**Institutional Stability, Foreign Investor Preference, and China’s Inward FDI**

***A Look into the Determinants of China’s 1992 FDI Surge***

By Nick Taber

**Introduction**

During the early stages of Chinese economic liberalization started by Deng Xiaoping in 1978, China’s economic reform strategy was focused primarily on reforming the domestic economy without much thought given to integration into the global economy. This liberalization was most pronounced in the agricultural sector, where the de-collectivization of land ownership raised agricultural productivity, and the de-criminalization of private enterprise provided peasants with access to markets for their surplus production. FDI was also permitted but did not, in the early stages of liberalization, play a major role in the growth of the Chinese economy.

Starting in the late 1980’s, Deng’s reforms gained increasing traction in the industrial sector, and China became an increasingly attractive environment for FDI. In 1989, however, the West’s opinion of China, and its sanguinity about China as a favorable environment for FDI, was dramatically harmed when the Chinese government massacred hundreds of protesters in Tiananmen Square. Even today, almost ¼ of a century later, public opinion polls show that China’s reputation in the West has yet to fully recover from this incident.[[1]](#footnote-1) Nonetheless, inward Foreign Direct Investment (FDI) soared in China beginning in the early 1990’s, doubling from 1991 to 1992 and doubling again from 1992 to 1993.[[2]](#footnote-2) How can we account for this?

The purpose of this paper is to take a closer look at what caused the surge in China’s inward FDI during the early 1990’s. To what extent was this surge a result of deliberate moves by the Chinese government to stimulate growth? How have shifts in China’s economic policies affected the patterns seen in FDI inflows? This paper will begin by discussing the theoretical framework of FDI in general, followed by a look at some of the unique characteristics of FDI in China.. This is followed by an overview of the literature on Chinese inward Foreign Direct Investment as it relates to the question posed by this paper. Finally, the paper will analyze the surge in FDI in the early 1990’s.

**Theoretical Framework**

The scholarly study of Foreign Direct Investment is broadly oriented around an understanding of Multinational Corporation (MNC) behavior and the incentives that drive the internationalization of their activities. MNC’s determine where to move production activities based on the locational advantages/incentives of particular nations. Locational advantages/incentives can include the presence of natural or human resources, access to a large and underserved domestic market, the potential for increased efficiency in the production process, strategic location with respect to markets, and a variety of other factors. The Hecksher-Ohlin model, although specifically addressing international trade and providing an explanation for why trade occurs, can also shed light on FDI in a theoretical sense because of its focus on factor endowments[[3]](#footnote-3) in production patterns. Factor endowments of host countries help to explain the entry of MNC’s into these countries, bringing FDI. An example would be India’s abundance of English speakers, which has helped the development of its business process outsourcing industry (most notably focused around call centers).

In the past several decades, there has been in shift in thinking on the part of policy makers in developing nations with regards to inward FDI. Following World War II, many developing nations, were primarily concerned with enhancing and protecting their newly acquired freedom from their former colonial masters. Their leaders saw the presence of MNC activity within their borders as a potential infringement on their autonomy and an insult to their national pride. As a result, many of these countries pursued Import Substitution Industrialization (ISI) as their primary economic policy, much as the developed world had done in the early stages of their industrializations. However, ISI delivered mixed results, producing unsustainable current account deficits and often harrowing financial crises. With the emergence of the Washington Consensus in the 1980’s, ISI began to lose credibility as a development strategy, and an export-oriented development model gained increasing traction in the international policy community. Moreover, the rapid development of the East Asian Tigers (South Korea, Taiwan, Hong Kong, and Singapore) lent credibility to an export oriented development strategy and further discredited ISI.

Even so, governments of developing nations today may still view FDI as a double-edged sword. (This paper will later examine how this dynamic plays out in Chinese policy regarding inward FDI.) For developing countries, there is considerable debate about the effect of FDI on raising or lowering of social welfare, and a reliable policy framework has yet to emerge that explains this.

A major and obvious benefit of FDI to developing nations is that it provides stable capital to spur domestic investment, raising productivity and wages and spurring indirect economic development. FDI is essential for this purpose in developing nations, because past underdevelopment has created little opportunity for capital accumulation, and domestic savings rates are typically low because the cost of subsistence is high relative to income levels. In addition, FDI spurs the transfer to developing countries of intangible assets such as technology and managerial expertise. Furthermore, FDI provides developing countries with opportunities for integration into international marketing networks.

However, even in a post-ISI world, FDI poses many potential disadvantages. Host countries must accept the presence of foreign decision-making within their borders. Since the MNC’s deploying FDI answer to shareholders out of country, their interests inevitably differ from those of the host country, leading sometimes to very unfavorable results, including environmental degradation[[4]](#footnote-4), political corruption, and cultural destabilization. Additionally, MNC’s have to potential to destroy local companies which are not competitive in the face of large MNC’s that have experienced constant returns to scale over their operating histories and have long since acquired effective managerial expertise.

Thus, the challenge for countries seeking FDI is to find a mechanism to minimize the disadvantages while still being a sufficiently attractive environment to receive FDI. As we will see later in this paper, China has done a remarkable job of maximizing the benefits of FDI while minimizing the disadvantages. This has lent political legitimacy to the opening up of China’s economy, an approach that was once very controversial among China’s governing Communist elite.

**Overview of FDI in China**

Similar to much of the developing world in the post-war period, China was very skeptical of foreign influence, largely because of its history of exploitation by great powers. In the 19th century, European colonial powers had scrambled for control of port cities on China’s eastern seaboard, to raise revenues to support their maritime empires. The effect of these intrusions, notably the Anglo-Chinese “Opium Wars” of the mid-19th Century, was devastating to Chinese national pride and to its culture. In 1949, when the Chinese Communist Party came to power, it based its legitimacy in part on its ability to rid China of foreign influences. From its founding until the late 1970’s, Communist China was one of the world’s most reclusive nations, with an economy thoroughly and deliberately disconnected from the rest of the world.[[5]](#footnote-5)

How, then, did China transform itself into a nation with one of the world’s most globally integrated and energetic economies? Abstractly speaking, the government’s reframing of the issue of foreign business presence played a crucial role in this transformation. In line with the theoretical framework mentioned above, China successfully maximized the benefits and minimized the disadvantages of inward FDI. The main locational advantage of China is its abundance of cheap, low-skilled labor, attracting primarily efficiency-oriented investments (as opposed to natural resource investments or market-oriented investments). Somewhat ironically, China built off of its memory of great power exploitation and foreign concessions on its eastern seaboard by establishing a handful of Special Economic Zones in the late 1970’s along the southeastern coast and implementing an open door policy for foreign investors.

The role of FDI in the development of the Chinese economy has been critical. FDI has been China’s main source of foreign capital, as foreign portfolio investment has been relatively small, particularly in the early stages of China’s development.[[6]](#footnote-6) As of 2002, 62% of foreign capital came from manufacturing, which, itself, makes up around 70% of foreign direct investment.[[7]](#footnote-7) The lack of portfolio investment allowed the Chinese economy to develop more steadily, given that the presence of hot money[[8]](#footnote-8) can make a nation’s economy more volatile and vulnerable to exogenous shocks. This is, in part, why China was not especially affected by the 1997 Asian financial crisis that ravaged the region[[9]](#footnote-9) (although FDI inflows did slightly fall as a result[[10]](#footnote-10)).

The so-called China Circle (Hong Kong and Taiwan) is the biggest source of FDI into China, at least nominally.[[11]](#footnote-11) Cultural ties, common language, and geographic proximity all help to explain this phenomenon. Another important part of what explains the massive inflow of investment from Hong Kong is that it is a transit point for investment from other nations. Despite Hong Kong becoming a Special Administrative Region of China and, indeed, legally a part of the nation, it is treated legally as “foreign” with regards to investment, for two reasons. First, Hong Kong’s economic system is thoroughly different from the rest of the country, because it has much higher levels of capital formation and is, overall, much more developed. Second, Hong Kong is administratively and politically different from the rest of the nation.

This brings us to another unique feature of FDI into China, known as “roundtripping”. This is essentially domestic investment from China that is disguised as foreign investment to take advantage of tax incentives given to foreign investors. This investment often travels through Hong Kong and offshore financial centers before it arrives back on the Mainland.[[12]](#footnote-12) It is inherently difficult to quantify the volume of roundtripping, since the domestic sources of capital have a compelling interest in concealing the source. With the presence of major investment houses such as Goldman Sachs, HSBC, and Standard Chartered Bank in HK, managing vast repositories of wealth for their partners and clients inside and outside China, distinguishing between what is truly FDI and what is actually domestic capital is a largely meaningless exercise. As China’s capital formation matures and its current account surplus grows, this will become an increasing problem, for scholarly as well as policy purposes.

**Literature review**

Once the connection between China’s rapid economic development and FDI became clear, academics from a diverse array of fields (business, economics, finance, international development, and political science) began looking into the determinants of FDI in China. Researchers were initially focused on the role of FDI in the growth and development of the Chinese economy. However, the scholarly community increasingly has looked more closely at the determinants of FDI, including the changes in laws and the historical events that affected FDI inflows.

Despite the vast literature on FDI in China, the question posed by this paper has not yet been conclusively answered. One potential reason for this is that it is difficult to numerically measure FDI into China because of the lack of credible quantitative data on the subject and the phenomenon of roundtripping.

Studies on China’s inward FDI tend to agree on the presence of a strong link between FDI policies and China’s export promotion development strategy. In this way, many policies regarding FDI were intended to promote exports. Additionally, the literature (for example, “Foreign Direct Investment in China: Policy, Trend and Impact”) generally appears to agree that the fluctuations in FDI inflows are closely determined by active government policy involvement, as opposed to serendipitous market forces at play in the domestic or global economy. This would suggest that the rapid increase in FDI that occurred in the early 1990’s was attributed to government policy shifts.

A number of studies have focused on the role of specific policy shifts in the increase of FDI. One of the most frequently cited experts on the Chinese economy, Barry Naughton, has given a very comprehensive overview of the various factors that led to this surge and cites deliberate policy shifts as the cause of the surge in FDI in 1992.[[13]](#footnote-13) According to Naughton, these policy changes were implemented in response to Deng Xiaoping’s Southern Tour, in which he called for a continuation of liberalizing reforms. The analysis also cites the opening up of new sectors to foreign investment as playing a role in the impetus for this surge. While Naughton provides sound rationale for his argument, it remains unclear from his study why this surge was so abrupt.

Similar to Naughton, author Natalie Lin in “Determinants of FDI in China: Intellectual Property Rights or Deng Xiaoping” argues that Deng Xiaoping’s Southern Tour was the main determinant of the FDI influx.[[14]](#footnote-14) In the study, Lin attempts to determine what caused the massive surge of FDI in the early 1990’s, initially looking at the effects of several macroeconomic factors, including intellectual property legislation, State Owned Enterprise output, college graduation number and others, and conducts a regression analysis attempting to correlate them with the inflow of FDI into China. She found no strong correlation for most of the variables and only a mild correlation with SOE Output, but she found a very strong correlation with Deng’s Southern Tour and, by implication, with the change in policies that resulted from it.

**Analysis**

As the scholarly literature on China’s inward FDI indicates, the Chinese economy is far too complex to attribute the rise of FDI in the early 1990’s to any one specific factor or policy shift. I would argue that the surge in FDI is caused by two primary determinants. First, the emergence of institutional stability in China was vital. The realization of this on the part of foreign investors indicated that their investments were safe and that their fixed investments would realize a high rate of return. I argue that Deng Xiaoping’s Southern Tour created the institutional stability that led to massive rise in FDI in the early 1990’s. Second, foreign investors were given greater freedom with regards to their investments, and this shift was backed by sound economic policy, especially the adoption of the Wholly Foreign Owned Enterprise Law.

Institutional stability, itself, was the result of a number of events that occurred in the Chinese political landscape, the most important being Deng Xiaoping’s Southern Tour. This event, more generally, played a pivotal role in the deliberately gradual economic reform process that has characterized China’s economic liberalization trajectory. Following the Tiananmen Square massacre, much of the conservative wing of the Chinese communist elite pushed for policies that would reverse the economic liberalization of the previous decade. These actors saw the events at Tiananmen as a sign that economic liberalization had led to instability and would cause China to descend into chaos if it continued. In the winter of 1992, although he had by then become an “elder statesman” removed from day-to-day leadership, Deng took action to halt the retrenchment of liberalization. He toured the South and inspired further reform, entrepreneurialism, and economic ambition amongst party leaders, policy makers, and citizens. It is important to note that southern China is where urban economic reforms began, with the establishment of Special Economic Zones in Guangdong and Fujian provinces.[[15]](#footnote-15) Deng’s speeches called for the furthering of economic liberalization, even declaring, “To get rich is to be glorious.”[[16]](#footnote-16)

It is remarkable that the cataclysmic events in Tiananmen Square and the combined reactionary forces of the sizable conservative wing of the Party could all be reversed almost overnight by the rhetorical force of one man, marshaling the entrepreneurial energy of the nation. By the spring of 1992, a mere few months after Deng travelled to the south, inward FDI had increased from 4.37 billion USD to more than 11 billion USD annually.[[17]](#footnote-17) This massive increase is, at least in part, the result of government officials’ policy response to Deng’s speeches. As the former head of the Chinese state, Deng was extremely well respected, and government policy makers proved eager to heed Deng’s advice regarding the furthering of economic liberalization and the promulgating of such policies. Furthermore, Deng’s Southern Tour restored foreign investor confidence, which had waned following the Tiananmen Square incident and the conservative government reaction.

Secondly, the main component of the argument put forth by this paper, there has been an overall policy trend towards greater control given to foreign investors. Theoretically speaking, both foreign investors and the host countries desire maximum control over economic activities supported by FDI. However, countries seeking to attract capital must compete against other FDI markets and therefore must generally cede domestic control of the FDI-funded activity to attract greater FDI inflows.

This greater level of control given to foreign investors has been codified into concrete policy that directly concerns foreign investor activity within China. The Chinese government recognizes several different kinds of foreign investment that are all explicitly regarded as FDI. These are contractual joint ventures, wholly foreign-owned enterprises, joint development projects, compensation trade, processing and assembly, and international leasing. From 1986 until 2000, equity joint ventures were the most common form of FDI and made up approximately 65 percent of consummated investment.[[18]](#footnote-18) In equity joint venture contracts, the foreign and domestic investors share in the profit, risks, and losses in proportion to their respective contributions of capital.

The Wholly Foreign Owned Enterprise law was established in 1986 as a method of attracting greater FDI.[[19]](#footnote-19) Wholly foreign owned investment grew steadily from 1987 onward, until it became the dominant form of investment in 2000. This reflects the desire on the part of the foreign investor to maximize control of the investment, as the incentives of the domestic investor do not always align with those of the foreign investor.

In addition to the increase in investment falling under the Wholly Foreign Owned Enterprise category, regulations on foreign investment were relaxed greatly during this time period(late 1980’s and early 1990’s). Restrictions on investment inputs were relaxed, including the abolition of the foreign exchange balance requirement, equal access to domestic and overseas suppliers, the removal of the mandatory export requirement, the abolition of business plan filing, and the unification of the tax system for domestic and FDI firms.[[20]](#footnote-20)

China’s FDI regime has been primarily concerned with the overall modernization of China. Thus, China’s policy initiatives towards FDI have been designed strategically, often translating into sector-based policies. During much of the 1980’s, many sectors were blocked off to FDI. By the early 1990’s, new sectors including real estate, banking, and pharmaceuticals were opened to foreign investors, as part of the continuing, gradual, and strategic liberalization of the FDI environment in China. Additionally, foreign investors were granted much greater access to China’s domestic market.

1986 saw the implementation of the Provisions of the State Council of the People’s Republic of China for the Encouragement of Foreign Investment. As the name suggests, these provisions were deliberately implemented for the purpose of attracting FDI. The costs were evident; China would have to accept that domestic actors would have less influence over foreign investments but would benefit from greater capital inflows. While the promulgation of this policy occurred in 1986, it is likely that it would have caused an FDI surge sooner (that is, before 1992) had it not been for the Tiananmen Square Massacre.

**Subsequent Impact of the 1992 FDI Surge and Policy Implications Ahead**

The surge of FDI that occurred in the early 1990’s was an important step in the process of China integrating itself into the global economy. Indeed, China would not have earned the nickname “the world’s workshop” if it were not for massive inflows of FDI. The incredible leap in FDI that took place ended around 1994, with FDI at approximately 6 percent of GDP. FDI as a percentage of GDP has been steadily but consistently decreasing since then. This not because of a net decrease in FDI but because of a growing, expanding, and diversifying Chinese economy. Hong Kong, Taiwan, and the world’s plethora of offshore financial centers (i.e. the Cayman Islands, Bermuda, etc.) as a group remain the largest source of FDI into China, with the European Union and United States contributing comparatively smaller amounts of FDI.

The existing policy regime surrounding FDI underwent significant changes in preparation for its WTO accession in 2001, in order to harmonize China’s regulatory apparatus with WTO rules.

China’s sectoral composition of FDI remains fairly restricted. Despite the loosening of restrictions on foreign investment described above, there has been relatively little in FDI inflows outside of manufacturing. Beyond the manufacturing sector, a modest increase in FDI occurred in the real estate sector, fueling China’s rapid growth in real estate development and construction. It is important to keep in mind that China’s process of economic liberalization has been a gradual one and, despite China’s rapid integration into the global economy and impressive economic growth, it is still midway in the reform process. Furthermore, China will likely continue to reevaluate its current policies and revise restrictions on FDI sectorally. China’s banking, finance, telecommunications, transportation, retail, and indeed the services sector as a whole will likely be opened up in the near future to greater foreign participation, precipitating greater FDI inflows in these areas.

**Conclusion**

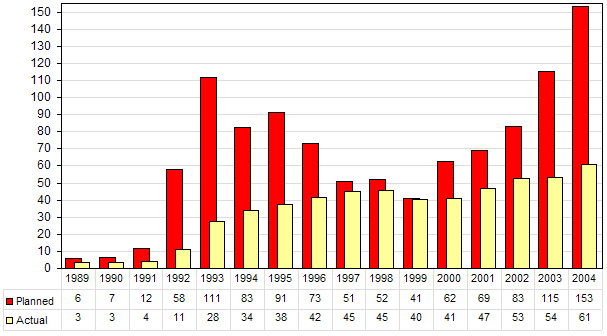
My general conclusions are the following: First, the surge was *not* caused by external macroeconomic events. Indeed, the major external event, the Tiananmen Square massacre, was inimical to FDI, yet FDI surged in the wake of the event. Second, the surge occurred in the wake of a struggle for control of the direction of Chinese economic liberalization between the conservative wing of the Party, which had been spooked by the massacre, and the forces for liberalization, which were more widely dispersed in the economy and in the regional governments. Once Deng assumed the mantle of leadership in opposing the conservatives, lower level and regional governmental actors were able to restore the pace of liberalization. This restored investor confidence, shaken by the massacre, and opened the floodgates for FDI. Finally, the process of liberalization has acquired its own inexorable momentum, as greater integration of the Chinese economy into the global economy has built a domestic constituency for liberalization and driven structural changes (such as WTO ascension) which compel liberalization.

The question posed by this paper carries a number policy implications that have relevance beyond the case of China. Many developing nations have looked to China for policy advice on how to attract FDI, while maximizing FDI’s benefits and minimizing the impact of its disadvantages.

An explanation of the uncanny abruptness of this FDI surge in the early 1990’s remains a possible avenue for contribution to the literature on China’s inward FDI. For further research on the topic, more data is needed regarding the specific policy changes that occurred as a result of Deng Xiaoping’s Southern Tour.

Figure 1

Foreign Direct Investment in China (Billion US$ at current prices)[[21]](#footnote-21)

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2. See Figure 1. [↑](#footnote-ref-2)
3. Factor endowments are the quantities of land, labor, and capital that countries have at their disposal. According to the Hecksher-Olin model, comparative advantages arise from factor endowments. [↑](#footnote-ref-3)
4. Notably the Rio Tinto mining operations in southeast Asia and oil production in the western Amazon and West Africa. See Mabey, Nick and Richard McNally, *Foreign Direct Investment and the Environment: From Pollution Havens to Sustainable Development*, World Wildlife Fund, United Kingdom, August 1999, <http://www.oecd.org/investment/guidelinesformultinationalenterprises/2089912.pdf>, accessed 8 December 2012.

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5. While China initially had fairly strong economic ties with the Soviet Union, the decline of relations between these two powers starting in 1960 resulted in the aborting of economic relations. [↑](#footnote-ref-5)
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7. Naughton, Barry, *The Chinese Economy*, Cambridge: The MIT Press, 2007, 416. [↑](#footnote-ref-7)
8. Hot money refers to financial capital that can be readily withdrawn, and often is when signs of crisis are lurking. [↑](#footnote-ref-8)
9. Contagion from the crisis mildly affected China but mainly hit Thailand, Indonesia, South Korea, Malaysia, and the Philippines. [↑](#footnote-ref-9)
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11. Naughton, Op.Cit., 416. [↑](#footnote-ref-11)
12. Naughton, Op.Cit., 415-416. [↑](#footnote-ref-12)
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16. Deng Xiaoping phrase, Shenzhen, January 19-23. [↑](#footnote-ref-16)
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