AN HISTORICAL PERSPECTIVE OF HONG KONG, SHENZHEN AND THE SPECIAL ZONES IN CHINA

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A THESIS SUBMITTED IN PARTIAL FULFILMENT OF

THE REQUIREMENTS FOR THE DEGREE OF

MASTER OF ARTS

in

THE FACULTY OF GRADUATE STUDIES

History

We accept this thesis as conforming

to the required standard

THE UNIVERSITY OF BRITISH COLUMBIA

December 23 1988

Department of HISTORY

The University of British Columbia
Vancouver, Canada

Date 18 JAN '89.

ABSTRACT

The Special Economic Zones (SEZs) are an important part of China's latest economic development strategy in its long history and drive for modernization. In many ways, they are as much a product of China's past as they are a product of the post-Mao Open Door Policy and economic reforms, and a precursor of things to come in China. Specially designated zones for trade and contact with foreigners have existed in China since the Tang dynasty when China conducted a frontier trade with its neighbours. The Canton system and the treaty ports were subsequent versions of special zones in China. Although the treaty ports were abolished by the Chinese Communist Party (CCP) after 1949, Hong Kong and Macau continued to exist and flourish as special zones in China, albeit under foreign control, as the treaty ports were.

In order to understand the reason(s) for the existence of the SEZs in China today, it is necessary to see them in the historical context of special zones in China as well as in the context of the post-Mao economic reforms. Since the Third Plenum in 1978, the main trend of the reforms has been towards increasing liberalization and decentralization of trade and other economic activities. These developments constitute a sharp departure from the radical leftist policies which have dominated politics and economics in China for three decades.

However, despite the promise of economic growth and development throught the Open Door Policy and the other post-Mao changes, they also raise some new political, ideological and economic problems for China. The political and economic stakes riding on the success or failure of the economic reforms and the SEZs are enormous. What happens to the SEZs, and the Shenzhen SEZ in

particular, would have profound implications for the post-Mao reforms, the Open Door Policy, the stability and prosperity of Hong Kong after July 1, 1997, the Chinese leadership, modernization and even socialism in China. The purpose of this study is to discuss the SEZs within the greater historical context of special zones in China, the post-Mao reforms, and to discuss the economic relationship between the Shenzhen SEZ, China's most successful SEZ, and Hong Kong, the most active investor in Shenzhen and China. The political and ideological dimensions of the SEZs and Hong Kong's relationship with Shenzhen will also be briefly discussed in this study.

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INTRODUCTION

Special zones in China are an interesting phenomenon in China because they represent the conflict between the need for greater contact with the outside world, while at the same time, the need to preserve that which makes China unique and different from the rest of the world. In earlier times, China sought to preserve its imperial order, based upon Confucian philosophical tenets, from foreign influences. Nevertheless, China was later forced open by foreigners. In China today, because of the desire for modernization, there is a similar need for greater openness to the outside world, while at the same time, the need to preserve the existing order in China. Ironically, however, this time, it is socialism, a foreign ideological and political import, not Confucianism, that China seeks to shield from the disruptive influences from abroad.

The purpose of this study is to discuss the SEZs in China today by focusing on the Shenzhen SEZ, the most important SEZ, and until the creation of the Hainan Island SEZ in 1988, also the largest, and Hong Kong's involvement as the most active investor in it. In looking at the relationship between Shenzhen and Hong Kong, several questions demand special attention, especially since the 1997 deadline for the turnover of Hong Kong back to China is rapidly approaching. The questions this study will address are: (1) why do Hong Kong businessmen invest in Shenzhen?, (2) what areas are they investing in, and why?, and (3) what does Hong Kong offer to China through its investments in Shenzhen? Aside from these three questions, other questions related to the economic reforms, which have an impact on the SEZs, that will be discussed in this study are: (1) how will the economic reforms and the SEZs affect socialism in China?, (2) do the SEZs in China also mean the re-emergence of foreign zones like the treaty ports, and all of the problems associated with them?, and (3) how will new problems such as increased crime and corruption, which are, in part, also a result of China's new reform policies, affect the future of the SEZs and the economic reforms? This study will also briefly look at the past performance of the SEZs since they were created in 1979 to about 1986.

The first chapter of this study will discuss the early special zones in China's history as well as Hong Kong's role as a special zone for China, mainly as a supplier of foreign exchange, an entrepôt, a financial centre, and a link with the outside world. Chapter Two will discuss the post-Mao reforms in China which set the stage for the creation of Shenzhen and the other SEZs. Most of Chapter Three will discuss Hong Kong's relationship with Shenzhen from an economic perspective. However, Hong Kong's cultural ties and its future relationship with China as a Special Administrative Region (SAR) of the People's Republic of China (PRC) will also be discussed briefly. Chapter Four deals with the SEZs within the context of the economic reforms and some of the related questions and issues which will affect the future of the SEZs and the economic reforms in China.

The romanization system used in this study for Chinese names and words is *pinyin*. However, names and places that appear as references in Wade, or other systems, will not be changed to *pinyin*. Furthermore, the *pinyin* version of commonly used and understood names and places such as Hong Kong (*Xianggang*) will not be used in this text unless they are quoted or translated as such from the original source.

I. THE HISTORICAL AND ECONOMIC BACKGROUND

A. THE EARLY SPECIAL ZONES IN CHINA

Specially designated foreign zones in China are an interesting phenomenon because they represent both the need for more openness and contact with the outside world, while at the same time, the need to quarantine these influences in order to minimize and control their impact on the existing political, economic and social institutions. It is thus, interesting to note that in this respect, there is a continuity between the SEZs in China today and the special zones that existed earlier in Chinese history. Michael Oborne noted that the SEZs and the 14 open coastal cities that are open to foreign investments in China today have their historical roots in the early special foreign trade zones in China's past, and that they

> ...are located in the same areas as those cities reserved for foreign contact and trade in the 19th century, as well as those traditional areas for trade and contact with Arab merchants under the Tang, Yuan and Ming dynasties. [1]

China's first special zone created specifically for the purpose of handling trade with Western traders (the Portuguese, the Dutch, and later, the British) was in Canton (Guangzhou). The trading arrangement, under which the foreigners operated was known as the "Canton system," which lasted from 1757 to 1842. It was the institutionalized product of China's earlier experiences with foreigners and foreign trade and its Confucian social ethics. China's external relations was an outward expression of its internal order based on Confucianism in which

[1] Michael Oborne, *China's Special Economic Zones* (Paris: The Development Centre of the Organisation for Economic Co-operation and Development, 1986), pp. 28-29.

social relations were hierarchical and unequal. The trading arrangements were also an outgrowth of traditional Chinese attitudes towards outsiders and China's Sinocentric world order in which the Chinese emperor, who was called the "Son of Heaven," was considered to be at the apex of civilization and the ruler of all mankind.[2]

China's attitude towards foreigners and trade was also conditioned by the fact that Chinese civilization had grown up surrounded by less sophisticated neighbours in which trade with them often took the form of gifts brought to the emperor, in the form of tribute, in exchange for gifts from the Chinese emperor. The exchange of gifts had another symbolic significance in that it represented the bestowing of generosity, compassion, and the blessings of civilized contact by the Son of Heaven to the foreign "barbarians."[3] Rhoads Murphey noted that

> ...the tribute system was in one sense a polite, formal cloak for a limited trade between China and her neighbours...this exchange served to regulate and control relations with foreigners. It kept them from disturbing the country as a whole. It also preserved the notion of China's superiority.[4]

Although tribute was an important part of foreign relations, there were also "trading countries" that traded with China but did not send tribute to China.[5] Joseph F. Fletcher also observed that China's relations with Central Asia through the tribute system were often misleading in that Central Asian kingdoms often submitted to the formalities of the tribute system, even though they did

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[2] Mark Mancall, "The Ch'ing Tribute System: An Interpretive Essay," in *The Chinese World Order: Traditional China's Foreign Relations*, ed. John King Fairbank (Cambridge: Harvard University Press, 1968), p. 64.
[3] Oborne, pp. 28-29.
[4] Rhoads Murphey, *China Meets the West: The Treaty Ports* (New York: Macmillan Publishing Company, Inc., 1975), p. 17.
[5] Mancall, p. 75.

not regard themselves as vassals, or recognize the suzerainty of the Chinese emperor, so that they could enjoy the benefits of a lucrative trade with China.[6] Furthermore, Fletcher also pointed out that China often maintained a double standard in its myth of world supremacy in that it preserved the notion of Chinese world supremacy within the empire, but often made exceptions to this principle in its foreign relations when it became a hindrance.[7] Nevertheless, the single most influential and dominant theme shaping China's foreign relations was its desire to control foreign contact and to keep it at an arms length.

Consequently, when the Europeans arrived in China and sought to establish trade relations, China's response to them was largely conditioned by these desires and its earlier foreign relations experiences. According to John King Fairbank, China's reaction to the West was also hampered by its traditional attitudes and stereotypes of barbarians. Therefore, China was unprepared for Western contact because it did not treat the Westerners as an entirely new phenomenon, but as a new form of Inner Asian barbarian.[8] As a result, the Chinese emperor limited all foreign trade to a single port city--Canton, where all trade activities were supervised and tightly controlled. The Westerners were only permitted to trade during set trading seasons--and then, only with the Cohong, a guild of Chinese merchants with a monopoly to trade with them. The foreign traders were also subject to a number of other restrictions, confined to a thin strip along the Canton waterfront and expected to leave once the trading season was over. By making Canton into a special quarantined trading zone (or port) to

[6] Joseph F. Fletcher, "China and Central Asia, 1368-1884," in *The Chinese World Order: Traditional China's Foreign Relations*, ed. John King Fairbank (Cambridge: Harvard University Press, 1968), p. 207.
[7] Fletcher, p. 224.
[8] John King Fairbank, *Trade and Diplomacy on the China Coast: The Opening of the Treaty Ports, 1842-1854* (Cambridge: Harvard University Press, 1953), pp. 7, 9.

deal with European merchants, the Chinese emperor was able to limit and control the "negative" or disruptive influences of the traders and foreign trade on the rest of the country.[9]

The British were dissatisfied with the terms of the Canton system and proposed to open up trade with China and conduct it on a more equal basis. However, Britain's proposals were rejected by the Chinese, who felt that China had very little to gain but much to lose by changing the existing arrangement and opening up the country to trade. More importantly, however, was the fact that foreign relations outside of China's ideological and political framework (and trade on a more equal basis as proposed by the British) was unacceptable because it threatened China's world order, which necessitated that relations between the "Middle Kingdom" and its "uncivilized" neighbours be conducted on an unequal basis.[10]

After efforts by Britain to open China up to trade through diplomatic means (in 1793 and 1816) had failed, the British merchants turned to trading (and later smuggling) opium in order to help balance their trade with China.[11] Disputes between China and Britain over the issue of opium eventually led to the first Opium War in 1839, and China's defeat in 1842.[12] The Treaty of Nanking of 1842 ended the restrictive Canton system, opened China up to

[9] *China Meets*, p. 17.
[10] John King Fairbank, "A Preliminary Framework," in *The Chinese World Order: Traditional China's Foreign Relations*, ed. John K. Fairbank (Cambridge: Harvard University Press, 1968), p. 2.
[11] *Trade*, pp. 14, 30.
[12] There are different views on the cause(s) of the First Opium War. For example, compare the views advocated by John King Fairbank in *Trade*, p. 74, and Rhoads Murphey in *Shanghai: Key to Modern China* (Cambridge: Harvard University Press, 1953), pp. 57-61, with Chang Hsin-pao, in *Commissioner Lin the Opium War* (Cambridge: Harvard University Press, 1964).

Western commercial exploitation with the establishment of five treaty ports (Canton [Guangzhou], Amoy [Xiamen], Foochow [Fuzhou], Ningpo [Ningbo], and Shanghai) for foreign residence and trade, ceded the island of Hong Kong to England for development as a naval and commercial base, and gave Britain extraterritoriality (the right to be governed by its own laws) in the treaty ports, and the most-favoured nation status, which would automatically give it any privileges that China may subsequently give to any other nation.[13]

The opening of the treaty ports marked a turning point and a new era in China's relations with the West characterized by the opening of more and more cities to foreign trade and influence by the foreign powers. According to Michael Gasster, more than 80 cities were eventually opened to trade, of which 17 included foreign settlements.[14] Out of the treaty ports emerged China's modern economic sector, which thrived on free trade and free market principles. Shanghai became the leading treaty port, possessing the most developed and sophisticated infrastructure and trade connections. By 1861, it accounted for over half of China's total export trade.[15]

The foreign powers in the treaty ports believed that the treaty ports were the wave of the future, representing progress that would eventually sweep across all of China, which they felt was "backward," as other Western outposts did in other parts of Southeast Asia.[16] However, despite the fact that these

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[13] *China Meets*, pp. 26-27.
[14] Michael Gasster, *China's Struggle to Modernize*, 2nd ed. (New York: Alfred A. Knopf, 1983), p. 12. Gasster's figure was much larger than the one given by Ramon Myers, of 48 port cities. See *The Chinese Economy: Past and Present* (Belmont: Wadsworth, Inc., 1980), p. 152.
[15] *Shanghai*, p. 65.
[16] Rhoads Murphey, "The Treaty Ports and China's Modernization," in *The Chinese City Between Two Worlds* (Stanford: Stanford University Press, 1974), p. 17.

special zones flourished, their impact on China's hinterland economy was largely insignificant. Ramon Myers noted that the influence of the modern sector was mainly restricted to the city-ports and its surrounding communities within a fifty mile radius.[17] Therefore, despite the fact that the treaty port era lasted for almost a century, they had failed to modernize or transform the rest of the Chinese economy.

Why China failed to modernize in the nineteenth and early twentieth century is still the subject of much historical writing. The Western historical analytical framework for the period in question, such as the impact-response approach, the tradition-modernity approach, and the imperialism approach attributed China's under-development to the traditional social and cultural characteristics of Chinese society, which inhibited a more vigorous reaction by China to foreign encroachment. This view was advocated in various writings by such scholars as John King Fairbank and Rhoads Murphey.[18]

Frances V. Moulder challenged this traditional view of modernization in China by comparing the different reactions and results to Western imperialism in China and Japan. She argued that it was the differences in the extent in which China and Japan were incorporated by the Western powers, rather than differences in their social and cultural characteristics, which resulted in the different results of foreign economic aggression in China and Japan.[19] Moulder

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[17] Myers, pp. 139-140.

[18] For example, see John King Fairbank and Ssu-yu Teng, *China's Response to the West: A Documentary Study, 1839-1923* (Cambridge: Harvard University Press, 1954), and Rhoads Murphey, "The Treaty Ports and China's Modernization," in *The Chinese City Between Two Worlds* (Stanford: Stanford University Press, 1974).

[19] Frances V. Moulder, *Japan, China and the Modern World Economy: Toward a Reinterpretation of East Asian Development ca. 1600 to ca. 1918* (Cambridge: Harvard University Press, 1964), pp. vii-viii, 8.

pointed out that China and Japan had more in common in the social and cultural spheres than they did with the foreigners, and that it was the fact that China was more strongly "incorporated" by the Western capitalist nations than Japan, which prevented China from developing the autonomy that it needed to industrialize as Japan did.[20]

The scope of the modernization question in China is a more complex problem than the explainations presented by Moulder or the traditional theorists. The analytical approach to the question of modernization in China by Western historians today is characterized by the de-emphasis of what Paul A. Cohen calls Western ethnocentric distortion and biases, which has dominated much of the earlier historical analysis of China. The thrust of the new approach is to reassess the West's role in China, and to see China not as a static society, but within its own, and not a Western context, as a dynamic society.[21]

Although Rhoads Murphey's historical analysis of China is based largely on the impact-response conceptual framework,[22] he has raised some very interesting and relevant points about the treaty ports which can also be applied to the SEZs phenomenon today. The following is a summarization of some of the main arguments presented by Rhoads Murphey in *The Outsiders: The British Experience in India and China*, and his article, "The Treaty Ports and China's Modernization," to explain why the treaty ports had failed to modernize the rest of the Chinese economy. The purpose of summarizing his arguments is to provide a basis for some comparison of the treaty ports with the special zones in China

[20] ibid.

[21] See Paul A. Cohen, *Discovering History in China: American Historical Writing on the Recent Chinese Past* (New York: Columbia University Press, 1984), pp. 1-6.

[22] For example, see "The Treaty," p. 18.

in Chapter Four.

Murphey argued that one of the reasons for the failure of the modern sector to change the traditional sector in China was the fact that the treaty ports were an isolated phenomenon on the Chinese coast which were "...an artificial graft which never grew into an organic union with the late traditional economy of China."[23] The treaty ports were essentially enclave economies, isolated from the rest of the Chinese economy, which was relatively content with its existing technology and institutions. Because of this isolation, the influence of the treaty ports failed to transform the rest of the Chinese economy. Furthermore, the treaty ports were only small pockets of foreign influence when compared to the immense size of the rest of the Chinese economy. Murphey pointed out that the Western influence on China's economy was small because China "...was simply too vast to be moved, let alone transformed by marginal seacoast contact with a relative handful of foreigners, however vigorous or effective they were."[24] He further pointed out that the sheer bulk of China's geography, demographics, and economy, and the huge total of its production "...helped both to absorb and deflect European efforts at penetration or transformation."[25]

The treaty ports failed to develop any significant linkages with the rest of the Chinese economy because China's traditional economy was still able to satisfy the needs of the Chinese in the countryside. Because traditional Chinese products were often equal or superior to foreign goods in quality, and usually

[23] Rhoads Murphey, The Outsiders: The British Experience in India and China (Ann Arbor: The University of Michigan Press, 1977), p. 104.
[24] *Outsiders*, p. 132.
[25] "The Treaty," p. 26.

cheaper, the modern sector did not make much of an impact on China's economy.[26] Consequently, the treaty port model did not spread outside of the treaty ports. Instead, they became outward-oriented, developing linkages with the other treaty ports, and with the West.[27]

Lastly, Murphey explained that the failure of the treaty ports to influence China was due to China's maintenance of territorial sovereignty (albeit nominally) over the treaty ports. Even though the foreigners ran the treaty ports, 99 per cent of the area and population that existed outside of the treaty ports was still under Chinese control.[28] As a result, the vast majority of China's territory and people were still a part of China and not affected by what happened in the treaty ports. Moreover, because China was not reduced to colonial status, it was able to ignore and reject the treaty ports as an alien influence and continue to exist as it had always existed. Although the economic impact of the treaty ports on the Chinese economy was limited, they were the hotbed for revolutionary change in China which would eventually bring an end to the era of the treaty ports in 1949 and change the face of China politically, economically, socially and culturally.[29]

John King Fairbank, in his article, "The Creation of the Treaty System," pointed out that the treaty ports were centres of criminal activities, corruption and dissidence, such as the orgainization of secret societies, opium smuggling, piracy and the coolie trade.[30] Moreover, because these activities were conducted

[26] *Outsiders*, pp. 104, 122., and "The Treaty," pp. 27, 30.
[27] *Outsiders*, p. 105.
[28] *Outsiders*, p. 135.
[29] See "The Treaty", pp. 18, 71.
[30] John King Fairbank, "The Creation of the Treaty System," in *The Cambridge History of China*, vol. 10, part 1, Late Ch'ing, 1800-1911, eds. Denis Twitchett and John King Fairbank (Cambridge: Cambridge University Press, 1980), pp.

under foreign protection, they were outside of China's jurisdiction and control. Consequently, this was another reason why the treaty ports were not very attractive models for economic development. The next section will deal with Hong Kong as a remenant of the treaty port era and how it serves China as an independent special zone.

[30] (cont'd) 235-237.

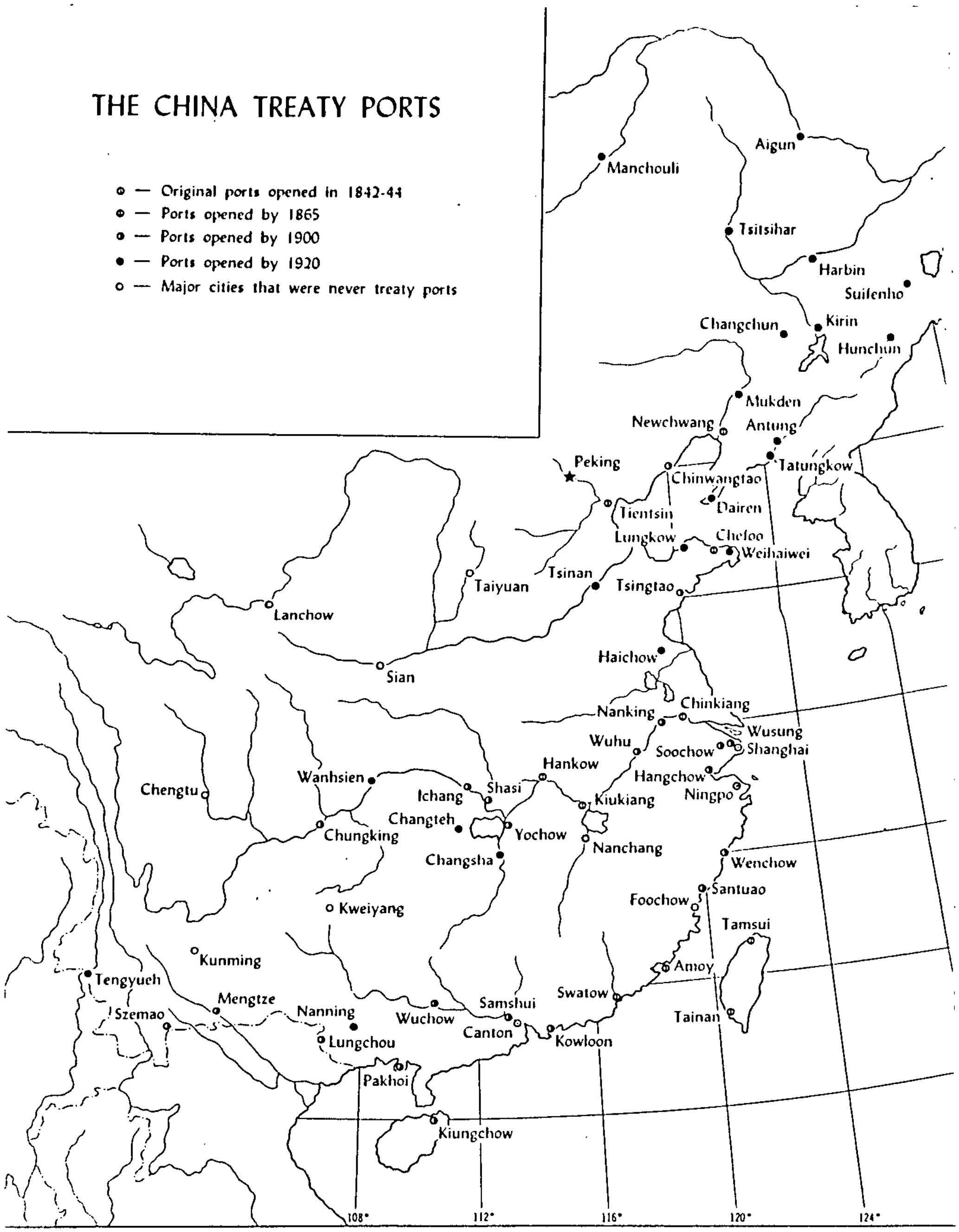

Figure 1. The Treaty Ports

Source: Rhoads Murphey, *The Outsiders: The Western Experience in India and China* (Ann Arbor: The University of Michigan Press, 1977), back inside cover.

B. THE CREATION AND THE ECONOMIC TRANSFORMATION OF HONG KONG

The present political area which makes up the British colony of Hong Kong was the product of British colonialism in the nineteenth century. The island of Hong Kong was ceded in perpetuity to Britain through the Treaty of Nanking in 1842, while the Kowloon Peninsula and Stonecutters' Island were ceded to Britain in 1860, as the result of The Convention of Peking. Britain obtained a ninety-nine year on the New Territories from China through The Convention of Peking in 1898.[31]

The acquisition of Hong Kong was the result of Britain's desire to open up the Chinese market to trade. Hong Kong was to serve as an anchorage, "a place of trade," and a launching-pad for British traders to the southern Chinese coast. However, the colony in the nineteenth century was, as the British Minister to Peking in 1868 put it, "little more than an immense smuggling depot."[32] Nevertheless, despite Hong Kong's unsavory reputation, it thrived on its entrepôt trade, which nurtured the early devlopment of banking, broking, shipping, ship-building and a host of other support industries.

Perhaps the most amazing fact about Hong Kong was that it did not suffer the same fate as the treaty ports when the CCP took over the Chinese mainland in 1949. Since its creation in 1842, when Hong Kong was little more than a "barren rock" with a tiny population struggling to survive, it has

[31] Ian Kelly, *Hong Kong: A Political-Geographic Analysis* (London: The MacMillan Press Ltd, 1987), pp. 26-33.

[32] D. K. Lewis, *The Prospects for Hong Kong* (London: Institute for the Study of Conflict, 1982), p. 4.

emerged as one of the world's largest manufacturing and financial centres. This was a remarkable achievement because before 1949 Hong Kong had a weak infrastructure based mainly on its entrepôt activities. After 1949, when Shanghai, China's largest and most developed commercial centre, and the rest of China was taken over by the Chinese Communists, much of the business, entrepreneurial and technical talent which fled from the modern sector in China found refuge in Hong Kong. As a result, after 1949, Hong Kong, in many ways, resumed the role as the main commercial centre for doing business with China. Perhaps even more important was that Hong Kong became China's window on the world and the world's window on China.[33] In a sense, Hong Kong became China's surrogate independent modern sector to replace the treaty ports.

In 1950, when the United Nations (UN) trade embargo was imposed on China because of its involvement in the Korean Conflict, Hong Kong's entrepôt trade was effectively wiped out. Although Hong Kong continued to serve as a link with the outside world, it had to turn to manufacturing its own goods (chiefly textiles) for export in order to survive. The textile manufacturing industry laid the foundations for the plastic products and electronic goods manufacturing industry to follow. The shift in economic strategy from entrepôt to manufacturing and exporting was possible largely because of the massive influx of capital, labour and entrepreneurial and industrial talent from Shanghai and other parts of China into Hong Kong between 1948-1951.[34] In a sense, China provided Hong Kong with the necessary industrial base and the initial momentum to develop

[33]Jack F. Williams, "Big Dragon, Little Dragon: The Economies of Hong Kong and Taiwan and Their Future Relationship with the People's Republic of China," in *The Future of Hong Kong and Taiwan*, ed. Jack F. Williams (East Lansing, Michigan: Michigan State University, 1985), p. 66.

[34]Edward K. Y. Chen, "The Impact of China's Four Modernizations on Hong Kong's Economic Development," in *China and Hong Kong: The Economic Nexus*, ed. A. J. Youngson (Hong Kong: Oxford University Press, 1983), p. 85.

into one of the world's largest manufacturing centres.[35]

D. K. Lewis commented on the remarkable and somewhat surprising success of Hong Kong when he wrote

> that no one in 1842 could have imagined that [the] Chinese [from the mainland] would flow into Hong Kong in such numbers and with such impetus and energy that they would change the original concept of the settlement utterly. Eventually the place became not a British trading post serviced by Chinese labour but a Chinese industrial community serviced by a British administration.[36]

Living in China's shadow has many important consequences for Hong Kong. The most significant of which is its precarious existence, which makes it particularly vulnerable and sensitive to its enormous neighbour, who can easily devour it. Besides living in an extremely fragile political environment, Hong Kong also has a weak economic foundation. Other than its people and its harbour, Hong Kong lacks any significant natural resources. As a result, Hong Kong cannot survive without the goodwill of China, and the food, water, fuel, raw materials, and other consumer goods which it provides Hong Kong at prices much lower than world levels.[37]

The relationship between China and Hong Kong is a mutually advantageous one. A. J. Youngson described the mutually beneficial relationship

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[35] Graham Johnson, *1997 And After: Will Hong Kong Survive?* (Toronto: University of Toronto-York University, Joint Centre on Modern East Asia, 1985), pp. 5-6., and Gregor Benton, *The Hong Kong Crisis* (Australia: Pluto Press Ltd, 1983), pp. 19-20.

[36] D. K. Lewis, p. 4.

[37] Walter E. Gourlay, "Hong Kong and Taiwan: The Colonial Heritage," in *The Future of Hong Kong and Taiwan*, ed. Jack F. Williams (Michagan: Michagan State University, 1985), pp. 10-12. See also L. C. Lau, "Imports of Consumer Goods from China and the Economic Growth of Hong Kong," in *China and Hong Kong: The Economic Nexus*, ed. A. J. Youngson (Hong Kong: Oxford University Press, 1983), p. 184.

between Hong Kong and China as a "unique symbiotic relationship."[38] China allows Hong Kong to exist, and subsidizes its economic growth and development, in return for the many services and benefits that it enjoys from Hong Kong as a relatively independent, modern and extremely successful economic entity. Since 1949, Hong Kong has served China faithfully as a supplier of foreign exchange, a trading partner, and an international trade intermediary. In 1959, Mao Zedong stated that "it is better to keep Hong Kong the way it is. We are in no hurry to take it back. It is useful to us right now."[39] It is interesting to note that before the Open Door Policy, China found it useful to maintain and help support Hong Kong because of the economic and non-economic benefits that it derives from the British colony. The purpose of the next section is to briefly explore some of the many benefits and advantages that Hong Kong, as an independent political and economic special zone offers to China in order to set the stage for looking at the relationship between Hong Kong and the Shenzhen SEZ.

C. HONG KONG: THE GOOSE THAT LAYS GOLDEN EGGS FOR CHINA

Perhaps one of the most important and obvious benefits that Hong Kong offers to the PRC is that of a steady and reliable source of foreign exchange. It is generally acknowledged that Hong Kong is China's single largest supplier of foreign exchange.[40] Although there has been much speculation over the exact

[38] A. J. Youngson, "Introduction," in *China and Hong Kong: The Economic Nexus*, ed. A. J. Youngson (Hong Kong: Oxford University Press, 1983), p. 11.
[39] Ma Hong, "How to Use the Hong Kong to Serve the Acceleration of China's Four Modernizations," *Economic Studies Reference Materials* (March 1979), as quoted in Joseph Y. S. Cheng, *Hong Kong: In Search of a Future* (Hong Kong: Oxford University Press, 1984), p. 61. *Economic Studies Reference Materials* is a publication for senior Chinese cadres.
[40] See John C. Hsu, "Hong Kong in China's Foreign Trade: A Changing Role," in *China and Hong Kong: The Economic Nexus*, ed. A. J. Youngson (Hong Kong: Oxford University Press, 1983), pp. 156-183. Also, Y. C. Jao, "Hong Kong's Role in Financing China's Modernization," in *China and Hong Kong: The*

figure of China's foreign exchange earnings from Hong Kong, the Chinese government has not published a great deal of detailed statistical information on this subject. Therefore, the purpose of this section is not to determine exactly how much China earns from Hong Kong, but just to discuss some of the most important benefits that Hong Kong provides China as an independent economic entity. The categories that will be analyzed in this section in order to illustrate the importance of Hong Kong to China are: (1) Remittances and Donations, (2) Trade, and (3) Investment Centre.

1. Remittances and Other forms of Unrequitted Transfers

The PRC has recognized the many significant contributions that the overseas Chinese (including Hong Kong and Macau residents) have made to China in the past. At this point, it is important to point out that the term, overseas Chinese (*huaqiao*), was used at one time to refer to all ethnic Chinese living outside of China. However, as relations between the overseas Chinese and China became more complex, there was a need to differentiate the many finer distinctions that this broad, and often confusing term encompasses. For example, the Chinese-speaking ethnic Chinese in Southeast Asia refer to themselves as *huaren* or *huazu*, meaning ethnic Chinese.[41] Other ethnic Chinese groups refer to themselves as Chinese-Malaysians, Chinese-Americans etc., in order to emphasize their local national identity and the fact that they are different from the Chinese in China.[42] Because of the awkward political situation of Hong Kong and Macau, which are presently governed by Britain and Portugal respectively, the

[40] (cont'd) *Economic Nexus*, ed. A. J. Youngson (Hong Kong: Oxford University Press, 1983), pp. 12-76.

[41] Leo Suryadinata, *China and the ASEAN States: The Ethnic Chinese Dimension* (Singapore: Singapore University Press, 1985), pp. 2-3.

[42] Suryadinata, p. 3.

PRC refers to them as Hong Kong and Macau compatriots (*Gangao tongbao*). Interestingly, Taiwan residents are also referred to as compatriots (*Taiwan tongbao*).[43] Technically, the term overseas Chinese today is used to refer only to Chinese nationals that are residing or travelling outside of China.[44] However, the usage of the term overseas Chinese in this study will be used in its broader context to include Hong Kong and Macau residents, as well as other groups of ethnic Chinese living outside of China.

In 1983, Lian Guan, the Vice Director of the Overseas Chinese Affairs Office of the State Council praised the overseas Chinese because of their active participation and significant financial support to China in times of need. He noted that they were actively involved in funding and supporting various revolutionary struggles such as the overthrow of the Qing dynasty in 1911, the Sino-Japanese War from 1937-1945, as well as the rebuilding of China after 1949.[45] Cash remittances and donations are two of the most important invisible sources of foreign exchange from the overseas Chinese. Because remittances and donations are invisible sources of foreign exchange for China, which flow through many formal and informal channels before they eventually reach their recipients, it is difficult to obtain an exact figure of such earnings. Moreover, because these two sources of foreign exchange often flow through personal networks, there is often no record of them. Nevertheless, there are many studies and estimates on this subject which provide a rough idea of their significance to China.[46]

[43] ibid.

[44] Suryadinata, p. 4.

[45] *China Official Yearbook, 1983-1984* (Hong Kong: Dragon Pearl Publications Ltd., 1983), pp. 458-460.

[46] For example, see Wu Chun-hsi, *Dollars, Dependents and Dogma: Overseas Chinese Remittances to Communist China* (Stanford: The Hoover Institution on War, Revolution and Peace, 1968)., H. B. Morse, *An Inquiry into the Commercial Liabilities and Assets of China in International Trade* (Shanghai: Chinese Maritime Customs, 1904)., C. F. Remer, *Foreign Investments in China* (New York: The

A number of factors were responsible for making Hong Kong the principal avenue for the retransfer of funds to the mainland before, and especially after 1949. Firstly, in the pre-1949 period, Hong Kong was not only an important centre of economic operations on the coast of China, but was already a vital focal point for the inward transfer of remittances into China because it had direct connections with all of the major cities in the world and was conveniently situated next to China. Secondly, after 1949, Hong Kong's role in forwarding remittances to China assumed an even greater importance because communications between overseas doners and China became increasingly difficult.[47] Moreover, because many countries had imposed restrictions on, or prohibited sending remittances to China, Hong Kong naturally became a major centre where remittances from abroad was sent to be relayed to China.[48] Many overseas donors also have relatives in Hong Kong, who would help forward remittances to their final destinations.[49] Lastly, Y. C. Jao attributed the reason why Hong Kong residents were responsible for the predominant share of remittances to the fact that they shared a closer and more immediate cultural and geographic relationship with China, as well as the fact that Chinese State Controlled Banks in Hong Kong, were for a time, the only channel through which remittances could officially enter into China.[50]

Because of the immensely dense networks through which remittances must traverse, and the unavailability of statistics from many sources, it is difficult to provide a complete picture, or an accurate figure on the amount of

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[46](cont'd) Macmillan Co., 1933)., and The United Nations, *The Economic Survey of Asia and the Far East* (The United Nations, 1950).
[47]Wu, pp. 151-156.
[48]Wu, pp. 84-88, and 155-156.
[49]ibid.
[50]Jao, p. 39.

remittances that China has received. Therefore, the estimates cited by the various sources in this study can, at best, only provide a rough approximation of the amount of remittances that China has received. Wu estimated that between 1950 and 1964, Hong Kong residents were the largest single source of remittances (an average of about 27 per cent, or US$12.23million/year), and was the most important avenue through which remittances passed into China (about 68 per cent of all remittances).[51] According to Y. C. Jao, Hong Kong provided an inordinate share (about 93 per cent) of all remittances and unrequitted transfers to China from 1950 to 1972. This amount declined somewhat in 1979 to about 83 per cent.[52]

Although it is impossible to determine the exact amount of remittances and other unrequitted transfers that China has received, it is known that at times, they were a valuable source of income for the recipients and the local economy. For example, in 1957, it was estimated that remittances were the main or only source of income and livelihood for about one-third of the more than ten million overseas Chinese family dependants.[53] Consequently, both the Nationalist government and the Communist government have regarded overseas Chinese remittances as an important asset and source of foreign exchange, and both governments were actively involved in wooing overseas Chinese support. Stephen Fitzgerald noted that

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[51] Averages derived from figures in Table 47 of Wu, p. 142.
[52] Table 1.10 in Jao, pp. 40-42. The sources upon which Jao based his study are Mah Feng-hwa, *The Foreign Trade of Mainland China*, (Edinburgh: University of Edinburgh Press, 1972)., Japan External Trade Organization, *China: A Business Guide, the Japanese Perspective on China's Opening Economy*, (Tokyo: Tokyo Press International Ltd., 1979)., and unpublished information from the Census and Statistics Department in Hong Kong. Table 1.10 also provided some estimates of remittances received in the form of gifts and donations.
[53] *Qiaowubao*, 27 February 1957, p. 10.

> ...the huge volume of overseas Chinese remittances before the Second World War was possibly the single most important factor influencing the KMT's attempts to prevent any weakening of the overseas Chinese attachment to China. In 1949, [after the communist victory on the mainland] the CCP appears to [also] have anticipated that the overseas Chinese would provide a major source of foreign exchange in the first years of its rule.[54]

Because most overseas Chinese have their ancestral roots in the southeastern provinces of Guangdong and Fujian, it is not surprising that these two provinces are also the major beneficiaries of remittances and other forms of unrequitted transfers from overseas. According to Yuen-fong Woon, southeast China receives over 80 per cent of all overseas Chinese remittances and investment funds as well as other projects supported by overseas Chinese capital.[55] The home provinces of the overseas Chinese were also the main recipients of donations and other forms of contributions used to fund the improvement or construction of public facilities such as hospitals, bridges, schools, theatres, roads, cultural and education centres, running water projects and nursuries.[56] In 1987, it was reported that Guangdong province received more than US$300 million in donations since the beginning of the Open Door Policy, and that Henry Fok, a Hong Kong billionaire, who was born in the Pearl River Delta area, donated US$50 million and invested US$100 million in Guangdong between 1980 and 1985.[57] According to the *1986 Guangdong Statistical Yearbook*, Hong Kong and Macau residents donated an enormous Rmb5.57

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[54] Stephen Fitzgerald, "China and the Overseas Chinese: Perceptions and Policies," *China Quarterly*, no. 44 (1970), pp. 12-13.

[55] Yuen-fong Woon, "The Voluntary Sojourner Among the Overseas Chinese: Myth or Reality?" *Pacific Affairs* 54 (Winter 1983-84): 681.

[56] *Guangzhou Nianjian, 1986* (Hong Kong: Xianggang Jingji Daobao Sheyinshua, 1986), p. 85., and *Guangdong Sheng Tongji Nianjian, 1986* Guangzhou: Guangdong Sheng Tongji Jubian, 1986), p. 50.

[57] Gene Linn, "Jewel in the Crown," *China Trade Report* 25 (May 1987): 8-9. Linn also noted that the close cultural, linguistic and familial ties between Hong Kong residents and the inhabitants of the Pearl River Delta region was the major factor in the donations and investments.

hundred million to their home villages (*jiaxiang*) in 1985.[58]

Remittances, donations and other forms of unrequitted transfers from Hong Kong and the overseas Chinese constituted an important source of foreign exchange for China. The large share of remittances from Hong Kong, and the intermediary role that Hong Kong plays in the transfer of remittances into China from abroad has made Hong Kong an extremely valuable asset to the PRC as a supplier of foreign exchange. The next section will look at Hong Kong as a trading partner with China as well as an entrepôt in China's international trade relations.

2. Hong Kong as a Trade Partner and Entrepôt

Today, Hong Kong is China's largest trading trading partner[59] and has often been called the gateway into China. China, on the other hand, is Hong Kong's largest trading partner, followed closely by Japan.[60] It is therefore not surprising that these two roles have deep historical roots in Hong Kong. Between the two World Wars, the Hong Kong economy experienced an incipient, but short-lived expansion of its industrial activities, which came to an abrupt halt in 1941, with the Japanese invasion of Hong Kong. After WWII, Britain resumed control of Hong Kong, and guided by the principles of free enterprise, low taxation and *laissez-faire* government policies, Hong Kong underwent a rapid period of reconstruction and recovery. However, the UN trade embargo on China had all but destroyed Hong Kong's post-war entrepôt role with China and forced

[58] *Guangdong*, p. 50.
[59] *Business China*, 20 June 1988, p. 84.
[60] *Xianggang Jingji Nianjian, 1986* (Hong Kong: Xianggang Jingji Daobao Chuban, 1986), sec. 4, p. 30.

it to embark on a new economic path towards export industrialism in order to survive.[61]

The low level of trade between Hong Kong and China from the 1950s to the early 1970s was the result of the trade embargo and China's own restrictive internal policies towards trade. During the 1950s, China's main trading partners were the Soviet Union and the Eastern Bloc countries. Nevertheless, despite the hostile attitude towards trade, and the internal turmoil within China caused by events like the Great Leap Forward and the Cultural Revolution, China maintained its trade relations with Hong Kong. Perhaps one of the main reasons for this was the fact that Hong Kong was an extremely valuable source of trade surplus for China. With the exception of 1950 and 1951, the balance of trade between Hong Kong and China was always in favour of China. According to estimates by Jao, China's cumulative trade surplus against Hong Kong from 1950 to 1979 was a staggering US$17,295.6 million.[62] The new attitude towards trade and the West in the post-Mao leaders in China was reflected by the dramatic increase in trade between Hong Kong and China from 1977 to 1981. China's trade surplus against Hong Kong in that period was US$13,032.80 million, more than half of China's trade surplus against Hong Kong from 1950 to 1981.[63]

Closely related to Hong Kong's role as a trading partner with China is

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[61] Kelly, pp. 46-54.
[62] Jao, pp. 14-17. Jao warned that due to the absence of reliable and systematic balance of payments data for both China and Hong Kong, his estimates should be regarded as an educated guess.
[63] ibid. On China's new trade policy in the post-Mao era, see Y. Y. Kueh and Christopher Howe, "China's International Trade: Policy and Organizational Change and their Place in the 'Economic Readjustment'," *China Quarterly* 100 (December 1984): 813-848.

its entrepôt role. Through Hong Kong, China is able to trade with other countries; even ones which it does not have any formal diplomatic or trade relations with. Because of Hong Kong's close relationship with China, and its unique political status, its entrepôt trade provides China with a means of conducting a hidden trade, and a convenient way of getting around awkward political obstacles to trade. During the UN trade embargo on China, Hong Kong's role as a trade intermediary with China served as a vital link and a window on the world for China even though domestic exports and re-exports from Hong Kong to China declined steadily from US$1,260 million in 1951, to a mere trickle (US$37 million) in 1969.[64] Although the trade embargo effectively closed down the entrepôt trade between Hong Kong and China, China, in 1950, was still able to obtain more than half, and in 1951, more than two-thirds of its imports from the non-Communist world through Hong Kong before the full effect of the trade embargo was felt. Nevertheless, after 1952, re-exports from Hong Kong to China, although drastically reduced, still found their way into China.[65]

Throughout the dark days of China's isolation, Hong Kong provided China with a vital channel through which it could funnel its goods for re-export and earn foreign exchange. According to Jao,

> ...even when xenophobia was at its height, the Chinese authorities thought it wise to export as much as possible in order to build up foreign exchange reserves. ...Hong Kong's facilities as an entrepôt--an excellent harbour, fully modernized container terminals, and an efficient international network of transport, communications and commercial ties--were so attractive to China that re-exports through Hong Kong survived even the most bitter period of domestic struggles and policy

[64] Jao, p. 15.
[65] Alexander Eckstein, *Communist China's Economic Growth and Foreign Trade: Implications for United States Policy* (New York: McGraw-Hill Book Company, 1966), pp. 197.

debates.[66]

In 1970, when China started to improve its external relations with the non-Communist world, Hong Kong's entrepôt trade with China also began to rise again. Since then trade between Hong Kong and China has increased steadily until Hong Kong today is China's single largest trading partner and export market, followed closely by Japan.[67] Since the lifting of the embargo, and China's entry into the UN, China has built up its own trade contacts. Nevertheless, Hong Kong still handles over one-fifth of China's total world trade.[68] Oborne noted that "...it is as if Hong Kong were acting as a large trading company [for China] which took charge of one-tenth of PRC trade, and which kept for itself another one-tenth of its trade."[69]

Besides being China's most important export outlet, Hong Kong has developed its own financial, banking, insurance and shipping facilities, and an international reputation as the prime point of commercial contact between China and the West. Hong Kong is also the third largest container port, the third largest financial centre and the seventeenth largest trading unit in the world.[70] Furthermore, Hong Kong is the largest, deepest and most modern port facility

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[66] Jao, p. 19. For a detailed breakdown of Hong Kong's entrepôt trade with China, see Table 1.3 on p. 18.

[67] *Statistical Yearbook of China, 1984* (Hong Kong: Economic Information Agency, 1984), p. 383. See also, *China Newsletter* 68 (May-June 1987): 20., and The Hong Kong and Shanghai Banking Corporation, *Business Profile Series: The People's Republic of China*, 7th ed. (Hong Kong: The Hong Kong and Shanghai Banking Corporation, 1987), pp. 24-25.

[68] Business Profile Series: The PRC, p. 26.

[69] Oborne, p. 53.

[70] Victoria, B. C. *China Economic Overview: A British Columbia Perspective* (Victoria: Ministry of International Trade, Science and Investment, 1986), p. 24. See also, Peter P. F. Chan, *China: Modernisation and its Economic Laws* (Hong Kong: The Hong Kong Economist Newspaper Limited, 1982), pp. 228-233.

along China's coast, something that the PRC is in great need of.[71] In view of Hong Kong's many assets and superior natural endowments, it is therefore not surprising that it is the intermediary for the trans-shipment of a large share of goods entering into China from abroad, and for China's exports destined for a third country trading partner.

Y. C. Jao pointed out that Hong Kong's involvement in China's trading activities was due partly to the inadequacies of China's port facilities, the desire to conduct an unofficial trade with countries like Taiwan and South Korea, and the desire by China to minimize exchange and other financial risks associated with foreign trade.[72] In 1983, it was estimated that Hong Kong's entrepôt trade amounted to about US$34 billion (almost three times the value of its own exports), most of which was in the form of goods trans-shipped to China.[73] Furthermore, because of China's lack of deep-water berths, warehouses, facilities and specialized bulk-handling equipment, China often uses Hong Kong as a trans-shipment centre for re-shipping goods from one part of China to another. It was estimated that the "repurchase" of PRC goods by China came to US$127 million in 1983, or about five per cent of all goods re-exported to China.[74]

But, perhaps one of the most interesting aspects of Hong Kong's entrepôt trade with China is the "unofficial" or "silent" trade with countries that do not recognize the Communist regime in China. The silent trade agreement is a testimony to the fact that despite political differences, countries can still share

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[71] Alvin Rabushka, *Hong Kong: A Study In Economic Freedom (Chicago: The University of Chicago, 1979), p. 25.*
[72] Jao, p. 20, and note 7, p. 62.
[73] *China Economic*, p. 24.
[74] Oborne, p. 53.

a mutually beneficial trade relationship, albeit, a covert one. Hong Kong, as a neutral third party intermediary, provides both sides a convenient vehicle to conduct their trade. It is in such situations that the usefulness and value of Hong Kong's unique status can be fully appreciated. It has often been noted that "Hong Kong's usefulness to China has always arisen from it being both a part of China yet apart from China."[75]

In 1978 and 1979, Hong Kong re-exported US$21 million worth of Taiwanese exports to the PRC, while Taiwan obtained US$57 million worth of PRC exports through Hong Kong.[76] In a 1983 study, it was estimated that about 90 per cent of Taiwan's exports to China probably went through Hong Kong, while the remainder passed through Japan, Macau and Singapore.[77] From 1979 to 1981, re-exports from Taiwan to the PRC through Hong Kong increased dramatically from HK$0.107 billion to HK$2.2 billion.[78] It is therefore appropriate that since Hong Kong was originally created as "a place of trade" and an entrepôt with China, that it is still performing this role over 140 years later.

3. Hong Kong as a Financial and Investment Centre

Hong Kong's amazing rise, in the late 1960s and early 1970s, as a major financial centre in Asia, was due largely to China's desire to enter a new era of peaceful economic development where trade and international finance would

[75] *The Economist*, 11 May 1985, p. 4., and Johnson, p. 4. Johnson went as far as saying that "it is the very uniqueness of Hong Kong that will likely ensure its existence beyond 1997."
[76] *China News Analysis* , 13 March 1981, p. 6.
[77] John L. Scherer, *China Facts and Figures Annual, 1983* (Florida: Academic International Press, 1983), p. 257.
[78] ibid.

play a greater role in its economic activities than it did in the past.[79] This new direction in China's foreign and economic policies had a stabilizing effect on Hong Kong and the entire Pacific Basin, and resulted in foreign investors and financial institutions converging on Hong Kong as a desirable place to do business. Edward Chen pointed out that the revival of the China trade also led to the expansion of financial services in Hong Kong to support and finance the increasing volume of the Hong Kong-China trade. Moreover, Chen pointed out that "had there not been China's new economic policies, Hong Kong would not have undergone the structural change that it has experienced in the past few years."[80]

After the death of Mao and the fall of the Gang of Four, it was realized by Deng Xiaoping and his supporters that China's ambitious Four Modernizations programme could only be achieved with substantial foreign financial assistance and increased foreign trade. As a result, China became involved in negotiating loans and obtaining credit from various foreign banks and international organizations. The rise of Hong Kong as an international financial centre also made it an ideal centre for financing China's foreign trade and investment, especially since Hong Kong's banking facilities and financial services are always at China's disposal.[81] Aside from increasing its exports to earn foreign exchange, China has also sought to attract foreign investments into China to help finance its modernization effort.[82]

[79] Jao, pp. 24-26.
[80] Edward K. Y. Chen, "The Impact of China's Four Modernizations on Hong Kong's Economic Development," in *China and Hong Kong: The Economic Nexus*, ed. A. J. Youngson (Hong Kong: Oxford University Press, 1983), p. 89.
[81] Jao, p. 25.
[82] See David L. Denny, "Recent Developments in the International Financial Policies of the People's Republic of China," in *China's Changing Role in the World Economy*, ed. Bryant G. Garth (New York: Praeger Publishers, 1974), pp. 163-186., and Lawrence Freedman, *The World and the Modernization of China*

But perhaps the most interesting and conspicuous embodiment of China's new attitude towards international finance is the enormous presence of CSCBs, and deposit-taking companies (DTCs) in Hong Kong. Prior to 1970, their chief role was to build up China's foreign exchange reserves and finance China's trade.[83] But around 1970, the number of Chinese banks in Hong Kong increased dramatically from 13 branches to 193 branches in 1981, 13 DTCs, five insurance companies, and two joint-venture merchant banks, making China the second largest banking group in Hong Kong (after the Hong Kong Bank Group of 350 branches) in 1981.[84] The expansion was part of a new strategy to broaden CSCB operations in order to make extensive use of Hong Kong's considerable financial resources. In 1979, shortly after China announced its Open Door Policy, Ma Hong advocated that

> Hong Kong should be used as a centre to raise the capital needed for speeding up China's modernization, especially since most Hong Kong Chinese are willing to contribute to their motherland. China should make good use of their assets, estimated to be in the order of US$30 billion.[85]

Aside from the expansion of China's financial activities in Hong Kong, the Chinese government also increased its investment activities and holdings in Hong Kong and has become heavily involved in nearly every facet of the economy. Some of China's considerable holdings include travel, shipping and real estate agencies, real estate, a huge department store chain, a shipyard, retail outlets, newspapers, theatres, film studios, industrial and manufacturing plants,

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[82] (cont'd) (London: The Royal Institute of International Affairs, 1979), pp. 26-31.
[83] Oborne, p. 87.
[84] Jao, p. 31., Oborne, p. 86., and *The Economist* 11 May 1985, p. 20. According to *China Economic*, p. 25, the number of CSCBs in 1986 was 239 branches.
[85] Ma Hong, as cited by Cheng, p. 64.

warehouses and utilities.[86] Again, it is difficult to determine how much China has invested in Hong Kong because China has not disclosed any complete figures on the extent of its activities or assets in the colony. This problem is exacerbated by China's tendency to use Hong Kong residents as "fronts" to conceal the identity of the real owners.[87] Although it is estimated that the CSCBs control roughly one-third of all deposits in Hong Kong,[88] the total value of China's assets in Hong Kong is still a subject of speculation.

Although it is unknown how much China has invested in Hong Kong, it was not until concerns about China's plans for the future of the British colony shortly before the Sino-British negotiations began in 1982 that this subject received widespread public attention in Hong Kong and abroad. Gregor Benton labelled China's aggressive policy of investing massively in the Hong Kong economy as subtle variation of the Chinese Red Army's well-know "vanishing border" strategy, that is, to "attack from without, [and to] co-ordinate from within."[89] China's desire to keep a low profile in its financial activities in Hong Kong seems well-founded because its heavy involvement in Hong Kong's economy has generated not a little cause for consternation and concern from Hong Kong residents. An example of the sense of uneasiness that China's activities in Hong Kong has generated can be illustrated by an excerpt from the Hong Kong based *China News Analysis*, which reported that

[86] Philip Geddes, *In the Mouth of the Dragon: Hong Kong--Past, Present, and Future* (London: Century Publishing Co., 1982), p. 62., see also, Oborne, p. 88., Jao, p. 45., Rabushka, pp. 92-93., and Christopher Howe, "Growth, Public Policy and Hong Kong's Economic Relationship with China," *China Quarterly*, no. 95 (1983), pp. 154-155.
[87] Jao, p. 45.
[88] *China Economic*, pp. 24-25., and *The Economist*, 11 May 1985, p. 20.
[89] Benton, p. 41.

> shops owned by the Mainland are mushrooming all around the city. ...It is difficult to assess how deeply China is involved in the business life in Hong Kong [because] China keeps a low profile. ...the whole business power [sic] of Hong Kong is gradually sliding into the hands of the Peking Government.[90]

Because the year 1997 was looming close on the horizon, and China had not made its intentions for the future of Hong Kong known, many people in Hong Kong interpreted China's economic activities in Hong Kong as a prelude to an eventual takeover of the colony.

Estimates of China's holdings in Hong Kong differ greatly. However, it is generally agreed that China is one of the biggest investors in the colony, in company with Japan and the United States.[91] According to the *1986 Hong Kong Economic Yearbook*, China was the largest foreign investor in the colony in 1985, accounting for 25.5 per cent of all foreign investments. China was followed closely by Japan, with 23.1 per cent. The United States came in a distant third at 9.5 per cent.[92]

Although it is generally accepted that the foreign exchange that China earns from Hong Kong is an important factor in helping it finance its balance of payments with other countries, there is a great deal of speculation over just how much foreign exchange it earns from Hong Kong. This phenomenon can be attributed to the fact that prior to 1981, China has released little or no financial statistics regarding its foreign exchange earnings and balance of payment schedule. However, after China's admission into the International Monetary Fund and the World Bank in 1981, China has released some of this information.

[90] *China News Analysis*, 21 May 1982, p. 4.
[91] See Williams, p. 68., *The Economist*, 11 May 1985, p. 20.
[92] *Xianggang*, pp. 13-15.

Nevertheless, a common consensus or a complete picture of China's finances still does not exist. Forty per cent of China's total foreign exchange earnings is the figure that is most often cited by many sources.[93]

This figure seemed to have emerged before the Sino-British negotiations over the future of Hong Kong began in 1982. Speculators on the future of the colony after 1997 argued that the prospects for Hong Kong's future were good because "China earns about 40 per cent of its foreign exchange in Hong Kong."[94] Other studies proposed figures which vary from 25 per cent to 40 per cent.[95] According to a 1979 Chinese source, China earns approximately 30 per cent of its annual total foreign exchange earnings from Hong Kong (and Macau).[96] Despite the great differences in estimates over how much China has invested in Hong Kong, or how much China benefits from Hong Kong in the form of investment income, trade surplus, remittances and other forms of foreign exchange income, there is no controversy over the fact that China benefits immensely from a prosperous and relatively independent Hong Kong.

Because Hong Kong plays such an important role in supplying China with foreign exchange, it has often been referred to as "the goose that lays golden eggs for China." It was pointed out in this chapter that Hong Kong, as

[93] For example, see Chu-yuan Cheng, "The Potential Impact of Mainland China's Modernization on the World Economy," in *Chinese Modernization*, ed. Yu-ming Shaw (San Francisco: Chinese Materials Center Publications, 1985), pp. 345-346., D. K. Lewis, p. 8., *China Economic*, p. 24., and Rabushka, p. 25.

[94] *The Economist*, 31 July 1982, p. 16.

[95] Frank Ching, *Asian Wall Street Journal*, 18 February 1983., as cited in Lucian W. Pye, "The International Position of Hong Kong," *China Quarterly*, no. 95 (September 1983), p. 461. According to Kueh and Howe, pp. 819 and 823, the trade surplus generated for China by Hong Kong during 1978-1980 was sufficient to cover four-fifths of the total trade deficit with the U. S., Western Europe and Japan in the same period.

[96] Ma Hong, as cited in Cheng, p. 63.

an independent and modern economy, provided China with a number of valuable economic and non-economic benefits. However, it wasn't until the post-Mao era that Hong Kong would become an active participant and investor in China's modernization effort, and particularly in the Shenzhen SEZ. The purpose of the next section is to discuss the post-Mao political and economic events in China which set the stage for a new era of economic co-operation with Hong Kong and the rest of the world.

II. POST-MAO REFORMS AND MODERNIZATION IN CHINA

A. THE HISTORICAL SETTING

Since the death of Mao Zedong and the fall of the Gang of Four, the post-Mao leadership in China has been faced with the monumental task of reviving a stunted economy as well as embarking upon the Four Modernizations programme (in agriculture, industry, defence and science and technology) which was proclaimed in 1978 under the leadership of Premier Hua Guofeng. The goal of the Four Modernizations, to put China in the same league as the modern, industrialized nations of the world by the year 2000, was initially announced by Zhou Enlai in 1975.[2]

The pre-1978 economic strategy had been characterized by heavy bureaucratic control and unbalanced growth which favoured the rapid build-up of the heavy industrial sector. The Chinese leaders believed that a large, modern, heavy industrial base, built up through large capital construction projects, would be able to pave the way for the modernization of the rest of the economy. Although there was a proliferation of heavy industrial activity throughout the country under the pre-1978 strategy, the economic results expected were not realized. The diversion of resources from the traditional (agricultural and light industrial) sectors into the building of a modern, heavy industrial infrastructure only resulted in a weakened traditional sector that was unable to sustain the ambitious heavy industrial initiative indefinitely. According to a World Bank Staff Working Paper, China's total factor productivity in industry had essentially

[2] Chu-yuan Cheng, *China's Economic Development: Growth and Structural Change* (Boulder: Westview Press, 1982), pp. 274-276.

stagnated since 1957.[3]

Despite a change in leadership, the immediate post-Mao period was still, in many ways, a continuation of the previous economic strategy. The Chinese leaders still sought to realize economic growth and modernization through huge investment programmes and unbalanced economic growth. The heavy industrial sector was still allocated a disproportionate share of the investment capital, while the agricultural and light industrial sectors continued to receive a lower investment priority. Premier Hua Guofeng's Ten-Year Plan (1976-1985) called for a massive capital investment and construction program with a proposed budget for the 1978-1985 period to be equal to the total investments of the previous 28 years.[4] The new twist to Hua's strategy, however was the Open Door Policy, or an outward-looking policy, in which foreign capital (mainly in the form of loans) and technology would play a significant role in helping China to achieve its modernization goals. However, it was not until the creation of the Joint Ventures Law and the SEZs in 1979 (which made possible the investment of foreign capital in China) that the Open Door Policy began to play a more pivotal role in China's modernization efforts.

The announcement of the Ten-Year Plan resulted in a rush to obtain foreign machinery and equipment and the concluding of many major construction projects with foreign companies because it was believed that foreign technology and equipment would help realize China's modernization goals. However, the

[3] Gene Tidrick, *Productivity Growth and Technological Change in Chinese Industry* (Washington: The World Bank, 1986), pp. 1-5.
[4] Samuel P. S. Ho and Ralph W. Huenemann, *China's Open Door Policy: The Quest for Foreign Technology and Capital: A Study of China's Special Trade* (Vancouver: University of British Columbia Press, 1984), p. 7., and *China's Economic*, pp. 276-277.

sudden buying-spree resulted in many wasteful and indiscriminate purchases and created a tremendous strain on China's foreign exchange reserves. Furthermore, in the rush to carry out the Ten-Year Plan, a great number of purchases were hastily made without careful consideration of their suitability, or how they would be integrated into the overall economic plan. As a result, much of the expensive, imported equipment was underutilized or wasted. According to N. T. Wang, "much of it [the imported equipment] actually laid [sic] on the docks and the warehouses. Even the equipment already installed fell victim to bottlenecks caused by shortages of electricity and other inputs."[5]

At the Third Plenum of the Chinese Communist Party's Eleventh Central Committee, which convened in December 1978, Hua and the Ten-Year Plan were ousted but the goals of the Four Modernizations and the Open Door Policy were retained. It was also announced that a period of economic readjustment and reform was necessary in order to address and correct some of the serious problems within the economy, and to recover from the damage caused by the 1977-1978 period. The period of the Readjustment (1979-1981) was essentially a period of political and economic house-cleaning, intended to get the economy back on its feet again, as well as a time for reassessment and rethinking of economic development strategies by China's leaders.

It was also recognized at the Third Plenum that the long-neglected agricultural and light industrial sectors must receive high priority in capital investments and resource allocation if they were to help support the

[5]N. T. Wang, *China's Modernization and Transnational Corporations* (Lexington: D. C. Heath and Company, 1984), pp. xxiv. See also Yuan-li Wu, "The Rocky Road to Beijing's Economic Reforms: Can Trial and Error Lead to Dynamic Equilibrium?" *Journal of Northeastern Asian Studies* IV (Fall 1985): 4.

modernization drive.[6] As a result, the economic reforms announced at the Third Plenum freed various segments of the economy from some of the bureaucratic mechanisms which had, in the past, made economic growth difficult. They were also designed to release the initiative and productive forces of the masses in order to increase economic efficiency and productivity. As a result, a limited degree of economic decentralization was permitted, which also enabled market, or economic forces, rather than admininstrative forces, greater play in the economy. The product of these reforms was the Production Responsibility System in the agricultural sector,[7] and the expansion of enterprise autonomy in the industrial sector.[8]

The strategy for modernization was no longer simply through the wholesale purchase and transplantation of whole foreign plants and hardware. The emphasis and thrust of the modernization effort now was on increasing economic productivity and efficiency through the transformation of China's existing industrial base and infrastructure with foreign technology, and modern management techniques--not the wholesale grafting of imported whole plants and sophisticated and expensive foreign equipment onto China's existing industrial infrastructure. Ho and Huenemann described the technology that China was interested in acquiring as

> ...not only technology that is embodied in machinery and equipment and technology that is codified (that is, documented in blueprints, drawings and engineering specifications), but also disembodied and undocumented technology (that is, information, skills, and know-how

[6] "The Potential," pp. 442-443.
[7] Greg O'Leary and Andrew Watson, "Economic Co-operation Revisited: New Directions in Chinese Agriculture," in *China: Dilemmas of Modernisation*, ed. Graham Young (London: Croom Helm, 1985), pp. 12, 22.
[8] Thierry Pairault, "Industrial Strategy (January 1975--June 1979): In Search of New Policies for Industrial Growth," in *China's New Development Strategy*, ed. Jack Gray and Gordon White (London: Academic Press, 1982), p. 145.

stored in the minds of individuals).[9]

These forms of technologies could not be obtained simply with foreign exchange, but could only be acquired through close international economic co-operation. Consequently, many of the investment projects and development contracts that were concluded during the 1977-78 period were either postponed or cancelled.[10] Furthermore, the Chinese leaders also realized that China could only achieve its ambitious modernization goals with substantial foreign financing, technological co-operation and assistance. Thus, it was proclaimed at the Third Plenum that China would be "actively expanding economic co-operation on terms of equality and mutual benefit with other countries ... [and would be] striving to adopt the world's advanced technologies and equipment...."[11]

The Open Door Policy provided the necessary channel through which China could interact with the West[12] in order to increase economic, scientific and cultural co-operation. The promulgation of China's first Joint Venture law (the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment),[13] and the State Council's authorization of Guangdong and Fujian Provinces to establish SEZs with broad trade and economic autonomy in July 1979,[14] laid the necessary foundations and provided the necessary vehicles

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[9] Ho and Huenemann, p. 23.

[10] *China's Economic*, p. 452.

[11] *Beijing Review*, 29 December 1978, p. 11.

[12] The term "the West" is used in this study to refer to the modern, industrialized, or "westernized" nations in the world. Although Japan is a Far Eastern nation, it is also a member of the international community of modernized, industrialized nations. Therefore, the term "the West" will hereafter also refer to Japan.

[13] See Hood and Lau.

[14] Michael J. Moser, "Law and Investment in the Guangdong Special Economic Zones," in *Foreign Trade, Investment and the Law in the People's Republic of China*, ed. Michael J. Moser (Hong Kong: Oxford University Press, 1984), p. 143.

upon which China would embark upon its latest path to modernization.

The Joint Venture Law and the SEZs created the necessary environment and conditions which would allow China to interact closely, in various mutually beneficial economic ventures, with foreign investors to acquire foreign capital and technology. To increase the chances of the SEZs to succeed, they were situated in the two coastal provinces with the most extensive international trade and non-trade links and experience with foreigners. The SEZs, like the Canton system and the treaty ports, were to be special zones in China where foreign investors could do business. However, although China's present policy towards the West is one of greater openness, China is not totally opened to foreigners. Thus, the need for "special zones," where foreign influences may be localized and regulated.

Although the doctrine of self-reliance has not been totally abandoned, this new approach to modernization was possible only after China had reinterpreted its earlier notions of economic independence and its previous convictions about trade as an exploitative relationship.[15] According to Zhao Ziyang,

> [The] expansion of exchange is a basic feature of large-scale socialized production, and it has extended from internal trade in China to trade with the world at large. By linking our economy with the world market, expanding foreign trade, importing advanced technology, utilizing capital and entering into different forms of international economic and technological co-operation, we [China] can use our strong points [comparative advantages] and make up for our weak points. ... Far from impairing our capacity for self-reliant action, this will only serve to enhance it.[16]

[15]See Susan Shirk, "The Domestic Political Dimensions of China's Foreign Economic Relations," in *China and the World: Chinese Foreign Policy in the Post-Mao Era, ed. Samuel S. Kim (Boulder: Westview Press, 1984), pp. 57-58.*
[16]*Beijing Review*, 21 December 1981, p. 3.

B. THE CREATION OF THE SPECIAL ECONOMIC ZONES

The present concept of the SEZs was the result of an evolutionary process of various earlier special zone models. Moreover, it is also important to view the SEZ phenomenon in China today as an important part of its present Open Door Policy and economic reforms. C. K. Leung added that the SEZs should also be seen as an important part of China's latest development strategy in its long-standing drive for modernization in China.[17] The SEZs are also an important part of China's re-emphasis on coastal-led economic development and the first step in China's desire to eventually create "economic zones" on China's coast. The economic zones are to be high economic growth areas which would lead the pace of economic development within its sphere of influence. They are to serve as nodes where appropriately assimilated advanced foreign technologies could be disseminated to the rest of the country, and help co-ordinate economic development.[18]

Two regions have been identified as economic zones--the Shanghai region, which includes Anhui, Jiangsu, Jiangxi and Zhejiang Provinces, which presently accounts for 26.6 per cent of China's industrial enterprises and about the same percentage of the country's total agricultural and industrial output--and the Guangzhou region, which includes the Pearl River Delta area.[19] Guangdong Province is expected to control about half of China's total foreign trade activities

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[17] C. K. Leung, "Spatial Redeployment and the Special Economic Zones in China: An Overview," in *China's Special Economic Zones: Policies, Problems and Prospects*, ed. Y. C. Jao and C. K. Leung (Hong Kong: Oxford University Press, 1986), p. 8.
[18] Oborne, p. 81.
[19] ibid.

by the year 1990.[20] Jan S. Prybyla pointed out that the two regional economic co-operation zones are, in the future, to carry the SEZs concept beyond its present limits.[21] Thus, as seen in the greater, long-term context of the economic reforms and China's development strategy, the SEZs are an "...experimental, fluid, and transitional phenomena...."[22] Deng Xiaoping even referred to the reform policies and the SEZs as "experiments."[23]

The earliest specially designated zones where Europeans could operate in China were, of course, Canton, under the Canton system (1757-1842), and the treaty ports (1842-1949). Although these earlier zones could, in many ways, be regarded as the forerunners of the SEZs, there are also many important differences between them. While the SEZs were created to serve as a bridge between foreign investors and China to promote and facilitate economic and technological co-operation, the Canton system was created to restrict the impact of foreign trade and influences on the rest of the country. Under the Canton system, trade and contact between China and the foreigners was limited to only one city port--Canton. The treaty ports were not created by China, but were actually concessionary zones to the militarily superior Western powers. China had no jurisdiction over the treaty ports, which were created and run by the Western powers. Although the treaty ports became important commercial and trade centres in China, their impact on China's economic development was, in the end, insignificant.[24]

[20] *China Trade Report*, June 1988, p. 6.

[21] Jan S. Prybyla, "Mainland China's Special Economic Zones," in *Mainland China: Politics, Economics and Reforms*, ed. Yu-ming Shaw (Boulder: Westview Press, Inc., 1986), p. 368.

[22] "Mainland," p. 369.

[23] "Deng Calls Reform an 'Experiment'," *Beijing Review*, 15 July 1988, pp. 6-7.

[24] This was the main theme of many books on the treaty ports by Rhoads Murphey. For example, see *China Meets*, pp. 52-54., and *The Outsiders*, pp. 104,

The next important predecessor for the SEZs concept were the 27 special economic commodity production bases (ECPBs) and the specialized export factories in Guangdong, Jiangsu, Shandong, Zhejiang, Liaoning, and Hebei provinces and some autonomous regions, that were created after the Cultural Revolution by the Ministry of Foreign Trade to help rebuild China's trade networks and stimulate agricultural and light industrial exports and earn foreign exchange.[25] The rationale for creating these special production bases and export factories was to utilize the comparative advantages (resources and skills) of selected areas of the country and to concentrate on developing export activities in these special areas.[26] Testimony to the enormous success of these special export bases and export factories was the fact that they accounted for about one-third of China's total export earnings in 1984.[27]

Although these special export-oriented factories and bases were still under the control of the central and local governments, the central government felt that if they were to succeed, that they must be able to

> ...cut through artificial administrative divisions and establish economically meaningful links between the government's various foreign trade organizations...for the purpose of encouraging [and facilitating] the export of certain targeted commodities.[28]

In order to create the ECPBs, selected prefectures were transformed into special foreign trade zones, under the collective control of local foreign trade bureaus and sub-branches of the national foreign trade corporations.[29] It is important to note

[24] (cont'd) 122, 132, 135.
[25] Oborne, p. 81.
[26] ibid.
[27] ibid.
[28] "Mainland," pp. 368-369.
[29] John Kamm, "Importing Some of Hong Kong...Exporting Some of China," *The China Business Review*, March-April 1980, pp. 29-30.

that the Chinese government recognized the need to simplify the bureaucratic mechanisms in order to create an economic environment that would be conducive to increasing exports. Therefore, although the ECPBs were limited in role and tightly controlled, they were an important forerunner of the SEZ concept because they set the precedent for creating economic zones that would operate in an environment that is more or less free from many of the constraints and bureaucratic mechanisms that the rest of the country is subject to in the PRC.

The next step in the evolution of the SEZs in China was the creation of the Shekou Industrial Zone in Guangdong Province in January 1979. However, the most interesting aspect of the one square kilometre industrial estate was that it was to be developed, managed and operated entirely by the Hong Kong-based, but Chinese-controlled China Merchants Steam Navigation Company,[30] and that it would offer a number of investment benefits to foreign investors to invest in the zone.[31] The decision to create special zones and to allow foreign investments in China was a remarkable one because it reversed Mao's long-standing policy of self-reliance and keeping the country closed to the outside world.

Nevertheless, the idea of creating special zones of the economy in order to attract foreign investments to speed up economic growth and development and promote technology transfer was not a Chinese innovation because many developing countries have employed such an approach to stimulate economic growth long before the SEZs were created in China.[32] Consequently, when China

[30]The Hong Kong and Shanghai Banking Corporation. *Special Economic Zones of the People's Republic of China: Shenzhen including Shekou* (Hong Kong: The Hong Kong and Shanghai Banking Corporation, 1982), p. 3.

[31]Ho and Huenemann, pp. 48-49., and Oborne, pp. 76-78.

[32]Kwan-Yiu Wong and David K. Y. Chu, "Export Processing Zone and Special Economic Zones as Locomotives of Export-led Economic Growth," in *Modernization in China: The Case of the Shenzhen Special Economic Zone*, ed. K. Y. Wong and

decided to create special zones in order to utilize foreign capital and technology in its modernization efforts, the Chinese government set out to study the various special zones, and "export processing zones" (EPZs) in countries like Taiwan, Mexico, and the Philippines.[33]

In scope and purpose, the Shekou Industrial Zone and the SEZs are similar to the EPZs that they were modelled after. According to Wong and Chu, EPZs are a modified and adapted version of the free trade zone (which are zones on the world's major trading routes which trans-ship, store and re-export goods without customs formalities) designed for the purpose of starting export-oriented industrial development to speed up economic growth and development in the host country.[34] More specifically, China's expectation for its special zones, which was based on its understanding of the EPZ concept, was to establish export-oriented manufacturing and industrial bases with foreign capital, create local employment, earn foreign exchange, and to upgrade the technological level of its domestic industrial base with foreign technology.[35] In return, the Chinese government would offer foreign investors a number of investment incentives which are not available in the rest of the country.

Although the types of activities in the EPZs of many developing countries are generally restricted to relatively simple assembly work and labour-intensive manufacturing industries involving investments that rarely exceed

[32](cont'd) David K. Y. Chu (Hong Kong: Oxford University Press, 1985), pp. 1-6.
[33]Moser, p. 143.
[34]"Export," pp. 1-3.
[35]D. K. Y. Chu, "The Special Economic Zones and the Problem of Territorial Containment," in *China's Special Economic Zones: Policies, Problems and Prospects*, ed. Y. C. Jao and C. K. Leung (Hong Kong: Oxford University Press, 1986), p. 21., "Export," p. 1., and Oborne, pp. 76, 78, 83.

US$1 million, there are some countries (ie. Korea and Taiwan) that have benefited from their experience with the EPZs and have since made a technological transition into more sophisticated industrial activities.[36] Therefore, when China decided to create its own version of the EPZs, it was in part, also an attempt to emulate their success. Chinese scholars were particularly aware of the EPZs in Taiwan, which were responsible for its enormous economic growth since they were created in 1966.[37] In the article, "Export Processing Zones in Taiwan and the People's Republic of China," George Fitting noted that the Chinese leaders were following in the path taken by Taiwan's leaders to attract foreign investments when they created their own special zones, which, like the EPZs in Taiwan, were intended to "...attract foreign capital, improve the international balance of payments, help in the development of native industry and serve as a conveyor of up-to-date technology."[38]

The next stage in the evolutionary process of the SEZs occurred when the Chinese government decided, later in the same year, to create other special zones which would attract a wider range of economic activities. This decision was probably due to China's recognition of the the limitations of Shekou's scope, which was essentially that of an EPZ. Consequently, Guangdong and Fujian Provinces were given formal authorization by the State Council in July 1979, to take extraordinary measures (including the creation of SEZs) to develop not only industry and manufacturing, but also agriculture, tourism, commerce, real estate development, foreign trade and investment.[39] As a result, the Shantou (Swatow, a former treaty port) Municipality in Guangdong Province was established as a

[36] Oborne, pp. 78-79.
[37] Oborne, p. 80.
[38] George Fitting, "Export Processing Zones in Taiwan and the People's Republic of China," *Asian Survey*, no. 8 (1982), pp. 732-733.
[39] Kamm, p. 28., and "Export,"p. 2.

"trade and investment zone" in August 1979, while Shenzhen and Zhuhai were established as "special export zones" in September 1979. Although these new zones were not called EPZs, when they were initially conceived, they were almost a replica of the EPZs, as their names would imply. The main difference between these new zones and the EPZs was the fact that these new zones were to be comprehensively developed and socialist in nature.[40]

It was not until these three special zones in Guangdong Province were collectively put under the management of the newly created Administrative Committee of the SEZs of Guangdong Province in August 1980 that they were called SEZs. The reason for the change in name was to emphasize that these new zones were to be different from Shekou and the EPZs. Over a year later, the Xiamen (Amoy, one of the first five treaty ports) SEZ in Fujian province was established in October 1980.[41] In April 1988, it was decided at the Seventh National People's Congress to elevate Hainan Island, an administrative region of Guangdong Province, to the status of a province and make it China's fifth and largest SEZ.[42] The scope and form of investment activities to be encouraged in the SEZs were to include

> all items of industry, agriculture, livestock breeding, fish breeding ...tourism, housing and construction, research and manufacture involving high technologies and techniques that have positive significance in international economic cooperation and technical exchanges, as well as other trades of common interest to investors and the Chinese side....[43]

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[40] D. K. Y. Chu, p. 23.

[41] Moser, pp. 143-144.

[42] Yang Xiaobing, "Hainan Province--China's Largest SEZ," *Beijing Review*, 2-8 May 1988, p. 18.

[43] 1980 Regulations on Special Economic Zones in Guangdong Province, art. 4, in *Shenzhen Jingji Tequ Nianjian, 1985* (Hong Kong: Shenzhen Jingji Tequ Nianjian Weiyuanhui, 1985), pp. 202-203.

Although there is a wide range of economic activities in the SEZs, export-oriented, light industrial activities are, by far, the most common form of investment in the SEZs.[44]

A SEZ, as generally defined by the Chinese, is a certain designated area

> ...to develop external economic cooperation and technical exchanges and promote the socialist modernization program. In the special zones, foreign citizens, overseas Chinese, compatriots in Hongkong and Macau and their companies and enterprises...are encouraged to open factories or set up enterprises and other establishments with their own investment or undertake joint ventures with Chinese investment....[45]

A separate body of legislation, different from the rest of the country, was created to formalize the special characteristics of the SEZs and guarantee foreign investors a stable political and economic environment.[46] Like the treaty ports, the SEZs were not to be burdened with the bureaucracy and regulations which the rest of the country is still subject to. However, unlike the treaty ports, where the Chinese government had no authority to interfere, let alone regulate, the SEZs were to be completely under the jurisdiction of the PRC. Liang Xiang, the mayor of Shenzhen in 1984, pointed out that "China's special zones are economic, not political. The word 'special' refers to the relaxation of economic policies. The governments of the special zones still possess complete sovereignty."[47]

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[44] Oborne, pp. 102-126.

[45] 1980 Regulations on Special Economic Zones in Guangdong Province, ch. 1, art. 1, in *Shenzhen Jingji Tequ Nianjian, 1985* (Hong Kong: Shenzhen Jingji Tequ Nianjian Weiyuanhui, 1985), p. 202.

[46] Tang Huai, "Guanyu Bianjing Jingji Tequ Fuzhan Fangxiang Chuyi," *Gangao Jingji*, no. 1 (1981), p. 1. For an English translation of some of the most important SEZ regulations, see *Shenzhen*, pp. 201-278.

[47] Liang Xiang, "China's Special Economic Zones," *Beijing Review* 27 (January 1984): 26.

The SEZs were to be channels through which foreign capital, advanced technology, and managerial know-how could enter China and would then be funneled into other parts of the country.[48] Thus, while the SEZs are foreign and outward-oriented in focus, they are also inward-oriented with linkages with the rest of the country. The SEZs were to become centres for the development of export-oriented industries in order to build up the volume of China's exports and foreign exchange.[49] The foreign exchange earned by the SEZs would be used to help fund technological imports in the SEZs. Aside from earning foreign exchange from the profits of manufactured goods sold on the international market, the SEZs also generate foreign exchange earnings in the form of rental and lease income on land and buildings, tourism earnings and services provided to the SEZ enterprises.[50]

Another function of the SEZs is that of a testing ground and a holding tank for the vast array of foreign economic and non-economic influences entering into the country. The physical seclusion of the SEZs to the Chinese coast provides China with a controlled environment to observe, study and learn about capitalism, new managerial techniques and other foreign influences while maintaining a degree of isolation from the rest of the country. Jan Walls believed that the SEZs were created in part, to avoid the chaotic and wasteful introduction of Western involvement in China's economic development. Therefore, the SEZs were also intended to be

[48] Lynette Kemp, *Investing in China: Where, How and Why?*(London: The Economic Intelligence Unit, 1987), p. 107., and Wang Yanyu, "Yige Yinjin Xianjin Jishude 'Chuangkou'," *Gangao Jingji*, no. 3-4 (1984), pp. 97-99.
[49] "Exports,". p. 9.
[50] Yu Guangyuan, "Tantan dui Shenzhen Jingji Tequ Jige Wenti Renshi," *Jingji Yanjiu*, no. 2 (1983), p. 32.

a control device to

> ...contain and highlight the results of the new modes of economic co-operation. In other words, if the experiments [in foreign economic co-operation] didn't work, their negative influence might be contained; if they did work, they could be easily highlighted and taken as models for imitation elsewhere in China.[51]

In a sense, the SEZs were to serve as gigantic sieves or filters which would strain out potentially "harmful" or undesirable foreign influences while those deemed useful were allowed to pass through them. Because of this function, Deng Xiaoping has referred to the SEZs as windows (*chuangkou*) through which advanced technology, knowledge, management techniques and policies and other ideas can enter into China. He also mentioned that because there are so many new foreign ideas and practices entering into China that are not yet fully understood, they will be tested in the SEZs first in order to determine if they are suitable for transfer into the interior.[52]

The SEZs are also laboratories in that they are the testing grounds where new legislative initiatives and reforms with extremely wide implications could be tested first before being transplanted into the interior.[53] Consequently, the SEZs have also been referred to as an experiment or experimental laboratories.[54] Since the creation of the SEZs,

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[51] Jan Walls, "China: Industrialization and Modernization--Challenge and Opportunities," in *Canada's Strategies for the Pacific Rim*, ed. Brian Macdonald (Toronto: The Canadian Institute of Strategic Studies, 1984), p. 114.

[52] *"Jingji Tequde 'Chuangkou' Zuoyang," Renminribao*, 8 March 1985, p. 5.

[53] Karl Herbst, "The Regulatory Framework for Foreign Investment in the Special Economic Zones," in *China's Special Economic Zones: Problems, Policies and Prospects*, ed. Y. C. Jao and C. K. Leung (Hong Kong: Oxford University Press, 1986), p. 124., Moser, p. 144., and Oborne, p. 96 n. 40.

[54] *Beijing Review*, 15 July 1985, p. 6.

various measures, which were originally restricted to the SEZs, have been introduced to other factories in China. Some of these measures include the duty-free importation of raw materials necessary for production of goods by export enterprises, various bonus systems, more flexible hiring and firing practices, and the extension of the right to attract foreign investments to 14 coastal cities in 1984.[55]

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[55]Just Faaland, "Preface," in Oborne, pp. 9-10.

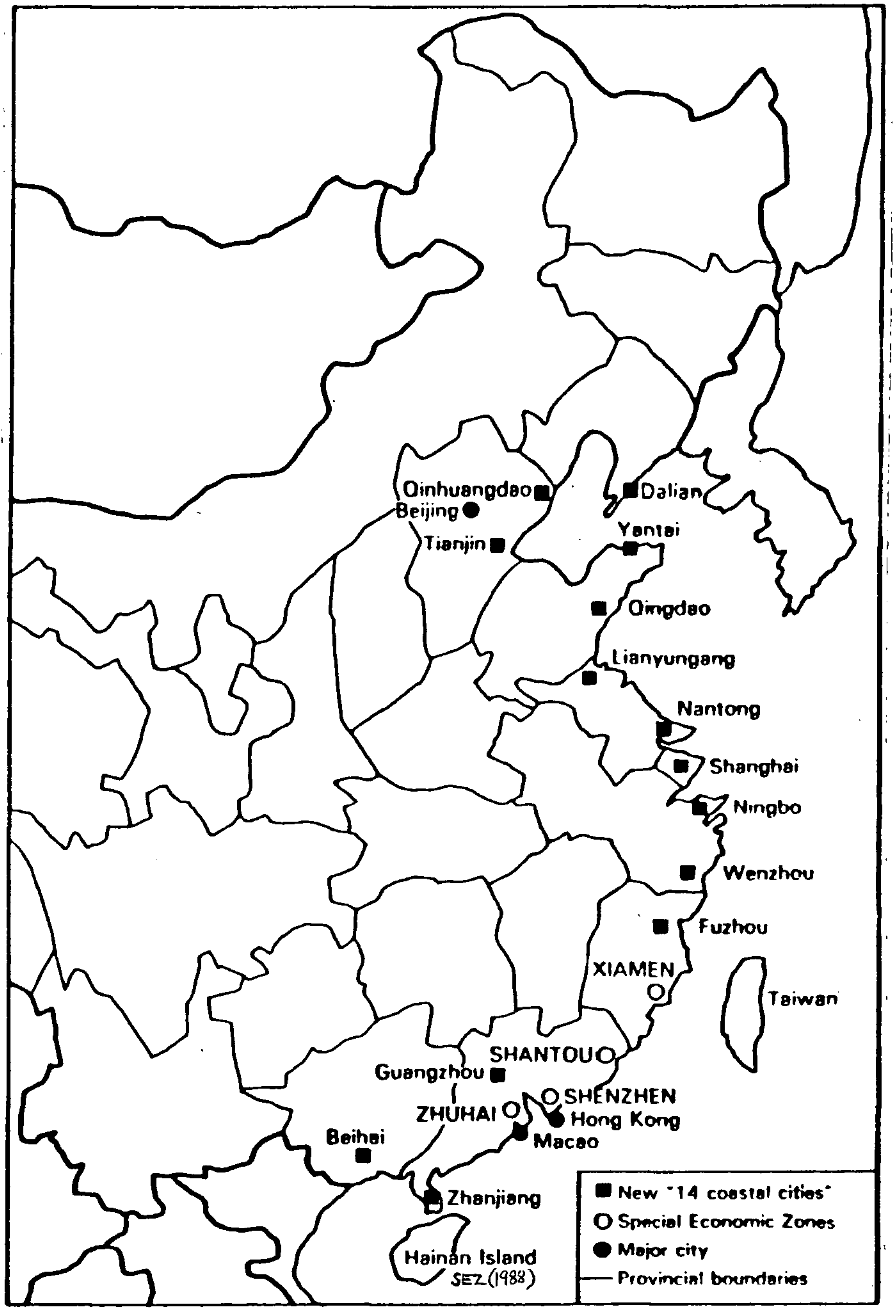

Figure 2. China's SEZs and Open Cities

Source: Michael Oborne, *China's Special Economic Zones* (Paris: Organization for Economic Co-operation and Development, 1986), p. 185.

C. THE SHENZHEN SPECIAL ECONOMIC ZONE

Over one-fifth of all foreign investments in China are made in the SEZs, of which 80 to 90 per cent comes from Hong Kong.[56] In terms of the amount of foreign investment capital that has been captured, the Shenzhen SEZ is, by far, the most significant and the most important of the five SEZs. Situated just north of the New Territories on the Hong Kong-Guangdong Province border, Shenzhen has an area of 327.5 square kilometers.[57] At the end of 1981, Shenzhen accounted for over 80 per cent of investments in the four SEZs.[58] Hong Kong investors were particularly attracted to Shenzhen. C. K. Leung pointed out that the locations of the SEZs were carefully chosen to take advantage of Hong Kong and Macau (the Guangdong SEZs) and Taiwan (the Fujian SEZ).[59] By 1984, Hong Kong (and Macau) investments accounted for about 90 per cent of the US$3 billion committed in Shenzhen.[60] By mid 1987, Shenzhen was still the dominant SEZ, capturing more investment capital than the combined total of the other three zones.[61]

Before Shenzhen became a SEZ in 1979, it was a small agricultural village named Lo Wu, with a population of about 20,000 situated in Bao An County (xian). It only had about twenty-six small factories with a total annual industrial output of less than US$10,000 and almost no infrastructure to support

[56] *Business Profile Series: The PRC*, p. 33.
[57] Yen-Tak Ng and David K. Y. Chu, "The Geographical Endowment of China's Special Economic Zones," in *Modernization in China: The Case of the Shenzhen Special Economic Zone* (Hong Kong: Oxford University Press, 1985), p. 54.
[58] Zhang Rongfeng, *Zhongyang Jingji Tequzhi Yanjiu* (Taibei: Zhonghua Jingji Yanjiuyuan, 1982), p. 35.
[59] Leung, p. 9.
[60] David Aikman, *Pacific Rim: Area of Change, Area of Opportunity* (Toronto: Little, Brown and Company, 1986), p. 90.
[61] For the investment figures, see *Business China*, 28 March 1988, pp. 44-45.

industrial development.[62] After Guangdong Province was officially granted the powers to establish SEZs in 1979, the Shenzhen area was elevated to the rank of a municipality (*shi*), making it directly reponsible to the provincial government.[63] This promotion was motivated by the need to simplify the institutional framework of the SEZs by eliminating the prefectural government from the bureaucratic hierarchy.[64]

The mayor of Shenzhen is the head of the SEZ administrative hierarchy at the municipal level. Under him are various agencies such as the Shenzhen SEZ Development Company, which is responsible for a wide range of activities such as real estate and infrastructure development, and introducing and attracting investments into the zone; and the Shenzhen SEZ Construction Company, which is responsible for the planning and development of capital construction within the zone.[65] The Guangdong Provincial People's Government, which is represented by the Guangdong Provincial Administrative Commission of SEZs, is the highest provincial authority in matters concerning Shenzhen.[66] This office is directly linked to the Office of SEZ Affairs, which is a special administrative branch of the State Council in Beijing.[67] The SEZ Office in Beijing is responsible for keeping the Chinese leaders informed of major events occuring in the SEZs as well as ensuring that the needs and interests of the SEZs receive special top priority.[68]

[62] Ng and Chu, p. 43., and Oborne, p. 118, 120.
[63] Oborne, p. 118.
[64] Kamm, p. 28.
[65] The Hong Kong, pp. 8-9., and Oborne, pp. 98-99.
[66] Oborne, pp. 98-99., and K. Y. Wong and David K. Y. Chu, "The Investment Environment," in *Modernization in China: The Case of the Shenzhen Special Economic Zone* (Hong Kong: Oxford University Press, 1985), pp. 176-177.
[67] Oborne, p. 98.
[68] Oborne, pp. 98-99.

Before Shenzhen could begin to attract foreign investments as a SEZ, it was necessary to construct its entire infrastructure and other basic supporting facilities from the foundation up. It was estimated that between 1979 and 1985, the Chinese government spent about Rmb7.7 billion on Shenzhen's infrastructure.[69] By 1985, Shenzhen could boast road, rail, sea, air and telecommunications links with Hong Kong and Guangzhou, and sea links with many of the coastal cities along China's southern coast, as well as a major highway linking Shenzhen to Guangzhou, Hong Kong, and Macau.[70] A new road tunnel, costing Rmb90 million, opened in September 1987, cutting 3 kilometres off the distance between Hong Kong and Shenzhen, while plans to build an airport just outside the Shenzhen city centre were announced in early 1988.[71]

Because the task of building Shenzhen's infrastructure was so massive and expensive, foreign investors have also been asked to participate and help finance this effort. Since 1981, Hong Kong business groups have figured prominently in helping to plan and finance the development of parts of Shenzhen.[72] More recently, Singapore's Sum Cheong Piling had agreed to enter into a co-operative agreement with China's Nanhui Oil Development and Service Corporation to build one of China's largest container ports, which would include a 35.5 kilometre railway line to link the port with the Canton and Shenzhen line.[73] Interestingly, a Taiwan consortium and Wharf Holdings of Hong Kong are also negotiating with Shenzhen authorities to take part in building southern China's largest deep-water port at Yantian.[74] Another example of foreign

[69] Kemp, p. 107.
[70] Oborne, p. 120.
[71] "Updating the Zones," *Business China*, 29 February 1988, p. 56.
[72] Ho and Huenemann, pp. 68-69.
[73] "New Port for Shenzhen," *China Trade Report*, January 1987, p. 5.
[74] "Taiwanese Funding Port in Shenzhen," *Sing Tao International*, 26 August 1988, p. 1.

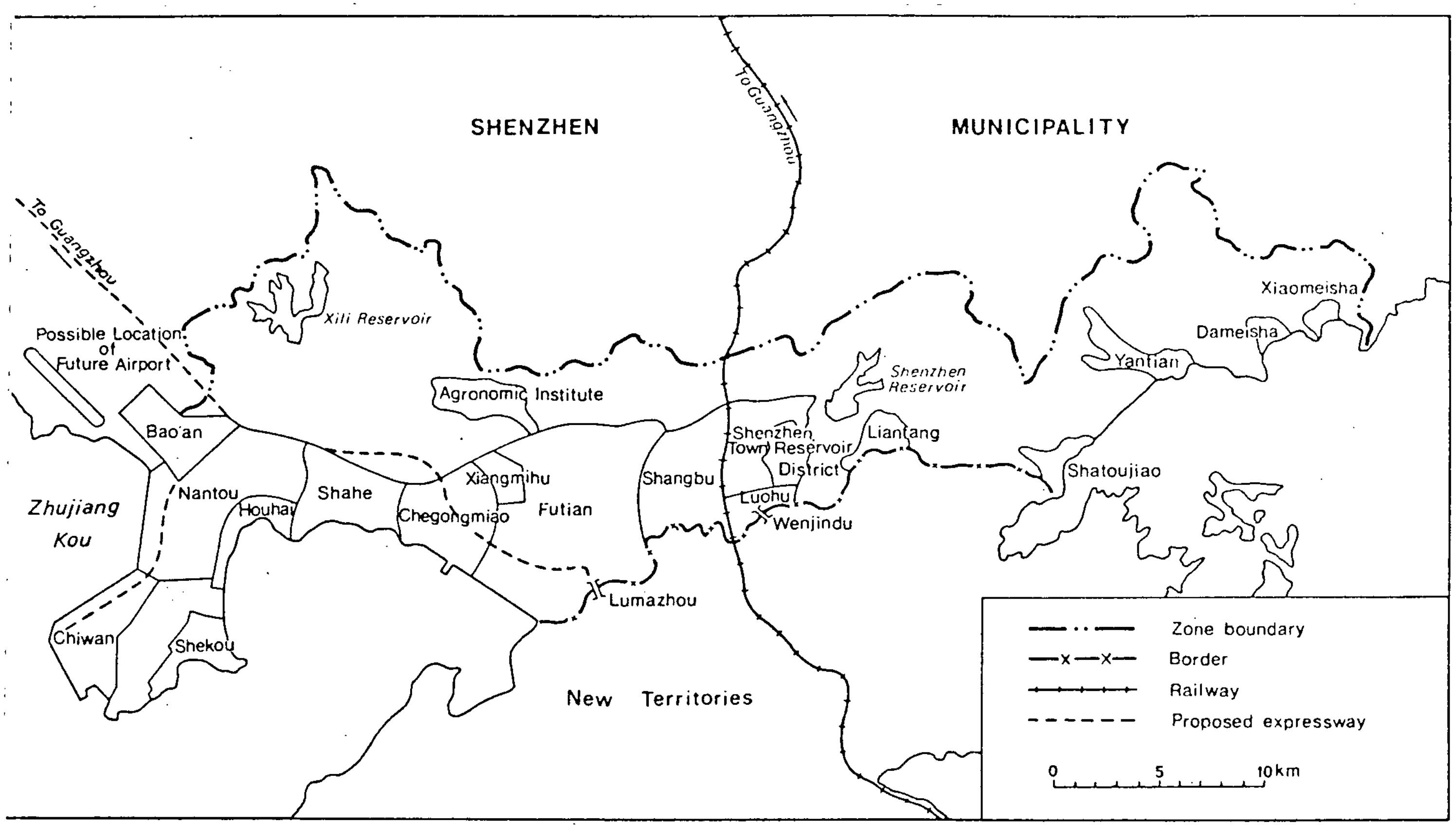

Figure 3. Proposed Planning Districts of the Shenzhen SEZ

Source: Anthony G. O. Yeh, "Physical Planning," in *Modernization in China: The Case of the Shenzhen Special Economic Zone*, eds. K. Y. Wong and D. K. Y. Chu (Hong Kong: Oxford University Press, 1985), p. 114.

participation to build Shenzhen's infrastructure was the 30-year (US$1.2 billion) co-operative joint venture between Hong Kong's Hopewell China Development and the Guangdong Provincial Highway Construction Company to build a 265 kilometre "super-highway" to connect Hong Kong and Shenzhen with Canton and Zhuhai.[75]

Shenzhen was created to be a comprehensive SEZ which could accomodate a wide range of investment activities. Thus, for planning and development purposes, the zone has been divided into various relatively self-contained sectors which would each specialize in a particular type of activity such as industry, agriculture, commerce, tourism or real estate.[76] Up to 1981, Shenzhen had not only been agriculturally self-sufficient, but it had also been an exporter of grain.[77] Nevertheless, at that time, Shenzhen's full potential as a producer of other agricultural export items such as vegetables, livestock and fish was not fully realized because of the over-production of grains and the under-utilization of arable land, of which Shenzhen had an abundance.[78]

Today, as the result of the active promotion of agricultural investments, agriculture in Shenzhen has grown to become one of the most important contributing factors to Shenzhen's success. Shenzhen today has centres in five administrative areas (Nantou, Shangbu, Luohu, Shatoujiao, and Bao An) producing

[75] Elizabeth Cheng, "Super-highway Gamble," *China Trade Report* April 1987, p. 5. Hong Kong billionaire, Li Kashing is also involved in this project.
[76] Anthony G. O. Yeh, "Physical Planning," in *Modernization in China: The Case of the Shenzhen Special Economic Zone*, ed. K. Y. Wong and David K. Y. Chu (Hong Kong: Oxford University Press, 1985), p. 115.
[77] Tianxiang Zheng, Qingquan Wei and David K. Y. Chu, "Agricultural Land-Use Patterns and Export Potential," in *Modernization in China: The Case of the Shenzhen Special Economic Zone*, eds. K. Y. Wong and David K. Y. Chu (Hong Kong: Oxford University Press, 1985), p. 103.
[78] Zheng et al, pp. 106-107.

and exporting a wide range of agricultural products such as fish, livestock, fruits and vegetables.[79] In September 1987, the total value of agricultural products was about HK$500 million, a 11.1 per cent increase over the previous year's output.[80]

In 1988, the population of Shenzhen had reached the projected target of a half million, which was set for the year 1990.[81] As the zone continues to grow, this figure is expected to rise to one million by the year 2000.[82] Wages in Shenzhen tend to be much higher than in other parts of China, but then, so is the cost of living.[83] In 1983, Shenzhen had an average annual income about two and a half times that of the national average.[84] The predominant form of economic activity in Shenzhen today is light industry.[85] According to predictions by the Shenzhen authorities, about 40 per cent of the workforce in the zone will be employed in the industrial sector by the year 2000.[86]

Shenzhen has also demonstrated to foreign investors that it can be a

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[79] *China's Foreign Trade* 3 (1988): 42.
[80] ibid.
[81] The Hong Kong, p. 3., and "Updating the Zones," *Business China*, 29 February 1988, p. 56. For the development programme of the Guangdong SEZs to the year 2000, see Oborne, p. 182.
[82] The Hong Kong, p. 3.
[83] David Bonavia, *Hong Kong 1997: The Final Settlement* (Hong Kong: South China Morning Post Ltd., 1985), p. 88.
[84] David K. Y. Chu, "The Politico-economic Background to the Development of the Special Economic Zones," in *Modernization in China: The Case of the Shenzhen Special Economic Zone* (Hong Kong: Oxford University Press, 1985), p. 30.
[85] Victor F. S. Sit, "Industries in Shenzhen: An Attempt at Open-door Industrialization," in *China's Special Economic Zones: Policies, Problems and Prospects*, eds. Y. C. Jao and C. K. Leung (Hong Kong: Oxford University Press, 1986), p. 235.
[86] Kwan-yiu Wong and David K. Y. Chu, "Trends and Strategies of Industrial Development," in *Modernization in China: The Case of the Shenzhen Special Economic Zone*, eds. K. Y. Wong and David K. Y. Chu (Hong Kong: Oxford University Press, 1985), p. 57.

profitable place to invest. By April 1988, most of the 1,000 foreign-funded enterprises in Shenzhen, half of which were being run as joint ventures with Chinese partners, were making profits.[87] According to information on 119 foreign-funded enterprises provided by the Shenzhen Investment Administrative Company, 99 enterprises earned Rmb119.9 million (US$32.37 million) in profits, while 20 sustained Rmb6.39 million in losses in 1987.[88] This works out to a success rate of about 83 per cent for foreign investors, a figure that is almost identical to the 84 per cent success rate for foreign-owned enterprises in Shenzhen cited by the *China Daily*, 28 December 1984.[89]

Nevertheless, there are many problems which must be resolved before Shenzhen and the other special zones are to successfully lead China's modernization effort. One of the most acute problems is the critical shortage of qualified people to fill key positions in the foreign trading enterprises. This problem is especially serious in Guangdong Province because it is expected by the central government to increase the number of its foreign trade enterprises so that it will control about 50 per cent of China's foreign trade by 1990.[90] Because of the tremendous pressure to expand its foreign trade capabilities, Shenzhen and the other SEZs regularly recruit foreign-language graduates for foreign trade related positions, even though they are inexperienced or unqualified for the job.[91] K. T. Li, a Taiwanese Minister in 1979, noted that one of the

[87] *Sing Tao International*, 25 April 1988, p. 1.
[88] ibid.
[89] *China Daily*, 28 December 1984, as cited by Suzanne Pepper, "China's Special Economic Zones: The Current Rescue Bid for a Faltering Experiment," *Bulletin of Concerned Asian Scholars* 20 (1988): 7. Although these figures indicate that about 16 per cent of the foreign firms in Shenzhen are not making money, I have not been able to find any published figures on foreign firms or joint ventures that have gone bankrupt in Shenzhen.
[90] "Skilled Manpower Needed," *China Trade Report*, June 1988, p. 6.
[91] ibid.

biggest obstacles to modernization in China was the lack of technically trained personnel and skilled workers to absorb the new technology and to efficiently operate the sophisticated technology from abroad.[92] Li estimated that China only has about half of the approximately 800,000 trained technicians that it needs for its modernization program.[93]

Another problem is that despite Shenzhen's present relative success, it must be noted that the majority of its foreign investment capital still comes from Hong Kong. Because of this overdependence on Hong Kong capital, the future success of Shenzhen is precariously tied with that of Hong Kong's. Until Shenzhen can attract a larger share of its investment capital from the international community, Hong Kong will ironically continue to be the source of its success, as well as its Achilles' heel. Other problems concerning the SEZs, and Shenzhen in particular, will be discussed in chapter four. The next chapter will examine Hong Kong's current economic relationship with China by focusing on Hong Kong's economic relationship with Shenzhen. This will be followed by a brief discussion on the cultural factors, and Hong Kong's role as a special zone in China after 1997.

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[92] K. T. Li, "Mainland China's Economic Modernization: An Evaluation Based on Taiwan's Development Experience," *Issues and Studies: A Journal of China Studies and International Affairs*, no. 7 (July, 1979), p. 20.
[93] ibid.

Shenzhen: Basic Economic Statistics[94] 1979-86[95]

(Unit = Rmb million)

Year	1979	1980	1981	1982	1983	1984	1985	1986
Capital construction	50	125	270	633	886	1584	n. a.	n. a.
Gross industrial output	60.6	88.4	242.8	362.1	720.4	1814.5	2674.2	3507.0
Gross agricultural output	114.7	110.8	130.0	140.6	152.1	168.4	188	n. a.
Total volume of retail trade	128.5	206.6	355.9	567.9	1284.9	2159.8	2777.8	2650
Foreign trade (US$million)								
Export	9.3	11.2	17.4	16	62.3	304.3	563.4	670
Import	n. a.	1.3	4.3	7.9	724.1	807	742.9	n. a.
Realized foreign investment (including foreign loans)								
(US$million)	15.3	32.6	112.8	73.9	143.9	210.5	193.4	360

[94] The investment figures cited in this table are much more conservative than many other sources. For example, David Aikman (p. 90) noted that foreign investment commitments in Shenzhen amounted to US$3 billion in 1984, but he did not specify how much of this amount was actually utilized. Much of the discrepancies over foreign investments in the SEZs arise from the difference between what has been commited and what has actually been invested. The investment figures cited in this table are slightly higher than those published by the Shenzhen authorities for 1979-1984. See *Shenzhen*, p. 599.

[95] Sources: Michael Oborne, *China's Special Economic Zones* (Paris: Organization for Economic Co-operation and Development, 1986), p.185., and *China Trade Report*, March 1987, p. 6. (Compiled by Thomas Chan).

III. HONG KONG AND SHENZHEN

As mentioned earlier, Hong Kong before the post-Mao reforms was important to China mainly as a supplier of foreign exchange and other services. The creation of the SEZs was intended to actively tap into and utilize resources from Hong Kong for China's latest modernization effort. However, an interesting fact about the SEZs is that they were created after Hong Kong business interests took the initiative to suggest to the Guangdong government that it should expand the scope of the Shekou Special Industrial Zone to include property development and tourism and that the name of the zone should be changed to "special economic zone" to reflect this broader perspective.[2] Consequently, when the SEZs were created by China in 1979, Shenzhen, the largest SEZ then, was, not surprisingly, situated next to Hong Kong. The selection of the Shenzhen's location next to Hong Kong was an extremely logical one since there was already a great deal of interest in China to co-operate with Hong Kong capitalists in joint ventures and to set up export-oriented assembly factories along the China-Hong Kong border.[3]

It is therefore not surprising that the most enthusiastic response to the new investment opportunities in Shenzhen came mainly from Hong Kong investors. About 80 per cent of the investors in Shenzhen are Hong Kong investors, who also account for about 90 per cent of the investment capital committed in Shenzhen.[4] Furthermore, between 1979 and 1985, Hong Kong investors in China accounted for 80 per cent of China's equity joint ventures,

[2] Ho and Huenemann, p. 49.
[3] Cheng, pp. 64-66.
[4] "China's Foreign Gains," *Asian Business*, March 1986, p. 8., and Zhang, p. 35.

which were concentrated mainly in the Pearl River Delta region.[5]

The enormous economic presence of Hong Kong investors and investment capital in the Shenzhen SEZ and the Pearl River Delta Region is a very curious phenomenon, especially with the year 1997 looming so uncomfortably close on the horizon. This interesting economic relationship raises some very fundamental questions about the relationship between Hong Kong and the Shenzhen SEZ, and Hong Kong and China. The next two sections will analyze these relationships by exploring the following questions: (1) why do Hong Kong businessmen invest in Shenzhen, (2) what investment areas are they interested in and why, and (3) are Hong Kong investors providing the technologies, modern managerial skills and foreign exchange earning capabilities that China had hoped for in the SEZs? These questions will be answered mainly by comparing the investment environment of Hong Kong with Shenzhen and by looking at some of the main investment incentives offered by Shenzhen. Cultural factors will also be explored briefly.

A. THE ECONOMIC FACTORS

Undoubtedly, Shenzhen's most conspicuous advantage over the other SEZs, and the key to its success is its size and location next to Hong Kong. These advantages have enabled Shenzhen to take in more foreign investment funds than the combined total of all of the other SEZs, despite the fact that the package of investment incentives offered by the other SEZs is almost identical.[6] For Hong

[5] "Jewel," p. 8., and *Business Asia*, 22 June 1987, p. 193.
[6] For the foreign investment figures and the special incentives of each of the SEZs, see *Business China*, 28 March 1988, pp. 44-45.

Kong investors, Shenzhen's greatest pull and advantage is the easy accessibility that it offers to the wide range of investment incentives that the SEZs offer. Foremost of these attractions is the lure of lower operating costs in Shenzhen. For foreign investors, however, the investment environment in Shenzhen has generally proven to be less accomodating to them than for their Hong Kong counterpart.

Oborne noted that Hong Kong investors in China were generally more interested in lowering their production costs than their American, Japanese and European counterparts, who were generally more interested in eventually gaining access to the domestic Chinese market.[7] A 1982 research survey of 32 Hong Kong industrial firms found that on a scale from 0 to 10, the SEZs satisfied such investment criteria as the availability of labour (6.9), cheap land (6.8) and cheap labour (6.8), tax concessions (6.2), and geographic proximity (4.9).[8] Because of these different investment motives, Hong Kong investors also generally tend to enjoy immediate benefits, in the form of higher profits, for investing in Shenzhen, while other foreign investors generally do not expect immediate profits for their investments. Although 80 per cent of China's population lives in the countryside and does not have much money to spend on domestically produced consumer goods, let alone expensive foreign goods, foreign firms are often willing to invest in China, and often incur high costs, with the hope that their investments will eventually pay off in the long-run in the form of market access.[9]

Another problem foreign investors must face in China is the desire by the central government to protect its domestic industries from being overwhelmed

[7] Oborne, p. 90.
[8] Oborne, table 25, p. 91.
[9] Shirk, p. 58. Also see Wang, pp. 147-148.

by foreign competition. Such an event would not only be economically disastrous, but would have serious political consequences as well. This puts the central government in a double-bind situation in that it wants to encourage foreign investments, and it also needs modern foreign machinery and equipment, but not at the cost of possibly damaging its own domestic industries. At the same time, it must also deal with lobby groups within China which have a vested interest in preserving the pre-reform economic situation.

One of the largest proponents of protectionist pressures in China against foreign competition is the Ministry of Machine Building, which represents nearly one-third of all the industrial enterprises in China. In the days of self-sufficiency and extensive economic growth, when China produced most of its own goods rather than imported them, the machine-building industry had a monopoly supplying equipment to Chinese factories. However, now that the machine-building industry's monopoly is being challenged by more sophisticated and modern foreign firms, it has often resorted to using its bureaucratic clout with the central government to protect its interests.[10] Protectionist pressures are, by no means, restricted to the heavy industrial sector in China. Light industrial enterprises have also succeeded in pushing for increases in customs duties and marketing restrictions on foreign goods and equipment.[11]

Although China now promotes a policy of import-substitution, and allows some foreign firms a limited access to the Chinese market, it is also mindful of the dangers of too much foreign penetration of its markets. As a result, previously exempted customs duties on imported production materials must be

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[10] Shirk, p. 65.
[11] Shirk, pp. 66-67.

paid if the finished products are subsequently marketed to the domestic Chinese market instead of the international market.[12] This legislation was primarily intended to attract export-oriented businesses to Shenzhen in order to help build up China's exports, while at the same time, prevent China's domestic industries from being overwhelmed by strong foreign competition. In an attempt to make the investment environment in Shenzhen even more attractive to foreign investors (especially those possessing desired technologies), the Shenzhen administrators in 1987 have allowed companies that have been experiencing difficulties in making a profit limited access to the domestic market.[13] However, this is only done on a selective basis, and only if the foreign goods meet certain criteria such as quality, technology etc.[14] In an attempt to reverse the large out-flow of foreign exchange from China (and especially in the SEZs), the central government imposed a strict clamp-down on spending and re-emphasized the development of export-oriented industries in the SEZs in 1985.[15]

Suzanne Pepper pointed out, incorrectly, that even though foreign investors have some access to the Chinese market, that "...they cannot convert renminbi profits earned therefrom [in China] into foreign currency."[16] According to Blaser and Mak, China introduced regulations in 1985 which would facilitate foreign exchange remittances for foreign enterprises in China which are entitled

[12] Fred Blaser and Constance Y. F. Mak, *Business and Tax Laws of the People's Republic of China* (Don Mills: Commerce Clearing House Canadian Ltd., 1987), p. 64., and Provisional Regulations of the State Council of the People's Republic of China on Reduction and Exemption of Enterprise Income Tax and Consolidated Industrial and Commercial Tax for Special Economic Zones and the Fourteen Coastal Cities, art. 8, *Shenzhen Jingji Tequ Nianjian, 1985* (Hong Kong: Shenzhen Jingji Tequ Nianjian Weiyuanhui, 1985), p. 271.
[13] Li Tiejun and Zheng Lianming, "China's Import-Substitution Policy," *China's Foreign Trade* 3 (1988): 11.
[14] ibid., and *Country Report: China, North Korea*, no. 4, 1987, p. 20.
[15] Pepper, pp. 16-19.
[16] Pepper, p. 13.

to sell their products and services to the PRC. This law was aimed particularly at attracting foreign firms to China that employ "...advanced technology or produces quality products which are internationally competitive and urgently needed in China...."[17] Therefore, despite the fact that China's foreign currency policy is designed to increase its foreign exchange earnings and reduce its foreign exchange outflow, it is not impossible to earn and remit foreign exchange from China. The main problems facing foreign investors are creating or finding a niche in the Chinese economy and then convincing the Chinese authorities to give them some access to it.

The limitations of access to the Chinese markets has tended to frustrate foreign investments in the SEZs and China. This problem, however, has tended not to affect the Hong Kong investors as much because they are mainly export-oriented, and thus, interested in Shenzhen mainly as a low-cost process and assembly and production base. The complex political and economic dimensions of this problem must be solved if the SEZs and China are to succeed in attracting advanced modern technology for its modernization effort.

In order to understand why Hong Kong investors have dominated Shenzhen, it is necessary to understand the historical and economic development of Hong Kong. Hong Kong's remarkable transformation from a struggling British trading post into one of the world's largest industrial centres was largely due to the massive migration of human and capital resources from China during the civil war. Since then, the steady influx of (legal and illegal) immigrants[18] from

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[17] Blaser, p. 89.

[18] Although legal immigration from China provides Hong Kong with a steady stream of workers, illegal immigration is a serious and persistent problem because the numbers of illegal immigrants that enter Hong Kong are often so overwhelming that they impose an unmanageable burden on housing, education,

China has tended to keep wages low and enabled Hong Kong industrialists to take advantage of the cheap and abundant supply of labour in the colony.[19] In a sense, then, it can be said that Hong Kong was built on cheap labour.

Although Hong Kong has emerged as one of the world's largest financial centres in the 1970s, the manufacturing sector has continued to be the backbone of its economy, accounting for about one-quarter of its GDP, about one-third of all employment, and over 85 per cent of its total exports.[20] Despite the fact that Hong Kong is losing its competitive edge in its traditional manufacturing sector (ie. textiles, plastics and electronics) to its Southeast Asian competitors like Taiwan, Thailand, the Philippines and South Korea,[21] its manufacturing sector is still strong and vigorous. This fact was recently demonstrated by the strong demand for labour and the rising wages and salaries of workers in the manufacturing sector in Hong Kong. In 1987, manufacturing wages experienced a nine per cent average increase in dollar terms from the previous year.[22] Although rising wages may be interpreted as an indicator of the vitality of Hong Kong's manufacturing sector, it is also one of the main reasons for the erosion of Hong Kong's comparative advantage (ie. cheap labour) in the manufacturing sector.

Aside from the high and rising labour costs in Hong Kong, the high cost of real estate and land use fees is another serious problem Hong Kong

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[18](cont'd) transportation and other social services in Hong Kong.

[19]Lewis, p. 4., and Jon Woronoff, *Asia's "Miracle" Economies* (New York: M. E. Sharpe, Inc., 1986), pp. 150-151.

[20]The Hong Kong and Shanghai Banking Corporation. *Business Profile Series: Hong Kong*, 6th ed. (Hong Kong: The Hong Kong and Shanghai Banking Corporation, 1986), p. 9.

[21]"Hong Kong Industries," pp. 274-275.

[22]"Employment, Wages and Prices," *Country Report: Hong Kong, Macau*, no. 4 (1987), p. 13.

manufacturers have to deal with. Because the amount of land in Hong Kong that is naturally suited for industrial and residential purposes is only about 40 square miles, or about 10 per cent of the total area, land is a scarce and very expensive commodity.[23] According to L. C. Chau, between 1959 and 1970, the average purchase price per square foot of industrial land in Hong Kong went up from HK$9.70 to HK$102.90, while the average purchase price of a small flat went up from HK$2,723 per square meter to HK$10,450 from 1976 to 1981.[24]

Faced with these high and rising land and labour costs, it was not surprising that when Shenzhen offered the opportunity to cut costs, many Hong Kong manufacturers decided to relocate there. The SEZs appealed particularly to those businesses (mainly factories) in Hong Kong that were losing their competitive edge because of rising operating costs. Such businesses could obtain a new lease on life simply by moving to Shenzhen, where production costs can be about one-third to one-half cheaper.[25] Not surprisingly, most of the relocated businesses from Hong Kong tended to be the labour-intensive industries.[26] According to John Scherer, approximately 70 per cent of the industries relocated to Shenzhen from Hong Kong are assembly and processing operations for re-export back to Hong Kong.[27] Although China does not receive a great deal of high technology from these forms of investments, they do provide China with foreign exchange earnings to obtain it. The other benefits that these forms of

[23] W. A. Reynolds, *Factors Which Hinder or Help Productivity Improvement: Hong Kong Report* (Tokyo: Asian Productivity Organization, 1980), p. 36.

[24] L. C. Chau, "Imports of Consumer Goods from China and the Economic Growth of Hong Kong," in *China and Hong Kong: The Economic Nexus*, ed. A. J. Youngson (Hong Kong: Oxford University Press, 1983), p. 217.

[25] Geddes, p. 147.

[26] ibid.

[27] Scherer, p. 259.

investments offer China are modern management skills, finished products from compensation trade investments, and low and medium technologies, which are just as important and useful as high technologies.

According to Lynette Kemp, the average monthly wage for a worker in Hong Kong in 1988 was HK$365, as opposed to HK$124 for his Shenzhen counterpart, while the average net rent for prime office space in Hong Kong was HK$25 per square meter, as compared with HK$9 in Shenzhen.[28] Another land use fee schedule also published in 1987, pointed out that land use fees of SEZ enterprises were determined on the basis of the type, duration and needs of the operation, as well as the type of technology that it employs.[29] Special provisions introduced in October 1986 to improve the investment environment in the SEZs entitled industrial SEZ operations that were engaged primarily in production for export, or possessing advanced, foreign-sourced technology, to even more preferential land use rates.[30]

Land use fees for agricultural, educational, scientific, technological, medical and health purposes are assessed on a case-by-case basis and could be totally exempted altogether.[31] These special measures were intended to encourage the introduction of a broad range of advanced foreign technologies which China had determined would be beneficial to its modernization efforts. In 1988, Shenzhen's new land-use fees of Rmb.20 to 1.6 per square metre/year, with possible reductions and exemptions for land development, and "extra high-tech" ventures,

[28] Kemp, p. 70.
[29] Blaser pp. 35, 67. According to the standard land use fee schedule, industrial investments have the most favourable rates.
[30] ibid.
[31] Blaser, p. 67., and Yeh, pp. 118-119.

were the lowest figures published to date.[32] Because of Shenzhen's proximity to Hong Kong, and the powerful lure of lower operating costs there, many Hong Kong businessmen and investors found it difficult to not consider relocating there. Kemp noted that "for Hong Kong companies, marginal net differences in production costs frequently make an investment in China attractive."[33]

The differences between Hong Kong and other investors may also be due to differences in business attitudes. Hong Kong businessmen generally tend to think in the short-term. They have an extremely short product and profit cycle (probably the shortest in the world) and usually expect to recover all of their original investment capital, and much more, in less than five years.[34] Lynette Kemp noted that the majority of investment contracts in Shenzhen in 1987 were for small-scale investments which do not exceed 15 years in duration, while the largest group of investors are committed for 10 years or less.[35] This pattern of investment seems to correspond to the short business cycle of Hong Kong businessmen and may explain why they are the largest group of investors in Shenzhen despite the fact that it does not fully meet an important criterion for investing outside of Hong Kong, that is, political stability.[36] The immediate benefits that could be realized from lowered production costs alone made Shenzhen an attractive investment centre, political risks aside. In short, from a Hong Kong businessman's perspective, once all the risks have been carefully weighed, investing in Shenzhen offers more "pluses" than "minuses".

[32] *Business Asia*, 28 March 1988, p. 44.
[33] Kemp, p. 76.
[34] *The Economist*, 12 November 1983, p. 91.
[35] Kemp, p. 78.
[36] Oborne, pp. 90-91.

Another inducement for investing in Shenzhen is the lower income tax rate and other tax-related benefits which are not available in Hong Kong. Hong Kong has a corporate tax rate of 18.5 per cent, and does not offer any concessionary rates or tax holidays, while Shenzhen has a 15 per cent corporate tax rate and offers a variety of generous tax concessions and tax holidays.[37] For enterprises that export 70 per cent or more of their products, the corporate tax rate is even lower at 10 per cent.[38] Although foreign enterprises and joint ventures in China, but outside of the SEZs, may also be eligible for many of the preferential tax treatment that the SEZs enjoy, they are not entitled to all of the preferential treatment that the SEZS offer. They are still subject to higher income tax rates (between 20 to 40 per cent) and must still pay a variety of other taxes such as local surtaxes and a withholding tax on repatriated profits. The Economic and Technological Development Zones (ETDZs) now also offer many, but not all of the preferential terms which were originally offered only in the SEZs.[39]

Another lure attracting investors to the zone are the simplified entry and exit procedures. This special consideration was designed to make it easy, especially for Hong Kong investors, to commute to and from Shenzhen on a regular basis. The Provisional Entry and Exit Regulations for the Special Economic Zones in Guangdong Province, adopted in 1981, have made multiple

[37] Kemp, table 19, p. 70. The corporate tax rate in Shenzhen is even more attractive than those offered in other Asian centres such as Singapore (40 per cent), South Korea (30 per cent), and Taiwan (25 per cent). However, the tax holidays offered Singapore (5-10 years), South Korea (5 years), and Taiwan (5 years) are comparable or better than Shenzhen's (3-5 years).

[38] *Business Asia*, 28 March 1988, p. 44.

[39] S. H. Cheung, "The Not-so-open cities," *China Trade Report*, December 1985, pp. 1, 4. ETDZs are located in the 14 coastal cities that are open to foreign investment. They were created to import advanced technology and develop new technologies and high quality consumer goods through joint venture research and investments. See *Business Profile Series: The PRC*, p. 34.

entry-exit visas available to Hong Kong (and Macau) investors who have to travel frequently to Shenzhen to perform their duties.[40] Regulations facilitating the movement of people in and out of the zone were also extended to include the duty-free importation of machinery, equipment, raw materials, vehicles and other materials deemed necessary for the production of goods intended for export.[41] These two regulations, which appeal largely to the Hong Kong investors, were intended to take advantage of Shenzhen's close proximity to Hong Kong, and have greatly facilitated the transfer of Hong Kong-based factories to Shenzhen.

Since Shenzhen is economically dominated by Hong Kong, it should not be surprising that Shenzhen should, in many ways, resemble Hong Kong. Some writers have even commented that Shenzhen is already like an industrial suburb of Hong Kong.[42] Graham Johnson noted that "the interesting feature of the [Shenzhen] special zone is how much it resembles some of the new towns on the Hong Kong side of the border."[43] The close economic bond between Hong Kong and Shenzhen was best illustrated by the shift from real estate to light industrial investments in Shenzhen, which corresponded with the rise and fall of the real estate boom in Hong Kong.

Shenzhen was created just as the demand for land in Hong Kong was

[40] Xiang Ming, "Shenzhen Tequ Geiyu Touzizhe Gengduo Youhui," *Jingji Daobao*, no. 38-39 (1983), p. 34., and Provisional Rules of the Special Economic Zones in Guangdong Province Governing the Entry and Exit of Personnel, 1981, art. 3, sec. 2. in *Shenzhen Jingji Tequ Nianjian, 1985* (Hong Kong: Shenzhen Jingji Tequ Nianjian Weiyuanhui, 1985), p. 211.
[41] Moser, p. 151.
[42] R. Y. W. Kwok, "Structure and Policies in Industrial Planning in the Shenzhen Special Economic Zone," in *China's Special Economic Zones: Policies, Problems and Prospects*, ed. Y. C. Jao and C. K. Leung (Hong Kong: Oxford University Press, 1986), p. 61.
[43] Johnson, p. 9.

beginning to peak, so Shenzhen provided an attractive alternative outlet for Hong Kong real estate investments. Because of the shortage of land in Hong Kong (which Shenzhen had in abundance for development), there was a high but unfulfilled demand for recreational space and facilities, as well as weekend and holiday resorts.[44] Consequently, the main investment areas in Shenzhen in 1981 were tourism and real estate development, accounting for about 68 per cent of the total investments, while light industrial investments accounted for only about 16 per cent.[45] The large real estate and tourism-related investments in Shenzhen during the early 1980s were due largely to the spill-over effect of the boom market in property in Hong Kong. They were also the result of the mutual satisfaction of Hong Kong's need for land, and Shenzhen's need for assistance in property development. Interestingly, many Hong Kong investors did not purchase property solely for their own use, but also purchased property to build housing for their relatives in China who wanted to relocate to Shenzhen.[46]

The predominance of real estate and tourism investments in the early years of the SEZs also influenced the views of some PRC scholars over how the SEZs should be developed. For example, Tang Huai argued that the SEZs should not compete with Hong Kong in those sectors that Hong Kong is strongest (the light industrial manufacturing industries) because Hong Kong already has a comparative advantage in these areas. Instead, he proposed that the SEZs should focus on those activities such as tourism, commerce, agriculture, animal husbandry and those industries which do not put them in direct competition with

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[44] "Industries," p. 233.
[45] "Trends," p. 57.
[46] Oborne, p. 140.

Hong Kong.[47] However, the end of the real estate boom in Hong Kong forced Shenzhen to refocus on more productive (export-oriented industrial) activities rather than non-productive (tourism and property development) activities. Furthermore, in 1985, there was also pressure from the Central government for the SEZs to concentrate on more productive (ie. export-oriented) activities. The reorientation was precipitated by a number of problems in the Chinese economy, such as a 40 per cent drop in foreign exchange reserves, a sharp worsening in the balance of trade, a 7 per cent drop in grain output, and a 9 per cent increase in the inflation rate (which was 3 times the 1984 rate),[48] which created a sharp demand for foreign exchange earnings.

The policy reorientation brought the focus of the SEZs back to the development of the light industries, which was originally accorded top priority in the SEZs when they were created.[49] Light industry and agriculture, which were neglected sectors in China in the Mao years, were regarded by the post-1978 Chinese leaders as the weakest links in the economy, and thus, the key to economic development.[50] The location of the SEZs in southern China, where the main types of economic activities are agriculture and light industries (such as textiles, processing of semi-manufactured goods and electronics),[51] was partly an attempt to utilize the region's comparative advantages to ensure the successful development of these two sectors.

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[47] Tang, pp. 2-3.
[48] Stanley Rosen, "China in 1986: A Year of Consolidation," *Asian Survey*, no. 1 (1987), pp. 35, 46.
[49] Nicholas H. Ludlow and James B. Stepanek, "China's Five and Ten Year Plans: 1981-1990," *The China Business Review*, (March-April 1980), p. 6.
[50] Pairault, pp. 131-132.
[51] Kemp, p. 57.

An interesting pattern emerges when real estate investment statistics are compared with industrial investment statistics. First, a small number of real estate development contracts accounted for a large portion of the capital invested in Shenzhen. Forty-three tourism and real estate contracts, which made up a little over five per cent of all signed agreements in 1981, accounted for almost HK$2 billion, or 70 per cent of the total pledged investments in the zone.[52] At the same time, 537 manufacturing agreements, or 66.1 per cent of all agreements accounted for only HK$450 million, or about 17 per cent of the total invested capital.[53]

This phenomenon can be explained by the fact that real estate investments were often negotiated in phased packages over a number of years, so that the amount of capital committed was actually the total amount of capital investment spread out over a number of years.[54] Industrial investments however, require a large capital outlay which could not be spread out over a number of years. Furthermore, while real estate development projects provide a shorter period of return and higher profits, industrial investments generally require a longer period of time in order to recoup the original investment.[55]

Another important factor which influenced the types of investments made in Shenzhen during the early years was the fact that Shenzhen did not have a very developed infrastructure. As a result, Shenzhen's infrastructure had to be built from the foundation up. Furthermore, the Chinese government at the central

[52] T. W. C. Lo, "Foreign Investment in the Special Economic Zones: A Management Perspective," in *China's Special Economic Zones: Policies, Problems and Prospects,* eds. Y. C. Jao and C. K. Leung (Hong Kong: Oxford University Press, 1986), p. 186.
[53] ibid.
[54] Oborne, p. 140.
[55] "Trends," p. 57.

and local levels lacked sufficient funds to develop Shenzhen on their own. As a result, a substantial amount of assistance was sought to help develop Shenzhen, especially from Hong Kong.[56] Because China was already heavily involved in many of Hong Kong's financial activities, it was only natural that Beijing-controlled companies in Hong Kong sought out Hong Kong companies to help develop Shenzhen.[57]

The fact that Shenzhen lacked an adequate infrastructure and legal framework may have also limited the amount and types of industrial investments attracted to the zone. According to K. Y. Wong, Shenzhen's weak infrastructure discouraged large industrial investments during the initial period of industrial development.[58] As a result, industrial development in Shenzhen tended to be small to medium processing and assembly operations in the HK$840 thousand range, as compared to commercial development (HK$18 million); housing (HK$47 million); and tourism (HK$439 million).[59] These conditions were well suited for the typical type and scale of industrial operations found in Hong Kong. The shortage of land and the high land-use costs in Hong Kong have tended to shape and limit the types of industries in Hong Kong to predominantly small and medium-sized light industries, as opposed to heavy industries, which generally require large amounts of land and capital.[60] Because most processing and assembly operations also import their raw materials or semi-finished goods into Shenzhen, they are not very dependent upon Shenzhen's infrastructure or supply system for production inputs. Furthermore, the close proximity of Shenzhen to Hong Kong's transport facilities and advanced infrastructure has made it easier

[56] Ho and Huenemann, pp. 67-69.
[57] *China's Economic*, *p. 478.*
[58] "Trends," pp. 57-58.
[59] "Trends," p. 58. Figures cited are 1981 averages.
[60] Cheng, p. 65.

for Hong Kong-based manufacturers to be relatively independent of Shenzhen's infrastructure for the supply of raw materials.

According to Karl Herbst, uncertainties and ambiguities in the Shenzhen legal regulatory framework, as well as the many burdensome requirements contained in the Shenzhen Provisional Technology Regulations, can be blamed for Shenzhen's comparative failure in attracting the advanced Western technology that it had hoped to obtain.[61] He listed some of the most important concerns foreign investors have with the technology transfer regulations as the

> ...very long list of documents, data and equipment that must be provided when transferring know-how. The supplier is responsible for training the Chinese party and must ensure that the recipient masters the entire technology. He must also guarantee the legal effectiveness and the anticipated technical results of the introduced technology. Finally, the technology must be capable of producing products suitable for the international market: if losses are caused by the influence of the supplier on sales the supplier is liable for those losses. Furthermore, in cases where the supplier has transferred the same technology to other persons, he must submit a duplicate of the original contract to the Chinese party. The Shenzhen Provisional Technology Regulations also provide that technology transfer agreements, except for the use of technology as investment capital, should generally not exceed five years, although extensions are possible. If the foreign party to a joint venture uses technology as investment capital the ratio of its technology capital is not to exceed 20 per cent of the registered capital of the joint venture.[62]

Many foreign firms have also tended to avoid investments requiring a long-term commitment of capital and human resources, or "running royalty" obligations for the licensing of technology with the PRC because they consider it financially risky to enter into long-term business relations with a socialist

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[61] Herbst, p. 130.

[62] Herbst, p. 130. See also, the Provisional Rules of the Shenzhen Special Economic Zone on the Import of Technology, 1984, in *Shenzhen Jingji Tequ Nianjian, 1985* (Hong Kong: Shenzhen Jingji Tequ Nianjian Weiyuanhui, 1985), art. 9, 10, 11, 12, 19 and 23, pp. 254-258.

country.[63] David Aikman attributed the reason why the vast majority of investments in Shenzhen comes from Hong Kong, while American, European and Japanese investors possessing advanced technologies and know-how are more reluctant to invest, to the fact that foreign companies were often concerned about any ultimate loss of competitive advantage to the PRC.[64] In other words, foreign investors possessing high technology tend to be afraid that if they transfer their technology to China, that China may someday use it to compete against them in the future. Adding to China's difficulties in acquiring Western technology (especially with military potential) are export control restrictions by various agencies in the West over the types of technology that could be transferred to China.[65]

Despite the large body of laws and regulations that have been published by the Chinese government relating to foreign trade and foreign enterprises, there is still a great deal of uncertainty in dealing with China for foreign firms. For example, even though China has created many new laws and regulations, they are often too brief and too vague, by Western standards, to satisfy the more legally-minded Western investors.[66] Exacerbating the legal differences of doing business in China is the fact that there are very few, or no precedents to provide a guideline as to how the laws will be interpreted and implemented, or how disputes may be settled.[67] Nevertheless, the situation can only improve as more and more detailed laws amplify and futher define the conditions of investment.

[63] "Technology Transfer Via Licensing: The Options," *The China Business Review*, March-April, 1980, p. 56.
[64] Aikman, pp. 65-66, 90.
[65] Wang, pp. 102-104.
[66] Wang, pp. 120-121.
[67] Wang, pp. 94-95.

Because most Hong Kong investors generally do not possess the most advanced technology, they tend not to be as threatened by the technology transfer regulations. However, it was found in a 1982 survey of technology transfer by Hong Kong investors to China that only 7 per cent of the investments involved "advanced" technologies, while "intermediate" and obsolete technologies made up 36 and 59 per cent of the investments respectively.[68] In an attempt to encourage more industrial investments and to satisfy the demand for advanced technology in China, the Chinese government has vigorously proposed mutually advantageous joint ventures in industry with Hong Kong investors for the purpose of industrial expansion (of Hong Kong activities in Shenzhen) and product research and development, particularly in the electronics industry.[69] The main appeal for industrial co-operation are the rising industrial production costs in Hong Kong and the strong challenge from other countries like Japan in the electronics industry.[70] Min Jianshu, a professor at a Hong Kong university hoped that increased economic co-operation between Hong Kong and China would spur development and open up more opportunities for Hong Kong's manufacturing industries. He also pointed out that if Hong Kong is able to gain more access to China's markets through increased economic co-operation that Hong Kong would be less dependent (and vulnerable) on the international marketplace.[71]

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[68] Oborne, pp. 92-93. See also, Joseph Chai, "Industrial Co-operation between China and Hong Kong," in *China and Hong Kong: The Economic Nexus*, ed. A. J. Youngson (Hong Kong: Oxford University Press,1983), table 3.17, p. 133.

[69] Shen Yuanzhang, "Shengang Liangdi Jingji Guanxide Huigu yu Zhanwang," *Jingji Kexue* 2 (1986): 58., Peng Jewen, "Xianggang yu Neidi ke Hezuo Fazhan Dianzi Gongye," *Jingji Daobao*, no. 38-39 (1983), pp. 62-63., Xie Yingzhen, "Zhongguo Neidi yu Xianggangde Dianzi Gongye Guanxi Miqie," *Jingji Daobao*, no. 38-39 (1983), pp. 67-68., and Chen Jiwen and Huang Yi, "Xianggang Dianzi Gongye yu Neidi Hezuode Qianjing," *Gangao Jingji*, no. 3-4 (1984), pp. 57-62.

[70] Xie, p. 67.

[71] Min Jianshu, "Jiaqiang Xianggang yu Neidide Jingji Hezuo," *Xianggang Jingji Nianjian, 1984*, sec. 1, p. 38.

Even though Hong Kong investors generally cannot offer Shenzhen much advanced technology, they can contribute advanced marketing and management skills and techniques, and stabilized technology, which is more easily transferred and assimilated than complex, advanced technology. Hong Kong has demonstrated that the most advanced technology is not a necessary ingredient for economic success. What is necessary for economic success, however, is the efficient management and the maximization of the available technologies and resources. Therefore, the most important contribution that Hong Kong can make to Shenzhen is not its technology, but its investment capital, marketing and management expertise and business savvy.

Jon Woronoff pointed out that the most appropriate technology for a developing country was not necessarily the most sophisticated or advanced technology. He argued that the gradual upgrading of existing technologies, rather than taking a big technological leap forward, would not only greatly simplify the learning and assimilation of new technologies, but was a more rational approach to modernization.[72] Simply grafting advanced technologies onto a backward economy that is not adequately prepared to make the "high-technology" transition was an extremely haphazardous and uncertain approach to modernization. Unless the recipient society had a technically trained and educated workforce that could take advantage of such technologies, the transfer of the most advanced technologies would be futile and only create confusion.[73]

Lucian Pye, in his article, "On Chinese Pragmatism in the 1980s," pointed out that key Politburo and Central Committee members, influenced by

[72] Wornoff, p. 267.
[73] Woronoff, p. 272.

Alvin Toffler's *The Third Wave*, believed that while China missed out on the earlier technological revolutions, it can skip over them and move to the top in the current technological revolution through the acquisition of the most advanced technologies.[74] Although less advanced technologies may be more appropriate and practical for China's needs, especially in generating more employment, Pye also attributed China's desire for the most advanced technologies to its desire to adopt only the best from the West and its desire to keep out undesirable influences.[75]

In the case of Shenzhen, where a great deal of the workforce is generally untrained and unskilled, many of the difficulties associated with the assimilation of technology (even with less advanced technologies) that Woronoff had mentioned were realized. Ho and Huenemann pointed out that because a large part of the workforce was recruited from the countryside, many workers even had difficulty functioning in a factory environment.[76] The ability of Shenzhen to absorb new technology not only dictates the speed at which technology can be transferred, but may also have a bearing on the type of investment activities that are attracted there. This may also be part of the reason why most of the industrial activities in Shenzhen do not necessarily involve the most advanced technologies.

Wong and Chu noted that although owners of marginal industries in Hong Kong found Shenzhen to be an attractive place to relocate, the large-scale, high technology and predominantly foreign-owned Hong Kong-based industries that

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[74] Lucian Pye, "On Chinese Pragmatism in the 1980s," *China Quarterly*, no. 106 (June 1986), p. 227.
[75] "On Chinese," p. 228.
[76] Ho and Huenemann, p. 69. See also, Kemp, p. 61., and Herbst, pp. 130-131.

are still profitable in Hong Kong are more hesitant to relocate to Shenzhen.[77] The reason for this may be that the well established and predominantly foreign firms do not have as great an incentive to relocate as the more marginal firms. Therefore, because of the different needs and motives of Hong Kong and Western investors, Shenzhen's investment environment tended to appeal more to the Hong Kong investors.

According to the *Shenzhen Jingji Tequ Nianjian, 1985,* light industrial investments (especially processing and assembly operations) were the most significant form of industrial activity in the zone.[78] The dominance of light industrial investments in Shenzhen should not come as a surprise because small-scale light industry are also, by far, the most common type of industrial activity in Hong Kong.[79] After the property boom had subsided in Hong Kong, light industrial investments rapidly took over as the main form of investment in Shenzhen so that by the end of 1983, they accounted for about three-quarters of all investments.[80] On the type of investors and investments found within Shenzhen, Kemp noted that

> ...almost 80 per cent are from Hong Kong for whom the SEZs are particularly suited [for their needs]. Such investors are anyway already engaged in light industries oriented for export that depend on cheap and relatively unskilled labour for cost competitiveness.[81]

Beijing's entry into the Convention for the Protection of Industrial

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[77] "The Investment," p. 194.
[78] "*Gongye Tongji,*" *Shenzhen Jingji Tequ Nianjian, 1985* (Hong Kong: Shenzhen Jingji Tequ Nianjian Weiyuanhui, 1985), pp. 587, 589.
[79] Geddes, pp. 18-19, 53. According to Geddes, more than 45,000 businesses, or 99 per cent of the businesses in Hong Kong in 1982 employed an average of 20 employees each.
[80] "Trends," p. 57. By 1984, this figure was about 80 per cent. See "Industries," p. 235.
[81] ibid.

Property,[82] and the creation of the 1984 Patent Law were steps in the right direction towards ensuring the protection of foreign industrial property rights (such as inventions and technologies).[83] This move has made it easier for high technology firms to invest in China. For example, in 1987, Philips of the Netherlands entered into a joint venture with the Shenzhen Advanced Science and Technology firm to manufacture and market (domestically and abroad) state-of-the-art laser optical systems.[84]

However, the root of China's problems in trying to attract foreign investments (other than from Hong Kong) and advanced technologies is that it has not adequately addressed the most important demand of foreign investors, especially those possessing modern technologies. A 1987 report by the United Nations Centre on Transnational Corporations pointed out that both China and foreign investors have different expectations about foreign investments in China. It noted that what China expects from foreign investments are foreign capital, modern technology and management skills, and revenue (foreign exchange)--while foreign investors expect to maximize their profits mainly by gaining a foothold in the Chinese market, obtaining scarce resources and finally, to establish low-cost offshore manufacturing bases.[85]

Although China has supplied investors with low-cost manufacturing bases and some access to scarce resources, such as coal and petroleum,[86] gaining access to the Chinese markets is still extremely difficult. Thus, the crux of the foreign investment problem are the inherent limitations of the SEZ concept. As a

[82] "Technology," p. 56.
[83] Moser, pp. 319-328.
[84] "Laser Technology to be Transferred," *China Trade Report*, July 1987, p. 4.
[85] "Some Positive Proposals," *China Trade Report*, (September 1987), pp. 8-10.
[86] See Ho and Huenemann, pp. 154, 156, 159, 168-170.

result, many multi-national corporations have not been interested in investing in China, despite the fact that investments involving advanced technology may receive special treatment. Consequently, the main types of investments attracted to the SEZs are those typically found in EPZs in other developing countries: that is, low to medium technology, labour-intensive, light industrial, and export-oriented. It is therefore not surprising that the main investors in the zones are from Hong Kong, where these types of economic activities are also the predominant form of economic activity.

B. "THE CANTONESE CONNECTION"

Any study which seeks a greater understanding of the economic ties between Hong Kong and China cannot ignore the cultural dimensions of their relationship. In the case of the Shenzhen SEZ, where about 80 per cent of the investors, and over 90 per cent of the investment capital comes from Hong Kong, this consideration is especially relevant. Unlike economic factors, which are objective, measurable, and can be easily expressed in dollar terms, cultural motives are not tangible, and often difficult to quantify. As a result, the intent of this section is just to show that, aside from economic considerations, cultural factors also play an important role in influencing Hong Kong investments in China.

Despite the fact that Hong Kong is a British colony, A. J. Youngson pointed out that the close identification of many Hong Kong residents with China has many economic and non-economic implications in that

> ...many people [in Hong Kong] wish to be useful to China. They are Chinese, and they sympathize with Chinese national aspirations. For

> this reason, many who are not Communists but who have special skills that are needed in China go there to work for a few years, as technical experts or teachers, or, while remaining in Hong Kong, go out of their way to help and to promote Chinese interests.[87]

Moreover, many overseas Chinese also maintain close business and commercial ties with their home province. Their informal commercial network has enabled the local Chinese businessmen in Guangdong to conduct foreign trade without having to deal with their Western counterparts.[88]

N. T. Wang noted that the often relaxed and friendly business relationship many overseas Chinese have with China is due to, and greatly facilitated by their linguistic ties, association with local Chinese business groups, and personal network of friends and relatives in China.[89] Wang also noted that this "insider" advantage also enables them to engage in business relations with China even though they do not agree with the politics of the CCP.[90] But perhaps even more important than the business aspect of overseas Chinese relations with China are their complex non-business motives for wanting to help China. Wang argued that "the aid element [of overseas Chinese relations with China] can be more important than the business element."[91]

When translated into economic terms, this complex and powerful overseas Chinese cultural identification and affiliation with China represents a significant economic asset for China which is manifested in various forms such as remittances and donations. In 1983, it was estimated that there were more than

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[87] Youngson, p. 11.

[88] Ezra F. Vogel, *Canton Under Communism: Programs and Politics in a Provincial Capital, 1949-1968 (Cambridge: Harvard University Press, 1969), pp. 20-21.*

[89] Wang, p. 61.

[90] Wang, p. 62.

[91] ibid.

1500 schools and universities that were built by overseas Chinese money in Guangdong and Fujian Provinces.[92] Because approximately 20 per cent of the population of Guangzhou have relatives in Hong Kong, Macau, or overseas, it is easy to understand why many overseas Chinese have maintained a strong sense of loyalty and identification with their home villages. It was reported that in some other regions of Guangdong province, this figure was as high as 34.7 per cent.[93]

In recognition of the past and present contributions of the overseas Chinese to their homeland, and their vast economic potential, the Chinese government has made several attempts to repair relations with the overseas Chinese, which had soured dramatically during the Cultural Revolution. In the early 1980s the Chinese authorities once again actively appealed to the patriotic zeal of the overseas Chinese by urging them to help China's modernization efforts by investing in [light] industrial and agricultural projects, which were now high priority areas for development.[94] The formation of the Guangdong Trust and Investment Corporation, which includes prominent Hong Kong businessmen as board members, is an example of the Chinese government's efforts to take advantage of the close ties and unique relationship that Hong Kong residents have with their home province.[95] That the Chinese government attached great importance to the economic influence of Hong Kong business interests can be illustrated by the fact that after the Shekou Special Industrial Zone was created in early 1979, China accepted Hong Kong's suggestion that the size and scope of

[92] *China Official Yearbook, 1983/84* (Hong Kong: Dragon Pearl Publications Limited, 1983), p. 459.
[93] *Guangzhou*, p. 85.
[94] Terry Cannon, "Foreign Investment and Trade; Origins of the Modernization Policy," in *The Chinese Economic Reforms*, ed. Stephen Feuchtwang and Athar Hussain (London: Croom Helm, 1983), p. 311.
[95] Cannon, p. 317.

the zone be enlarged and that the name of the zone be changed to "special economic zone" to reflect this new broader scope.[96]

The location of the SEZs in Guangdong and Fujian Provinces was also an attempt to take advantage of the ethnic and familial ties many ex-patriate overseas Chinese businessmen, especially from Hong Kong, have in these two provinces.[97] Because China's Pearl River Delta has traditionally been the base for the Cantonese culture, when the SEZs were created, the Cantonese in Hong Kong took full advantage of their cultural, linguistic and familial ties with this region, and spearheaded the flow of investment and modern business practices into the region.[98] The decision to locate the SEZs in Guangdong and Fujian Provinces was also motivated by the desire to facilitate contact between China and the West. Guangdong Province already has extensive foreign trade connections, and a special relationship with Hong Kong, which also has extensive international trade and non-trade links.

On the advantages of the special relationship between Hong Kong and Guangdong, it was noted by *The Economist* magazine that

> the cultural and linguistic links between Guangdong and the predominantly Cantonese Hong Kong Chinese make the difficult task of conducting business between China and the West easier. Unlike the big trading corporations [in the other parts of China], they [the municipal and local level Chinese officials and managers] may not know even how to contact an IBM or an ICI, let alone do business with it; but they do know how to call their cousin in Hong Kong, who does.[99]

[96] Ho and Huenemann, p. 49. See also, Cheng, p. 65.
[97] Wolfgang Klenner and Kurt Wiesgart, *The Chinese Economy: Structure and Reform in the Domestic Economy and in Foreign Trade* (New Brunswick: Transaction Books, 1985), p. 101.
[98] "Jewel," p. 8.
[99] *The Economist*, 11-17 May 1985, p. 17.

Ho and Huenemann added that the linguistic similarities of Guangdong and Fujian Provinces with Hong Kong "...facilitates communication and thus helps reduce the transactions [sic] costs of investing in China and the cost of transferring technology and skills to China."[100] As a result, this factor was important in situating the SEZs in these two provinces because China was "...anxious to tap its [ie. Hong Kong] capital, its entrepreneurship, its market know-how, and its managerial and technical skills."[101]

N. T. Wang noted that the Chinese language often poses a difficult barrier to foreigners, especially in the negotiation process because many technical terms often do not have Chinese equivalents, is full of subtleties and different shades of meaning.[102] Complicating the difficulty with the language is the fact that it must be interpreted within its cultural context.[103] Therefore, because many Hong Kong businessmen understand the language and culture, and are often also experienced, or familiar with Chinese business practices, they are often more confident, and in a more advantageous position to do business with China than their foreign counterparts.

Because of cultural and linguistic similarities, blood ties, and the close physical proximity of Guangdong to Hong Kong, the (Cantonese) Chinese in the delta region have maintained close contacts with Hong Kong despite differences in political environments. The influence of this close contact is perhaps best illustrated in the lifestyle and attitudes of the people in the delta, which closely

[100]Ho and Huenemann, p. 51.
[101]ibid.
[102]Wang, pp. 114-115.
[103]ibid.

resembles those in Hong Kong.[104] A great deal of Hong Kong's influence in Guangdong Province is also due to the fact that Guangdong residents are able to pick up radio and television broadcasts from Hong Kong.[105] David Phillips also noticed that even the business attitudes and commercial activities of the Chinese in Shenzhen, who are predominantly Cantonese, are more advanced than in the other SEZs.[106] In conclusion to this section, although studies of Hong Kong investment activities in Shenzhen tend to focus on the legal and economic dimensions, and often overlook or underestimate the ethnic and cultural factors, they must be considered as an important part of the larger picture in Hong Kong's relationship with the Shenzhen SEZ, and China.

C. HONG KONG AS A SPECIAL ADMINISTRATIVE REGION OF CHINA

Before the Communist takeover of China in 1949, Canton, and then later, the treaty ports were the main focal points and commercial centres for foreign trade in China. However, after the abolition of the treaty ports in 1949, Hong Kong became the main centre for foreign commercial interests in the region. In many ways, Hong Kong became a special zone for China in that it played an important part in providing China with foreign exchange (in the form of remittances, donations, trade surpluses, and recently, investment earnings), trade links, and a window to the West. Although Hong Kong functions in many ways as a modern sector for China, Hong Kong, like the treaty ports, remains apart from China and only belongs to China nominally. Nevertheless, even during the UN trade embargo on trade with China in the early 1950s, and periods of

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[104] "Jewel," pp. 8-9.
[105] ibid.
[106] David Phillips, *China's Modernization: Prospects and Problems for the West* (London: The Institute for the Study of Conflict, 1984), p. 23.

turmoil in China such as the Great Leap Forward and the Cultural Revolution, Hong Kong continued to serve China as a special zone linking it with the outside world.

With the normalization of relations between China and the West in 1972, following Nixon's visit to China, China became increasingly more outward-oriented. Accompanying this shift in political orientation was the increase of China's economic presence and activities in Hong Kong, particularly in the lucrative banking and real estate industries.[107] This also marked the beginning of a period of increased interaction between China and Hong Kong. For China, this meant that Hong Kong was no longer regarded as just an entrepôt for its foreign trade, or simply as a source of foreign exchange. Christopher Howe noted that what China wants from Hong Kong

> ...is not simply foreign exchange, but organic links with economic dynamism of a kind that China conspicuously lacks. [Howe further pointed out that] the parallels between Hong Kong and Shanghai, while not exact, are very illuminating.[108]

What Howe meant was that Hong Kong today, as a modern city and a dynamic economic entity, is much like what Shanghai was during the treaty port era. However, this is where the similarities end. While Shanghai, when it was a treaty port, remained apart from the rest of the Chinese economy and society, and did not make a significant material impact on the Chinese economy,[109] the Chinese intend to use Hong Kong as a dynamic catalyst to stimulate and help transform and modernize the Chinese economy.[110]

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[107] Bonavia, p. 9.

[108] Howe, p. 531.

[109] This was the main thesis of many studies on the treaty ports by Rhoads Murphey.

[110] The renewed emphasis of the Chinese economic development strategy under the post-Mao era on the industrial urban centres, where the treaty ports were

The announcement of the Open Door Policy had enormous implications for Hong Kong because it meant that it would now play a more active role as an intermediary and participant in China. Because China lacks the necessary modern business, marketing and management skills and business connections, which Hong Kong possesses, to upgrade its own domestic economy, it was only natural that it would turn to its traditional intermediary for assistance. Hong Kong, which has historically been the traditional meeting place between China and the West, and has a large body of people experienced and familiar with Chinese business practices, as well as extensive international connections, was particularly suited for the job. Furthermore, it is also the world's third largest financial centre and container port, as well as a major player in the Southeast Asian and the Pacific Rim economies. In return, Hong Kong also benefited from the Open Door Policy because it signaled a new era of political stability from China, which sparked increased investment activities in Hong Kong. In a very real sense, China's new economic policies were a significant contributing factor for the dramatic growth of Hong Kong's financial sector.[111]

Under the post-Mao regime, Hong Kong was viewed in a different and more positive perspective as an economic model whose success and phenomenal growth should be emulated by all of China's cities. Hong Kong was a source of pride not because it was capitalist, but because it was Chinese. It was seen as the most successful Chinese metropolis of them all and an example of what the Chinese people could achieve through hard work and determination.[112] A 1979

[110](cont'd) once located, will be discussed in chapter 4.

[111]Jao, pp. 13, 24-27.

[112]Audrey Donnithorne, "Hong Kong as an Economic Model for the Great Cities of China," in *China and Hong Kong: The Economic Nexus*, ed. A. J. Youngson (Hong Kong: Oxford University Press, 1983), pp. 282-283. See also, Zhuang Weiming, "Xianggang Moshi Dui Woguo Shiban Jingji Tequede Jejian Zuoyong." *Gangao Jingji*, no. 3-4 (1984), pp. 62-65.

economic publication for senior Chinese cadres proclaimed that China could learn some useful economic lessons from Hong Kong such as producing goods to meet the needs of the market, speed, flexibility, quality control and economic efficiency in production.[113]

The new era of openness in China also marked the beginning of a new phase in Hong Kong's relationship with China (and the Shenzhen SEZ in particular). The SEZs were to serve as special modern sectors of the economy which would set the pace for the modernization of the rest of the economy. However, according to Gregor Benton, the SEZs were not created solely with economic objectives in mind because they are part of a larger plan to reincorporate Hong Kong with China in that they were to

> ...act as buffers to absorb the shock of collision between two different political, social and economic systems, and between two ways of thinking. Through them Beijing hopes to integrate Hong Kong and Macau gradually into China, without any open confrontation with the British...and to prepare Hong Kong, Macau and Overseas Chinese psychologically for reintegration with the mainland by allowing them to enter and leave these zones freely, so that they become used to mainland officials and lose their fear of them. Politically, economically and psychologically, the SEZs are part of Beijing's preparations for the recovery of Hong Kong: through them Beijing hopes to incorporate the colony painlessly into China, by a simple widening of the boundary when the time is right.[114]

This view of the political implications of the SEZs was also shared by many other scholars. David Bonavia referred to the SEZs as a "...'dummy run' for the handling of Hong Kong after 1997."[115] In other words, the SEZs were designed to give the Chinese government practice in dealing with "...a pseudo-capitalist social unit, while retaining control of its essential levers of

[113]Exerpts from Ma Hong's article reprinted in Cheng, pp. 58-60.
[114]Benton, p. 40.
[115]Bonavia, pp. 91-92.

administration and letting market forces play a much bigger role than they are permitted to in other parts of the country."[116] Therefore, SEZs are a demonstration of the "one society, two systems" (*yige shehui, liangge zhidu*) solution that China had proposed for Hong Kong after 1997, in which socialism would co-exist with capitalism.

The debate over whether the SEZs were created solely for economic purposes, or both economic and political purposes with the intention of eventually reasserting sovereignty over Hong Kong usually depends upon the interpretation of China's intentions for the SEZs before the Hong Kong issue became polarized by Margaret Thatcher in 1982. Before the Sino-British discussions over Hong Kong's future began, there was practically no mention of China's desire to reclaim Hong Kong in any of its discussions of the SEZs.[117] There was also no mention in the SEZ regulations of any intentions to use the SEZs to reintegrate Hong Kong back into China. C. K. Leung pointed out that, before 1982, the purpose of the SEZs was mainly economic in orientation. It was only after the subject of sovereignty over Hong Kong after 1997 became a major concern in Hong Kong that Shenzhen's policies were further developed to include the political objective of reintegration.[118]

There was even the distant hope in Hong Kong that if nobody raised the subject China might have been content to maintain the status quo beyond 1997. Paradoxically, however, it was the Hong Kong business community that

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[116] ibid.

[117] The only mention that I could find of China's being interested in reclaiming Hong Kong before the negotiations began was Sun Ru's article, "The Conception and Prospects of the Special Economic Zones in Guangdong," *Chinese Economic Studies* (Fall 1980), pp. 68-78., as cited by Prybyla, p. 371.

[118] Leung, p. 10.

lobbied the British government to get China to clarify its position over the future of the colony.[119] So the question is, did Thatcher provoke and thus, force China's hand over the issue of Hong Kong's future by insisting on the legality of the unequal treaties which created Hong Kong, which China adamantly refuses to recognize, and therefore force China to adopt a hard-line stand on the issue of sovereignty over Hong Kong, or was China's decision to resume control over Hong Kong already made up long before its position on Hong Kong was finalized with the Joint Sino-British Accord on September 26, 1984? It is interesting to note that China's policy towards Hong Kong has always been to maintain the status quo rather than to instigate uncertainty and change. For example, in 1967, during the Cultural Revolution, when leftist-inspired riots in Hong Kong offered China the perfect excuse to move in to "restore order," China did not do so. Again, in 1974-75, China turned down Portugal's offer to return Macau to China, seemingly for fear of jeopardizing investor confidence in Hong Kong.[120]

Regardless of whether or not the SEZs were created with the intention of eventually recovering sovereignty over Hong Kong, the goal of closely linking the Shenzhen economy with the Hong Kong economy[121] was consistent with the general thrust of the post-Mao emphasis on coastal-led economic development. The rationale for the coastal approach was that because the coastal regions have the most developed infrastructure and industrial base (as well as links with the outside world), they are better equipped to successfully absorb foreign capital and advanced technologies than the other regions in China. After the Joint Accord, China announced that Hong Kong would become a Special Administrative Region

119 See "The International," p. 458.
120 See Benton, pp. 34-41., Bonavia, p. 9., "The International," pp. 456-468., and Anthony Dicks, "Treaty, Grant, Usange or Sufferance? Some Legal Aspects of the Status of Hong Kong," *China Quarterly* 95 (1983): 428.
121 See Bonavia, p. 92.

(SAR) of China after July 1 1997, and that it would continue "...to help these [coastal] areas by providing them with information and consultant services, investment funds, technology transfer, marketing networks and training."[122] The economic integration of Hong Kong with Shenzhen has been facilitated by the opening of a representative office in Hong Kong of The China Council for the Promotion of International Trade, which will supersive the process.[123]

Perhaps the most serious problem threatening to undermine the success of the Open Door Policy and the SEZs is the reunification of Hong Kong with China. Hong Kong is not only an important base of operations for foreign investors in Asia, but is also one of the most active investors in China.[124] Therefore, foreign investors will be paying a great deal of attention to developments in Hong Kong, Shenzhen, China, and the reassimilation process in the years leading up to 1997 (as well as after 1997) in order to see how well capitalism functions within a socialist system. The approaching deadline may dampen investor confidence in Hong Kong and seriously cripple China's ability to attract foreign investments from Hong Kong or elsewhere. Besides resulting in an outflow of capital and entrepreneurial talent, "1997 nerves" may also discourage long-term investments from being made in Hong Kong.

Interestingly, the sovereignty issue has not dampened the optimism of several of Hong Kong's entrepreneurial giants. Although Li Ka-shing, Hong Kong's richest entrepreneur, recently purchased the Expo 86 site in Vancouver,

[122] *Country Report: Hong Kong and Macau*, no. 2, 1988, p. 7.
[123] ibid.
[124] According to *Business Asia*, 22 June 1987, p. 193., between 1979 and 1985, Hong Kong and Macau investors invested US$10.6 billion, or 63.8 per cent of all direct foreign investments in China. The United States was second with US$2.2 billion, or 13.1 per cent, and Japan, with US$9.8 billion, or 9.8 per cent was third.

he is still actively acquiring land in Hong Kong for development. It was reported in August 1988, that Li and Gordon Wu's Hopewell Holdings had purchased an industrial site, at HK$470 million, and plan to develop it into residential and commercial estates at a cost of HK$9 billion--the largest property development project in Hong Kong's history.[125] In April of 1988, Hutchison Whampao bid HK$4.4 billion to build a seventh terminal at Hong Kong's container port, a massive project that would cost an estimated HK$6.8 billion upon completion.[126] Nevertheless, the timing of the sovereignty issue to emerge in 1982 was extremely unfortunate because it threatens to jeopardize the Open Door Policy and the SEZs. On the other hand, it offers China a unique opportunity to demonstrate to the world that two very different political and economic systems can indeed function within a single country.

The "one country, two systems" policy for Hong Kong is a reflection of China's desire to maintain investor confidence, economic prosperity and political stability in Hong Kong. Under the "one country, two systems" policy, Hong Kong, as a SAR, would be allowed to retain its capitalist system for 50 years after 1997. It would also be able to retain its free port status, its legal and judicial structure, currency, police force, and bureaucracy for 50 years after 1997.[127] The first draft of the Basic Law for the Hong Kong SAR was made public early in 1988, in order to solicit opinions from Hong Kong and abroad. As a SAR, Hong Kong would be a local administrative region in China which would enjoy a high degree of autonomy and be directly responsible to the

[125] "A Man of Action Again," *Far Eastern Economic Review*, 4 August 1988, p. 52.
[126] ibid.
[127] See the first draft of the Basic Law of the Hong Kong SAR, reprinted in whole in "Draft Basic Law of HKSAR, PRC," in *Beijing Review*, 9 May 1988, ch. I, art. 2, art. 3, ch. II, art. 15, pp. 23-24.

Central People's Government.[128]

The Hong Kong SAR will also include the two neighbouring SEZs (Shenzhen and Zhuhai) to Hong Kong and will be fenced off from the rest of China.[129] The relatively autonomous status of the Hong Kong SAR after 1997, will be much like that of the SEZs in that the SAR would have independent finances and control over its own revenues for its own use, while the Central government maintains overall political control over the region.[130] In order to ensure that Hong Kong continues to prosper after 1997, it was also necessary to allow it to participate in its own separate international trade relations and agreements such as the General Agreement on Tariffs and Trade (GATT).[131] From a purely economic perspective, it is in China's interest to allow Hong Kong to continue to exist as a semi-independent economic entity so that it does not have to share its export quotas with it.

Perhaps just as important as allowing Hong Kong to maintain control of its own economic affairs and relations are the regulations pertaining to the rights of the individual, and the right to own private property, which protects Hong Kong residents and investors and their property from unlawful seizure or arrest.[132] Of particular concern to the people of Hong Kong is the fact that the Central government in China will appoint the Chief Executive and the principle executive officials of the Hong Kong SAR through a process of consultation or local election.[133] However, even more disturbing is the fact that

[128] "Draft," ch. II, art. 11, p. 24.
[129] Benton, p. 41., and Bonavia, pp. 91-92.
[130] "Draft," ch. V, art. 104, p. 33.
[131] "Draft," ch. V, art. 117 to 120, pp. 34.
[132] "Draft," ch. I, art. 6, ch. III, pp. 23, 26, 27.
[133] "Draft," ch. IV, sec. 1, art. 43, p. 27.

the central government retains the power to interpret the Basic Law as well as the power to amend the law,[134] and, in effect, the power to severely undermine the "high degree of autonomy" of the SAR.

However, the high economic stakes and the possible political consequences for interference by the Central government may deter it from tampering with the SAR's autonomy. Despite the vigor and vitality of the Hong Kong economy, it is still a fragile economy built upon the confidence of both foreign and domestic investors. Without investor confidence in Hong Kong, China could quite possibly inherit an economic burden and a political liability instead of a powerful economic force and ally to assist its modernization effort. Moreover, if the Hong Kong economy collapsed, China would be faced with having to feed an additional 5.5 million people who would probably not only demoralized, but hostile to the regime as well. The collapse of the Hong Kong economy would also have serious implications for the special zones and the Open Door Policy. Undoubtedly, the possibility of such a scenario has not escaped the attention of the Chinese leaders. However, whether or not this will serve as a insurance policy for Hong Kong's future remains to be seen.

Audrey Donnithorne warned that the differences between the economies of Hong Kong and China lay not in the use of different economic techniques, but rather in differences in their fundamental philosophy and outlook. In other words, in Hong Kong, the rule of law is paramount, as opposed to absolute state authority in China.[135] The next chapter will deal with some of the new problems that the SEZs and the economic reforms have introduced into China.

[134] "Draft," ch. IX, art. 169, 170, p. 39.
[135] Donnithorne, pp. 308-309.

How these problems are handled will have enormous implications for the economic reforms, the SEZs, and modernization in China.

IV. THE POLITICS OF REFORM

Since the introduction of wide-sweeping economic reforms, which were announced in the Third Plenum of the Chinese Communist Party's Eleventh Central Committee, in December 1978, and the subsequent creation of the SEZs, and the opening of 14 coastal cities to foreign investment, China has embarked upon a bold new path towards economic development and modernization. It was felt that these measures, under the leadership of Deng Xiaoping, were necessary to help stimulate economic growth, which had essentially stagnated in China, and to help China achieve the goals of the Four Modernizations. However, in bringing about these new changes, it seems that Deng and his supporters have also opened a Pandora's Box of new problems, political controversy, and debate over the correctness of these new measures.

Some of the most important questions and problems that have arisen, which threaten the future of the economic reforms, the Open Door Policy, and the SEZs are: (1) Do the economic reforms and the SEZs mean that China is turning away from socialism and embracing capitalism?, (2) Does the return of foreign coastal enclaves (SEZs) also signify the re-emergence of regionalism, urbanism, and isolated and alienated spheres of foreign influence in China, as the treaty ports once were?, (3) How will China deal with problems such as crime and corruption, which have been on the increase since the introduction of material incentives and new opportunities to "get rich"? This problem is especially relevant to the SEZs because they are the most conspicuous centres of foreign influences and change. Lastly, this chapter will briefly assess the performance of the SEZs (and Shenzhen in particular) until 1986. It seems that the post-Mao economic development strategy has raised more problems and questions than it has produced answers and solutions. The purpose of this chapter is just to explore these new problems in order to provide some insight on where the economic reforms, the SEZs, and modernization may be headed in China.

Western observers have often described the post-Mao economic reforms as an experiment by China to combine selected features of capitalism with its socialist economy.[2] They see the post-Mao economic reforms as an attempt to blend seemingly incompatible elements such as state ownership with private property, and central bureaucratic planning with decentralization and market forces. In his article, "On Chinese Pragmatism in the 1980s," Lucian Pye claimed that Deng's pragmatic ideology and politics, typified by such statements as "the colour of the cat [is not important] so long as it catches mice," really signifies the abandonment of the supremacy of politics and ideology in China.[3] Stephen N. S. Cheung, in his book *Will China Go Capitalist?: An Economic Analysis of Property Rights and Institutionalized Change*, argued that communism had failed in China and that while the Chinese leaders continue to pay lip-service to the superiority of their system, in practice, they are actually undermining it.[4]

The Chinese leaders argue that they are upholding Marxism-Leninism-Mao Zedong Thought and deny that they are subverting these ideologies for capitalism. Instead, they argue that they are building "socialism with Chinese characteristics." They also contend that they are simply building a "commodity economy," or a preliminary state of capitalism, which was by-passed by Mao, as

[2] For example, see Pepper, p. 2.
[3] "On Chinese," p. 207.
[4] Stephen N. S. Cheung, *Will China Go Capitalist?: An Economic Analysis of Property Rights and Institutionalized Change* (London: The Institute of Economic Affairs, 1982), pp. 50-51.

a necessary transitional stage to achieving socialism, and ultimately, communism.[5] Xue Muqiao pointed out that according to Marx's *Critique of the Gotha Program*, socialism was regarded as an elementary stage of communism, and that in this stage (socialism), some traditions or remnants of the old society (capitalism) must still be retained.[6] Thus, the Chinese leaders can justify the economic reforms by arguing that China cannot leap-frog Marx's stages of social development. China must build a commodity economy first, as proposed by Marx, before it can be ready for socialism, and ultimately, communism.

However, Kueh and Howe believed that a mixed economy, one part part of which was outward-looking, market-oriented and institutionally reformed, the other part still locked in the old system, would be totally contradictory and irreconciliable. Ultimately, either economic or political considerations will force the elimination of one of them.[7] Bill Brugger also argued that the nature of the economic reforms was incompatible with socialism because they challenge the presumption that state ownership is a superior form of organization.[8] Graham Young argued that the CCP's strategy of labelling China's economic reforms as "socialist modernization" was simply an attempt by the Party leaders to rationalize and defend their authority and the need for the Party to maintain control.[9] Young also contended that the CCP's claims of the superiority of socialism are merely rhetoric and smoke-screen tactics, when he wrote, "it often appears that people are urged to maintain values which are inconsistent with the

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[5] "On Chinese," pp. 210-211.

[6] Xue Muqiao, *Current Economic Problems in China*, ed. and trans. by K. K. Fung (Boulder: Westview Press, Inc., 1982), p. 119.

[7] Kueh and Howe, p. 830.

[8] Bill Brugger, "Democracy and Organisation in Chinese Industry--New Directions?" in *China: Dilemmas of Modernization*, ed. Graham Young (London: Croom Helm, 1985), p. 71.

[9] Graham Young, *China: Dilemmas of Modernization*, ed. Graham Young (London: Croom Helm, 1985), p. 10.

way recent [reform] policies encourage them to behave."[10]

The Chinese leaders also pointed out that capitalism only plays a small and complementary role in China's economy. Even Chen Yun, the First Secretary of the Central Committee for Discipline Inspection, and one of Deng's most vocal critics, saw the role of the market in a planned economy only as a supplementary, temporary measure.[11] Robert Hsu also interpreted the controlled use of capitalist elements such as market mechanisms in China as intended to make central planning more flexible and consistent, while at the same time, ensuring that competition does not become spontaneous and anarchic.[12] Xue Muqiao further pointed out that the principle of competition within a socialist economy is not the same as competition within a capitalist economy because "our competition is based on public ownership of [the] means of production and guided by the state plan. It is not free competition."[13]

On the subject of the SEZs and other specially designated spheres of "capitalist" influence (the ETDZs in the 14 open coastal cities), Deng Xiaoping conceded that although these special zones are a form of "miniaturized capitalism," that

> ...its relative magnitude will be small and it can't affect our system of socialist public ownership of the means of production. Absorbing foreign capital and technology and even allowing foreigners to construct plants in China can only play a complementary role to our effort to develop the socialist productive forces.[14]

[10] ibid.
[11] As noted in Aikman, p. 84.
[12] Robert Hsu, "Conceptions of the Market in Post-Mao China: An Interpretive Essay," *Modern China*, no. 4 (October 1985), p. 447.
[13] Xue, p. 129.
[14] Deng Xiaoping, *Selected Works of Deng Xiaoping: 1975-1982*, trans. The Bureau for the Compilation and Translation of Works of Marx, Engels, Lenin and Stalin Under the Central Committee of the Communist Party of China

Xu Dixin further pointed out that the SEZs are not really capitalist in nature but are a form of state capitalism because the foreign enterprises are still controlled and administered by the state.[15] Moreover, China (and the SEZs) are not turning capitalist because there is no private ownership of land, which, according to Marx and Engels' *Communist Manifesto*, is the basis for exploitation and classes. The state retains ownership of all land in China and only leases out the right to use it.[16]

China's arguments on state capitalism are derived from Lenin's writings on foreign concessions and state capitalism developed during the period of the New Economic Policy in Russia, in which a concession was "a contract between the [socialist] government and a capitalist who undertakes to organize or improve production, and to pay the government a share of the product obtained, keeping the rest as his profit."[17] Lenin argued that the granting of foreign concessions was not dangerous to developing socialism, but would only help realize socialism because state capitalism, in the form of foreign concessions

> ...strengthens large-scale production as against petty production, advanced production as against backward production. It also obtains a large quantity of the products of large-scale industry (its share of output) and strengthens state-regulated economic relations as against the anarchy of petty-bourgeois relations.[18]

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[14](cont'd) (Beijing: Foreign Languages Press, 1984), p. 382.
[15]Xu Dixin, "Salient Feature: State Capitalism," *Beijing Review* 27 (January 1984): 29.
[16]Stephen Morgan, "Ideology on the Block," *Far Eastern Economic Review*, 14 July 1988, p. 22.
[17]V. I. Lenin, "Recorded Speeches: 2. Concessions and the Development of Capitalism," (25 April 1921), in *Collected Works* (Moscow: Progress Press, 1965), vol. 32, p. 368., as quoted in Thomas Chan, E. K. Y. Chen, and Steve Chin, "China's Special Economic Zones: Ideology, Policy and Practice," in *China's Special Economic Zones: Policies, Problems and Prospects*, ed. Y. C. Jao and C. K. Leung (Hong Kong: Oxford University Press, 1986), p. 93.
[18]V. I. Lenin, "The Tax in Kind (The Significance of the New Policy and its Conditions)," (21 April 1921), in *Collected Works* (Moscow: Progress Press, 1965), vol. 32, p. 334., as quoted in Chan et al., p. 94.

Deng's argument that because of the small size of the SEZs in relation to the rest of the economy they cannot affect the rest of the economy, could also be interpreted to mean that the SEZs will also fail to modernize the Chinese economy. As mentioned earlier, this was one of the main arguments that Rhoads Murphey used to explain the failure of the treaty ports to transform China. Does this also mean that the impact of the SEZs will also be limited because of their size? Other parallels between the treaty ports and the SEZs can also be used to question the wisdom of the SEZ strategy to modernization. For example, the foreignness, isolation, and outward-orientation of the SEZs also fit major arguments proposed by Rhoads Murphey to explain why the treaty ports failed to establish any meaningful linkages with the Chinese economy. These questions and comparisons are inevitably made between the treaty ports and the coastal-led development strategy, in which the SEZs and the open cities, many of which were former treaty ports, are to play a pivotal role. Although judgement of the SEZs and the development strategy based upon these questions would still be somewhat premature, given their contemporary nature, related concerns such as the fear of corruption from foreign influences, "spiritual and ideological contamination," alienation from China's socialist goals, exploitation, and the re-emergence of regionalism have been raised and will be discussed in this chapter.

On the controversial subject of exploitation, the Chinese have maintained that there can be no exploitation because foreign trade and investment relations are conducted on the basis of equality and mutual benefit thus enabling both partners to use their comparative advantages.[19] It was only after China

[19] Wang, p. 124., and Shu-yun Ma, "Recent Changes in China's Pure Trade Theory," *China Quarterly*, no. 106 (1986), p. 292-293.

overcame its ideological aversion to international trade and investment as an exploitative relationship based upon unequal exchange that it could embark upon a more liberal, outward-oriented policy towards foreign trade and investment. Concerns of exploitation re-emerged in China because the economic reforms resulted in a number of contract responsibility systems in the countryside where peasants obtained the right to tend their "own" plots of land. The subject of land is controversial because the ownership of land was attributed to be the root cause of exploitation, landlessness and rural poverty in China before 1949. Therefore, the abolition of private ownership of land also removed the basis for rural exploitation in China. As mentioned earlier in the discussion over whether China was turning capitalist, China maintains that there can be no exploitation in China because the state owns all land. What is transferred is only the right to use the land for a specific period of time.[20]

However, the abolition of the ownership of land has not eliminated all exploitation in China. Because contracts under the early contract responsibility system were only for one to three years, many peasants often developed a "robber mentality" and exploited the land for short-term profits and did not reinvest in it. In order to prevent such "anti-social" practices and to encourage peasants to invest in the land, the Chinese government lengthened the term of the contracts to 10 to 15 years.[21] In order to prevent the exploitation of labour, restrictions were also placed on the number of people that could be hired by agricultural and non-agricultural individual operations.[22] Nevertheless, these restrictive measures are still no guarantee against the possibility of exploitation because the opportunity for personal gain and profit are powerful incentives to

[20] "Ideology," p. 22.
[21] ibid.
[22] Hershkovitz, p. 444.

stretch the spirit of the economic reforms. The creation of various safeguards designed to discourage exploitation is evidence that the Chinese government recognizes that there is a trade-off between the possibility of some exploitation and economic growth, and no exploitation, which breeds an "iron rice bowl" mentality, and economic stagnation. The challenge for the Chinese leaders is to try to encourage economic growth through various material incentives and responsibility schemes, while at the same time, to guard against exploitation.

In the SEZs or with foreign firms, labour relations are regulated through labour contracts which are concluded between the employees or a union and the employers. Aside from stipulating the job descriptions, conditions of employment, benefits, rights of the employee etc.,[23] the labour contract is also intended to serve as a safeguard against exploitation of labour and wage relations. Labour disputes are resolved by consultation, arbitration by the local labour management department or in the people's court.[24] Moreover, there are also provisions to ensure that Chinese employees in staff positions who perform the same work as their foreign counterparts also receive the same pay even though their foreign counterparts may have more managerial experience.[25]

It is important to not read too much into China's economic reforms, despite all of their apparent problems and contradictions. The Chinese leaders have always maintained their confidence in the theoretical superiority of socialism. Although the spirit of the economic reforms (decentralization and liberalization of economic responsibilities) appears to run directly counter to policies that the PRC

[23] Regulations on Special Economic Zones in Guangdong Province, in *Shenzhen Jingji Tequ Nianjian, 1985* (Hong Kong: Shenzhen Jingji Tequ Nianjian Weiyuanhui, 1985), ch. 4, art. 21, p. 205., and Blaser and Mak, pp. 48-49.
[24] Blaser and Mak, p. 50.
[25] Blaser and Mak, p. 49.

has adhered to for the first three decades of its existence (centralized bureaucratic control), the Chinese leaders argue that their version of socialism, and not Mao's ultra-leftist interpretation, represents the correct path for socialism in China. Gale Johnson also pointed out that the Chinese economic policies and institutions, which had a negative effect upon the economy "...were in no way required for a socialist economy, but represented the particularly idiosyncratic view of Mao and his associates."[26] By blaming China's economic problems on Mao's version of socialism, the Chinese leaders are able to salvage socialism in China, but at the cost of Mao's reputation.

The transferring of blame to Mao, instead of socialism was also possible because Marx did not write in detail about how a socialist economy should be run. To attribute the blame for China's economic problems to socialism would be an admission of the impossibility of achieving socialism, which would also threaten to undermine the legitimacy of the CCP. Thus, although the interpretations may be different, the goal (socialism) has not changed. Economic reform and restructuring of the economy, the shift from extensive to intensive economic development, and the development of a socialist commodity-based economy were all considered necessary elements in the process of socialist development.[27] The ultimate objective of the post-Mao changes is to make the socialist economy more efficient and productive and eventually develop communism, not capitalism.

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[26] Gale D. Johnson, *Progress of Economic Reforms in the People's Republic of China* (Washington: American Enterprise Institute for Public Policy Research, 1982), p. 4.

[27] John P. Hardt, "Highlights," *China's Economy Looks Toward the Year 2000: The Four Modernizations*, Joint Economic Committee, Congress of the United States (Washington: United States Government Printing Office, 1986), p. vii.

Consequently, market mechanisms still operate within the boundaries of state planning and guidance. Therefore, the current mix of central bureaucratic planning, supplemented by market mechanisms, cannot truly be interpreted as China's turning capitalist. As Robert Hsu pointed out,

> the Chinese conception of the market is necessarily a narrow one, not to be equated with its Western counterpart. It is true that the role of ideology is relatively subdued [but not supplanted] in China's post-Mao economic theorizing, but socialist ideals, more flexibly interpreted, still constitute the yardstick by which the long-term efficacy of the market mechanism is to be measured.[28]

The Chinese leaders are still in full control of the reins of power and are extremely sensitive to anything that may pose as a challenge or a threat to socialism. The campaigns against "spiritual pollution" in 1983, and "bourgeois liberalism" in 1987, following the student demonstrations, are stark reminders that China has not foresaken socialism for capitalism and is not totally comfortable with all of the post-Mao changes.

When the CCP came to power in 1949, it promised hope and optimism for the future of China based on the teachings of Marxism-Leninism. However, instead of building the new Chinese society from the existing economic framework (before 1949, over 70 per cent of China's industries were situated along its coast[29]) Mao decided to take economic development back to the countryside or the undeveloped hinterland, which was the basis of the CCP's support. The treaty port experience was also influencial in shaping the Chinese development strategy after 1949 because it had made a profound impression on the Chinese psyche. Rhoads Murphey noted that "the treaty-port experience continues to

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[28] Hsu, pp. 444-445.
[29] Leung, p. 2.

plague the Chinese mind long after it has passed into history."[30] Audrey Donnithorne noted that the basis of the CCP's deep-rooted unease with urban centres also lay in its agrarian origins and Marxist ideology, which states that "...the developed metropolis plays an imperialistic role and practices exploitation by exporting capital to its satellite regions from which it draws labour and raw materials."[31]

Consequently, the treaty port legacy was used by Mao as a counter-example for economic development. According to John Gurley, Mao's brand of socialist ideology was the very antithesis of capitalism in that Mao rejected the capitalist principle of building on the best (ie. the coastal regions). Instead, Mao chose to build on "the worst" by rejecting the experts in favour of the decision-making of "the masses;" building new industries in the rural areas rather than taking advantage of the developed urban sector; producing goods domestically, instead of importing them at a lower cost; and discouraging the cities as centers for industry and culture.[32] Therefore, the CCP leaders were willing to sacrifice the comparative advantages of the coastal urban centres, which were the best sites to begin rapid economic growth and industrialization, in order to correct economic imbalances and disperse industrial activity to the interior. The opportunity cost for doing so was high, however, the Chinese were willing to forego immediate economic benefits in order to pursue long-term political objectives.[33]

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[30] *China Meets*, p. 83.
[31] Donnithorne, p. 282.
[32] John G. Gurley, *China's Economy and the Maoist Strategy* (New York: Monthly Review Press, 1976), p. 9.
[33] "The Treaty," pp. 68-69.

Mao's approach to economic development contrasted sharply with Chiang Kai-shek's, which emphasized the development of an industrialized manufacturing economy led by experts and technicians. Consequently, Chiang stressed the importance of the education system to teach the natural sciences (such as physics, biology and mathematics) which would provide the foundations for the applied sciences (such as mechanical and civil engineering, mining, metallurgy and medicine) to produce the technicians and experts necessary to help develop China.[34] Mao, on the other hand, despised and was deeply suspicious of the city-bred or foreign-educated intellectuals. Instead, he believed that the best approach to economic development was through the unleashing of the latent initiative of the masses through active participation, selfless struggle and unity of purpose.[35]

China's present coastal-oriented economic development strategy characterized by the creation of urban foreign enclaves (the SEZs and the ETDZs) inevitably invites comparisons with the treaty ports. This comparison is particularly applicable because many of the sites opened to foreign investment were former foreign concessions and spheres of capitalistic influence. The SEZs puts the CCP in an awkward political position because they, like the treaty ports, symbolize all that the CCP had fought to expel from China. The treaty ports were the result of foreign imperial domination and the forced opening of China. However, the founding of the PRC in 1949 marked the end of the treaty port era in China, and ended a humiliating chapter of foreign imperialism and exploitation in its long history.

[34] Chiang Kai-shek, *China's Destiny: Chinese Economic Theory* (New York: Roy Publishers, 1947), pp. 171, 172, 180.
[35] Gurley, pp. 6-8, 284.

Murphey also noted that the CCP development strategy under Mao was paradoxical and contradictory because it sought to achieve technological modernization, but was anti-urban, while the undeveloped countryside was regarded as the model for the new China. Murphey summed up the incongruity of the CCP development strategy and echoed Kueh and Howe's observation that ultimately, China will have to chose between political or economic objectives when he wrote that

> such an ideologically structured contradiction [China's economic development strategy] may have its political value but must sooner or later be resolved in favor of the city, as technological and industrial growth proceed. Even the new cities, or those whose major growth has come since 1949, must breed the kind of revisionism, economism, or bureaucratism that Mao execrates. The Maoist vision of a true socialist society is inspiring, but one of its principal goals, industrialization, can be won only at the cost of seeing urbanism triumph, with the risk that urbanism's anti-Maoist tendencies may persist.[36]

Therefore, the return to coastal-led development and the creation of the SEZs was a radical departure from the development strategy which had guided the PRC's economic development for three decades. The new strategy not only recognizes the economic potential of the coastal regions, but also the need for international co-operation so that China could benefit from international trade and investment. The CCP's rationale for the new Open Door strategy was that it could only strengthen economic development, increase self-reliance, and help develop socialist construction. This argument, as mentioned earlier, was first advocated by Lenin in his discussion on providing concessions to foreign capital in order to help develop the socialist system. Moreover, it was determined that China's foreign trade and investment relations would not be contradictory to its socialist system because they will be conducted in accordance with the principles

[36] "The Treaty," pp. 70-71.

of equality and mutual benefit.[37]

Deng's reinterpretation of China's economic development strategy has not only redefined its relation with its own urban centres (and especially the former treaty ports), which have always been regarded as tainted and suspect because of their historical development, but also its relation with foreign capitalists, and Hong Kong in particular. Despite the fact that Hong Kong is regarded as an "overseas Chinese" compatriots settlement, it is also admininstered by a foreign power, and, as such, is also one of the remaining bastions of foreign imperialism in China (aside from Macau). However, does the return of urban, coastal-led economic development also mean the return of regionalism in China? Rhoads Murphey pointed out that the treaty ports were blamed for the rise of regionalism in China before 1949 because the treaty ports promoted an almost exclusively urban and coastal-led approach to modernization, which Mao rejected.[38] Susan Shirk noted that the new foreign trade and investment opportunities have stimulated economic competition among Chinese cities and provinces, and revived regional conflicts and prior cleavages between the coastal areas and the inland provinces.[39] There was even the fear among some of the Chinese cadres that the SEZs might become foreign concessions like the treaty ports, which were established under unequal treaties.[40]

The political and economic costs for pursuing the economic reforms and the present development strategy is the threat of intensifying regional disparities, the re-emergence of income disparities, and class polarization. Because of the

[37] Jin Qi, "China Expands Flexible Policies," *Beijing Review* May 1984, p. 4.
[38] "The Treaty," p. 67.
[39] Shirk, pp. 60-61.
[40] Xu Xuehan, Mao Rongfang, and Wu Jian, "Guanyu Jingji Tequ Jianshe Zhong de Jige Wenti," *Renmin ribao*, 13 September 1982, p.5.

vested interest of the inland provinces in the pre-1978 strategy, they often play up these concerns to the central government by arguing that the economic reforms and the Open Door Policy have resulted in the infiltration of dangerous bourgeois foreign culture and influences which threaten to destroy Chinese culture, undermine socialism, and return China to the pre-Liberation days.[41]

Because the economic reforms and the SEZs have re-introduced material incentives, opportunities for personal gain and profit, and other capitalistic influences into China, there has also been an upsurge of crime and corruption in China. Because the SEZs are centres where much of the foreign influences enter China, where market forces operate, and where many new policies are introduced, they are also seen as a source for many of China's new problems. Unfortunately for the special zones, many of them were also former treaty ports, which were also centres of crime and corruption. Orville Schell noted that despite a nationwide anti-crime campaign that was launched in January 1982, over 192,000 cases of economic crime was reported by April 1983--of which 71,000 involved Party members.[42] Schell also cited the highly publicized billion dollar 1985 Hainan Island smuggling and black marketeering scandal involving top officials as an inevitable by-product of a more liberalized economy that increasingly becomes subject to market forces rather than central control.[43]

In the countryside, the introduction of the production responsibility system, which promotes the policy to "permit some peasants to get rich first," has led to increased "anti-social" behaviour, competition and new levels of conflict

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[41] Shirk, pp. 62-63.
[42] Orville Schell, *To Get Rich Is Glorious: China in the 80s* (New York: New American Library, 1986), pp. 39-42.
[43] Schell, p. 50.

between households, and among households, the collective and the state.[44] Jealous peasants and local officials often engage in illegal activities such as the expropriation of resources, blackmail, extortion, and squeeze in order to force prosperous peasants into sharing some of their new-found wealth with them.[45] Hershkovitz attributed the root of these problems to the incompatibility of having "...a relatively autonomous small-scale private sector [based on capitalistic principles] within what is supposed to be an economy dominated by public ownership and central planning."[46]

In a veiled reference to criticisms and the new problems that the economic reforms and the Open Door Policy have introduced, Deng Xiaoping reaffirmed the correctness of the new strategy when he stated that

> there are those who say we should not open our windows because open windows let in flies and other insects. They want the windows to stay closed, so we all expire from lack of air. But we say, "open the windows, breathe the fresh air, and at the same time fight the flies and insects."[47]

However, despite Deng's commitment to the reforms, he has also made some knee-jerk reactions to the "flies and insects" which may have been partly motivated by a desire to silence his critics and partly by an attempt to deal with some of these problems. For example, his "anti-spiritual pollution" campaign in late 1983 was in reaction to "ideological contamination" in China. However, because "spiritual pollution," or "ideological contamination" was not clearly defined,

[44] David Zweig, "Prosperity and Conflict in Post-Mao Rural China," *China Quarterly*, no. 105 (1986), p. 1.
[45] Zweig, p. 6. For a similar response to the re-emergence of the urban individual economy (labelled "tails of capitalism" in the Mao era) see Hershkovitz, pp. 429, 446, 447.
[46] Hershkovitz, p. 429.
[47] Aikman, p. 73.

the campaign quickly got out of control and had to be terminated.[48]

Aside from the political and ideological implications of the economic reforms, it is also important to ask a few questions about the feasibility of the SEZ strategy of modernization. As mentioned earlier, Deng expressed his concerns about the SEZ concept, which he pointed out was still in the experimental stage, and as such, could fail.[49] In terms of realizing the goals that the SEZs were created to achieve, they could only be regarded as a qualified success. This is because the vast majority of investments in the SEZs do not involve advanced technology, but tend to be labour-intensive, low-technology, export-oriented assembly and processing operations. This investment trend was largely a reflection of the source of much of the investment capital in the zones (ie. mainly from Hong Kong). But, although these forms of investments do not deliver a great deal of high technology to China, they do provide it with modern managerial and marketing skills, low to medium technology and foreign exchange earnings.

Suzanne Pepper attributed the blame for the disappointing results of the SEZs to the failure of the Chinese administrators to realistically assess the inherent limitations of the EPZs, which the SEZs were modelled after.[50] Consequently, the PRC had overblown expectations of what the SEZs could do for them. As a result, the main forms of investments in the SEZs are very similar to the main forms of investments in the EPZs.

The Chinese administrators wanted to attract advanced foreign technology

[48] An Zhiguo, "Ideological Contamination Clarified," *Beijing Review*, 13 February 1984, p. 4.
[49] "Deng," pp. 6-7.
[50] Pepper, p. 5.

to the zones but were largely unsuccessful because the SEZs were still essentially EPZs in nature. The investment incentives encourage investors to produce in the SEZs for export on the international market, not the Chinese market. Part of the difficulty was also due to the fact that China wanted to earn foreign exchange and use foreign capital and technology to help it develop its export potential. However, because it is very difficult for foreign investors to gain access to the Chinese market, they are generally discouraged from investing in China. In short, because of the inherent limitations of the SEZ concept, the SEZs are not the best vehicle to attract foreign capital and technology into China.

Another serious problem with the SEZs was the tremendous costs involved in building the SEZs entirely from scratch. The Chinese government's willingness to accept the high capital construction costs may be due to its desire to situate the SEZs in overseas Chinese districts which already has much contact and experience with foreign influences and "...are far removed from China's main population centres and from the country's economic and political power bases."[51] Another reason may have been the expectation that foreign investors would also be involved in developing the infrastructure of the zones. However, according to various statistics published on the Shenzhen SEZ,[52] its capital construction costs for the first six years dwarfed its foreign exports and realized foreign investments.[53]

[51] Pepper, p. 4.
[52] Refer to the table on the basic economic statistics for Shenzhen in this study for the figures in the following discussion.
[53] The foreign investment figures published by the *China Trade Report* are extremelty low when compared to other estimates of foreign investments in Shenzhen. For example, David Aikman, (p. 90.) noted that about $3 billion in investments was pledged in Shenzhen by 1984. The discrepancies between the two figures arise from the fact that for various reasons, not all investment contracts are utilized by the SEZ authorities.

Despite the fact that the SEZs were to be export-oriented, according to the basic economic statitistics published on Shenzhen, between 1979 and 1986, only a small proportion of its gross industrial and agricultural output was actually exported. Shenzhen's enormous volume of retail trade also suggests that a large share of its output was actually sold within the zone. Shenzhen's small volume of exports may also be due to the fact that much of the goods produced in the zone through joint ventures or co-operative arrangements were marketed by the foreign investors. Therefore, what was exported by Shenzhen was only its share of jointly produced goods. Exacerbating the situation was the fact that between 1980 and 1983, capital construction costs exceeded the value of industrial output (industrial goods are the main export items), and thus, a major part of the zone's ability to earn foreign exchange to help offset the investment costs.

Another telling statistic was that realized foreign investments only accounted for a very small share of the cost of building the SEZ between 1979 and 1986. Since 1979, Shenzhen's level of realized foreign (including Hong Kong) investments never exceeded its capital construction costs, which had to be borne by the central government. The gap between realized foreign investments and capital construction costs was the greatest in 1982, when construction costs exceeded investments over eight times. The same figures for 1983 and 1984 were not much better.[54]

According to the basic economic statistics for Shenzhen, imports greatly

[54] See also, Chen Wenhong, "Where do Shenzhen's Problem Lie?" *Guangjiaojing*, no. 2 (1985), pp. 48-55., As cited by Pepper, p. 11. The *China Trade Report*, March 1987, p. 6, statitistical figures used in this study was also compiled by Chen Wenhong (Thomas Chan).

exceeded exports, and thus, its main means of paying for them. Chen Wenhong also noted that only 40 per cent of Shenzhen's imports remained in the zone while the rest was re-sold or trans-shipped inland. Shenzhen's reduced duties and duty-free privileges have turned it into an entrepôt and smuggling center for foreign goods to other parts of China.[55] Remedial measures were taken by the central government in 1985 to deal with excessive imports, unauthorized re-sale of imported foreign goods to the inland provinces, excessive consumerism and cash-flow problems in Shenzhen. In order to reverse the large outflows of foreign exchange, the central government also cut Shenzhen's allocation of state funds by about 40 per cent,[56] and tightened the control over the extension of credit and loans, and their repayment on SEZ operations.[57] Reminiscent of the cancellation or delaying of investment projects and purchases after the huge outbursts of spending in the 1977-78 period, 150 projects in the SEZs were delayed or cancelled due to the clamp-down on credit.[58] The Chinese government also reaffirmed Shenzhen's original goals to establish an export-oriented economy based on industry and foreign investment, to import advanced technologies, and to serve as a "window" between China and the outside world. However, it seems that the SEZ officials after 1985 do have a more realistic appreciation of the inherent limitations of the SEZs. For example, one of Shenzhen's deputy mayors stated that official preference will still be given to export-oriented, labour-intensive, small operations that have "...high efficiency...management and craftsmanship standards, [and] innovative products, and the ability to generate foreign exchange."[59]

The political consequences for the failure of the SEZs strategy have

[55] Chen, pp. 48-55., as quoted by Pepper, p. 11.
[56] *Asian Wall Street Journal*, 2-3 August 1985, as cited by Pepper, p. 16.
[57] Pepper, p. 16.
[58] *China Trade Report*, October 1985, pp. 1, 4.
[59] *South China Morning Post*, 20 May 1986., as cited in Pepper, p. 19.

already been discussed earlier in this study. Suzanne Pepper placed the blame for the SEZs' problems squarely on Deng's shoulders when she wrote,

> Deng Xiaoping's mistake was, first, to have set up the zones without fully understanding their limited capabilities. That error was then compounded by allowing the SEZs to be trumped up into the vanguard not only of his new open-door policy, but of the entire urban economic reform experiment. It was an unfortunate choice, given the generic weaknesses of export processing zones, and those in China proved no exception in this regard. The effects of those weaknesses were then augmented by the extra role Shenzhen in particular was made to play as vanguard and model.[60]

Bo Tao, a Chinese economist, argued that the SEZs have very little to offer the big multinational corporations whose advanced technology China needs most. He advocated that China should, instead, encourage foreign investors into China's most advanced northern industrial heartland and give foreign investors direct access to the domestic Chinese market and natural resources.[61] However, as discussed earlier, many obstacles stand in the way of this ever happening: for example, the possibility of foreign investors dominating the less competitive domestic Chinese markets and the fear that huge sums of foreign exchange may move out of the country. Moreover, there are already disagreements from within the Party itself over how far some of the post-Mao changes should go.

However, the opening of 14 coastal cities, and a new SEZ (the Hainan SEZ) to foreign investment has reaffirmed the coastal development strategy and the SEZ concept. The opening of the 14 cities is also a more rational approach to attracting foreign investments because it does not involve the burdensome and costly task of building an entire industrial site and infrastructure where one did

[60] Pepper, p. 19.
[61] As cited in Robert Delfs, "Changing the Pattern," *Far Eastern Economic Review*, 9 May 1985, pp. 70-1. See also *The China Business Review*, September-October 1985, p. 4.

not exist before. The trade-off is less control over foreign influences on the Chinese population. Despite the present difficulties surrounding the SEZs, there is the hope that the merging of Shenzhen with Hong Kong in 1997, and Zhuhai with Macau in 1999 will instill new vigor and meaning back into the SEZs.[62]

[62] For example, see Pepper, p. 21.

CONCLUSION

The history of special zones in China has been a long and eventful one. The Canton system was the first special zone created specifically to handle foreign trade with Europeans. However, this system was replaced by the treaty ports in 1842, after China was defeated in the Opium War by Britain. Although the treaty ports lasted for almost a century in China, they were not successful in transforming the Chinese economy. They failed to develop any meaningful linkages with China and remained outside of its control, small, isolated, relatively self-contained, and outward-oriented foreign enclave economies. Moreover, the treaty ports were not regarded as attractive models for economic development because they were symbols of foreign imperialistic domination and were also centres of crime and corruption. After the CCP came to power in 1949, the treaty ports were abolished in China. Although Hong Kong and Macau continued to exist as remnants of the treaty port era and served as special zones for China, providing it with foreign exchange, investment earnings and ties with the outside world, they also failed to transform the Chinese economy because China remained largely closed to foreigners and foreign influences.

It wasn't until the post-Mao era that special zones, where foreigners could invest, began to appear in China again. The SEZs were modelled after the EPZs in other developing countries and were also the product of earlier special zone experiences in China. Because of the proximity of the Shenzhen SEZ to Hong Kong, the lower production costs, the investment incentives and cultural factors, Hong Kong investors are the dominant economic force in Shenzhen. However, despite the more comprehensive scope of the SEZs, as compared with the EPZs, and efforts to attract foreign capital and technologies to China, foreign investors still tend to regard them mainly as cheap industrial production bases. The main reason for this is because it is still difficult to gain access to the Chinese markets. It is largely because of this limited nature of the SEZs that large multi-national corporations possessing advanced technologies have generally not been attracted to the SEZs. Consequently, the SEZs have generally not been very successful in attracting advanced technologies.

Despite the fact that the treaty ports and Hong Kong and Macau, as special zones, had not brought about the economic and technological transformation of China, they provide some useful lessons for the SEZs. Firstly, the treaty port experience has shown that if the SEZs are to be successful in facilitating technological diffusion and establishing links with the rest of the economy, they should not be concentrated largely on the coast but should be more dispersed throughout China. Foreign investors today desire greater access to the Chinese markets as the early European traders did during the early days of contact between China and the West. Rhoads Murphey argued that one of the reasons why the treaty ports failed to transform China technologically and economically was because they were unable to develop any meaningful links with the Chinese economy. Instead, they remained small, foreign, outward-oriented and relatively self-contained communities that were isolated on the Chinese coast.

In many ways, China's desire to concentrate the foreign economic presence in China largely to the SEZs is partly a continuation of its earlier desires to quarantine foreign influences to specially designated zones which would help facilitate control over them. Moreover, although opening the country and the markets to foreign investors may greatly facilitate technological diffusion and enable China to benefit more from Western contact, such a solution is a double-edged sword for China because doing so would also introduce new problems into the country. Opening China's markets to foreign investors may be devastating for its domestic industries and result in massive outflows of foreign exchange. Furthermore, providing foreign investors with greater access to China's domestic markets may also make it more difficult for the Chinese government to control the vast array of foreign influences which also accompany foreign investments. Nevertheless, if the current development strategy is to succeed, China must offer foreign investors greater access to its domestic markets.

Secondly, Hong Kong has shown that the most advanced technologies are not a guarantee for economic success. What is essential, however, is that the available resources be used and managed efficiently. Moreover, it is also necessary for the industrial sector to be more responsive and flexible to market demands. Perhaps two of the greatest lessons that China can draw from Hong Kong is that political stability and less government regulation and control are as important for successful economic growth as advanced technologies.

The SEZs and the economic reforms have also created some very volatile issues for the Chinese leaders, the most controversial of which is the compatibility of capitalist or market mechanisms within a socialist state. Furthermore, the SEZs also signify a return to urbanism and foreign enclaves in China--things rejected by Maoists. Even more disturbing to the Chinese leaders, and Deng Xiaoping included, is the increase in crime and corruption, which has been blamed on the economic reforms. Aside from the complex political, ideological and social problems of the economic reforms, the economic feasibility of the SEZs as the spearhead of the modernization drive has been seriously questioned.

It was proposed in this study that the SEZ strategy was not the best tool to lead China's modernization effort because of their inherent limitations as low-cost industrial bases, which generally do not appeal to large transnational corporations possessing advanced technologies. Also, the tremendous costs involved in building and running the SEZs was another major reason which contributed to the clamp-down of the SEZs' activities and the reaffirmation of the SEZs' goals as essentially the same in nature and scope as those of the EPZs. Paradoxically, however, is the fact that although this clamp-down may help to cut back on excessive spending, it also makes it more difficult for the SEZs to attract the foreign capital and advanced technologies necessary for modernization.

However, how the Chinese leaders deal with the complex political, ideological, social and economic issues associated with their economic reforms will ultimately determine the fate of the Four Modernizations. Despite all the new questions and problems that the SEZs and economic reforms have raised for China, they also represent an important policy shift in China and a desire to pursue more rational economic policies. It is perhaps this new attitude, and not the SEZs, which will prove to be the necessary ingredient to bring about modernization in China.

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