further evidence of the stability of China's open-door policy.

(C) Economic Development. Statistical evidence on zone performance is incomplete and imprecise. Yet, available figures provide a notion of rapid growth. For example, last year the gross value of industrial and agricultural output (GVIAO) in the four zones reached 3.3 billion yuan, compared with 2.1 billion yuan in 1983. The Shenzhen zone alone accounted for 45 percent of last year's turnover and more than 50 percent of the growth. The Zhuhai zone, in contrast, accounted for only 12 percent of the turnover and 16 percent of the growth, even though GVIAO in that zone more than doubled.

(C) The industrial development of Shenzhen is used by Chinese officials as a showcase. In 1983, the gross value of industrial output (GVIO) accounted for almost 84 percent of GVIAO; rapid

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growth last year probably raised the share of industry to about 87-88 percent. Much of this activity, however, reflects the pace of construction, not increases in production for sale outside the zone. In 1983, for example, the construction sector accounted for more than four-fifths of turnover in industry.

(C) This pattern of activity probably is typical of growth in the other zones as well. Investment in capital construction in the four zones grew more than 80 percent in 1984. Although the largest portion was devoted to Shenzhen, it is likely that shares have remained roughly constant and that one main difference among the zones is variation in the scale of the building boom.

(C) In terms of ownership, foreign investors in Shenzhen are cashing in on the building boom but evidently are not contributing as expected to development of exports:

	Percent 1983 GVIO
Chinese enterprises	48
Sino-foreign enterprises and solely owned foreign firms of which engaged in:	52
Assembly and processing	15
Other activities	37

(C) Exports from Shenzhen are said to be projected to reach $5.2 billion in 1990 but despite growth remain a tiny fraction of that figure, as illustrated in the following tabulation in (millions of US$):

1980	1981	1982	1983
11.2	10.2	15.0	21.1

This compares with exports from Xiamen worth $120 million in 1983.

(C) Enterprises in Shenzhen engaging in foreign trade suffered a net loss during 1979-81; they turned a small profit in 1982 and earned 6.6 million yuan in 1983. Although profits reportedly doubled the latter amount in the first half of 1984, earnings still are not spectacular considering Shenzhen's location and relatively low labor costs.

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(C) Internal trade with China proper appears to be a more important component of Shenzhen's sales than exports. In 1982, Shenzhen sold goods worth 460 million yuan to the rest of China, purchases amounted to only 125 million yuan. While more current figures are unavailable, recent comments by Vice Premier Yao Yilin indicate that about one-third of sales by all four zones are exports and two-thirds are oriented toward the internal market.

(C) Foreign Investment. The amount of foreign investment in China is exaggerated by the way the government defines it, and often it is further inflated in Chinese reporting. Nonetheless, inclusion in Chinese data of agreements on licensing, processing, and compensation trade and of the potential value of investment agreements provides a basis for evaluating the success of the special zones policy in attracting and concentrating investment.

(C) Data on total direct foreign investment in China presented in Table 1, appended, are collected mainly from Chinese sources that sometimes conflict. While the data at best constitute a preliminary estimate, the trends depicted in the table are indicative--especially the surge in investment since 1982. Excluding investment in joint oil exploration projects, direct foreign investment in 1984 increased by about $200 million. Between one-third and one-half of this amount probably represents investment in joint equity ventures and cooperative production agreements. In part, the increase in investment derives from the improved ability of foreign firms to use joint ventures to penetrate the China market. The incentive for joint ventures was strengthened last year by a decision to allow repatriation of profits from domestic sales when internal sales of joint-venture products are deemed in China's interest.

(C) A similar breakdown of investment by type of activity in special economic zones is not available. Aggregates, however, have been published. By the end of 1984, pledged foreign investment in the special economic zones reached about $4 billion, roughly two-fifths of the 1979-84 total for all of China. Realized foreign investment in the four zones since 1979 exceeded $800 million, about one-fifth of the total for China. The lower "capture" rate in the zones compared with China as a whole probably reflects greater pressure on zone officials to show results as well as exaggerated expectations on the part of some foreign investors.

(C) Shenzhen accounts for nearly 70 percent of realized foreign investment in special economic zones and about 15 percent

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of total realized foreign investment in China. Nearly three-fifths of the investment in Shenzhen occurred during 1983-84. If data for Shenzhen were excluded from investment totals, the other three special economic zones would account for less than 8 percent of total realized foreign investment.

(C) The poor showing for the other zones suggests that in general the special zones policy has failed to serve its investment function. The degree to which China has succeeded in concentrating foreign investment in the zones seems largely determined by Shenzhen's proximity to Hong Kong and efforts to improve facilities in the zone. Concessions were a much less important factor in determining location of investment, a result that is consistent with analysis of the effect of tax variations on industrial location in other parts of the world.

(C) In general, the special zones policy also has failed to attract technology-intensive industry. By the end of 1983, China had concluded, by its count, 188 agreements for joint equity ventures, of which 105 were keyed to the special economic zones. A sectoral breakdown of these agreements provided by Chinese sources is presented in Table 2; but these sources do not identify joint ventures located in the special economic zones.

(C) Some high-technology firms, of course, are located in the special zones. For example, a microwave communications equipment plant is in Zhuhai and a number of electronics-related enterprises are located in Shenzhen. In addition, several manufacturing enterprises in Shenzhen incorporate advanced industrial technology, including computer-controlled production lines. Compared with other areas in China, however, the special zones have fared poorly. An examination of 134 joint equity ventures concluded by mid-1984 suggests that the zones have been relatively unattractive (see Table 3). An examination of location decisions by a subset of US and Japanese firms--a category more likely to promote technology--reinforces this finding.

(C) Two factors that reportedly disadvantage the zones in competition with other Chinese cities are the shortage of skilled labor and the lack of supportive industrial development. These shortcomings will be difficult to eliminate. Information on a large number of new joint venture agreements that were initialed in late 1984 has not yet been released, but significant change in the established pattern is unlikely.

(C) <u>Leadership Reaction</u>. Some senior Chinese officials, evidently including those in favor of reform, again are growing

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critical of the zones. In a recent interview with foreign reporters, Vice Premier Yao Yilin, thought not to be one of the zones' staunchest supporters, aired some general criticisms in an ostensible defense of zone performance. He noted that the zones have received construction assistance from the whole nation and that foreign investment in infrastructure--an original objective--has not been forthcoming. Yao also took up the issue of buying and selling foreign currency on black markets, observing that the problem was particularly serious in the Shenzhen zone and in Guangdong and Fujian provinces.

(C) Gu Mu, who carries the zone portfolio in the Secretariat, recently gave zone performance a mixed review. In an interview with a Hong Kong correspondent which was published in April, he singled out as shortcomings Shenzhen's lack of competitiveness compared with opportunities for foreign investment in the recently opened cities and such problems as issuing excessive credit, a falloff in foreign exchange earnings in the second half of 1984, and the rampant black market in currency.

(C) Gu Mu highlighted the zones' lack of success in attracting technologically advanced industry and indicated a shift in priority to put less emphasis on this objective and more on promoting exports. This redirection of policy likely results from an early 1985 reassessment of the zones by top leaders. Remarks by Gu Mu on zone progress that were published in January had given no hint of pending policy changes of this sort, but the redirection was clearly evident in late February at a conference he chaired in Shenzhen.

(C) Premier Zhao Ziyang, who is at the forefront of the move to open China to foreign investment and a strong proponent of special economic zones, also is critical of widespread corruption in the zones and surrounding provinces. In addressing the 1985 National People's Congress, Zhao notably did not pursue the open-door theme as he did at the congress last year, even though some new areas will soon be authorized to grant investment concessions.

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[redacted] <u>Law and Order</u>. The government is moving to check corruption. Hainan Island was singled out last year for special attention because of its growing role in smuggling. Earlier this year, 3,000 untaxed cars imported through Hainan reportedly were seized in Wuhan. More recently, the government published laws on foreign exchange controls and is taking steps to curtail currency black markets, especially in Shenzhen and in Guangdong province.

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(C) Corruption in the zones for some years has been a favorite target of conservative critics. Stronger government action in recent months may be designed to preempt the conservatives and protect zone officials from a shakeup. Inflation in urban areas and declining foreign exchange reserves also may be prompting leaders to reimpose control over activities in the zones.

(C) Zone managers nonetheless are under attack, but from an unexpected direction. A recent article published in a few influential Chinese newspapers charges the manager of the Shekou district--Shenzhen's premier industrial area--with failing to supervise properly, overstaffing administrative positions, and permitting officials to enrich themselves. The thrust of the criticism is that management has not kept up with the pace or kept faith with the spirit of reform.

(C) <u>Economic Reform</u>. Special economic zones are continuing to point the way in reform of the economic system. Reform leaders note improved results in production (from contract labor and piece-work wages) and in construction (from use of contract bidding) and tout them as examples of "Shenzhen speed." Most recently, foreign banks were authorized to open branches in the special zones, although the branches are prohibited from dealings with Chinese individuals and Chinese enterprises. Admitting branches of foreign banks even with tight restrictions is a major step toward improving financial services in the zones.

[redacted] Further development of the zones is being frustrated by the delay in enacting two crucial measures: the issuance of a convertible zone currency, and the establishment of a customs control line between the zones and the interior. In part, the delay may reflect ideological opposition from influential conservatives, such as Chen Yun; practical objections, however, appear more important. Local officials reportedly fear that a customs line would harm development of the Shenzhen economy because of its dependence on trade with the interior. Particularly threatened would be foreign exchange investments by provinces and enterprises seeking to profit from the Shenzhen zone's more liberal regulations. 25X1

[redacted] Indecision on the customs line is one factor delaying introduction of a currency--once scheduled for the beginning of 1985--because officials do not want this currency to go into surreptitious circulation in China. Without a barrier, the value of Renminbi would fall rapidly relative to the value of the zone currency unit, and individuals and organizations could use zone currency to circumvent foreign exchange controls. 25X1

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Officials may also have delayed action because they perceive the recent decline in foreign exchange reserves as a threat to China's ability to support a zone currency against competition from the Hong Kong dollar.

(C) Prospects remain good that action will be taken by the end of 1985 on establishing the customs line at least for the Shenzhen zone. The zones were intended to provide an area for freer movement of goods and people. Some reformers argue that the zones can not develop to their potential and that foreign trade can not flourish if the customs line is not established.

[redacted] The need for a zone currency is becoming acute 25X1
because businesses in the zones prefer (and sometimes only accept) Hong Kong dollars and Chinese foreign exchange certificates. Those paid in Renminbi, especially party cadre, are suffering from an inflation driven by the inflow of foreign exchange, a situation which has worsened significantly since first criticized by Gu Mu nearly two years ago. Strong opposition by conservatives, however, will likely keep the government from taking this step until it strengthens its control over corruption and currency speculations.

Prospects

(C) Major changes in the government's policy toward special economic zones do not appear imminent, nor likely in the medium term. The zones' lackluster record in obtaining key objectives, however, probably has tarnished the credibility of the policy, if not the policymakers. Reformers are nimbly switching their strategy for China's modernization and are now focusing on upgrading technology in major industrial centers through licensing agreements and joint ventures.

[redacted] The orientation of the special zones remains 25X1
an unresolved issue. The debate centers on using them strictly as export centers--cut off from the rest of China--or on using them to speed development of less developed provinces in the interior. In recent years, these provinces have invested heavily in the zones to boost their own foreign exchange earnings. If the provinces prevail or obtain a compromise on this issue, chances are slim that the zones ever will develop into export/industrial centers.

(C) Prospects for the zones are only slightly brighter if the leadership remains firm on the policy of developing export centers. The push to attract foreign investment in special

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economic zones is certain to encounter stiffening competition from other areas eager to modernize--especially major coastal cities and industrial regions--as well as from other export processing zones in Asia. The special economic zones are likely to record only modest gains in obtaining technology-enhancing foreign investment if they continue to lack the added attraction of access to the China market, which other Chinese cities are able to offer.

(C) While slow progress toward attaining policy objectives is the most likely outlook for the medium term, it is possible that the development pace can accelerate and bring about a substantial rise in zone exports. Success hinges on the zones acquiring sizable domestic investment in export-oriented industry along with the needed spending on infrastructure projects.

[redacted] Plans for three of the zones--Shenzhen, Xiamen, and Shantou--include construction of joint-venture oil refineries by the China Petro-Chemical Corporation and a foreign partner, according to Petroleum Intelligence Weekly. Shenzhen officials already have received government approval for a refinery and have explored the costs of such a project [redacted] The refinery in Shenzhen initially would process crude oil from Daqing and Southeast Asia, but is being built in anticipation of processing crude oil from the South China Sea once commercial production begins in that area. 25X1 25X1 25X1

(C) In the near term, the economics of locating refineries in the zones appears fragile because of the current oil glut, existing excess refinery capacity, and the expense of shipping crude oil for processing. Over the longer term, the key factor is the development of large commercial oil finds in the South China Sea. Oil exploration companies operating in that area have reduced their initially high expectations because of limited discoveries to date. If oil is found, refineries in the zones could become the keystone of subsequent development. If the South China Sea does not become a major producing area, the refineries in the zones would become another problem for the leadership--dressing up the landscape, but dragging down performance.

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Table 1. Direct Foreign Investment in China
(billions of US$)

	Pledged			Realized		
	1979-82 annual average	1983	1984	1979-82 annual average	1983	1984
Total of which:	1.24	1.74	3.3a/	.43	.91	1.34
Joint equity ventures	.04	.20	1.07	.03	.06	n.a.
Cooperation agreements	.68	.22	1.48	.13	.24	n.a.
Joint oil exploration	.25	1.04	.75a/b/	.12	.29	.52
Compensation trade	.18	.21		.09	.20	n.a.
Other	.09	.07		.06	.12	n.a.

n.a. = not available

a/ Minimum, estimated by INR.

b/ As of June 1984, joint oil exploration $360 million, compensation trade (-) $130 million, other $360 million.

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Table 2. Distribution of Joint Equity Ventures in China By Type, Year-End 1983

Total of which:	188
Petrochemical	20
Communications	7
Light Industry	60
Engineering, Electronics, Metallurgy	44
Construction	15
Tourist Services	21
Agriculture and Fishing	6
Other	15

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Table 3. Joint Equity Ventures in China By Location and Type

A. With Western firms, 134 cases examined

		Located in Special Economic Zones: yes	Located in Special Economic Zones: no
Technology-Intensive[a]	yes	11	54
	no	13	56

B. With US and Japanese firms, 73 cases examined.

		Located in Special Economic Zones: yes	Located in Special Economic Zones: no
Technology-Intensive[a]	yes	7	39
	no	6	21

a/ The term technology-intensive was broadly defined because specific contractual details were unavailable.

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