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RECENT DEVELOPMENTS IN CHINA'S SPECIAL ECONOMIC ZONES: PROBLEMS AND PROGNOSIS

EDY L. WONG

I. INTRODUCTION

As a result of China's open door policy on foreign investment and trade, four special economic zones (SEZs) were established in the Southeastern provinces of Guangdong and Fujian between 1979 and 1980. The SEZs were conceived primarily as a means of attracting foreign investment and technology and promoting Chinese exports for the four modernizations of China. By granting special investment incentives to foreign investors, it was hoped that an export-oriented industrial base might be created in the SEZs via foreign capital and technology.[1] Many of these privileges were also extended to domestic enterprises to encourage their participation in the SEZs and thereby increase their contact with foreign technology and managerial skills. Since the SEZs were largely based on the market system, their emergence had therefore created a de facto economic laboratory where policies of economic reforms might be tested prior to their introduction elsewhere in China.

Despite a disparate pattern of development among the SEZs, the SEZ policy has until recently been considered a rather successful endeavor. Of the four SEZs, the Shantou, Shenzhen, and Zhuhai SEZs in Guangdong and the Xiamen in Fujian, the Shenzhen SEZ (hereafter Shenzhen) has emerged as the fastest-growing SEZ accounting for 69 per cent of all foreign investment in the SEZs up to the end of 1984 [7, p. 70]. In contrast, the progress of the Shantou and Xiamen SEZs, and to a lesser degree the Zhuhai SEZ, has lagged so much behind Shenzhen that most discussions of the SEZs have focused on Shenzhen as the flag-bearer of the SEZ policy, a practice which we will follow in this paper.

The years since Shenzhen's inception in 1980 have witnessed its transformation from a small border town into a burgeoning industrial economy and a major recipient of foreign capital. The gross industrial output of Shenzhen has increased by thirtyfold from 60 million yuan[2] in 1979 to 1,800 million yuan in 1984 [6] and which has continued to expand at a rate of 92 per cent during the first half of 1985 [32, July 31, 1985]. An average growth rate of 59.2 per cent has also been recorded for its exports between 1980 and 1984 [30, p. 70].

1 See [24] for a discussion of the background and structures of the SEZs.

2 The yuan is the unit of account of the Chinese currency Rmb.

Insofar as foreign investment is concerned, Shenzhen has accounted for 7.8 per cent of all cooperative investment, 67.6 per cent of all joint investment, and 80 per cent of all sole-ownership investment in China by the end of 1983 [17, Table V, p. 6]. The rapid growth of Shenzhen has resulted in a rising living standard for its populace and its new-found status as a symbol of China's modernization. Indeed, other Chinese cities have on various occasions in the past been encouraged by Chinese leaders Deng Xiaoping and Hu Yaobang to emulate the economic example set by Shenzhen [21, p. 54].

Its purported success notwithstanding, the performance of Shenzhen, and indeed the propriety of the SEZ policy, have come under heavy scrutiny and criticisms since early 1985. The principal subjects of the controversy surrounding Shenzhen are its failure to attain to predetermined economic goals, its reliance on central fiscal transfers, and its contributions to the emerging socioeconomic ills of China. Given the importance of the SEZs as a vanguard of China's open door policy, the above debate may have significant ramifications for the future of this policy and other measures of economic reforms.

The aim of this paper is therefore to examine the origin of the Shenzhen controversy and its implications for the future of Shenzhen and the SEZ policy. We will begin with a discussion of the criticisms of Shenzhen's operations in Section II. Thereafter, the fundamental contradictions inherent in the SEZ policy which have given rise to this debate will be examined in Section III. A prognosis of the future of Shenzhen will then be attempted in Section IV in light of the preceding discussions before the conclusion of this paper in Section V.

II. THE SHENZHEN CONTROVERSY

The controversy surrounding Shenzhen was triggered by China's probe into her foreign exchange difficulties in early 1985. Since then, the debate has been gathering momentum within both the official and academic circles. Unlike earlier optimism about the SEZs, the recent polemics have gone beyond the realm of administrative difficulties and have called into question the acceptability and long-term viability of Shenzhen and other SEZs. The intensity and scope of the controversy is reflected in the involvement by the highest level of Chinese leadership in it. Indeed, the remark by Deng Xiaoping in June 1985 that "Shenzhen is merely an experiment and if it fails, we can draw lessons from it" [23, p. 2], has added much fuel to the burning debate and aroused fears of a policy reversal.

The problems which have been identified with Shenzhen may be broadly classified into four categories: (1) foreign exchange leakages, (2) cost ineffectiveness in attracting foreign investment, (3) failure to achieve stated objectives, and (4) economic crimes and related social problems.

First of all, with respect to foreign exchange leakages, Shenzhen is reputed to have been a net user of foreign exchange with its foreign exchange earnings being a portion of its foreign exchange outlays only. For example, its foreign exchange earnings were only 75 per cent of its foreign exchange spendings in

1984 [35, p. 6] and 48.3 per cent of the same during the first half of 1985 [10, p. 57]. This excess of foreign exchange spendings over foreign exchange earnings is generally attributed to the importation of "wasteful" consumer goods such as color televisions, video recorders, and various fruits products, etc. [26, August 12, 1985] and Shenzhen's inability to generate adequate export earnings [35]. Instead of being a production center for exports, much of Shenzhen's output has been destined mainly for internal consumption. The proportions of its 1984 output consumed within Shenzhen and by the rest of China were 14.4 and 65.6 per cent respectively leaving only 20 per cent for exports [35, p. 6]. Indeed, the rising level of Shenzhen's entrepôt trade with other Chinese regions is seen in the increase in its retail sale from being in excess of the combined industrial and agriculture output by 1 million yuan in 1979 to an excess of 380 million yuan in 1983 [23, p. 2].

The impetus for Shenzhen's becoming a trading center with the rest of China has originated largely from the desire of Chinese enterprises to take advantage of its "special" status. Specifically, the relative lack of customs controls and the freedom to respond to market conditions, coupled with the scarcity of many consumer items in the Chinese market, have made possible several avenues whereby enterprises in Shenzhen may enhance their profitability through the trading function. First of all, a Chinese firm may augment its profits by diverting its exports from their regular channels to be sold through an agent in Shenzhen where more lenient exchange regulations apply. The primary responsibility of the agent is then to market such products to foreign traders and, with the proceeds from such sales, to purchase scarce consumer goods for resale to the local market. In so doing, the enterprise is able to obtain consumer items unavailable at home and thereby increase its profits through the resale of such products in the Chinese market. The firm's access to foreign exchange may also be increased through the underinvoicing of its exports by its agent [21, p. 56]. Secondly, foreign parts may be imported into Shenzhen to be assembled into scarce consumer goods intended for the Chinese market [35, p. 6]. The competitiveness of Shenzhen as a supplier of such products is derived from its ease of access to foreign components and lower wage rates than those abroad. Lastly, with a greater variety of consumer goods available in Shenzhen than elsewhere in China, Shenzhen's trade with the rest of China is further aided by direct purchases by many Chinese tourists to Shenzhen. The influx of commodities into the Chinese market from Shenzhen is sometimes augmented also by the failure of many Chinese enterprises in Shenzhen to manufacture products of sufficiently high quality for exports leading to their ultimate disposal in the Chinese market. Therefore, since the outflows of foreign exchange necessitated by the importation of consumer goods or foreign parts are not accompanied by an inflow of foreign exchange earnings, a net outflow of foreign exchange is said to have resulted from Shenzhen's entrepôt activity.

However, Shenzhen's contribution to China's foreign exchange woes must not be analyzed independently of the larger perspective of China's overall economic policy. For instance, the rise in consumer imports and the resultant drain on

China's foreign exchange reserves have been a general phenomenon of the Chinese economy and are therefore not unique to Shenzhen.[3] In fact, with an overall trade deficit of U.S.$3.16 billion for the first half of 1985 [13, July 26, 1985], a generalized regime of import control is now in place to stem the rise in Chinese imports [27, August 15, 1985]. The problem is hence a general surge in Chinese imports rather than a specific problem of foreign exchange loss due to Shenzhen. In other words, while Shenzhen may have increased the ease with which imports are absorbed into China, the relevance of other Chinese policy measures must also be brought to bear on the present debate.

At the theoretical level, the overvaluation and rigidity of the Chinese currency[4] and the distortions present in China's planned economy are potentially important causes of China's trade deficit. First, given the overvaluation of the Chinese currency as evident in its black market value,[5] a balance-of-payments deficit seems all but inevitable since imports are now artificially cheap relative to the prices of exports. The usual adjustment mechanisms associated with a flexible exchange rate or the monetary movements under a fixed exchange rate are now rendered ineffectual by the rigidity and non-convertibility of the Chinese currency and the attendant absence of automatic adjustments in the balance of payments.[6] Second, in addition to the artificial exchange rate, the trade deficit may also be exacerbated by the price distortions and misallocation of resources in the Chinese economy. Like other developing countries, the latent demand for consumer imports and the relatively low export capability in China are difficult obstacles on the road to balance-of-payments equilibrium. Indeed, it is generally agreed that a planned economy, with all its distortions, is not compatible with an open trade regime [11, p. 41]. Trade liberalization will worsen rather than improve the balance of payments if inconsistencies and distortions are found among domestic policy variables [12]. Therefore, while the "special" status of Shenzhen has undoubtedly created a loophole in China's exchange control system, it is by no means the root cause of the problem. Indeed, if the alternative to purchasing products assembled in Shenzhen was to import the commodities directly, the resultant foreign exchange outlays are apt to exceed the "loss" of foreign exchange due to the importation of parts.

Secondly, the alleged cost ineffectiveness of Shenzhen in attracting foreign investment is suggested by estimates showing a greater value of infrastructural investment than that of foreign investment to date. Specifically, for the estimated U.S.$1 billion China has spent on infrastructure in Shenzhen, actual direct foreign investment up to March 1985 has amounted to no more than U.S.$840 million [23, p. 2]. Meanwhile, for the 3.5 billion yuan the government has spent on

3 A discussion of the rise in Chinese imports is contained in [16].

4 A brief discussion of China's exchange policy is given in [34].

5 The Chinese currency was traded at 68–70 yuan to H.K.$100 in the black market in Shenzhen in early September [13, September 12, 1985], while its official buying rate was 37.05 yuan to H.K.$100 in late August [34, p. 63].

6 See [18] for a discussion of the role of the black market for foreign exchange under a regime of fixed exchange rate and exchange controls.

infrastructure between 1980 and 1984, only 1.17 billion yuan has been collected in fiscal revenue [21, p. 53]. Therefore, since the heavy expenditures on infrastructural investment are estimated to be the single most important impetus in the growth of Shenzhen [23, p. 2], accusations of being a "parasite" living off state subsidies have also been leveled at Shenzhen.

The above assessment of infrastructural investment overlooks the fact that the streams of benefits generated by such investment outlays are likely to persist into the future and must therefore be taken into account when compared to the value of foreign investment to date. In fact, the external economies of scale and increased absorptive capacity associated with infrastructural investment are essential prerequisites to a greater level of foreign investment. Without an adequate supply of infrastructure, investment incentives and tax concessions are unlikely to produce the desired level of foreign investment since their appeals are obviated by the adverse impact a lack of infrastructure will have on the productivity of private capital and thus the return on investment. Indeed, the availability of infrastructure is considered by some to be a more important prerequisite than investment and tax incentives [18, p. 374]. An example of the dampening effect inadequate infrastructure may have on foreign investment is furnished by the low level of such investment during the formative years of Shenzhen when infrastructure was woefully lacking. Hence, to the extent that future inflows of foreign investment are related to today's infrastructural investment, spendings on infrastructure must be considered a long-term investment rather than a one-time expenditure. Additionally, given the rather short time-span Shenzhen has been in operation and a possible lagged response of foreign investment to infrastructural investment, the above criticism of Shenzhen appears rather myopic.

Thirdly, in conjunction with the preceding indictments, Shenzhen is also said to have failed in its role as a SEZ. That is, it has so far been unable to establish an export-oriented, foreign-financed industrial base which may also serve as a conduit for technology transfers to China. Instead of being a source of foreign exchange earnings and capital for the modernization of China, it has led to a net outflow of foreign exchange and a net drain on government fiscal resources. Its lack of success in attracting foreign investment is seen in the facts that of the 409 manufacturing firms in Shenzhen 290, or 70.9 per cent, are Chinese in origin [15, p. 13] and that only 22.5 per cent of all investment is financed by foreign capital [6].[7] A study of Shenzhen's investment sources reveals that 90 per cent of its foreign investment to date has originated from Hong Kong instead of truly "foreign" or overseas sources [25, p. 99] and that most of which are characterized by simple subcontracting or intermediate processing of light industrial products [3]. As a result, a significant portion of Shenzhen's manufacturing output is accounted for by light industries such as textiles, food and beverages, furniture and household goods, and electronics, etc. [33, pp. 72–74]. Although such industries' share of Shenzhen's manufacturing output has

[7] The remainder is financed through central government allocations, borrowing from the Bank of China and investment by Chinese enterprises.

declined by 25.1 per cent in the first five months of 1985, they remain responsible for at least 60 per cent of such output during the same period [3]. Concomitant to the predominance of light industries is a level of technical requirement in Shenzhen 35 per cent lower than that of the national average [27, August 15, 1985]. Insofar as exports are concerned, 95 per cent of Shenzhen's total exports is still accounted for by traditional exports from the agriculture sector [6].

While it is palpable that Shenzhen has yet to realize much of its original objectives, the cause of its failure and its long-term potential to achieve such objectives are deserving of a considered analysis. The fundamentals of the SEZ policy are pertinent determinants of Shenzhen's performance and must therefore not be overlooked in evaluating the same. Indeed, as indicated in Section III below, Shenzhen's inability to generate results expected of it is symptomatic of the basic contradictions inherent in China's SEZ policy.

Finally, the erosion of the socialist ethics represents yet another greivance against Shenzhen. Opponents of the SEZ policy often point to the rise in corruption, rising materialism, speculations on the black market for foreign exchange, frauds and other economic crimes, etc. as obvious indictments against this policy [21, p. 55] which is said to be inconsistent with the basic tenets of a socialist economy [13, August 23, 1985]. However, while the above developments have indisputably been observed in Shenzhen, they are clearly not confined to the SEZs alone. The rise in economic crimes and other social problems are now seen as an adverse byproduct of the reform programs in China [32, August 31, 1985] and must therefore be approached from that perspective.

As a result of the controversy, a number of measures have been adopted to rectify the emerging problems in Shenzhen and to appease its critics. They are (1) a reduction in the foreign exchange allocations to state-owned enterprises [26, August 13, 1985], (2) a one-third reduction in Shenzhen's budget for infrastructural development [23, p. 2], (3) tighter access to other markets in China for enterprises operating in the SEZs [23, p. 2], (4) the replacement of the mayor of Shenzhen, Liang Xiang, by the deputy secretary-general of the State Council, Lio Hao [28, August 22, 1985], (5) greater efforts to crackdown on economic crimes [26, August 13, 1985], and (6) the creation of a task force to study Shenzhen's problems [27, October 7, 1985]. The objectives of the new measures are to concentrate Shenzhen's energy once again its appointed task of building an export-oriented economy through foreign investment. The predominance of Hong Kong investment in Shenzhen has also led to calls that a larger portion of the new foreign investment must ideally come from truly "foreign" sources. It is believed that, in order to make Shenzhen a successful economic experiment, at least 70 per cent of its output must be exported and 50 to 60 per cent of its industries must be financed with foreign capital [27, August 10, 1985] and that greater efforts must also be made to increase the presence of heavy industry and high technology in the SEZs. Indeed, a more rapid rate of industrial development and a greater emphasis on trade and advanced technology are the guiding principles for Shenzhen development plan for the immediate period up to 1990 [4, p. 325].

The desirability of the above criteria aside, they reflect once again the failure to understand the basic economic realities of the SEZs and the penchant to formulate economic objectives independently of such realities. To a large degree, the controversy surrounding Shenzhen and the disappointments in its performance are results of assigning goals to the SEZs without studying the SEZs' capability to fulfill them. An attempt is made in the subsequent section to explore the basic strengths of the SEZs and the contradictions in China's SEZ policy.

III. CONTRADICTIONS IN THE SEZ POLICY

In order to put the above controversy in its proper perspective, we must have a clear understanding of the nature and basic character of China's SEZ policy. An examination of the basic premises of the SEZ policy has however revealed a number of inherent contradictions which have contributed much to Shenzhen's difficulties. These contradictions are found to exist between (1) China's desire to isolate the SEZs and her demand for cost effectiveness in them, (2) the role of the SEZs as a conduit of technology transfers and their comparative advantages, (3) the SEZs' reliance on market forces and China's avoidance of market discipline, and (4) the capitalistic propensity of the SEZs and the socialistic foundation of the Chinese economy.

To begin with, China's desire to limit the SEZs' potential disruptions to the existing economic order has run counter to the goal of cost effectiveness in the SEZs. By locating the SEZs away from the major centers of population and industry,[8] the containment of their possible impact on the established industrial facilities has necessitated the construction of a brand new industrial base and its attendant administrative framework and infrastructural facilities. This means significant outlays on infrastructural investment must be incurred to ready Shenzhen for foreign investment. However, given the initial lack of agglomeration and external scale economies and the limited absorptive capacity in Shenzhen, the infrastructural investment is unlikely to be accompanied by a high level of foreign investment immediately. The high level of start-up costs implied by an inadequate infrastructure are an important deterrent on foreign investment.[9] And with a low level of capital inflow, a high "per unit" cost of attracting foreign investment becomes inevitable. The high cost of operating the SEZs and attracting foreign investment are thus a logical consequence of China's attempt to isolate the SEZs from her established industrial facilities where less infrastructural investment is needed. The underdevelopment of the sites chosen for the SEZs may also explain their initial low export-capability and the tardy pace at which their export industries are developing.

Secondly, given the SEZs' initial lack of an industrial base, a contradiction between their goal to become a conduit of high technology[10] transfers to China

[8] Neither the Guangdong nor the Fujian province, where the SEZs are situated, have much heavy industry and are among the least developed of the coastal provinces [19, pp. 41–42].

[9] See [18, pp. 373–74].

[10] Since the definition of high technology has never been clearly spelled out in the present debate, it will be presently employed to denote capital-intensive modes of production or innovations.

and their comparative advantages is apparent. Because technology is not a "free good" by nature, its private transmission[11] is generally dictated by the profit-motive of multinational firms. As such, basic economic conditions rather than the policy aims of the Chinese government are more significant determinants of the process and character of foreign investment and thus private technology transfers to China. According to the product cycle theory [42], foreign investment in the SEZs will most likely involve products which are entering their maturing stage and which are produced by a technology in the process of becoming standardized internationally. As a result, the cost-price conditions or the comparative advantages of the SEZs are most important in influencing the kinds of foreign investment and technology the SEZs will receive. This means, with the SEZs' lack of infrastructural facilities, trained personnel, and natural resources, high-technology production is not likely to be an advantage they will enjoy for some time. The fact that most of Shenzhen's exports are composed of light industrial goods and agricultural products seems to suggest a pattern of comparative advantage different from its appointed task. Indeed, based on the Heckscher-Ohlin Theorem,[12] the compositions of exports and foreign investment in the SEZs must be compatible with their relative factor abundance making low-cost production facilities in the production of "maturing" products the most important rationale for foreign investment in the SEZs. This proposition is affirmed by the shift into Shenzhen from Hong Kong industries and processes which can no longer function competitively in Hong Kong because of the rising wages and rents there [13]. The search for lower-cost production facilities have led many Hong Kong investors to Shenzhen where lower wage rates than those in Hong Kong and a relatively abundant supply of land are available. By the same token, other areas in China where her established industries and natural resources are situated are much better medium of technology transfers than the SEZs.[13]

Thirdly, Shenzhen's problems with foreign exchange speculations and its unintended role as a domestic entrepôt have demonstrated clearly the difficulties involved in using market forces as a means of development while avoiding the constraints of market discipline. The attempts by Chinese enterprises and individuals to take advantage of the relative lack of institutional controls and the availability of scarce consumer goods in Shenzhen, as well as the opportunity to speculate on the black market for foreign exchange, are but rational economic responses to emerging market opportunities and distortions. The excess demand for scarce consumer goods elsewhere in China and the disequilibrium nature of the Chinese exchange rate, rather than the criminal propensities of the traders, are the prime reason behind such activities. It is precisely these profit maximizing

[11] The transmission of technology through private investment is distinguished from that which is sponsored by official bodies.

[12] This theorem suggests that a country will tend to export products using intensively its relatively abundant factor and import products using intensively its relative scarce factor. See [29].

[13] The emergence of Shenzhen as a trading center suggests that its "special' status may have conferred upon Shenzhen the role of an entrepôt.

activities which are responsible for the allocative efficiency of a market economy. And it is these same activities which will propel the growth of the SEZs according to market forces. Although China's refusal to accept the discipline of the market is understandable in view of the distortions in her economy, her attempt to circumvent the results of market forces in the SEZs remains contradictory to the market foundation of the SEZs.

Finally, a more fundamental contradiction is found between the capitalistic character of the SEZs and the socialist origin of the Chinese economy. Although it is said that the SEZs are merely an experiment in market principles and are established primarily to augment the socialist productive forces, both the success and failure of the SEZs will likely be problematic for the Chinese leadership. A successful performance by the SEZs will undoubtedly exert unwanted pressures on the socialist system by affirming the superiority of the market economy. Whereas failures of the SEZs will surely damage the prestige of their proponents and undermine their reform programs. This dilemma is heightened by the experimental character of the SEZs which will oblige the government to deal with their rather ambivalent status in the Chinese socialist economy in the longer run. In due time, the SEZs' place in the Chinese economy must either be modified or clearly defined and defended on the basis of socialist principles. The resolution of this dilemma will undoubtedly require enormous imaginations on the part of Chinese policymakers and will reveal much about the future direction of the Chinese economy.

Clearly, the above contradictions have revealed the SEZ policy to be rather tentative and ambivalent in nature. The stated objectives and evaluation criteria for the SEZs appear to have been dictated by state policy pronouncement rather than a considered analysis of the basic realities of the SEZs. As a result, much of the debate has focused on the symptoms rather than the root cause of the SEZs' difficulties. To be sure, the above contradictions are but a manifestation of the reform process that is taking place in China and, therefore, must not be divorced from other economic and political events in China. Particularly, the SEZ policy are not exempt from the vacillations, periodic adjustments and uncertainty characteristic of the process of liberalization and reforms in the Chinese economy.[14] In the long run, however, closer attention to the SEZs' positions in the international division of labor is required for their proper development.

IV. THE FUTURE OF THE SEZs

Insofar as the future of the SEZs is concerned, we must distinguish at the outset between its political and economic elements. The pertinence of political influence on the SEZs is evident in the facts that the SEZs are essentially an economic policy sponsored by the present government and that its long-term survival is contingent upon its continual acceptance by the political elite. Consequently, any change in political direction is likely to have an impact on

[14] See [20] for a brief discussion of the past changes in Chinese policy.

the SEZs. However, since considerations of politics are outside the scope of this paper, it is the economic factors which will be examined in the following paragraphs in which a number of conjectures are made of the future of the SEZs.

To begin with, on the basis of their comparative advantages, the SEZs are unlikely to become centers for high-technology production as many have hoped. The Heckscher-Ohlin Theorem suggests that the pattern of exports from the SEZs and, thus the types of foreign investment they will attract, will likely reflect their relative factor abundance. The production processes and investment in the SEZs will tend to be intensive in factors which are relatively abundant in the SEZs, namely, low-cost labor and land. By implication, the planned expansion and integration of Shenzhen's industrial areas and the proposed increment in its population over the next five years will likely serve to reinforce its current comparative advantages. Unless a rapid growth in skilled personnel and factors conducive to high-technology production occurs in the near future, an event of doubtful likelihood, the prospects for an expansion in advanced technical production will diminish in accordance with the Rybczynski Theorem.[15] This means, aside from some showcase projects,[16] the present trends of light industrial production and intermediate processing activity are predicted to continue into the future. The above pattern of development will in turn oblige the SEZs to compete for foreign investment with other developing countries in the region such as Hong Kong, the Republic of Korea, and Taiwan, etc., which are able to offer foreign investors similar advantages. The long-term competitiveness of the SEZs in this regard will thus be a significant determinant of the level of foreign investment they will experience. In the immediate future, however, the global recession or its reversal will be a much more important factor in deciding the growth rates of the SEZs.

Secondly, the opening up of the fourteen coastal cities in early 1984[17] and the planned establishment of other "economic and technical development" zones for foreign trade and investment are likely to dilute the SEZs' share of foreign investment in China.[18] No longer being the only open zone in China, the SEZs must now compete with other newly open regions where better industrial facilities and resource endowments are found.[19] The competitiveness of the fourteen coastal cities is seen in the fact that, by the end of 1984, an estimated U.S.$4.95

[15] The Rybczynski Theorem suggests that the growth of one factor of production must always lead to the absolute decrease in the output of the good using intensely the non-growing factor in a two-good world with unchanged terms of trade and the small country assumption. See [22].

[16] A number of "high technology" projects such as the production of optical fibre cable materials, digital-control injection molding machines and manufacturing technology and equipment for video-recorders were announced during the first half of 1985 [28, October 17, 1985].

[17] A description of these cities and the regulations governing them are given in [4].

[18] China has recently announced plans for a New Economic Zone in the Yellow River Delta [27, August 6, 1985], a Northeast Economic Zone in the Northeastern provinces [28, October 3, 1985] and an opening of the Northwestern provinces [32, August 18, 1985].

[19] Their reduced access to the Chinese market has also served to eliminate an advantage they previously enjoy.

billion has already been pleged by foreign investors to these cities, an amount twice the sum Shenzhen claims to have received between 1980 and 1984 [9, p. 102]. As a result, the significance of the SEZs as a means of attracting foreign capital is destined to decline as other regions in China become more open to foreign trade and investment.

Thirdly, despite competition from other Chinese cities, the proximity of the SEZs to Hong Kong will continue to afford them a locational advantage in attracting investment from that city. Irrespective of their competitiveness insofar as overseas investment is concerned, the complementarity between the SEZs and Hong Kong is manifested in the former's ability to supply factors that are becoming increasingly scarce in the latter such as low-cost labor and land. Indeed, as foreign investment in China is diverted away from the SEZs, their reliance on Hong Kong as a source of foreign capital is apt to increase. This means the industries which are presently dominated by Hong Kong investors such as the light industries, intermediate processing, and tourist facilities, etc., will remain significant players in the SEZs. The comparative advantages of the SEZs are thus reinforced by the above locational factor. Over time, a greater degree of economic integration between the SEZs and Hong Kong can also be expected as a result of such investment activities. This is especially true for Shenzhen where an eminent role is played by Hong Kong capital.[20]

Furthermore, the purported difficulties of the SEZs are unlikely to abate their value as an economic laboratory for the prior testing of China's reform policies. The policies which have so far been tested successfully in Shenzhen before their introduction in the Chinese economy include the wage contract system, the institution of wage bonuses, the adoption of tenders in the construction industry, and the home purchase scheme [1] [5, pp. 216–17]. In fact, the opening up of the fourteen cities and other areas in China for foreign trade and investment are motivated primarily by the early successes of Shenzhen [9]. Similarly, the recent decisions to permit the Hong Kong and Shanghai Bank of Hong Kong [28, August 22, 1985] and the Bank of Commerce and Credit (HK) of Belgium [2] to begin branch operations in Shenzhen and the establishment of the first Sino-foreign bank in the Xiamen SEZ confirm once again the function of the SEZs as China's economic testing grounds and signal the preparation of financial reforms planned for the second stage of China's Seventh Five-Year Plan, 1986–90.[21] Therefore, in view of the experimental character of Chinese economic reforms, the SEZs will remain a valuable assets to Chinese policymakers in the foreseeable future.

Lastly, the symbolism surrounding the SEZs and their role as an economic laboratory will render the SEZs an important "window" on Chinese policies for some time to come. As an economic laboratory, happenings in the SEZs are possible preludes to future developments in the Chinese economy. The degree to which capitalistic practices are allowed to interact with the Chinese economy

20 Investment by overseas Chinese are also important in the Shantou and Xiamen SEZs.

21 See [4, October 3, 1985] for a brief summary of the plan.

will also provide valuable clues as to how the contradictions between capitalism and socialism may be accommodated in China. This function of the SEZs is particularly significant insofar as China's reunion with Hong Kong in 1997 and her desired reunification with Taiwan are concerned. It is widely believed that confidence in the future of Hong Kong after 1997 and the prospects for reunification with Taiwan are crucially affected by the future of the SEZs. Failures by the SEZs to survive in China's socialist system will suggest the same for Hong Kong and Taiwan and will thereby reduce confidence in the former and undermine China's chances of peaceful reunion with the latter. In addition, as a symbolic vanguard of China's economic reforms, the SEZs will likely remain a focus of contention in the political struggle between Deng Xiaopeng and his conservative detractors. This means any fundamental shifts in the political balance or resurgence in "leftist" politics in China are apt to be reflected her treatment of the SEZs making them a political barometer. As a result, a branch office has been established in Shenzhen by the official mouthpiece of the Chinese Communist Party, the *Hongqi* [red flag) magazine, to monitor developments in the SEZs as a presage of China's reform policies [14].

V. CONCLUSIONS

According to the above analysis, the Shenzhen controversy is to a large-degree born of the contradictions inherent in China's SEZ policy. Recognition of the basic economic realities of the SEZs is essential to the resolution of this debate and the economic problems of Shenzhen. Instead of directing and appraising the SEZs on the basis of policy objectives, the development and performance of the SEZs should be guided by their natural advantages. The long-term viability of the SEZs is dependent more on the judicious exploitation of their comparative advantages than the pursuit of high-technology production. In addition, with the further opening up of other Chinese cities, an erosion of the SEZs' appeals to foreign investors appears as inevitable. This, coupled with their proximity to Hong Kong, suggests a continuation of the current pattern of production in the SEZs and closer integration with the Hong Kong economy. Although such a pattern of development may not coincide with the vision Chinese officials have for the SEZs, it is nevertheless consistent with the SEZs' fundamental strengths. Even in the absence of an advanced industrial base, however, the SEZs' contributions through their absorption of foreign managerial techniques and increased experience and skills of its workforce must not be discounted. When applied to the Chinese economy, the experience gained through the administration of the SEZs will help to augment the absorptive capacity and improve the external economies of scale of the Chinese economy.

Furthermore, the short-term benefits generated by the SEZs' experimental role are underlined by a concern with their long-term compatibility with and their place in the socialist Chinese economy. The prominent role observers have bestowed on the SEZs will only serve to focus our attention on this dilemma making its resolution so much more tenuous. However, given the significant investment the present Chinese leadership has made in the SEZs both in monetary and political terms, the SEZs are likely to remain at the forefront of political and economic discussions in China for some time to come. Meanwhile, the unique position of the SEZs will afford us an effective "window" on Chinese policy.

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